For Discussion
On 19 April 2004

Legislative Council
Panel on Information, Technology and Broadcasting

Telecommunications Authority Guidelines: Mergers and Acquisitions in Hong Kong Telecommunications Markets

Introduction

At the Panel meeting on 23 October 2003, Members invited deputations on the first round consultation of the Telecommunications Authority (TA) Guideline: Mergers and Acquisitions in Hong Kong Telecommunications Market (the Guidelines). Taking into account the views of the deputations and the Panel, the Administration issued a response to the issues raised in December 2003 and conducted a second round consultation. This paper aims to brief the Panel on the outcome of the second round consultation.

The Telecommunications (Amendment) Ordinance 2003

2. Mergers and acquisitions (M&A) are normal business activities which can enhance efficiency, and many do not raise competition concerns. However, some deals may lead to undesirable market consolidation and a significant reduction in consumer welfare through substantially lessening competition in the telecommunications markets. The Telecommunications (Amendment) Ordinance 2003 (the Ordinance), enacted by the Legislative Council in July 2003, will enable the TA to review and identify those M&A that are likely to harm the interests of consumers and other industry players. The objectives are to protect consumer interests through the promotion of fair and effective competition, and assist the industry in making informed decision on M&A matters through the provision of a clear and transparent regulatory regime.

3. To achieve the above objectives, the Ordinance has built in various safeguards to provide more certainty to the industry while still ensuring efficient and effective regulation of anti-competitive M&A. These safeguards include:

- Only M&A that may substantially lessen competition in a telecommunications market may be regulated.

- Only carrier licensees (e.g. fixed operators, mobile operators) may be regulated.

- An investigation may only be triggered if there is a "change" in a carrier licensee which leads to a person holding more than 15%, 30% or 50% (or control of the carrier licensee) of its shares. For a new entrant, the thresholds are further limited to 30% and 50% only.

- A "benefit to the public" test is included such that in the case of an M&A which is found to substantially lessen competition, the TA may decide not to intervene if the public benefits should outweigh the detriment to the public arising from the substantially lessened competition in the telecommunications market.

- The TA's decisions are only appealable by the M&A proponents and investors.

4. With the various safeguards built-in, the Ordinance already strikes the right balance between protecting consumer interests and providing certainty to the industry.

Key Issues in second round consultation

5. To provide more certainty and guidance to the industry, the TA will publish guidelines on how he will enforce the Ordinance. He issued the first draft Guidelines, which took into account industry comments made during the Bills Committee stage of the Ordinance, for consultation in August 2003. In December 2003, at the request of the industry he issued the second draft Guidelines which took into account comments made during the first consultation. He also met again with interested parties to discuss their views in greater detail.

6. The TA has carefully considered the views received during the second consultation. He has decided to make further improvements to the second draft Guidelines to incorporate these views as far as practicable. A list of all the key improvements made during the two rounds of consultation are summarized at Annex 1. Among them, two key issues continue to draw

different views from the industry and other parties. These issues are discussed below.

Safe harbour

7. Some M&A that fall under the Ordinance are clearly not going to substantially lessen competition. To provide certainty to the industry, the TA has taken on board industry requests for a so-called "safe harbour" mechanism to quickly "screen out" these kinds of M&A. A safe-harbour mechanism is usually based on an assessment of post-merger market shares to determine whether or not the increase in market concentration could cause a potential competition issue.

8. In the international arena, two measures are most commonly used as "safe-harbour" measures, namely the Herfindahl-Hirschman Index (HHI) and the combined market share (CR4) ratio. The former is adopted by the US, UK and EU, while the latter is adopted by Australia, Japan and Canada. Both measures use market share data. A brief description of the two measures is at Annex 2.

9. It is important to note that "safe-harbour" measures are intended to be "screening devices" to screen out those M&A which are clearly not going to substantially lessen competition. Where an M&A falls outside a safe harbour threshold, this does not mean it will necessarily breach the Ordinance – only that further inquiries should be made by the TA to assess the extent of any anti-competitive effects. The TA may well conclude that the M&A does not substantially lessen competition after proper investigation. On the other hand, if the threshold is set too wide, some M&As which may substantially lessen competition may be prematurely excluded without a chance for the TA to investigate properly.

10. Views received during the second consultation vary, and there is no consensus as to which safe-harbour measures should be used. Taking into account the views received, the TA has chosen to use both the standard/traditional HHI and the CR4 ratio as commonly applied in overseas jurisdiction, concurrently. This approach has the effect of increasing the size of the "safe harbour" over the use of just one measure thereby enhancing certainty to the industry while at the same ensuring that Hong Kong applies internationally recognized standards.

11. The TA would like to point out that some industry members have proposed modifications to the above measures, with a view to significantly expanding the "safe-harbour". The TA does not find such modifications appropriate for the reasons set out below:-

(a) Hong Kong would deviate from international best practices, while the industry has always been urging the TA to adopt international best practices in other aspects. The TA does not see any justifications for such deviation for the "safe-harbour" measure.

(b) While these "safe-harbour" measures are used in many different countries, including in some of the largest economies and in some of the smallest, the relevant "safe-harbour" thresholds remain essentially constant and modifications are rare[1]. These thresholds indicate when a regulator would normally not want to look at the M&A in question.

(c) It is worth noting that although Singapore does not adopt any "safe-harbour" measures as such, the Infocomm Development Authority has nonetheless indicated that M&A in the telecommunications sector will be considered less problematic if the combined entity has a market share of less than 40%. This is similar to the threshold adopted by the standard/traditional CR4 ratio.

(d) Some proposed modification like the modified HHI by PCCW to significantly expand the HHI thresholds is based on the assumption that the majority of M&A in the mobile market should not require even preliminary investigation by the TA. The TA does not accept this assumption. The extent of the proposed modification is also more far reaching than any existing HHI safe harbour thresholds of which the TA is aware. Significantly, PCCW has not identified any relevant precedent in any other competition law country.

(e) The Consumer Council opposes any modifications to the standard safe harbour measures. In addition, some international operators like AT&T support the use of traditional HHI thresholds and object to using modified HHI. The Telecoms Users Group's has also commented that the government should adhere to international best practices.

[1] The EU is about to implement slightly broader HHI Index thresholds. However, M&As which newly fall into the "safe-harbour" because of the change will still be subject to investigation before the EU gives its clearance. Hence, the new thresholds are not really "safe-harbour" as such, which is a screening device, but rather an initial indicator for the EU in assessing an M&A.

12. The TA therefore considers an approach that seeks to adopt a standard or traditional approach, with the variation of using both HHI and CR4 measures together simultaneously, is the best way forward.

Burden and standard of proof

13. During the second consultation, the industry provided further views on various burden and standard of proof issues, including that the TA should give reasons to support his decision to reject claims that are unfounded, and that the merging parties claiming that there is no substantial lessening of competition should not be required to substantiate the claim.

14. The ultimate burden of proving that an M&A is likely to substantially lessen competition in a market rests with the TA. He will give reasons to support his decisions. M&A proponents may make efficiency and public benefit claims, and it is for such parties to make their case and to substantiate their views. This is similar to the practice in Germany, Canada, the US, New Zealand and Australia. It is neither practical nor desirable for the TA to have the responsibility of verifying every claim or argument that could be made about prospective efficiencies and benefits to the public. Where a strong, substantiated and persuasive argument is put to him, the TA will seek to verify the claim as far as possible.

Conclusion

15. The Guidelines being finalised after two rounds of extensive public and industry consultation will provide a guide to the approach the TA will take in his analysis of M&A that may raise competition concerns. The Guidelines should accord with international best practice, and reflect a proper balance between providing certainty to the industry and protecting consumers.

16. We aim to publish the finalized Guidelines as soon as possible, so as to bring the Ordinance into force within this legislative session. This is necessary to protect consumer interests and assist the industry in making informed decision on M&A matters. Early commencement of the Ordinance is also urged by the Consumer Council and the Telecoms Users Group.

Office of the Telecommunications Authority
April 2004

Annex 1

List of key improvements to the TA's Guidelines

1. A statement of merger review principles has been included in the Guidelines following industry requests. These principles clarify the importance of M&A activity in the industry, and the importance of competition policy in ensuring that the incentives for competition and the interests of consumers are protected.

2. The TA has agreed to quickly screen-out those mergers and acquisitions that are unlikely to substantially lessen competition. As requested by the industry, he will do this using a safe harbour mechanism based on market shares. By utilising two standard/traditional safe-harbour measures concurrently, this approach will effectively expand the coverage of the safe harbour mechanism while still complying with international best practice.

3. The Guidelines have been amended to clarify the onus of proof on various parties during the assessment process envisaged under the Telecommunications (Amendment) Ordinance. As noted above, the Guidelines now accord with the TA's clear legal responsibilities and international best practice in these areas. Further textual amendments will be made to put matters beyond doubt.

4. The Guidelines provide further comfort for those involved in transactions that the Ordinance is not intended to cover. In this regard, specific amendments have been made to the section "Financial transactions which do not raise competition concerns."

5. The TA has confirmed that the Guidelines are more specific than similar guidelines in other jurisdictions, and include a number of examples based on the TA's previous decisions. However, unlike other countries, the competition law in Hong Kong is relatively new and there are fewer past decisions on which to draw.

6. The Guidelines now incorporate an expanded discussion of the concept of barriers to entry as requested by some industry players, including specific references to principles used overseas to assess strategic entry barriers.

7. The Guidelines contain more references to the meaning given to the substantial lessening of competition test in a number of other jurisdictions. They now also contain the most authoritative statement on this issue in the Hong Kong context as recently stated by the Appeal Board.

8. The Guidelines have been amended to describe in greater detail the TA's approach to the assessment of efficiencies and how this approach is consistent with that adopted in other jurisdictions.

9. The TA has explained how his approach to considering the so-called "failing firm defence" is consistent with the approach adopted in other leading competition law jurisdictions, including Australia, New Zealand, the US, the UK and Singapore.

10. The TA has added examples of the kinds of public benefits he would consider for any given merger, however he has also made it clear that these examples should not be read as limiting the kinds of public benefits that may be claimed.

11. The requirement for performance bonds to guarantee the realization of claimed public benefits has been deleted. At the same time, the need to ensure that such claims are capable of substantiation has been reinforced.

12. Information required from the merger proponents for review is now described in two lists - a short list for easy cases and a longer list where more in-depth inquiry is necessary - thereby increasing the efficiency of the review process for the TA and the parties involved.

Annex 2

Summary of the standard/traditional safe-harbour measures

Herfindahl-Hirschman Index (HHI)

This index measures the sum of the squares of the market shares of all players in a market. For instance, a market with 4 equally sized players would yield an HHI figure of 2,500 ($25\%^2 + 25\%^2 + 25\%^2 + 25\%^2 = 2{,}500$). Where a market has only a few large players or one large player and only a few smaller players, the HHI figure will be larger than in a market with many similar sized competitors.

Standard HHI "safe harbour" thresholds:

- Post-merger HHI of less than 1,000 **OR**
- Post-merger HHI of less than 1,800 and a change in the HHI (pre-merger to post-merger) of less than 100 **OR**
- Change in the HHI of less than 50

Combined market share (CR4) ratio

This ratio measures both the market share of the merged entity and the sum of the market shares of the 4 largest players in the market. For instance, if there is a market with 10 equally sized players and 2 of these players merge, the market share of the merged entity will be 20% and the CR4 ratio will be 50 (20 + 10 + 10 + 10 = 50).

Standard CR4 Ratio "safe harbour" thresholds:

- The merged entity has less than 15% market share in the relevant market **OR**
- The merged entity has less than 40% market share and the 4 largest firms post-merger have a combined market share of less than 75%