**For Information**
**On 10 May 2004**

# Legislative Council
# Panel on Information, Technology and Broadcasting

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

## Introduction

The Administration briefed the Panel on Information, Technology and Broadcasting (the Panel) on the outcome of the second round consultation of the "Telecommunications Authority Guidelines : Mergers and Acquisitions in Hong Kong Telecommunications Markets" (the M&A Guidelines), and our proposed way forward, at the meeting held on 19 April 2004 (the Meeting). At the Meeting, the Administration has explained in full its response to the major views expressed during the second round consultation via a powerpoint and a discussion paper (LC Paper No. CB(1)1507/03-04(06)). The Panel was also informed of the Administration's intention to gazette the commencement notice for the Telecommunications (Amendment) Ordinance 2003 in May 2004 after publication of the M&A Guidelines.

2. At the meeting, the Administration has also verbally responded to Members' enquiries on the letters from PCCW Limited (PCCW) and Hutchison Telecommunications (Hong Kong) Limited (Hutchison) to the Panel dated 15 April 2004 and 17 April 2004 respectively. At the request of the Chairman of the Panel, the Administration has now prepared a detailed written response in relation to the issues raised in these letters for Members' ease of reference at Annex.

**Latest Position**

3. Two extensive rounds of consultation on the M&A Guidelines were conducted. The Telecommunications Authority (TA) also met with interested parties to discuss their views in greater detail. In addition, the Administration also briefed the Panel in October 2003 and April 2004.

4. Having considered the views of the deputations and Members, the TA has finalized the M&A Guidelines. We believe that the finalized M&A Guidelines accord with international best practice, and reflect a proper balance between providing certainty to the industry and protecting consumer interests. We have also obtained an independent opinion on the M&A Guidelines from Professor Richard Whish of King's College London who concludes that our M&A Guidelines provide a sound basis for the application of the Telecommunications (Amendment) Ordinance 2003, and are consistent with the regulatory policy for mergers and acquisitions of other jurisdictions, including the US, EU, UK and Australia (copy of opinion is available at http://www.ofta.gov.hk). The finalized M&A Guidelines which were published on 3 May 2004 are also available at http://www.ofta.gov.hk.

5. The Administration plans to gazette the commencement notice of the Telecommunications (Amendment) Ordinance 2003 on 14 May 2004 in order to bring the Ordinance into force within this legislative session.

**Office of the Telecommunications Authority**
**May 2004**

**Annex**

**Summary of views from PCCW Limited and Hutchison Telecommunications (Hong Kong) Limited on Telecommunications Authority (TA) Guidelines Mergers and Acquisitions in Hong Kong Telecommunications Markets ("the M&A Guidelines") and the Administration's Response**

| Issues | Organization | Concerns / Views | The Administration's Response |
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| 1 Safe Harbours | PCCW | • Global best practices approach should be only the starting point. The safe harbour tools should be modified to fit the Hong Kong market. | • It is important to note that "safe-harbour" measures are intended to be "screening devices" to distinguish between those M&As which are clearly not going to substantially lessen competition as opposed to those which may. Where an M&A falls outside a safe harbour threshold, this does not necessarily mean that it would have the effect of substantially lessening competition for the purposes of the Telecommunications (Amendment) Ordinance 2003 (the Ordinance) – only that further inquiries should be made by the TA. 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 loosely, some M&As which may substantially lessen competition may be prematurely excluded without a chance for the TA to investigate properly.<br><br>• We have taken on board industry's suggestions for more "safe harbour" provisions which accord with international best practice: -<br>(a) Reference to the Herfindahl-Hirschman Index (HHI) based on the US Horizontal Merger Guidelines has been added. Similar thresholds have been adopted in the guidelines published by the Office of Fair Trading in the UK; and<br>(b) A second "safe harbour" has been added based on the four-firm concentration ratio (CR4) following the practice of the Australian competition authority. This 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.<br><br>• We have carefully studied the modified HHI as proposed by PCCW which was included in the revised M&A Guidelines we published for comments by the industry. There was no consensus as to which safe harbour measures should be used. The TA does not find the proposed modified HHI appropriate because: - |

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| | | | (a) Hong Kong would deviate from international best practices, although 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.<br><br>(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 substantial modifications are rare. These thresholds indicate when a regulator would normally not want to look at the M&A in question.<br><br>(c) It is worth noting that although Singapore does not adopt any "safe-harbour" measures as such, the Infocomm Development Authority (IDA) has nonetheless indicated that an M&A in the telecommunications sector will be considered less problematic as far as unilateral exercise of market power is concerned if the combined entity has a market share of less than 40%. This is similar to the corresponding threshold adopted in the M&A Guidelines based on the standard/traditional CR4 ratio. IDA Singapore has not proposed any safe harbour for coordinated exercise of market power.<br><br>(d) PCCW's modified HHI is based on the assumption that the majority of M&As in the mobile market should not require even preliminary investigation by the TA. The TA does not accept this assumption as it is not based on a proper competition analysis. PCCW's proposed modification to the HHI would also enlarge the safe harbour as defined by international best practice so much that many M&As would likely fall within the safe harbour, resulting in TA not having the chance to investigate them further if necessary. Indeed, PCCW has not been able to identify any relevant precedent in other jurisdictions in respect of their proposed HHI.<br><br>(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 has also commented that the government should adhere to international best practices. |

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| | | • It is unclear whether the safe harbour in practice is actually a safe harbour or whether the TA will merely 'not likely' review a merger that falls below the 'size' measurement. | • The Guidelines are merely administrative guidance. The TA cannot categorically state that he will never investigate an M&A which falls within the safe harbour. The use of wording "not likely" instead of a definitive "will not" is on legal ground. It is accepted principle that administrative guidelines, such as the M&A Guidelines, cannot override, or fetter the discretion conferred on a regulatory authority, such as the TA, by the legislation. Similar wording is also used in merger guidelines in overseas jurisdictions. |
| 2. "First-mover" | PCCW Hutchison | • In relation to an operator's strategic behaviour creating barrier to entry, overseas guidelines (including those from US, EU, UK and Australia) only refer to that of an incumbent operator. There is no proposition in relation to "first-mover" in overseas guidelines. Therefore, the advantage created from being first in the market may well be viewed as anti-competitive. It is worrying to note that Hong Kong's regulatory regime may view "first-mover" advantage negatively. | • As with other merger guidelines in overseas jurisdictions, the TA's intention is that the "first-mover" advantages should refer to the behaviour of incumbent operators (which refer to all established players in the relevant market). The TA has modified the M&A Guidelines to make this clear.<br><br>• In the TA's M&A Guidelines, the TA will not view first-movers (i.e. incumbents) negatively. The "first-mover" (i.e. incumbent) advantages are included in the TA's M&A Guidelines to assess the <u>effect on competition</u> of a merger, not the conduct of the "first-mover" (incumbent) per se. "First-mover" (incumbent) advantages may impact on the barrier to entry to a market, which may in turn impact on the level of competition in a market, as incumbent firms may enjoy strategic advantages over new entrants to raise barriers to entry because of their established position.<br><br>• The principle of strategic "first-mover" (incumbent) advantages is widely recognised in other jurisdictions. For example, the EC Guidelines[1] state that *"incumbents may also enjoy technical advantages, such as preferential access to essential facilities, natural resources, innovation and R&D, or intellectual property rights, which make it difficult for any firm to compete successfully…barriers to entry may also exist because of the established position of incumbent firms on the market."* The UK Merger Guidelines[2] state that "*OFT will consider absolute and strategic incumbency advantages, and the costs of entry…Strategic advantages arise where incumbent firms have advantages over* |

[1] Guidelines on the Assessment of Horizontal Mergers under the Council Regulation on the Control of Concentrations between Undertakings (2004/C 31/03)
[2] Substantive Assessment Guidance on Mergers issued by the Office of Fair Trading (May 2003)

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| | | • The entire section on strategic behaviour and "first-mover" advantages should be deleted as it presumes a market with little or no entry. They are 'conduct' concerns and should not be covered in the M&A Guidelines but are suitable to be addressed in the Competition Guidelines. | *new entrants because of their established position (first-mover advantages) or if incumbent firms are expected to behave strategically, for example, by responding to entry with very low prices or by investing in excess capacity or additional brands to deter entry."* The TA's M&A Guidelines have also been amended to include an example on "first-mover" (i.e. incumbent) advantages from the Australian Guidelines. |
| 3. Scope | PCCW | • A carrier licensee as defined in section 2 of the Telecommunications Ordinance includes all licensees employing apparatus or equipment to provide services to the public. This is broader than just fixed and mobile licensees and may include ETS and PNET licensees. This is a drafting error in the telecommunications regulation and guidelines which needs to be fixed before the guidelines become effective. | • Under section 2 of the Telecommunications Ordinance, "carrier licence" is defined to mean a *"licence used for the establishment or maintenance of a telecommunications network between… locations…, such locations within Hong Kong being separated by unleased Government land"*. It refers to a licence which is used for (i) the establishment or maintenance of a telecommunications network between locations; *and (ii) such locations within Hong Kong being separated by unleased Government land*. It is not the case as suggested by PCCW that any licensee establishing or maintaining telecommunications apparatus or equipment qualifies as a carrier licensee.<br><br>• The Telecommunications (Carrier Licences) Regulation (Cap. 106V) has further provided a clear reference on the types of licences covered under "carrier licences". Fixed or mobile carriers which establish or maintain their networks *across unleased Government land* have been categorically identified by Telecommunications (Carrier Licences) Regulation as carrier licensees. Telecommunications operators such as ETS and Internet Service Providers (ISPs), on the other hand, do not establish or maintain any network *across unleased Government land*. Rather, ETS and ISPs rely on networks or telecommunications infrastructures operated by carriers to provide their services and are licensed as Public Non-Exclusive Telecommunications Services (PNETS) |

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| | | | licensees under section 7 of the Telecommunications Ordinance as licensees other than carrier licensees.<br><br>• Our "carrier licence" regime vs other non-carrier licence regime is therefore clear and appropriate. There is no drafting error as suggested by PCCW. |
| 4. Standard of Proof | PCCW | • Efficiency gains must be substantiated by the merging parties with great particularity. This appears to be a harsh test where the parties are asked to prove and guarantee a future event/result. | • The standard of proof is the civil standard of a balance of probabilities and the parties must substantiate their claim so that the TA can verify by reasonable means. Similar standards of proof are adopted in other jurisdictions:-<br>– In the EU, claimed efficiencies must be "substantiated and likely" and the EU Merger Guidelines state that "efficiencies have to benefit consumers, be merger-specific and be verifiable."<br>– In the UK, there must be "compelling evidence" of efficiencies. In Australia, the authority requires "strong and credible" evidence.<br><br>• The TA will need to be reasonably satisfied that the efficiencies are real and compatible with the requirements specified above. |
| 5. Overseas Precedent and Examples | PCCW | • Case laws should be included in the Guidelines to provide more predictability. | • We have taken on board this comment and have included more relevant overseas cases in the M&A Guidelines as far as appropriate. However, overseas jurisprudence would be of referential value only as, among other things, it is related to the facts of the cases in question. The situations in Hong Kong, as well as the facts of cases to be considered, can be entirely different. |

**Office of the Telecommunications Authority**
**May 2004**