MERGERS AND ACQUISITIONS IN HONG KONG TELECOMMUNICATIONS MARKETS

Statement of the Telecommunications Authority

3 May 2004

INTRODUCTION

1.1 On 9 July 2003, the Legislative Council passed the Telecommunications (Amendment) Ordinance 2003 (the 2003 Amendment Ordinance) which introduces a new section 7P to regulate mergers and acquisitions (defined as "changes in relation to carrier licensees" in the legislation) in the telecommunications industry. The legislation will come into effect in two stages. In the first stage, various sections of the 2003 Amendment Ordinance, including the amended section 6D(2), came into force on 18 July 2003. Under the amended Ordinance, the Telecommunications Authority (TA) is required to issue guidelines specifying the matters he will take into account in considering mergers and acquisitions under section 7P. Before publishing the guidelines, the TA shall consult those who may be affected by the legislation. The TA is also required to publish the guidelines as soon as is practicable. In the second stage, the remaining sections of the 2003 Amendment Ordinance, including the new section 7P, will come into operation on a day to be appointed by the Secretary for Commerce, Industry and Technology by notice published in the Gazette.

1.2 The TA has conducted two rounds of consultation on the proposed "Guidelines on Mergers and Acquisitions in Hong Kong Telecommunications Markets" (the Guidelines). The first consultation paper was published on 4 August 2003. Following consideration of the comments received during the consultation period, and discussions with the industry, the TA revised the draft Guidelines and published a second consultation paper on 23 December 2003. The TA gave careful consideration to the submissions made in response to the revised draft of the Guidelines and held further discussions with the industry.

1.3 The TA received a total of 20 submissions during the two rounds of consultation from the following parties:

- AT&T Global Network Services Hong Kong Ltd (AT&T)

- British Telecommunications PLC (BT)
- CM Tel (HK) Limited (CM Tel)
- Consumer Council
- Hong Kong Telecommunications Users Group (HKTUG)
- Hong Kong Cable Television Limited (HK Cable)
- Hutchison Global Communications and Hutchison Telecom (Joint submission) (HGC & HTHK)
- The Law Society of Hong Kong (Law Society)
- New World Telecommunications Ltd (New World)
- PCCW Limited (PCCW)
- Smartone Mobile Communications Limited (Smartone)
- Telstra Corporation Limited and Hong Kong CSL Limited (Joint submission) (Telstra & CSL)

The submissions can be downloaded from the OFTA web site at www.ofta.gov.hk.

1.4 Having considered the submissions received and the discussions held with the industry, the TA sets out in this Statement his final views on the key issues raised during the two rounds of consultation.

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Specific guidance and industry examples

2.1 PCCW, HTHK, HGC, Smartone and Telstra commented that more specific guidelines can and should be formulated and more examples of how the analytical framework will be applied should be provided in the Guidelines.

2.2 The TA has responded to the industry's request as far as practicable. The revised Guidelines are more specific than similar guidelines in other jurisdictions. For instance, the TA has included the recent decision of the Telecommunications (Competition Provisions) Appeal Board on the meaning of "substantial" lessening of competition. The TA also included an example of a decided case from the EU (*Vodafone Airtouch*) on what constitutes co-ordinated effects of a merger. Conscious effort has been made to insert examples relevant to the telecommunications sector throughout the document where available

and applicable. The Guidelines also include a number of examples based on the TA's previous decisions.

2.3 Unlike other countries, the competition law regime in Hong Kong is relatively new and restricted to the telecommunications and broadcasting industries. There are fewer past decisions on which to draw. The TA will update and improve the Guidelines as decisions accumulate.

2.4 The TA considers that in providing more specific examples and guidelines, the TA should caution against providing answers to hypothetical questions or to provide answers to questions related to a specific market situation before all relevant facts about the situation are known and submissions from industry participants are received and considered. Each case should be considered on its own merits.

Safe Harbours

3.1 Some M&A that fall under the Ordinance are clearly unlikely to substantially lessen competition. To provide further guidance to the industry, the TA has accepted 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 potential competition concerns.

3.2 In the international arena, two measures are commonly used as "safe harbour" measures, namely the Herfindahl-Hirschman Index (HHI) and the four-firm concentration ratio (CR4) (the combined market share of the four (or fewer) largest firms in the market). 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.

3.3 It is important to note that "safe harbour" measures are intended to be "screening devices" to screen out those M&A which are unlikely to substantially lessen competition. Where an M&A falls outside a safe harbour threshold, this does not mean it will necessarily substantially lessen competition for the purposes of section 7P of 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, M&A

which may substantially lessen competition could prematurely be excluded without a chance for the TA to make proper investigation.

3.4 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 jurisdictions, concurrently. This approach has the effect of increasing the size of the "safe harbour" over the use of just one measure while at the same ensuring that Hong Kong applies internationally recognized standards.

3.5 PCCW, HTHK, HGC, Smartone and Telstra submitted that, because Hong Kong is a smaller economy which can tolerate higher market concentration, a modified HHI should be applied with a view to significantly expanding the "safe harbour".

3.6 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 urged 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].

(c) It is worth noting that although Singapore does not adopt any "safe harbour" measures as such, the IDA has nonetheless indicated that M&A in the telecommunications sector will be

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

The Merger Working Group of the International Competition Network, a network of leading competition authorities, identified New Zealand as a relatively smaller economy that sets the safe-harbour at a higher level. The safe harbour in New Zealand is based on a three-firm concentration (CR3) - where CR3 is less than 70%, the merged firm may have a market share of up to 40%, and where CR3 is 70% or above, the merged firm may have a market share of up to 20%. The Commerce Commission of New Zealand however stresses that the safe harbours provide a screening process for the purposes of administrative convenience and are not intended as a replacement for case-by-case analysis.

considered less problematic if the combined entity has a market share of less than 40% as far as the risk of unilateral anti-competitive conduct is concerned[2]. This is similar to the threshold for unilateral market power adopted in the Guidelines based on the standard/traditional CR4 ratio where CR4 is less than 75%. The IDA has so far not proposed any safe harbour for co-ordinated market power.

(d) The modification proposed 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 because the assumption is not based on any proper competition analysis. The proposed modification is 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 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.

3.7 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, is the best way forward.

3.8 PCCW further considered that it is unclear whether the safe harbour in practice is actually a "safe harbour" or whether the TA will merely "not likely" review the merger that falls below the "size" measurement.

3.9 The Guidelines are merely administrative guidance and cannot override the legislation. The TA cannot categorically state that he will never investigate an M&A which falls within the safe harbour. However, it is made clear in paragraph 2.6 of the final version of the Guidelines that a merger or acquisition that falls outside the safe harbour thresholds does not necessarily have the effect of substantially lessening competition for the purposes of section 7P. It merely indicates that further inquiry

[2] Paragraph 6.2.2.1 of the Public Consultation Draft of the "Advisory Guidelines Governing the Telecommunications Consolidation Review Process" published by IDA on 7 May 2003.

may be made by the TA to assess the extent of any anti-competitive effects for the purposes of section 7P.

Burden of Proof

4.1 During the second consultation, PCCW, HTHK, HGC and Smartone provided further views on various burden and standard of proof issues, including a request 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.

4.2 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. The civil standard of proof applies to the TA. 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 practices in Germany, Canada, the US, New Zealand and Australia. Where a strong, substantiated and persuasive argument is put to him, the TA will seek to verify the claim as far as possible. If the TA rejects the claim, he will give reasons.

4.3 PCCW further submitted that the draft Guidelines proposed to apply a high standard of proof on the claims of efficiency gains. PCCW considered that this appears to be a harsh test where parties are asked to prove and guarantee a future event or result as efficiency gains must be substantiated by merging parties with great particularity.

4.4 The TA considers that a civil standard of proof should be applied and it is for the parties to substantiate their claims. The TA will verify the claims to the extent possible. The TA has taken into account the international best practices for the competition authorities to vet efficiency claims and considers that he should adhere to the accepted requirements under these practices. 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." In the UK, there must be "compelling evidence" of efficiencies. In Australia, the ACCC requires "strong and credible" evidence. According to the Guidelines, the TA will need to be reasonably satisfied that the efficiencies are real and compatible with the requirements specified above.

Scope

5.1 PCCW submitted that a carrier licensee as defined in section 2 of the TO may include External Telecommunications Services (ETS) and Public Non-Exclusive Telecommunications Services (PNETs) licensees as they are have networks with apparatus or equipment within the meaning of telecommunications networks.

5.2 Under section 2 of the TO, "carrier licence" is defined to mean a "*license used for the establishment or maintenance of a telecommunications network between… locations…, such locations within Hong Kong being separated by unleased Government land"*. Fixed or mobile carriers which establish or maintain their networks across unleased Government land are obvious examples which fall within the definition of "carrier licence". ETS, on the other hand, are services providers, which do not establish or maintain any network across unleased Government land. Rather, ETS rely on networks operated by carriers to provide their services and are licensed as PNETS licensees under section 7 of the TO who are licensees other than exclusive or carrier licensees.

Public Benefits

6.1 The Consumer Council commented that the TA's public benefit analysis should be confined to factors external to competition, e.g. other than efficiency claims which should be assessed during the TA's competition analysis prior to assessing public benefits. Telstra & CSL considered that it is not clear why public benefits will only be considered if they are real, will be realised within a reasonable time and are sustainable. PCCW commented that the TA should provide guidance on what public benefits he would consider.

6.2 The TA agrees with the Consumer Council's comments - any benefits which relate directly to competition (such as claimed efficiencies) will be considered during the competition analysis prior to the consideration of the public benefits. As far as the comments from Telstra & CSL are concerned, the TA considers that he has a responsibility to ensure that the claimed benefits are real, rather than merely illusory, and therefore adopts the usual tests accepted as normal practice in other countries. To address PCCW's concerns, the TA has added further discussion of the kinds of public benefits he would consider, which may include more innovation (perhaps as a result of engagement in R&D), wider choice, higher capacity or better quality of services as a result of investment in

network infrastructure, continuity of service and enhancement of the international competitiveness of Hong Kong's industry. However, this list should not be read as exhaustive or in some way limiting the kinds of public benefit claims that merger proponents may wish to make.

Statement of Competition Policy

7.1 PCCW, Telstra & CSL commented that there is a need to incorporate in the Guidelines a statement of competition policy underlying the new merger law and its enforcement, and that the Guidelines should not contain a negative presumption about mergers being anti-competitive.

7.2 The TA has taken note of the industry's request. A new section headed "Merger Review Principles" has been incorporated into the Guidelines to address these issues. The TA makes it clear that the Government sees competition policy as a means to enhance economic efficiency and free trade, thereby benefiting consumers. It is the TA's policy only to intervene in merger and acquisition activities if there is a potential adverse effect on competition. In those circumstances, the TA will only prevent a merger or acquisition from going ahead, or require it to be unwound, where other remedies to address the competitive concerns cannot be devised or are considered unsatisfactory.

CONCLUSION

8.1 The Guidelines have been finalised after two rounds of extensive public and industry consultation. The Guidelines accord with international best practices.

8.2 The TA has obtained an independent legal opinion on the Guidelines from Professor Richard Whish of King's College London. The opinion is being published together with this Statement.

8.3 The final text of the Guidelines is attached to this Statement. The TA considers that the promulgation of the Guidelines to be in the best interests of protecting consumers and will provide appropriate guidance for the industry. The Guidelines will be effective from the date of this Statement.

Office of the Telecommunications Authority
3 May 2004