

Telstra Corporation  
Limited

and

Hong Kong CSL  
Limited –

Submission to  
OFTA on Merger  
and Acquisition  
Guidelines

Dated 29 September 2003

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# 1 Introduction and Structure

## 1.1 Introduction

This is a joint submission by Telstra Corporation Limited (“**Telstra**”) and Hong Kong CSL Limited (“**CSL**”) to the Office of the Telecommunications Authority (“**OFTA**”) in response to OFTA’s consultation paper on the “Draft Merger Guidelines for Hong Kong Telecommunications Markets” of 4 August 2003 (the “**Draft Guidelines**”).

Telstra and CSL would like to thank OFTA for the opportunity to make this submission and for the meeting between the Telecommunications Authority (the “**TA**”), OFTA and the industry on 18 September 2003. We consider such consultations useful.

## 1.2 Structure of comments

Section 2 of this submission contains an executive summary of Telstra’s and CSL’s key comments on the Draft Guidelines. Section 3 contains our comments on enhancing predictability by applying the economic principles in the Draft Guidelines to the Hong Kong telecommunications industry. In section 4 we comment on “safe harbours” and in section 5 we comment on the TA’s approach to some specific issues.

Telstra and CSL note that the TA has stated that he will amend the timeframes in paragraph 6.9 of the Draft Guidelines and, accordingly, Telstra and CSL do not comment on that paragraph.

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# 2 Executive Summary

Telstra and CSL generally agree with the principles that the TA will apply and consider in exercising his powers under section 7P of the *Telecommunications Ordinance* (Cap 106) (the “**Ordinance**”).

Telstra and CSL consider that the key purpose of the guidelines should be to provide guidance (and therefore predictability) to carriers and other persons as to how the TA will exercise his powers under section 7P. Telstra and CSL submit that the Draft Guidelines should be enhanced to provide a greater level of guidance on how the TA will exercise his powers. Such clear guidance enhances predictability and, consequently, compliance. Clear and detailed guidelines enable regulated firms to anticipate the circumstances in which a transaction is

likely to give rise to regulatory concerns and respond appropriately. Greater predictability reduces regulatees' compliance costs and the costs of investigation and enforcement by the regulator. This submission sets out some key areas where we believe more detailed guidance would be useful.

Telstra and CSL consider that a further, brief period of public consultation should be conducted after the TA has revised the Draft Guidelines, in light of comments from this consultation process.

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### **3 Predictability - Application of economic principles to the Hong Kong Telecommunications industry**

#### **3.1 Introduction**

The key purpose of the Draft Guidelines should be to provide guidance (and therefore predictability) regarding how the TA will exercise his powers under section 7P. Telstra and CSL consider that the Draft Guidelines provide a good summary of the relevant economic principles that the TA will use in making decisions under section 7P. However, Telstra and CSL consider that in a number of areas the Draft Guidelines set out a summary of economic principles but then do not take the necessary next step of indicating how the TA is likely to apply those principles to transactions in the Hong Kong telecommunications market.

Given that the TA is a sector-specific regulator and the Hong Kong market is geographically relatively small, Telstra and CSL submit that the TA should be able provide a greater level of guidance on how general principles will be applied by the TA. Telstra and CSL anticipate that a greater degree of specificity may be possible in guidance on how the TA will approach competition analyses in the Hong Kong telecommunications markets than can be offered by general, economy-wide competition regulators such as the Australian Competition and Consumer Commission (“ACCC”) or the Competition Commission in the United Kingdom.

Telstra and CSL appreciate that the TA cannot bind himself as to how he will apply the principles in all circumstances - it would be inappropriate for the TA to do so. However, Telstra and CSL submit that the guidelines could be substantially improved if the TA indicated how, in general terms, he is likely to apply principles to the Hong Kong telecommunications market.

As currently drafted, the Draft Guidelines do not provide the level of guidance and predictability which industry needs in

order to determine in advance the TA's likely approach to mergers and acquisitions in the telecommunications industry.

In this submission Telstra and CSL have set out specific examples of where greater guidance could be provided. However, Telstra and CSL consider that as a matter of general principle, to the extent reasonably possible, the TA should endeavour to provide as much guidance as possible on all issues set out in the guidelines.

### 3.2 The structure of the TA's analysis

Section 4 of the Draft Guidelines sets out the factors the TA will take into account in considering the level of competition in the market. In order to assist predictability, Telstra and CSL submit that the factors in section 4 should be tied together by:

- (a) a clear statement of the overall objective of the analysis; and
- (b) a general description of the order in which the TA will consider the factors and their relative weighting.

In regard to the overall objective, paragraph 4.10 states that the TA will "*interpret a substantial lessening of competition in terms of the creation or enhancement of market power*". It would assist if the TA could clarify if this is the core concept of his analysis and what the TA means by the creation or enhancement of market power. For example:

- (a) is there a need for substantial market power?
- (b) does the TA regard the key indication of market power as the ability of market participations to unilaterally raise prices or decrease quality?
- (c) does the TA regard a concentrated market as being a necessary condition to a finding that a merger may substantially lessen competition?<sup>1</sup>

Telstra and CSL are concerned that the interpretation of "substantial lessening of competition" merely "in terms of the creation or enhancement of market power" appears to marginalize the concept of substantiality, which is integral to the statutory formulation. While the Draft Guidelines note that "...substantiality is a subjective test that does not lend itself well to economic analysis" it is nevertheless familiar in competition law, as the excerpts from the Horizontal Merger Guidelines and ACCC Merger Guidelines show. Telstra and CSL submit that something more than a *de minimis* lessening is required and

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<sup>1</sup> We note that ACCC's Merger Guidelines, June 1999, state that market concentration is a necessary condition to enable the exercise of market power - see paragraph 5.87.

submit that the Guidelines should provide further guidance on this threshold.

Telstra and CSL also note that in paragraphs 4.13, 4.14 and 4.15, the Draft Guidelines set out the views of other regulators as to what is meant by substantially lessening competition (or similar concepts), however, the TA does not set out his own view. This is a key issue where predictability can be enhanced by the guidelines including a statement of the TA's own view of the meaning of the term substantially lessen competition.

### **3.3 Market Definition**

Telstra and CSL do not disagree with the analytical approach outlined by the TA in section 3 of the Draft Guidelines. However, a statement of the analytical process, while helpful, falls short of providing the level of guidance that would assist users of the guidelines form an accurate view of how the TA will define the market in particular transactions. Telstra and CSL submit that the Draft Guidelines should be amended to provide specific guidance as to how the TA is likely to apply these principles to the Hong Kong telecommunications markets.

### **3.4 Co-ordinated exercise of market power**

The Draft Guidelines set out in some detail the potential for a merger in oligopolistic markets to increase the potential for co-ordinated exercise of market power by the remaining competitors (paragraphs 4.16 to 4.20). Given the relatively small number of carriers that are likely to exist in any Hong Kong telecommunications market, the possibility of such co-ordinated action will theoretically be an issue in almost all transactions that the TA is required to consider under section 7P.

In order to provide greater guidance and predictability, Telstra and CSL submit that the TA should provide greater guidance on how the TA will approach this issue. In this regard, Telstra and CSL note that the overt and covert exercise of market power is prohibited under the Ordinance.

### **3.5 Removal of a vigorous and effective competitor**

The Draft Guidelines state that one factor which may provide guidance on whether "*market power is created or enhanced is whether the merger results in the removal of a vigorous and effective competitor*". However, the Draft Guidelines do not elaborate on what constitutes a vigorous and effective competitor. Telstra and CSL submit that the Draft Guidelines should be amended to provide further guidance on this issue, particularly in the context of the mobiles sector.

### **3.6 Barriers to entry**

The Draft Guidelines set out a broad view of barriers to entry including such matters as sunk costs, product differentiation and brand loyalty and strategic behaviour<sup>2</sup>. The Draft Guidelines acknowledge that sunk costs and economies of scale and scope are particular features of telecommunications. The Draft Guidelines also note that the unavailability of useable spectrum may constitute a physical barrier to entry.

Given that the issue of sunk costs and economies of scale are likely to apply to every transaction to be considered by the TA and the issue of limited availability of spectrum may arise in many transactions, it would assist in predictably if the guidelines stated:

- (a) the extent to which interconnection and other obligations on carrier licensees would countervail any negative effects from sunk costs and economies of scale; and
- (b) how important the availability of spectrum will be in analysing consolidations in the mobile sector.

### **3.7 Periodic Review**

The telecommunications industry continues to evolve and change more rapidly than most other industries. In order to ensure that the guidelines continue to be applicable to changing industry circumstances, the guidelines should have a sunset date and the TA should periodically review the guidelines to ensure they remain applicable to the prevailing industry structure and update them as necessary. Telstra and CSL submit that a scheduled review should be carried out, in consultation with industry participants and other interested parties, once every two years.

### **3.8 Financing Transaction**

The Draft Guidelines do not address how the TA will approach requests for approvals under section 7P(6) in the context of the owner of a carrier licensee granting a security interest over its shareholding in a carrier licensee. There are two scenarios that may arise in this context, namely:

- (a) the lender may obtain an interest in the carrier licensee at the time the security interest is created - this may trigger the operation of section 7P; or
- (b) the lender's interest may only arise if the security interest is enforced but the lender may want to make an application under section 7P(6) at the time the security is granted.

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<sup>2</sup> See paragraph 4.35.

Given that such transactions are likely to be common (in particular the second scenario described above), it would assist if the guidelines set out how the TA will deal with each of the above scenarios.

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## **4 Predictability - Need for Safe Harbours**

### **4.1 Introduction**

One of the key ways the Draft Guidelines can provide certainty is by stating the circumstances in which the TA will generally not investigate mergers.

### **4.2 Market Concentration**

The Draft Guidelines provide that:

- (a) if the combined market share of the parties to a merger is less than 15%, then the TA takes the view that is unlikely that there is a need to carry out detailed investigations or to intervene; and
- (b) where the combined market share of the parties to the merger is 40% or more, it is likely that the TA will wish to make detailed investigations.

The Draft Guidelines do not provide any guidance on the situation of where the combined market share of the parties to the merger is between 15% and 40%. It seems likely that many, if not the majority, of mergers will fall within this range.

These thresholds are low by international standards. For example, the ACCC's Merger Guidelines provide that Commission will not investigate a merger unless:

- (c) the resultant combined market share of the four (or fewer) larger firms is 75% or more and the merged firm will supply at least 15% of the relevant market; or
- (d) the merged firm will supply 40% or more of the market.

The ACCC's guidelines apply to all sectors of the economy. Given that the TA is only required to deal with one sector, the TA should be able to provide more specific guidance on when he will wish to investigate mergers.

Telstra and CSL do not at this stage have firm views on the particular guidance the TA should provide. Telstra and CSL note that PCCW has suggested that the TA should develop a version of the Herfindahl-Hirschman Index ("HHI") for the Hong Kong telecommunications market. Such an index may be useful in providing some degree of additional certainty. Telstra and CSL are tentatively of the view (subject to necessary further consideration and modelling work) that a

version of the HHI methodology may be appropriate in the present setting but note that the concentration ratios conventionally taken as indicative of market power in the USA should not be assumed to be applicable in the much smaller Hong Kong market.

We note that OFTA has calculated the pre-merger HHI figures for certain Hong Kong telecommunications markets. The figures are useful in illustrating that within the Hong Kong telecommunications industry there is a broad range of markets with very different levels of concentration. Whilst the application of the benchmarks in the US Horizontal Merger Guidelines would lead to the conclusion that most of the markets are highly concentrated, the figures do illustrate that there is significant diversity in the concentration levels in the Hong Kong telecommunications markets. Therefore it may be possible to develop benchmarks that are suitable for use in Hong Kong. Telstra and CSL consider that the possibility of developing such benchmarks should be further discussed with the industry.

#### **4.3 Size of transactions**

Some transactions may be so small that any effect on competition will be minimal and accordingly the transaction should be allowed to proceed. Telstra and CSL submit that the guidelines should contain a safe harbour for such transactions. Telstra and CSL consider that a turnover test may be the best approach and suggest a threshold of HK\$2 billion.

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## **5 Comments on approach to certain issues**

### **5.1 Introduction**

Although the key purpose of this submission is to make suggestions as to areas where the Draft Guidelines could be improved to enhance the ability of carriers and other parties to predict how the TA will approach a particular transaction, there are certain matters where Telstra and CSL submit that the Draft Guidelines should take a different approach. These issues are:

- (a) how the TA assesses efficiencies that may result from a merger;
- (b) how the TA assesses public benefits;
- (c) the TA's bias for structural remedies; and
- (d) the information to be provided as part of making an application under section 7P(6).



## 5.2 Efficiencies

The Draft Guidelines state that the TA will only take efficiencies into account if the TA is satisfied as to specific matters (see paragraph 4.76). The TA does not impose such pre-conditions on factors which tend to suggest that a party has market power. In addition, the Draft Guidelines provide that the TA will put the onus on the parties to the merger to provide convincing evidence that the claimed efficiencies will come to fruition (see paragraph 4.80).

It is not clear why in respect of this factor:

- (a) the onus of proof is shifted to the parties to the merger; or
- (b) the level of proof is higher than for other factors.

Telstra and CSL submit that this factor should be analysed on the same basis as other factors. That is, there should be no limit on the nature of the efficiencies the TA will consider, the onus should not be shifted to the parties to the merger and the TA should not require a higher level of proof.

## 5.3 Benefit to the public

The TA has applied the benefit to the public test too narrowly. The Draft Guidelines effectively state that the TA will only consider public benefits if the benefit is real and:

- (a) is likely to be realised within a reasonable period; and
- (b) is sustainable.

It is unclear why these requirements need to be met. Moreover, the Draft Guidelines provide that the TA may require commitments guaranteed by performance bonds to ensure that the claimed public benefit will be realized or sustained. Telstra and CSL are not aware of any other competition regulator that requires performance bonds as surety for claimed public benefits and submit that this factor should be dealt with on the same basis as all other factors.

## 5.4 Structural Remedies

The Draft Guidelines expressly state that the TA prefers structural remedies rather than conduct remedies<sup>3</sup>. This approach is inconsistent with international practice, for example, the Infocomm Development Authority (the “IDA”) in its draft Telecom Consolidation Guidelines states that it will only restrict a consolidation where the transaction would be likely to unreasonably restrict competition and where the anti-competitive harm cannot be adequately remedied through the

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<sup>3</sup> See paragraph 6.16.

imposition of narrowly tailored structural or behavioural conditions<sup>4</sup>.

## 5.5 Information required for simple transactions

The Draft Guidelines contain an extensive list of material to be provided as part of any application under section 7P(6). Telstra and CSL understand that for simple cases the TA will not require all of the listed information. Telstra and CSL submit that the Draft Guidelines should expressly state that for simple cases, on a case-by-case basis, the TA will be willing to agree to the provision of less information.

Telstra and CSL also submit that the Draft Guidelines should be amended to provide that the TA will not require a person to submit information if:

- (a) the information is subject to legal professional privilege;
- (b) the provision of the information would result in the provider of the information breaching the law (either in Hong Kong or another jurisdiction); or
- (c) the gathering or provision of the information would be overly burdensome.

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## 6 Conclusion

Telstra and CSL generally agree with the factors that the TA will consider in considering how he will exercise his powers under section 7P. However, Telstra and CSL submit that the Draft Guidelines should be improved by including more detailed guidance on how the TA will apply those principles in the context of the Hong Kong telecommunications markets.

Telstra and CSL would appreciate a further opportunity to comment on the Draft Guidelines after they have been reviewed to take into account comments arising from this consultation process.

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<sup>4</sup> See section 2.3.1 of the IDA's Telecom Consolidation Guidelines, Public Consultation Draft