PCCW Limited Submission on the Draft Merger Guidelines for Hong Kong Telecommunications Markets

Good guidance goes beyond commonplace knowledge to offer specifics, to bridge gaps, to resolve ambiguities. It has an edginess; and because it provides details, it limits agency discretion.

The best guidance aspires to anticipate and address with clarity all states of the world that fall within its scope. Recognizing that the world is a complex place, we cannot reasonably expect that any drafter will succeed in capturing all possible states. We should therefore be satisfied with well-specified guidance that does not avoid the difficult questions through ambiguous phrasing or selective treatments. If the guidance is incomplete and selective or ambiguous, it is less than entirely accurate, in the sense that it does not enable the public to predict the outcome of an enforcement decision. It will also tend to mislead those members of the public who are less sophisticated.[1]

PCCW Limited ('PCCW') welcomes the opportunity to provide comments on the Draft Merger Guidelines (the 'draft Guidelines') for Hong Kong Telecommunications Markets. The draft Guidelines were attached to the Consultation Paper issued by the Office of the Telecommunications Authority ('OFTA') on 4 August 2003.

PCCW worked closely with the Government on the underlying legislation and looks forward to again working closely with the Government on finalising these draft Guidelines.

This submission commences with a number of general in-principle comments about the draft Guidelines as a whole. These general comments are then followed by points of detail about particular aspects of the draft Guidelines.

In general, PCCW considers that the present draft Guidelines are a good first step. However, considering that the draft Guidelines cover only the telecommunications industry, more specific guidelines can and should be formulated.

PCCW has suggested a number of ways in which the draft Guidelines could be improved to provide the necessary transparency and predictability to which the 'best guidance aspires'. All of these suggestions are considered to be consistent with global best practice and the requirement of section 6D of the *Telecommunications Ordinance* (the 'Ordinance') to provide practical guidance.

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[1] W. Blumenthal, *Clear Agency Guidelines: Lessons from 1982*, 68 Antitrust Law Journal 5(2000), pp 25-26.

To seek to ensure that these important changes and suggestions for improvement are fully considered by all parties in a public consultation, PCCW would respectively request that the Government conduct a second round of consultations on the draft Guidelines before they are finalised.

GENERAL IN-PRINCIPLE POINTS

The main functions of the draft Guidelines should be to provide transparency and predictability about the decision-making process of the Telecommunications Authority (the 'TA') in relation to a merger. This is the essential message from the quotation at the beginning of this Submission: transparency to limit the regulator's discretion and predictability to enable affected parties to plan and make investment decisions efficiently and with reasonable certainty.

The new merger law will, by its nature, impose a substantial compliance cost on industry. In theory, this cost is balanced by consumer benefits. A critical component of this balance is predictability as reflected in the adoption of clear draft Guidelines. If the final Guidelines ultimately lack the necessary transparency and predictability, they will greatly increase compliance costs and upset this policy balance.

Importantly, the draft Guidelines will potentially cause substantial commercial damage if the parties to a merger wrongly interpret them. Commercial damage in turn will deter the flow of investment funds into the industry, raise capital costs and harm investment and innovation. This leads us to the first in-principle point.

1. The investment imperative

Investment is listed first among the objectives of the Government's information technology strategy:

> *To enhance Hong Kong as a place for investment in telecommunications, to encourage competition and innovation under an open, fair and predictable regulatory framework, and to maintain Hong Kong's position as the pre-eminent telecommunications centre in Asia.*[2]

In line with this investment policy imperative, the Government focused on the need for increased investment certainty when it introduced the new merger law in May 2002. The Government thus is aware in the merger review context of the link between investment and a predictable merger review process:

> *Our proposed regulatory framework will help investors make informed decisions on mergers and acquisitions. It will also remove unnecessary uncertainties licensees now face when going about*

[2] *Digital 21: Hong Kong Special Administrative Region Information Technology Strategy*, Hong Kong Information Technology and Broadcasting Bureau, November 1998, p 12.

> *merger and acquisition activities, as there are no statutory provision that govern such activities at present.*[3]

Thus the Government has made the promotion of investment a key telecommunications goal. It would be unfortunate if the final Guidelines undermined the increased certainty which the Government intended by enacting the new merger law. This, in turn, would adversely affect the investment and innovation which the Government has consistently wanted to promote.

Without certainty, investment in the Hong Kong telecommunications sector will inevitably suffer. Without investment, there will be less innovation and fewer new services in telecommunications. Without investment in telecommunications, there will be less economic stimulus and growth in the Hong Kong economy. And, as the telecommunications industry has been designated by both Hong Kong and Mainland authorities as playing a central role in China's development, particularly that of the Pearl River Delta, there will be less economic development and integration generally.

2. Statement of policy objectives

It is considered that the application of the new merger law must be considered in its policy context. Accordingly, there is a need in the draft Guidelines for a statement of the competition policy that underlies the new merger law. A policy statement would increase coherence in the TA's approach and hopefully avoid overly literal applications of section 7P which may lead to outcomes not consistent with the policy or spirit of the law.

For example, a literal interpretation of the effect on competition of a merger in the mobile sector may be that it substantially lessens competition because it reduces the number of competitors from six to five. However, such an outcome is not necessarily consistent with the objectives of competition policy as competition is not necessarily about numbers. It may well be that competition is increased by the merger because it makes the merged entity a more vigorous and effective competitor. Or at the least, it may be that the merger would be competition neutral.

The risk of inappropriate policy outcomes is heightened by the fact that the TA is presently constituted by one 'public officer' rather than by a multi-member board or commission as is typically the case with overseas competition authorities (and in the case of the other competition authorities in Hong Kong, the Broadcasting Authority and the Telecommunications (Competition Provisions) Appeal Board). Multi-member decision making is subject to innate checks and balances as the members with their different backgrounds and expertise bring their considered views to the joint decision.

A statement that section 7P has as its objective the promotion of competition should hopefully avoid inappropriate outcomes such as those which may simply preserve the

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[3] Information Technology and Broadcasting Bureau, *Bill to Foster Fair and Effective Competition in Telecommunications Market Gazetted*, Press Release, 3 May 2002.

number of competitors at the expense of the level of actual competition. In this respect, PCCW notes the following statement on competition policy from the Government's Competition Policy Advisory Group which encapsulates the essence of the objectives of competition policy in Hong Kong:

> *The objective of the Government's competition policy is to enhance economic efficiency and free flow of trade, thereby also benefiting consumer welfare. The Government is committed to competition as a means to achieving the said objective, and not as an end in itself.*
>
> *The Government considers competition is best nurtured and sustained by allowing the free play of market forces and keeping intervention to the minimum. We will not interfere with market forces simply on the basis of the number of operators, scale of operations, or normal commercial constraints faced by new entrants. We will take action only when market imperfections or distortions limit market accessibility or market contestability, and impair economic efficiency or free trade, to the detriment of the overall interest of Hong Kong.* [4]

It is considered that the above statement would be a useful starting point for the drafting of a statement of policy objectives for inclusion in the draft Guidelines.

3. Statement of enforcement policy

As indicated above, the Government's enforcement policy in relation to competition is to keep intervention to a minimum. Merger policy is an integral part of competition policy and the Government reiterated the light-handed enforcement policy approach in relation to mergers in the Government's merger statement of May 2002 (referred to above):

> *Having studied the overseas examples, we propose to adopt a light-handed approach to establish a clear regulatory framework for mergers and acquisitions in the telecommunications market.*
> …..
> *We recognise that many of the mergers and acquisitions do not raise regulatory concern. Indeed, mergers and acquisitions are part of normal activities and are economically beneficial to the society.*
>
> *The Authority is concerned, and will step in, only if there is potential adverse effect on competition in the market. The ex post regulatory regime achieves this purpose.*

One possible interpretation of a 'light-handed approach' is that, because the new law only applies to telecommunications markets and then only to carrier licensees in those markets, the approach is light-handed. The better interpretation is that, irrespective of the limited application of the law, it should be applied lightly to the carrier licensees subject to the law.

PCCW is concerned that the enforcement policy as currently reflected in the draft Guidelines is not as light-handed as it could and should be. Some examples of this approach discussed in the body of the submission are the overly low market share thresholds, the lack of clearly defined 'safe harbours', and the excessive information burden imposed on parties applying for prior consent to a merger.

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[4] Competition Policy Advisory Group, *Statement on Competition Policy*, May 1998

To clarify the situation the draft Guidelines should contain a statement that the TA will adopt a light-handed policy in relation to both merger processes and enforcement.

4. Detail and examples

Guidelines should provide practical guidance. Indeed, section 6D of the Ordinance requires that the issue of guidelines be '….for the purpose of providing **practical** guidance….' (PCCW's emphasis).

The draft Guidelines as currently drafted essentially consists of an analytical framework of economic concepts and principles. Undoubtedly, the framework is useful but it is no more than a working tool in which to analyse particular mergers in particular markets. It does not in itself provide practical guidance. Examples would perform this role.

However, there is little by way of example in the draft Guidelines to give life to the somewhat abstract framework. Currently, there are only a limited number of examples, such as those on the concept of cluster markets (paragraphs 3.34 - 3.35) and the measurement of market share (paragraph 4.28) . PCCW considers that similar examples in other areas would be appropriate. When dealing with a very limited segment of the overall economy (ie, telecommunications networks), instructive examples should not be difficult to construct.

The need for practical guidance is particularly needed in Hong Kong given the relatively recent introduction of competition law and policy to the Special Administrative Region, and then only in respect of two industries: telecommunications and broadcasting. The introduction of new economic and legal concepts not previously used and recognised can, naturally, create confusion and uncertainty. In these circumstances, there is a definite additional need for practical guidance on how the law will apply in Hong Kong.

It should be feasible to illustrate each of the abstract concepts and principles in the draft Guidelines with examples of specific situations together with a discussion as to how they would be treated in practice. Guidelines in overseas jurisdictions, whether relating to mergers or otherwise, typically illustrate the abstract concepts and principles with examples, despite the fact that they apply universally to all industry sectors rather than a specific telecommunications industry such as telecommunications. The inclusion of examples in industry-specific guidelines should be an easier task given the more limited field to cover. For example, the EC's draft Guidelines on market analysis and the calculation of significant market power in electronic communications networks and services is replete with examples from that sector.[5]

[5] European Commission, *Proposed New Regulatory Framework for Electronic Communications Networks and Services Draft Guidelines on market analysis and the calculation of significant market power under Article 14 of the proposed Directive on a common regulatory framework for electronic communications networks and services*, Commission Working Document COM (2001)175 final, Brussels, 28 May 2001.

PCCW submits that the draft Guidelines should contain far more examples of how the analytical framework will be applied in practice to mergers occurring in Hong Kong telecommunications markets. Unless such examples are given, they may not meet the statutory requirement of providing practical guidance to parties who may be affected by the operation of section 7P.

To the extent that practical guidance by example enhances compliance, it is a win-win situation for the regulator, industry and users. The regulator wins because greater compliance has been achieved in a light-handed fashion since licensees better understand the legal framework. Industry wins because there is greater certainty about the regulatory treatment of a merger and users win through more efficient markets. Ultimately, the Hong Kong economy and consumers win because the necessary investment needed for growth and international competitiveness in telecommunications is not stifled by uncertainty.

5. Positive aspects of mergers

As recognised by the Government, the great proportion of mergers are economically beneficial. There is a vast amount of economic literature on this point. Suffice to provide a quote from the General Counsel of the Federal Trade Commission in the US:

> *Most mergers are motivated by goals of efficiency and improved performance, and from an antitrust perspective are at least competitively benign. Of the thousands of premerger filings we reviewed last year, almost 70% received what is called "early termination", that is they were cleared by the agency in less than our statutorily allotted 30 day period. Indeed, the average time for review was less than 16 days. Generally, less than 4% of all transactions receive an in depth investigation and less than 2% of all transactions are challenged.*
>
> *Simply put, there is nothing inherently bad with firms getting bigger, or with an industry consolidating by eliminating excess capacity and squeezing out inefficiencies, or with firms combining complementary products or services.*[6]

As the quotation indicates, only a very small proportion of mergers raise anti-competitive concerns. OFTA itself states at paragraph 1.24 of the draft Guidelines that mergers involving non-carrier licensees are unlikely to raise any competition concerns.

There is no inherent reason why mergers between carrier licensees should be likely to raise greater competition concerns than non-carriers. Yet, there is little recognition in the draft Guidelines that mergers (whether involving carriers or non-carriers) are generally pro-competitive and efficiency enhancing. Rather than highlighting the positive economic benefits, the draft Guidelines start in paragraph 1.1 by stating that any mergers involving carriers will be analysed for their likely anti-competitive effect. In other words, there appears to be a negative presumption about mergers involving carriers in the draft Guidelines.

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[6] Debra A. Valentine, *Global Mergers: Trade Issues and Alliances in the New Millennium*, 10th Annual OWIT Trade Conference, October 4-5 1999.

In recognition of the fact that there is nothing inherently bad with firms getting bigger through merger, the draft Guidelines should start with a statement about the positive economic benefits of mergers and then move to a statement that section 7P is only concerned with the very small proportion of mergers that are likely to raise competition concerns.

In line with a neutral or positive presumption, the draft Guidelines should contain a statement that, where the TA forms an opinion that a merger is likely to substantially lessen competition without any outweighing public benefits, he will first consider modifications to the merger under section 7P(4) (such as the implementation of a compliance and monitoring program) before considering action to block the merger under section7P(1)(b).

Such a statement would convey the message that the TA recognises the innovative and efficiency enhancing benefits of mergers and is only prepared to consider blocking a merger in the last resort. Furthermore, such a statement would go part of the way to filling the void in the current draft Guidelines in respect of the types of action the TA will take against a merger under section 7P(1)(b).

6. Risk of regulatory failure

Regulatory best practice is to do the minimum necessary to deal with the conduct in question. In this way, not only are the inevitable compliance costs of regulation minimised but the risks of regulatory failure are mitigated. Regulatory failure occurs when the regulator 'calls it wrong' and blocks a merger for its likely anti-competitive effects when, in fact, it would have been pro-competitive and generated economic benefits or, at least, been neutral.

Whenever a judgement is required to be made about the likelihood of certain effects occurring in an uncertain future, there is always the risk of regulatory failure by a regulator. The risk of this regulatory failure is increased in high technology industries such as telecommunications where rapid technological change and product innovation continually and fundamentally alter market structures and the dynamics of competition in those markets.

Not only is the risk of regulatory failure greater in high technology industries, but the consequences for consumers and the economy of that failure are also greater. In these industries, competitors typically remain competitive through continual innovation and investment in new forms of technology. Not only would regulatory failure stifle the necessary investment and innovation, but it would damage the very competitive processes which the TA is attempting to promote.

Obviously, the obverse risk is that the TA will not take action against a merger which in fact does have anti-competitive effects. However, as discussed in the preceding section, only a very small proportion of mergers are likely to raise competition concerns.

Accordingly, the risk of letting through anti-competitive mergers is far less than the risk of stopping pro-competitive mergers. Furthermore, in the less likely event a merger is approved which may have some anti-competitive effects, they can be fully addressed through conduct regulation under sections 7K, 7L or 7N.

In explicit recognition of the highly technological nature of telecommunications and the concomitantly greater risk of regulatory failure and its consequences, the draft Guidelines should contain a statement of enforcement principle that where there is reasonable doubt about the likelihood of a substantial lessening of competition, the TA will not take action under section 7P.

7. Burden of proof

Mergers are the expression of the fundamental freedom to contract and otherwise engage in commercial activity. A merger should therefore be only blocked when there is clear evidence that, in the broad terms of section 7P, it is likely to substantially lessen competition and does not have any outweighing public benefits.

Accompanying this fundamental right is the equally fundamental legal principle that, when someone alleges a breach of a law that adversely affects someone else's commercial interests, the burden of proving the breach lies with the person alleging that breach. Accordingly, the burden of proving anti-competitive conduct in breach of sections 7K, 7L and 7N of the Ordinance lies with the TA. Similarly, the burden of proving that a merger breaches section 7P also lies with the TA.

Placing the burden of proof with the TA is also consistent with a positive presumption about the economic benefits of mergers. At the risk of losing these benefits, the TA is required to present hard, credible and substantiated evidence about any claimed anti-competitive effects of a proposed merger before he proposes to deny or impose conditions on it.

To avoid confusion about where the burden of proof lies in relation to a merger the draft Guidelines should contain a statement of principle that the burden is on the TA to provide evidence and analysis as to why a merger is likely to substantially lessen competition in a telecommunications market. As discussed in other sections, even where a merger proponent may have a burden to present a prima facie case, the ultimate burden of proof remains on the TA.

8. Clarity about overlapping provisions

The draft Guidelines in paragraph 1.22 state the TA's intention to remove uncertainties about the potential application of other provisions that may apply to mergers (in particular, sections 7K and 7L and their equivalent provisions in the carrier licences).

The same section states that the TA will not apply the non-merger provisions when a merger transaction falls within the scope of section 7P.

This approach is caveated with language that indicates the TA 'will usually rely primarily' on the merger legislation. This caveat raises uncertainty about whether the TA will apply sections 7K and 7L to a merger. Compounding the uncertainty is the statement in paragraph 1.25 that non-compete covenants in merger transactions will be dealt with under section 7P if they are integral to the transaction but under section 7K if they are 'non-essential'.

Sections 7K and 7L, which certainly may apply to any subsequent anti-competitive conduct, have a different test ('prevent or substantially restrict' competition rather than 'lessen' competition) and it could be placing the parties to a merger in a position of double jeopardy and great uncertainty unless it is categorically stated that only section 7P will be applied to a merger. Indeed, the statements in the draft Guidelines on overlapping provisions appear to be somewhat inconsistent with the Government's objective in enacting the new merger law to remove the unnecessary uncertainties licensees now face when going about merger activities.

A precedent categorically ruling out application of other provisions is section 45(7) of the Australian *Trade Practices Act* which removes any agreements relating to the acquisition of assets from the application of the general prohibition on anti-competitive agreements.

It is considered that there should be a categorical statement in the Guidelines along the lines of section 45(7) to remove uncertainty about the potential application of other provisions. This would appear to be consistent with the policy intention to address conduct under the conduct provisions of the Ordinance and mergers under the merger provisions of the Ordinance.

POINTS OF DETAIL

1. Market definition

The following points of detail are made in respect of section 3 of the draft Guidelines on market definition.

Statutory definition of telecommunications markets

Under section 7P(1)(a), the necessary anti-competitive effect must occur in a 'telecommunications market'. Section 2 defines a telecommunications market as any market for the provision or acquisition of telecommunications networks, telecommunications systems, telecommunications installations, or customer equipment or services.

There is no guidance on how the TA will interpret the statutory definition. For example, customer equipment providers may not even be licensees and purely services licensees do not own underlying carriage networks which are the stated focus of the new merger policy. Another example might be a merger involving a carrier licensee and a mobile phone manufacturer. Would a customer mobile equipment market be considered a telecommunications market under the terms of the merger regime? Similarly, is a pay TV network market included within the statutory definition?

There should be more guidance on this statutory threshold issue of what markets are actually covered by the statute.

Previous cases (para 3.50)

PCCW generally supports the use of case law and decisions made by other regulatory authorities. In many situations, case law and other decisions may be quite relevant. However, the Hong Kong market is small and higher market concentrations are necessary to achieve desirable efficiency levels.

One caution would be to note that the merger legislation in overseas jurisdictions may have different policy objectives. In this respect, caution should be exercised in using EC case law as the law has broader objectives (such as the protection of small business and free movement across borders) than the efficiency-enhancing policy behind the Ordinance.

Precedents under US and Australian competition law would be more relevant as they both have the same efficiency-enhancing objective as the Ordinance.

Temporal markets (para 3.51)

PCCW understands the concept of ‘temporal markets’ to generally refer to the time period over which substitution possibilities occur. The concept used in this paragraph (‘peak’ as distinct from ‘off-peak’ services) is considered to be another form of product description more applicable to paragraph 3.9 (indeed, ‘peak’ and ‘off-peak’ are used as examples of different product descriptions in that paragraph).

PCCW agrees that markets may be defined not just by reference to product characteristics as described in paragraph 3.9 but also by reference to other characteristics and dimensions such as ‘temporal’ and user perceptions or user approaches in purchasing a product.

2. Competition analysis

The following points of detail are made in respect of the competition analysis in section 4 of the Guidelines (apart from comments on market shares, efficiency gains and failing firms, which are discussed separately).

'Unilateral v. co-ordinated exercise of market power' (paras 4.16 – 4.20)

The potential for co-ordinated exercise of market power as a result of a merger is raised as a potential anti-competitive effect which may cause the TA to take action against the merger. PCCW considers that invoking the potential for co-ordinated conduct without firm evidence is inappropriate for three reasons.

First, in conducting an analysis of this issue in a merger case, the TA is essentially judging the likelihood of anti-competitive practices and misuse of dominance, conduct which would normally be considered under sections 7K and 7L which adopt the different competition test of 'prevent or substantially restrict' competition. However, to do so raises the previously discussed issue of overlapping provisions and consequent uncertainty.

Secondly, the potential for co-ordinated exercise of market power subsequent to a merger is largely speculative. PCCW acknowledges that there is some economic theory on the matter but there is no general agreement on the theory. More importantly, theory is a long way from the firm evidence needed to form a reasonable opinion about what is essentially only described as a 'potential' for co-ordinated action in the draft Guidelines. This point appears to be acknowledged in paragraph 4.20 where it states that there is the added uncertainty of predicting whether market conditions are conducive to reaching terms of co-ordination and punishing 'mavericks'. PCCW doubts whether a mere concern about potential co-ordination without further hard evidence would satisfy the statutory burden of proof placed on the TA.

Thirdly, to invoke a potential for co-ordinated action goes against what should be a positive presumption for mergers. As indicated previously, in an unlikely event a merger is approved which may be anti-competitive, the negative effects should be addressed through conduct regulation under sections 7K, 7L or 7N.

'Removal of a vigorous and effective competitor' (paras 4.30 – 4.32)

The draft Guidelines describe the concept of a vigorous and effective competitor in terms of being 'particularly competitive' or of being a 'maverick'. Little more can be gleaned from the guidance on this new concept which is listed as a merger factor to consider in Schedule 2 of the Ordinance.

At the industry meeting with OFTA on 18 September, a number of interpretations of this concept were given. One interpretation was that a vigorous and effective competitor was seen as a 'market leader' in terms perhaps of market share. Another (and perhaps opposite) interpretation was of a company having an impact on a market, of being a 'maverick', of stimulating responses from competitors.

As every competitor could be seen as vigorous or effective, or both, it is important that this concept be fully explained in the draft Guidelines., PCCW would therefore request

that more guidance be provided in the draft Guidelines on the concept of 'vigorous and effective competitor'.

'Extent of effective competition remaining' (para 4.33)

Another new merger factor of 'effective competition remaining' is introduced into the analytical framework. However, the concept would logically appear to be the obverse to a conclusion on a 'substantial lessening of competition' analysis rather than being a factor to consider in reaching that conclusion. Nonetheless, it is statutorily listed in Schedule 2 as one of the factors to be taken into account in forming the conclusion.

Currently, there is only cursory reference to the factors to be considered in forming an opinion on whether 'effective competition remaining'. These factors are price levels, number of suppliers, product innovation and market structure – all of which are elsewhere used in the Guidelines to form an opinion on 'substantial lessening of competition'.

PCCW considers that, given that it is a new concept, there needs to be significantly more elaboration on the factors that constitute 'effective competition remains'. It should be made clear in the draft Guidelines that the concept is a factor to consider in arriving at a conclusion and not a conclusion in itself. Otherwise, there is the potential for the concept to become a de facto and different standard for determining whether a merger 'substantially lessens competition'.

'Other factors – dynamics and technological change' (paras 4.92 – 4.98)

It is stated in paragraph 4.93 of the draft Guidelines that:

> *Telecommunications is characterised by dynamic and rapid technological changes. In such an industry, market boundaries are not likely to remain constant. Digitalisation and convergence in particular are changing the structure of telecommunications markets and the nature of competition within those markets.*

There should be no doubt that this characterisation of the telecommunications market is accurate. As the Chairman of the Federal Trade Commission has remarked:

> *….it leaves open the question of whether antitrust principles, developed primarily in the context of smokestack industries, should apply comparably and with equal force to new problems that emerge in connection with high-tech industries. Some would argue that it is dangerous to undermine investment incentives in these dynamic industries, and therefore that antitrust should have no role at all. A less confrontational approach suggests that because of the robust pace of innovation in high-tech industries, government should not intervene "unless certain that doing so will benefit consumers and the economy". A variation on that theme argues that litigation lags are likely to be longer than the time it would take for competitive forces to reconfigure an industry, and therefore that antitrust should intervene only in the most unusual circumstances. Even under these last two approaches, antitrust would have a modest role.*[7]

[7] Robert Pitofsky, Chairman, Federal Trade Commission, *Antitrust Analysis in High-Tech Industries: A 19th Century Discipline Addresses 21st Century Problems*, Prepared Remarks to American Bar Association,

The factor ‘dynamics and technological change’ should actually be one of the first factors considered in a competition analysis given its ability to dynamically change the level of competition in a market irrespective of market shares.

Moreover, this factor should also be listed in section 3 of the draft Guidelines on market definition as market definition in telecommunications must be forward looking and must take into account technological trends and its ability to rapidly change market boundaries.

3. Market shares and concentration

Paragraphs 4.24 to 4.29 overview the role market share and concentration play as factors in determining whether a merger is likely to substantially lessen competition. PCCW has a number of comments to make on this overview.

Safe harbours

The ‘guidance’ on this important merger factor is somewhat ambiguous. No threshold indices or tests are provided in this section on whether a merger is likely to raise concerns and warrant further investigation or fall into a ‘safe harbour’ without further investigation. Instead, terms such as ‘high market shares and concentration levels’ and ‘only small market share’ are used.

Market share thresholds of 15 and 40 percent are noted in the Introduction to the draft Guidelines (in paragraphs 1.16 – 1.19 under the heading ‘Scope of application’). However, in the more specific sections of the draft Guidelines, the language is both vague and qualified. For example, it is stated that the TA is ‘unlikely’ to carry out a ‘detailed investigation’ if the threshold is less that 15 percent but a following statement that the TA will ‘not categorically rule out intervention’ adds to the uncertainty. In relation to market shares between 15 and 40 percent, the TA will decide on a ‘case by case basis’. In relation to shares at 40 percent or above, the TA will be ‘likely’ to make a detailed investigation.

PCCW accepts that these statements provide some guidance about the application of the law. However, it is clear that this guidance is very limited. In particular, there is the very large grey area between the 15 and 40 percent thresholds where the TA will decide on a case by case basis. In the interests of transparency and predictability, there should be a clear definition of ‘safe harbours’ without the lingering uncertainty of possible investigation and intervention. To this end, there should be a clear statement that if a threshold is not exceeded, the TA will refrain from further investigating the matter or otherwise intervening. Such thresholds may be based on market share, turnover or other specific factors as found in other merger guidelines.

Section of Antitrust Law’s Antitrust Issues in High-Tech Industries Workshop, Arizona, 25-26 February 1999.

Even when a threshold is exceeded, there should not be a presumption of anti-competitive effect. This is in line with the presumption about the efficiency enhancing benefits of mergers. Alternatively, if there is a need for a presumption about the anti-competitive effect, PCCW suggests that the threshold be set at significantly higher level than the current thresholds of 15 and 40 percent.

In this respect, PCCW generally considers that the thresholds of 15 and 40 percent are low by international standards and do not take into account the relatively small size of affected markets in Hong Kong. Australia, an example of a jurisdiction with relatively small markets, has a 15 percent threshold but it is only triggered if the four-firm concentration ratio or CR4 is greater than 75 percent - otherwise a 40 percent threshold is invoked[8]. PCCW would request that the initial threshold for safe harbours should be at least 40 percent in line with the Australian situation and that a lower threshold should attach only when a three firm concentration ratio exceeds 75 percent.

Concentration ratios and the HHI

More fundamentally, PCCW questions the use of relatively crude market share figures as a merger factor in light of the availability of more sophisticated benchmarks, particularly the Herfindahl-Hirschman Index (HHI) of market concentration.

Market shares, three or four company concentration ratios and the HHI are essentially proxies for assessing the likelihood of a merged entity sustaining a price increase above competitive levels (ie, its ability to exercise market power). In turn, the ability to exercise market power as a result of a merger is essentially a proxy for a substantial lessening of competition (as recognised in paragraphs 4.10 to 4.12 of the draft Guidelines).

However, it is widely recognised that simple market share figures may not be good proxies for market power. Obviously, if markets are defined too narrowly, they will overestimate the merged entities ability to raise prices. Further, as market shares are based on historical data, they are less likely to be useful in identifying future anti-competitive effects in dynamic markets such as telecommunications. In addition, three or four company concentration ratios may not reflect the need for operators in small markets to have larger market shares to produce efficient competitors. As has been noted in relation to small markets and economies in a recently published book by Michal Gal:

> *Small economies need a competition policy that is specially tailored to their markets. As Chapter 1 demonstrates, small economies face different welfare maximization issues than do large ones. A critical feature of small economies is the concentrated nature of many of their markets, resulting from the presence of scale economies and high entry barriers. Smallness has adverse implications for domestic market structure and performance. The size of some industries is sub-optimal to the extent that limited market demand constrains the development of a critical mass of domestic productive activities necessary to achieve the lowest costs of production. But even when*

[8] Australian Competition and Consumer Commission, *Merger Guidelines*, June 1999, para 5.95.

productive efficiency can be achieved, small economies cannot support more than a few competitors in most of their industries.[9]

Instead of simple market share figures, the US Guidelines use the more sophisticated and robust Herfindahl-Hirschman Index (HHI). The HHI is generally recognised as the most useful threshold indicator of market power. As the US Guidelines indicate:

The HHI is calculated by summing the squares of the individual market shares of all the participants. Unlike the four-firm concentration ratio, the HHI reflects both the distribution of the market shares of the top four firms and the composition of the market outside the top four firms. It also gives proportionately greater weight to the market shares of the larger firms, in accord with their relative importance in competitive interactions[10].

Since the HHI was originally adopted in the US Merger Guidelines, it has been increasingly used elsewhere, for example:

- the draft EC horizontal merger guidelines (expected to come into force May 2004), which notes that the HHI provides a particularly good indicator for the competitive situation in a market;[11]

- the UK Competition Commission merger guidelines, which notes that they are a commonly used measure which takes account of all firms in the industry and their relative size;[12]

- the OFT merger guidelines, which use the HHI as one of three principle measurements of market concentration and structure (the other two being market shares and concentration ratios);[13]

- the TA Statement of 14 March 2003 on the extension of the directions to Reach and PCCW regarding the declaration of non-dominance in the market for external bandwidth services, which described the HHI as the most generally accepted measure of market concentration. [14]

The main reason for the increasing use of the HHI is the greater predictability and certainty that it provides to the industry, to the regulator and to the public. It is an

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[9] Michal S. Gal, *Competition Policies for Small Market Economies*, Harvard University Press, 2003, p 4.
[10] US Department of Justice and Federal Trade Commission, 1992 Horizontal Merger Guidelines [with April 8, 1997, revisions to section 4 on Efficiencies], section 1.5.
[11] Commission of the European Communities, *Commission Notice on the appraisal of horizontal mergers under the Council Regulation on the control of concentrations between undertakings*, COM(2002), Brussels, 11 December 2002,), paras 16 and 27.
[12] Competition Commission, *Merger References: Competition Commission Guidelines*, Consultation Document, September 2002, para 3.7.
[13] Office of Fair Trading, *Mergers: substantive assessment*, Consultation Paper, OFT506, October 2002, para 4.3.
[14] Statement of the TA on extension of the directions issued to Reach Networks Hong Kong limited and PCCW-HKT Telephone Limited on 15 March 2002 and 1 June 2002 respectively pursuant to General Condition 44 of their fixed telecommunications network services licences regarding declaration of non-dominance in the market for external bandwidth services, 14 March 2003, para 26, footnote 3.

extremely useful tool and starting point for further analysis. As Professor Richard Whish states in his Competition Law textbook:

> *Having determined what substantive rule [i.e. substantial lessening of competition] is appropriate, it is also necessary to provide guidance on how that rule will be applied in practice. Firms should be able to predict with reasonable certainty whether their mergers are likely to cause concern on the part of the competition authorities. The authorities themselves ought not to be given an unduly wide margin of appreciation in determining the outcome of cases. It is important therefore to give an objective meaning to expressions such as a 'substantial' lessening of competition or a 'significant' impediment to competition. The use of the Herfindahl-Hirschmann Index can provide some guidance on the likely effect of a merger on the structure of the market, as may concentration ratios.*[15]

In the US Guidelines, three HHI threshold levels are used:

- below 1000 following a merger: market is unconcentrated and unlikely to have adverse competitive effects. The Guidelines state that such mergers 'ordinarily require no further analysis'.

- between 1000 and 1800: market is moderately concentrated but
  - an increase of less than 100 in HHI is unlikely to have adverse competitive consequences and 'ordinarily require no further analysis'; and
  - an increase of more than 100 in HHI potentially raises significant competitive concerns depending on other merger factors.

- above 1800: market is highly concentrated but
  - an increase of less than 50 in HHI is unlikely to have adverse competitive consequences and 'ordinarily require no further analysis'; and
  - an increase of more than 50 in HHI potentially raises significant competitive concerns depending on other merger factors; and
  - an increase of more than 100 in HHI is presumed to create or enhance market power or facilitate its exercise (but presumption can be rebutted by showing that other merger factors make it unlikely).

However, the thresholds adopted in one particular market are not necessarily appropriate in other markets. Thresholds similar to those in the US are used in the two UK merger guidelines referred to above but the EC has adapted the HHI to suit the different circumstances of European markets (for example, a merger is likely to raise 'serious doubts' when the post-merger HHI is 2000 (as opposed to 1800 in the US) and when the increase in the HHI is 150 or more (as opposed to 50).

PCCW strongly recommends that a HHI be applied in Hong Kong and that higher thresholds should be developed given the small market conditions of Hong Kong. The use of an index promotes predictability and transparency.

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[15] Richard Whish, *Competition Law*, Butterworths, Fourth Edition, 2001, p 730.

In view of the concerns expressed above about the imperfections of stand alone market share figures in general, PCCW is attempting to develop appropriate HHI thresholds for Hong Kong market conditions. PCCW considers that such an index specifically developed for the small telecommunications markets in Hong Kong should provide a more precise and telling benchmark than the HHI used in the larger markets of the US and Europe. As Michal Gal notes in the book on small markets:

> …the small size of a market and the resulting need to enable firms to grow relatively large in order to realize scale economies require the rejection of the U.S. concentration threshold in small economies. Adoption of the U.S. HHI levels will result, for example, in a presumption of illegality in a merger between the two smallest firms in a market with six businesses, four holding approximately 20 percent market shares and two holding approximately 10 percent each.
>
> Objections to such a merger will not comply with the special economic conditions of a small economy. In small economies, especially when fixed costs and scale economies are substantial, it is not uncommon for firms to possess such market shares. Accordingly, many if not most proposed mergers would cross this threshold, although they would not always increase or create market power or facilitate its exercise, and most firms would be prevented from realizing scale economies.[16]

PCCW has recently begun to develop HHI thresholds for Hong Kong. Further, it has received useful information from OFTA. PCCW intends to finish its proposed HHI for Hong Kong and to circulate it as part of the consultation process as soon as possible.

4. Efficiency gains

The draft Guidelines indicate in paragraph 4.76 that efficiency gains are a relevant factor to take into account in forming an opinion on whether a merger substantially lessens competition.

As previously mentioned, the burden of proving a substantial lessening of competition lies with the TA. This placement of the burden of proof on the Government competition authority is consistent with established legal principle and global best practice. It has recently been supported by a recent Canadian judgment in the *Superior Propane* case which involved an appeal by the Competition Commissioner against a decision of the Competition Tribunal.[17]

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[16] Michal S. Gal, *Competition Policies for Small Market Economies*, op. cit., pp 233-234.

[17] *Canada (Commissioner of Competition) v. Superior Propane, Inc.*, Federal Court of Appeal, [2003] FCA 53, in particular, paras 37-38 and para 62. To avoid drawing the wrong inferences from this landmark Canadian case, a brief outline of the Canadian legislative regime is in order. Section 92 of the Act provides that if the Tribunal finds that a merger is likely to lessen competition substantially, it may, subject to section 96, take action against the merger. Section 96 is referred to as the 'efficiency defence'. The Tribunal cannot take action under section 92 if it finds that the merger is likely to bring about gains in efficiency that will be greater than, and will offset, the effects of any lessening of competition that will likely result from the merger and that the gains in efficiency would not likely be attained if the merger were stopped. Under the Canadian regime, the treatment of efficiencies as an 'efficiency defence' under section 96 of the Competition Act is much like the consideration of public benefits as a 'defence' under section 7P(1)(b) of the Ordinance. However, unlike the Canadian regime, efficiency claims under the Ordinance

In this case, the Federal Court of Appeal made two relevant judgments:

- the Commissioner has the onus of proving a substantial lessening of competition in breach of section 92(1) the *Competition Act*; and

- there is a high evidentiary burden on the Commissioner to establish a substantial lessening of competition under section 92(1) and to rebut any efficiency claims under section 96(1) of the Act once a prima facie case is presented.

In upholding the Tribunal's decision in respect of the Commissioner's high evidentiary burden, the Court found that:

> *Paragraph 233 [of the Competition Tribunal's decision] is guidance to the Commissioner as to the nature of the evidence required to demonstrate the extent of the relevant effects - he must quantify effects where they can be quantified. I think it is understandable why the Tribunal would be of this view.*
>
> *Including the wealth transfer in the effects analysis necessarily involves a significant degree of subjective judgment. The Tribunal's goal appears to have been to minimize the degree of subjective judgment required in the effects assessment process under subsection 96(1). The Tribunal's insistence on quantification, where possible, is to enable it to make the most objective judgment that can be made in the circumstances. In my view, that is not unreasonable.*

It is possible to read the section in the draft Guidelines on efficiencies and conclude that the burden of proof in relation to efficiency claims has been switched to the merging parties. This is particularly the case when one reads the statement in paragraph 4.76 that, in forming an opinion whether a merger substantially lessens competition, the TA needs to be satisfied that efficiencies arising from the merger are merger-specific, verifiable and will be passed on.

In the interests of avoiding confusion on this matter, PCCW would request that the draft Guidelines should clearly state that the consideration of efficiency gains are an integral part of the process of forming an opinion on a substantial lessening of competition and as such, the TA carries the burden of proving that claimed efficiency gains are not relevant or not sufficient to overcome a finding of a substantial lessening of competition once the merger proponent has presented a prima facie case.

In line with the *Superior Propane* case, the draft Guidelines should clearly state that the TA carries the burden of proof to rebut a prima facie case of efficiency once these gains have been presented to establish a prima facie case made by merging parties. This should be the case as long as claims of efficiencies are reasonable and made in good faith.

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are considered as an integral part of the inquiry under section 7(a)(1) into a substantial lessening of competition. Indeed, the Canadian law is somewhat unique in this respect. Merger law in other jurisdictions such as the United States, Australia and the EC is similar to the law in Hong Kong where efficiencies are considered as part of the process of reaching a view on anti-competitive effect, not as a defence to an adverse finding.

Such a position on the burden of proof would also be consistent with a positive presumption about the efficiency-enhancing effects of mergers, a presumption which is apparent from the description of the efficiency-enhancing effects of mergers in paragraphs 4.73 – 4.75.[18]

5. Failing firms

It is stated at paragraph 4.82 that the acquisition of a failing firm is a relevant matter for the TA to take into account when forming an opinion on whether a merger substantially lessens competition. Merger guidelines often identify 'failing firms' as a special set of merger cases as absent a merger the firm will exit the market, users may be significantly inconvenienced for some period of time, jobs may be lost, etc.

In dissimilar vein to efficiency gains, the burden of proof does not appear to have been switched to merging parties. It appears to accept that the burden of proving that the acquisition of a failing firm would substantially lessen competition rests with the TA.

To avoid any doubt about where the burden of proof lies, PCCW would request that there should be a categorical statement in the draft Guidelines to the effect that the burden of proving that the acquisition of a failing firm would substantially lessen competition rests with the TA.

The failing firm test found in the draft Guidelines requires the meeting of three special conditions before the acquisition of a failing firm is considered not to cause competition concerns. One of these conditions is that the licensee's assets would exit the market if the licensee fails. This approach is not well suited to 'networked' industries where not insubstantial assets are often characterised as 'sunk'. That is, the assets (or, at least, not an insubstantial proportion of a firm's assets) are not likely to exit the market. This being the case, and the draft Guidelines only offering the 'defence' of assets exiting the market, the 'defence' is for all practical purposes not available for network industries in Hong Kong. PCCW would suggest that this part of the three prong test be deleted.

In short, there should be no negative presumption about the acquisition of a failing firm when its assets do not exit the market. It is in the nature of the industry for assets not to exit and such a presumption negates any merger assistance to failing firms.

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[18] In this respect, PCCW considers it worth repeating what the US Guidelines have to say on the matter and why they are properly an issue for consideration in the formation of an opinion on competitive effect rather than as a defence against an adverse finding:
'Competition usually spurs firms to achieve efficiencies internally. Nevertheless, mergers have the potential to generate significant efficiencies by permitting a better utilization of existing assets, enabling the combined firm to achieve lower costs in producing a given quantity and quality than either firm could have achieved without the proposed transaction. Indeed, the primary benefit of mergers to the economy is their potential to generate such efficiencies.
'Efficiencies generated through merger can enhance the merged firm's ability and incentive to compete, which may result in lower prices, improved quality, enhanced service, or new products.'

6. Public benefit test

Concept of public benefit

In broad terms, section 7P(1)(b) provides that the TA may not take action against a merger that would or would be likely to substantially lessen competition if he is satisfied that the merger is likely to have public benefits that outweigh the anti-competitive detriment.

This provision appears to be derived from a similar test under section 90(6) of the Australian *Trade Practices Act* for the authorisation of certain forms of anti-competitive conduct (but not mergers) and the waiver process found in the EC. The authorisation test for mergers in Australia merely requires that the merger results in such a public benefit that it should be allowed to take place. It does not have any balancing of public benefit against anti-competitive detriment.

From a practical point of view, the analysis of public benefits and a weighing against possible detriments will be a critical part of any merger review. From a predictability point of view, the draft Guidelines need to provide as much guidance as necessary. For example, the Australian Merger Guidelines devote nearly 13 of their 92 pages to providing guidance on the authorisation process and what constitutes public benefit.[19] The draft Guidelines only devote one page (page 40) to the subject. While a page number comparison is obviously not conclusive, there is a genuine need for more detailed guidance on what constitutes public benefit under section 7P .

Moreover, guidance on public benefits takes on far greater importance because section 7P(1)(b) because there is an onus on the merging parties to establish a prima facie case. Vagueness in the draft Guidelines about what constitutes public benefit makes it extremely difficult for parties to a merger to know in advance what is likely to satisfy the TA. In short, it creates great uncertainty.

PCCW was advised at a meeting with OFTA on 18 September 2003 that OFTA saw no restriction on what may constitute public benefit and that parties could claim any benefits that they wished to raise. This statement is welcomed and the draft Guidelines should reflect this. However, guidance on what would satisfy the TA as to what are major or minor benefits to the public is still necessary.

PCCW would request that substantially more guidance should be provided on the determinative concept of public benefit. Given its importance in forming an opinion on whether to take action against a merger, public benefit should be given as much treatment as substantial lessening of competition in the Guidelines.

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[19] Australian Competition and Consumer Commission, *Merger Guidelines*, June 1999, pp 62-74.

Performance bonds

It is proposed in paragraph 5.3 that parties claiming the existence of public benefits may be required to propose measures, including commitments guaranteed by performance bonds or the modification of the licence conditions of the carrier licensee in question where necessary and appropriate, to ensure that the claimed public benefit will be realised and sustained.

PCCW is unaware of any similar remedy in any other jurisdiction where there is a formal authorisation process in place.

As far as PCCW is aware, all other major antitrust jurisdictions such as those in the EC, the UK, the US, Canada and Australia do not have a formal penalty process where reasonably anticipated public benefits do not occur or do not occur to the extent envisioned.

Apart from the serious doubts about the legality of requiring performance bonds and changes to licence conditions on sufferance of the 'performance' of a public benefit, the proposal appears to misunderstand the objectives of competition law, including merger law.

Competition law is fundamentally about preventing companies from doing certain things in the market, such as engaging in anti-competitive conduct and mergers. It is not about forcing companies to do certain things. In other words, competition law is essentially negative rather than positive in nature. This contrasts with say, an industry policy, which forces or requires licensees to perform certain things. A good example is the requirement as a licence condition that the FTNS licensees meet certain network roll-out targets.

Accordingly, the enforcement of competition law is also essentially negative in nature: action is taken to prevent conduct, not require the performance of conduct. For this reason, there are no enforcement remedies such as performance bonds in other 'authorisation' jurisdictions. If parties to an authorisation do things in breach of the terms of the authorisation (such as engage in anti-competitive conduct outside of its terms), they may be fined or the authorisation revoked. But they are not fined for non-performance of public benefits. That the benefits are likely to accrue has already been decided in the authorisation process.

The proposal also does not recognise that claims of public benefit made reasonably and in good faith (and deemed reasonable by the TA) may not always eventuate because of events outside of the merging parties control. It is in recognition of this fact that 'force majeure' is such an important principle in contract law.

It is clear that the imposition of performance bonds is totally inconsistent with competition law and its enforcement philosophy. A requirement to perform 'public benefits' and an imposition of remedies for non-performance should not be a part of Hong Kong's competition and merger law, including the draft Guidelines.

7. Procedures

Length of detailed investigations

It is indicated at paragraph 6.9 that the TA will be able to give consent to an application within one month in cases which do not raise serious competition issues and a further three months (ie, four months in all) when a detailed investigation is necessary.

At the meeting with OFTA on 18 September, OFTA indicated that it was the intention for the overall period for investigation to be three months (ie, only a further two months for detailed investigations). PCCW looks forward to confirmation of the three month total investigatory period.

Remedies

The draft Guidelines provide little guidance on the types of action that the TA considers necessary to take against a merger under section 7P(1)(b). Presently, the guidance on the types of action that may be taken simply makes a distinction between structural and behavioural remedies.

PCCW considers it important that greater guidance be provided in the interests of transparency and predictability. As mentioned at the outset, transparency is needed to limit agency discretion in the types of action that will be taken. Predictability is needed so that potential remedies can be factored in by business when making a decision about a merger.

PCCW has already requested that the TA first consider modifications to the merger under section 7P(4) (such as the implementation of a compliance and monitoring program) before considering action to block a merger under section7P(1)(b).

PCCW more generally requests that the section on remedies in the draft Guidelines be considerably expanded so as to provide the necessary guidance about the range of remedies that the TA intends to take in relation to a merger. PCCW further requests that the draft Guidelines prioritise the potential application of particular remedies (for example, behavioural remedies be implemented before structural remedies, the remedy of blocking a merger only as a last resort, etc).

8. Information requirements

The Annex to the draft Guidelines lists thirty categories of information that parties to a merger are required to provide when seeking prior consent. Some of the information requirements are excessively burdensome (for example, item 21 which requires, for each product and service of both the acquiring company and the target, information regarding close substitutes, market shares (including that of affiliates and the top five competitors) and estimated share of the business of the top five customers).

Some of the requirements involve the provision of extremely commercially sensitive or privileged information (for example, requests under item 15 for business plans for the current and previous two years). In some cases, some of the requirements are likely to be outside the knowledge of either the acquiring party or target, particularly in a hostile takeover environment (for example, item 9 which requires information on board members of the target who are also board members of any other telecommunications companies). Some of the information requested is purely speculative (for example, item 22(b) which requests information on the capital expenditure required to gain 5 per cent market share).

Importantly, some of the information is considered irrelevant to a competition assessment under section 7P (for example, the request under item 15 for business plans and the information requested in items 22(c), (d), (e), 25 and 26 under the category 'Motivation for the merger'). Other information (for example, item 22(a) should be well known to the TA.

Section 7P only embodies an 'effects' test (ie, an assessment of whether the merger will have the likely effect of substantially lessening competition). Unlike in some other merger jurisdictions (for example, Australia) and in sections 7K, 7L and 7N, there is no 'purpose' test in section 7P (ie, an assessment of whether the merger will have the likely purpose of substantially lessening competition). PCCW is unclear how information relating to the motives (that is, the purpose) of a merger is relevant an assessment of the effects of a merger.

PCCW considers that the information burden imposed on parties seeking clearance of a merger is excessive and inconsistent with the light-handed policy approach intended by the Government in relation to merger enforcement. Accordingly, PCCW would request that the information requested in the Annex to the draft Guidelines should be thoroughly reviewed in consultation with the parties who may be subject to such information requests.

It is not unlikely that these information provision requirements appear in the merger guidelines (if so, it would be useful to know which requests are from which guidelines and in which context). More importantly, it would be beneficial to consider whether these requests are relevant to the specific telecommunications markets in Hong Kong.

PCCW Limited
29 September 2003