Submission by

SmarTone Mobile Communications Limited

on

the Draft Merger Guidelines for

Hong Kong Telecommunications Markets

29 September 2003

1. Foreword

1.1 This paper sets out the comments of SmarTone Mobile Communications Limited ("SmarTone") on the Draft Merger Guidelines for Hong Kong Telecommunications Markets ("Guidelines") issued by OFTA on 4 August 2003.

1.2 Before going into the detailed comments of the Guideline, SmarTone would like to quote the following statements from a speech of the former Secretary for Commerce, Industry and Technology, Mr. Henry Tang, on the topic of "Hong Kong as an Asian Hub for doing Business":

> *"The Government's job is not to tell the businessmen how to do business. We would continue to promote a more business-friendly environment. Over the last few years, the Government has introduced over 300 measures to improve our services for the business sector through cutting red tape, eliminating over-regulation, and introducing new services. As an ex-businessmen who has years of experience tackling government bureaucracy from the private sector's point of view, I assure you that the momentum will not stop. Removing red tape will always come high on my agenda."* [1]

1.3 SmarTone strongly supports the above governance philosophy and spirit. To improve Hong Kong's competitive advantages and attractiveness as an Asian hub for doing business and investment, a light-handed regulatory approach and cutting red tape must be the primary and crucial policy objectives of the Government. This also echoes with the view of the Chief Executive in his Policy Address 2003 that Hong Kong should adopt a "Market-led Approach" for economic restructuring.

1.4 However, SmarTone is of the view that the current Guidelines have departed significantly from the above governance philosophy and spirit. The market definition and competition analysis set out in the Guidelines fail to provide adequate and practical guidance as to how the TA will apply the test in practice according to Hong Kong's telecommunications market environment. Hence the Guidelines would be subject to the wide discretionary power of the TA and fail to provide the industry and investors with a transparent and efficient regulatory regime. SmarTone submits that clarity and consistency in policy are fundamental and crucial for an effective regulatory environment and efficient operation of OFTA. However, the current Guidelines fail to achieve either one of these objectives. SmarTone is also of the view that the public benefit test, as a counterbalancing factor, is too stringent which would unreasonably deny a party from claiming public benefit in the M&A application and discourage M&A transaction with public benefit in the telecommunications sector. Furthermore, the information required under the M&A application form is also excessive which will put unnecessary burden on the applicants.

[1] A speech by the former Secretary for Commerce, Industry and Technology, Mr. Henry Tang, at a meeting of Hong Kong Institute of Arbitrators on 28 February 2003

1.5 SmarTone would like to submit its comments on the Guidelines according to the following structure:

- Section 2 – SmarTone's comments on sections 3 and 4 of the Guidelines (i.e., Market Definition and Competition Analysis).
- Section 3 – SmarTone's comments on section 5 of the Guidelines (i.e., Benefit to the Public).
- Section 4 - SmarTone's comments on section 6 of the Guidelines (i.e., Procedures).
- Section 5 – SmarTone's comments on the proposed application form for prior consent to a merger under section 7P(6) of the Telecommunications Ordinance.
- Section 6 - SmarTone's request for a second consultation for the draft merger guidelines.
- Section 7 – SmarTone is of the view that the finalized Guidelines should be subject to review from time to time to reflect the changes in the telecommunications market.

2. Market Definition and Competition Analysis

2.1 SmarTone appreciates the effort of OFTA in drafting the Guidelines which provide detailed information on the analytical framework which the TA intends to adopt to assess the competition effects of M&A. It is understood that the two key policy objectives of the Telecommunications (Amendment) Bill 2002 (the "Bill") are to provide a transparent and efficient regulatory regime governing M&A activities and to assist the industry in making informed decisions concerning such transactions which are of regulatory concern[2]. The past submissions on the Bill have strongly advocated for a regulatory framework that would provide certainty for M&A activities in the telecommunications industry. SmarTone strongly supports this objective and considers that the Guidelines should provide clear and objective guidance in detail on how the TA will apply the test in practice.

2.2 Unfortunately, SmarTone finds that some important areas of the Guidelines lack clarity and would be subject to wide interpretation at the TA's discretion. In particular, sections 3 and 4 of the Guidelines which sets out the TA's approach on market definition and competition analysis would require further deliberations and more specific guidance and examples. Consequently, the industry will have difficulties to make informed decision on M&A transaction with certainty based on

[2] "Legislative Council Brief – Telecommunications (Amendment) Bill 2002" issued by Information Technology and Broadcasting Bureau, 3 May 2002

the information provided in the Guidelines. The following areas of concern are highlighted for TA's consideration.

Market Definition

2.3 Section 3 of the Guidelines provides a lengthy and rather academic elaboration on the factors that will be taken into account by the TA in defining the relevant market for a particular M&A transaction. While SmarTone admits that the approach described in this section is also generally adopted by M&A regulatory bodies in other jurisdictions, it is considered that there is little practical and specific guidance available to Hong Kong's telecommunications industry. Unlike other jurisdictions in which M&A regulation is applied across the economy, Hong Kong adopts a sector specific approach which only governs M&A activities of the carrier licensees in the telecommunications sector. The Guidelines should therefore be able to provide some specific views of the TA on the market definition of some major telecommunications markets in Hong Kong so that the industry can have a better understanding on the likely market definition that will be adopted by the TA in his assessment for M&A activities.

Substantiality Test

2.4 Under Section 7P of the Telecommunications Ordinance, the TA is required to form an opinion as to whether any merger or acquisition has, or is likely to have, the effect of substantially lessening competition in a telecommunications market. It is therefore an important issue for the industry to understand what would constitute to "substantially lessening competition". It is noted that sections 4.8 to 4.15 of the Guidelines deal with the test of substantiality.

2.5 Section 4.9 suggests that *de minimus* situations, such as the day-to-day injury to competitors where there are barely any discernable effects on the competitive process, are not being regarded as "substantially lessening competition". Section 4.10 then explain that "beyond distinguishing the de minimus situations, the TA will interpret a substantial lessening of competition in terms of the creation or enhancement of market power". Section 4.11 then goes on to elaborate what is "market power", which states that "The antithesis of competition in a market is market power. Instead of firms constraining each other, there is a firm that is unilaterally (or a group of firms in co-ordination) not constrained by other firms in its (or their) ability to increase its price above competitive levels for a significant period of time".

2.6 The above description does not provide adequate guidance on the concept of substantiality. The only clear point being that *de minimus* situations are not areas of concern. The industry would need to be provided with more guidance on situations which is neither *de minimus* nor substantial. SmarTone believes that most of the M&A activities will fall into this mid-way category. However, the Guidelines only

state that the TA will consider whether a merger creates or enhances market power as a factor in assessing whether a merger substantially lessens competition.

2.7 SmarTone considers that such a wide interpretation of the term "substantially lessening competition" is problematic. There is no appreciation on the magnitude of the market power created or enhanced by the merger. Does the test under section 7(P) prohibits the creation or enhancement of **any** market power? If the answer to the above question is positive, it would mean that the test is very restrictive in that only the *de minimus* situations will be approved. SmarTone believes that a merger that creates or enhances merely a minimal level of market power of the merged companies or other companies in the market may not necessarily mean that competition in the market is substantially lessened. Market power may be created or enhanced through the normal competition process. The term "substantially" in itself requires the TA to look at the degree or extent to which competition is lessened as a result of the merger. Accordingly only merger which has a substantial effect on the competition of a market should be prohibited.

2.8 Sections 4.13 to 4.15 of the Guidelines states that the current approach proposed in the guideline is in line with that of the other jurisdictions, such as US, EU and Australia. However, SmarTone wishes to point out that the merger regulations and guidelines in these overseas jurisdictions are applicable to all sectors of the economy, which justify a more general and wider approach when dealing with a wide range of M&A transactions across different sectors of the economy. However, the M&A regulatory framework in Hong Kong only governs M&A activities of carrier licensees in the Hong Kong telecommunications market. The small size of the Hong Kong market and the scope of the regulation which is specific to the telecommunications sector only warrant the Guidelines to provide more practical and precise guidance as compared to the overseas merger guidelines.

<u>Removal of a "vigorous and effective competitor"</u>

2.9 As previously submitted by SmarTone in its response to the "Explanatory Note on the Guidelines on the Competition Analysis of Mergers and Acquisitions in Telecommunications Markets" issued by the Government, it is necessary to have a clear definition of the term "vigorous and effective competitor" for the purpose of Section 7P of the Telecommunications Ordinance. The term "vigorous and effective competitor" is rather general and it can be easily inferred that, in a competitive market, any serious and substantive player is a vigorous and effective competitor. It follows that any horizontal merger or acquisition in a fiercely competitive market such as the mobile market could be inferred as a removal of a vigorous and effective competitor. SmarTone believes that it is not the intention of the TA to apply the factor in such a broad sense and therefore requests the Guidelines to provide a clear definition and preferably with more examples to illustrate this factor, otherwise the ambiguity of the term will create a lot of uncertainties.

Barriers to entry

2.10 Sections 4.34 to 4.47 of the Guidelines give a detailed account of the factor "barriers to entry", which is considered as an important structural factor influencing the level of competition in a market. However, SmarTone notes that these sections have only described the general factors that would affect the height of barriers to entry without much regard to the market situation in Hong Kong. Since Hong Kong has fully liberalized most of its telecommunications market and OFTA has introduced measures such as the open network access requirement for MVNOs in the mobile market, it is expected that the height of barriers to entry in most telecommunications market should be relatively low and therefore this factor may not be as fundamental as in other jurisdictions.

3. **Public Benefit Test**

3.1 Section 5 of the Guidelines deals with the factor of public benefit which acts as a counterbalancing factor in the TA's analysis. While it is believed that the original intention of specifying the term "a benefit to the public" in the legislation have a wider meaning than "a benefit to the consumer", SmarTone notes that the only example of public benefit given in the section is consumer benefits, such as lower prices, more innovations, wider choices, better quality of services and continuity of services. SmarTone considers that the Guidelines should give more examples of public benefit which should cover benefits to the society and economy in general.

3.2 Reference may be made to the Australian Merger Guideline issued by the Australian Competition and Consumer Commission ("ACCC") which states the following:

> *"The concept of a benefit to the public is not limited to a benefit to consumers, a benefit to a private party which is of value to the community generally is a public benefit".*[3]
>
> *"For example, a merger may result in economies of scale or other resource savings which may not be immediately available to consumers in lower prices. However, the community at large has an interest in resource savings, releasing those resources for use elsewhere."*[4]

3.3 The Australian Competition Tribunal has also suggested that the term public benefit should be given its widest possible meaning – "*anything of value to the community generally, any contribution to the aims pursued by society including as one of its principle elements … the achievement of the economic goals of efficiency and progress*".[5]

[3] Australian Merger Guidelines, Section 6.42
[4] Australian Merger Guidelines, Section 6.43
[5] Australian Merger Guidelines, Section 6.30

3.4 In particular, the ACCC has stated in its Merger Guideline the following matters which could constitute public benefits[6]:

- *economic development, e.g. in natural resources, through encouragement of exploration, research and capital investment;*
- *fostering business efficiency, especially where this results in improved international competitiveness;*
- *industrial rationalisation resulting in more efficient allocation of resources and in lower or contained unit production costs;*
- *expansion of employment or prevention of unemployment in efficient industries and employment growth in particular regions;*
- *industrial harmony;*
- *assistance to efficient small businesses, such as guidance on costing and pricing or marketing initiatives which promote competitiveness;*
- *improvement in the quality and safety of goods and services and expansion of consumer choice;*
- *supply of better information to consumers and businesses to permit informed choices in their dealings;*
- *promotion of equitable dealings in the market;*
- *promotion of industry cost savings resulting in contained or lower prices at all levels in the supply chain;*
- *development of import replacements;*
- *growth in export markets;*
- *steps to protect the environment.*

3.5 This section also requires any claim of public benefit to be substantiated with detailed and verifiable evidence. The Guidelines suggests that the party claiming public benefit should bear the burden of proof that the benefit will be realized. Furthermore, the party claiming public benefit may be required to make guarantee by way of performance bonds and modification of licence condition where the TA considers it necessary and appropriate.

3.6 Firstly, SmarTone wishes to point out that it is often difficult and almost impossible to measure public benefits in precise quantitative terms. The requirement of providing detailed and verifiable evidence to substantiate public benefit would be very difficult, if not impossible. SmarTone considers that, since what the legislation required is "*the Authority is satisfied that the change has, **or is likely to have**, a benefit to the public*", a claim of public benefit should be accepted if operators can

[6] Australian Merger Guidelines, Section 6.38

establish, to a reasonable standard, that public benefit will be realized after merger. Of course, if more evidence and factual information could be provided by the applicant to support the claimed public benefit, more weight would be given by the TA.

3.7 Secondly, SmarTone is concerned that party claiming public benefits may be required to provide guarantee by way of a performance bond or modification of licence condition. Operator will be subject to great risk and uncertainties if it is obliged to meet certain target of public benefit which is out of its control. For example, public benefits such as fostering economic development and preventing unemployment could be affected by local and overseas economic and political environment which is totally out of the control of the operator. In fact, SmarTone is not aware of any international precedent which requires party claiming public benefit in merger application to guarantee the claim by performance bond or licence condition. These are substantive requirements failing which the operator will be subject to financial penalty or even cancellation of licence. SmarTone considers that such a stringent requirement will unreasonably deny any party claiming public benefit for M&A application and hence discouraging M&A transactions which have public benefit.

3.8 Lastly, SmarTone wishes to comment on the burden of proof issue. It is noted that for the counterbalancing factors such as public benefit and efficiency gain, the Guidelines state that "the TA will put the onus on the parties to the merger to provide convincing evidence that the claim benefit or gain will come to fruition". While it is reasonable to require the parties claiming the benefit to provide information to substantiate their claim, the TA should conduct investigation which he considers necessary to review the information provided by the parties so as to form his opinion under section 7P(1). SmarTone believes that it is the duty of the TA to consider the representations made by the parties to the merger on claims of public benefits or efficiency gain and to decide whether such claim is substantiated or not.

4. Procedure

4.1 SmarTone is pleased to receive the clarification from OFTA that the maximum length of the investigation period for prior approval (complicated case) as stated in section 6.9 of the Guidelines should be 3 months instead of 1 plus 3 months. SmarTone requests the Guidelines to be amended in this section accordingly.

4.2 SmarTone also wishes that the Guidelines could provide details about the OFTA's normal workflow during the investigation period for both prior consent and ex post cases.

4.3 Section 6.10 states that "*within 2 weeks after the transaction has been publicly announced or made known to the TA, the parties will be notified if the TA wishes to carry out a detailed investigation*". SmarTone believes that this section corresponds

to Section 7(P)(2) of the Telecommunications Ordinance which states that "*an investigation under subsection (1)(a) may only be commenced within 2 weeks after the Authority knows or ought reasonably to have known (whichever is the earlier) that* ***the change has occurred"*** *(with emphasis added).* To avoid confusion as to the commencement of the two weeks period for the ex post case, SmarTone proposes that section 6.10 should be amended to reflect the principle in Section 7(P)(2) of the Telecommunications Ordinance.

4.4 Confidentiality – Section 6.23 suggests that in some occasions the TA may need to publish submission received from a merger investigation. SmarTone considers that the Guidelines should make clear that if the TA considers it is necessary to publish party's submission (or part of it), the party's prior consent should be obtained.

5. Draft M&A application form

5.1 SmarTone is concerned about the extensive scope of information required by the draft application form. Some of the information requested is considered excessive and unnecessary for the M&A review process. Most importantly, such requirements are contrary to the lighted-hand regulatory approach and will impose heavy burden on the applicants.

5.2 Under item 8 of the form, parties to the merger are required to list all the other companies in the telecommunications sector in which either of them hold more than 5% of the voting rights, issued share capital or other securities. However, since section 7P is only applicable to carrier licensee, SmarTone submits that the information to be provided under item 8 should be related to other carrier licensees only, instead of all other companies in the telecommunications sector (which may include non-carrier licensees or even non-licensees). The same issue appears in items 9, 10, 19, 21(b) & 23 of the form.

5.3 Item 26 requires the applicants to submit any copies of analyses, reports, studies and surveys which are prepared internally for the applicants or the applicants' shareholder for the purpose of analyzing the proposed merger. SmarTone is concerned that the scope of information requested under this section is excessive, unnecessary and most likely involve sensitive commercial information. The applicant should have the absolute discretion in deciding what information is required for submission in order to substantiate the application. There is no justification for OFTA to obtain copies of all internal documents related to the merger other than unnecessarily complicates the process.

5.4 Item 15 requires applicant to provide business plans for the acquiring company and the target for the current and two previous years. SmarTone questions the relevancy of the business plans for previous years in assisting the TA in its assessment of the M&A application. SmarTone considers that the provision of the most recent annual report should serve the purpose.

5.5 Under items 21 (c) and (d), applicants are required to provide information (name and contact details) about the acquiring company's and the target's top five customers and top five competitors. SmarTone would like to seek clarification as to what constitute "top five" and what is the purpose of obtaining the contact details of customers and competitors. SmarTone wishes to point out that the applicants may not have information related to its competitors, such as the contact details and market share. Furthermore, if the purpose of obtaining the contact information of the applicants' customers is for the TA to contact the customers for obtaining information or interview, such action would inevitably cause disturbance to the customers, who have no obligation or responsibility to provide information to the TA. SmarTone is also concerned that the provision of personal contact details of the applicants' customers and competitors may be a breach of the Personal Data (Privacy) Ordinance unless prior consent has been obtained.

5.6 Under items 22 (b) & (c), applicants are required to provide an estimation of capital expenditure and annual expenditure on advertising/promotion to achieve 5% market share of the market. It will be difficult to provide correct estimation as these costs could vary significantly depending on the technology used and the strategy adopted by each company. Most importantly, the estimation depends crucially on competitor behaviour. To achieve any market share usually has very little, if at all any, relationship to capital expenditure and expenditure on advertising/promotion. The estimated figure would be meaningless and misleading.

5.7 SmarTone would like to seek clarification on item 17 as to what constitutes to "exchange of contracts".

5.8 SmarTone would like to seek clarification on item 19 as to what is the meaning of "each product or service" and the level of detail/segmentation expected under this head. For example, service package which comprises of a number of value-added services is generally regarded as one service although it may be sub-divided into a large number of services. The level of details required will have direct implication to the information requested under item 21. SmarTone is concerned that if services are required to be defined in very small segments, it will put an unnecessary and substantial burden on the applicants in providing information for the application.

6. Request for second consultation of the draft merger guidelines

6.1 It has always been SmarTone's view that the merger guidelines are the crux of the M&A regulation. The merger guidelines therefore warrant a detailed deliberation by the industry. As pointed out in this submission, there are a number of areas in the Guidelines that require amendments and clarifications. SmarTone therefore requests the TA to conduct a second round of consultation on the revised draft merger guidelines after this consultation so that the industry has another opportunity to make representation on the revised draft merger guidelines.

7. Review of the Merger Guidelines

7.1 Since the telecommunications market is constantly evolving given the rapid technology development in the industry, SmarTone considers that the Guidelines, after its finalization, should be subject to review from time to time. Any change to the Guidelines should be subject to thorough consultation exercise.