For discussion

Bills Committee on
Competition Bill

Guidelines on the First Conduct Rule

Purpose

This paper sets out the key topics and contents which could be covered in the guidelines on the first conduct rule with a view facilitating Members' scrutiny of Part 2 of the Competition Bill ("the Bill").

Role of regulatory guidelines

2. Under the Bill, it is a statutory requirement for the future Competition Commission (the Commission) to issue guidelines indicating the manner in which the Commission expects to interpret and give effect to the conduct rules. The Bill also requires the Commission to consult any persons the Commission considers appropriate before issuing any such guidelines or amendments to them.

3. As Clause 1 of the Bill allows a phased commencement of different parts of the Ordinance, our plan is to first set up the Commission which will conduct consultation and prepare the guidelines, after the passage of the Bill and before the prohibitions come into force. During this transitional period, stakeholders, particularly the business community, can better understand the new law, put in place compliance and training programmes and make adjustments to their business practice as necessary.

4. The Administration notes Members' request for details on the interpretation and implementation of the proposed conduct rules during the scrutiny of the Bill. To address Members' concern, we have prepared information at **Annex** on the prohibition imposed by Clause 6(1) of the Bill (which is referred to in the Bill as "the first conduct rule") with reference to the guidelines developed in other jurisdictions.

5. The document explains the elements of the first conduct rule, clarifies key concepts involved and provides examples of conduct that could infringe the first conduct rule. The document is drawn up on the basis of the provisions in the Bill as currently drafted and are subject to changes

when there are amendments to the statutory language arising from the deliberations of the Bill at the Bills Committee.

6. It should be noted that the document is prepared on a provisional basis. It serves merely as an indication of the topics that future guidelines on the first conduct rule might address. The actual guidelines can only be prepared after consultation with relevant stakeholders. It therefore remains the Commission's duty, which should not be construed as having been affected by the document in any way, to draw up, consult on and issue its guidelines after the passage of the Bill.

Advice sought

7. Members are invited to note the contents of the paper.

Commerce and Economic Development Bureau
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Annex

1 SCOPE OF THE FIRST CONDUCT RULE

1.1 Clause 6(1) of the Bill provides that an undertaking must not -

(a) make or give effect to an agreement;

(b) engage in a concerted practice; or

(c) as a member of an association of undertakings, make or give effect to a decision of the association,

if the object or effect of the agreement, concerted practice or decision is to prevent, restrict or distort competition in Hong Kong.

1.2 Clause 6(2) of the Bill provides an illustrative list of such agreements, concerted practices or decisions which -

(a) directly or indirectly fix purchase or selling prices or any other trading conditions;

(b) limit or control production, markets, technical development or investment; or

(c) share markets or sources of supply.

1.3 In terms of geographical application, Clause 8 of the Bill provides that the first conduct rule applies to an agreement, concerted practice or decision that has the object or effect of preventing, restricting or distorting competition **in Hong Kong** even if —

(a) the agreement or decision is made or given effect to outside Hong Kong;

(b) the concerted practice is engaged in outside Hong Kong;

(c) any party to the agreement or concerted practice is outside Hong Kong; or

(d) any undertaking or association of undertakings giving effect to a decision is outside Hong Kong.

1.4 An agreement[1] will not be prohibited if it falls within the general exclusions in Schedule 1 to the Bill or meets all the requirements specified in a block exemption order issued by the Commission under Clause 15 of the Bill or meets all the requirements specified in an order made by the Chief Executive in Council under Clause 31 or Clause 32 of the Bill.

2 TERMS USED IN THE FIRST CONDUCT RULE

Undertaking

2.1 Undertaking means any entity, regardless of its legal status or the way in which it is financed, engaged in economic activity and includes a natural person engaged in economic activity. Undertakings could be companies, partnerships, individuals operating as sole traders, co-operatives, societies, business chambers, trade associations and non profit-making organisations.

2.2 The key consideration in assessing whether an entity is an undertaking is whether it is engaged in economic activities. The term "economic activity" is a broad term that refers to any activity consisting in offering goods or services on a market and which could, at least in principle, be carried on to make profits. An entity may engage in economic activity in some of its functions but not others.

2.3 The first conduct rule only applies to agreements between **two or more** separate undertakings. The first conduct rule does not apply to agreements where there is only one undertaking, that is, between entities which form a single economic unit. Whether or not the entities form a single economic unit would depend on the facts of each case. However, generally, if undertaking A has a high degree of operational and financial control over another undertaking B, A and B are likely to be considered as a single economic unit. In particular, an agreement between a parent company and its subsidiary company, or between two companies which are under the control of a third company, will not be agreements between undertakings if the subsidiary has no real freedom to determine its course of action in the market and, although having a separate legal personality, enjoys no economic independence.

[1] Unless the context otherwise suggests, the term "an agreement" in the document is to be read as "an agreement, a concerted practice and a decision by an association of undertakings" (but with any necessary modifications).

Agreement

2.4 "Agreement" has a wide meaning and includes both legally enforceable and non-enforceable agreements, whether written or oral; it includes so-called gentlemen's agreements. There does not have to be a physical meeting of the undertakings for an agreement to be reached: an exchange of letters or telephone calls may suffice. Generally, all that is required is that undertakings arrive at a consensus on the actions that each undertaking will or will not take.

2.5 The fact that -

- an undertaking may have played only a limited part in the setting up of the agreement; or
- may not be fully committed to its implementation; or
- may only have participated under pressure from other undertakings,

does not mean that that undertaking is not a party to the agreement (although these factors may be taken into account in deciding the level of any sanction).

Vertical Agreement

In respect of "vertical agreement", it is expected that the first conduct rule will be applied in a much more limited fashion. A vertical agreement is an agreement made by two or more undertakings, each operating (for the purposes of the agreement) at a different level of the production or distribution chain. For instance, where undertaking A produces raw material, and undertaking B uses raw material acquired from A as an input, A and B are in a vertical supply relationship.

Generally, a vertical agreement should be viewed simply as a legitimate way of influencing how a supplier's product is distributed and marketed. A supplier competing with other suppliers generally has no incentive to use a distribution or marketing strategy that makes its product less attractive to consumers than its competitors' products. Restricting a supplier's vertical supply chain (restrictions on intra-brand competition) can have positive benefits for competition between different brands (inter-brand competition) by promoting inter-brand competition, for example, improved quality of service.

If a supplier instead was vertically integrated (i.e. it has its own retail shops rather than relied on independent retailers), its conduct between the wholesale and retail levels would be internalised within the supplier's own business organisation and there usually would be no competition concerns about that conduct. A supplier which chooses not to be vertically integrated and to distribute its services and goods through contract-based vertical supply arrangements should not face a materially higher burden under competition law. To do otherwise could distort how businesses organise themselves in markets.

However, there are two situations where vertical arrangements may give rise to some competitive concerns. First, a supplier with a substantial degree of market power in a market could use a vertical agreement to limit access to the market by competing suppliers. Second, a vertical supply arrangement may, in effect, be the means by which direct competitors agree to limit competition between them.

We expect that the Commission would consult the stakeholders and the public on how vertical agreements should be dealt with under the first conduct rule. The Commission could deal with vertical agreements through the guidelines on the first conduct rule. Alternatively, the Commission could issue a block exemption order to exempt vertical agreements from the application of the first conduct rule in light of their pro-competitive effects, and to impose appropriate conditions or limitations given the possible competitive concerns arising from certain types of vertical agreements and given the circumstances in Hong Kong.

Concerted Practices

2.6 A concerted practice may exist where there is informal cooperation between competitors, without any formal agreement or decision. A concerted practice would be found to exist if parties, even if they did not enter into an agreement, knowingly substituted the risks of competition with co-operation between them.

2.7 However, just because competitors are engaged in similar or parallel behaviour does not mean that they are involved in a "concerted practice". Often it will show quite the opposite. If a market is highly competitive, it would be expected that competitors have no choice but to respond to each other's moves in the market. For example, if one competitor drops its prices, other competitors may quickly follow its lead otherwise customers will buy from the competitor who dropped its prices first.

2.8 It is therefore important to consider any particular conduct within the overall economic context. The following are examples of factors that the Commission may consider in establishing if a concerted practice exists -

- whether the parties knowingly entered into practical co-operation;
- whether behaviour in the market is influenced as a result of direct or indirect contact between undertakings;
- whether parallel behaviour results from contact between undertakings leading to conditions of competition which do not correspond to normal conditions of the market;
- whether the structure of the relevant market and the nature of the product involved are favourable to collusion. For example, whether there are only a few undertakings in the market and whether the undertakings in the market have similar outputs.

Decisions by Associations of Undertakings

2.9 Trade associations are the most common form of association of undertakings but the provisions are not limited to any particular type of association. The members of trade associations are usually direct competitors against each other.

2.10 Trade and other associations generally carry out legitimate functions intended to promote the competitiveness of their industry sectors. A decision by an association may include -

- the constitution or rules of an association;
- resolutions or binding decisions of the management committee of the association;
- resolutions of the full membership of the association during a general meeting;
- rulings of the chief executive of the association; and
- recommendations.

2.11 Trade associations have continued to function effectively to the benefit of their members in jurisdictions which have had competition laws for many years. The key consideration is whether the object or effect of the decision, whatever form it takes, is to influence the conduct or co-ordinate the activity of members in some commercial matter. An association's coordination of its members' conduct in accordance with its constitution may also be a decision even if its recommendations are not binding on its members, and may not have been fully complied with. It will be a question of fact in each case whether an association of undertakings is itself a party to an agreement.

3 OBJECT OR EFFECT TO PREVENT, RESTRICT OR DISTORT COMPETITION

3.1 The first conduct rule applies where the object or effect of the agreement is to prevent, restrict or distort competition in Hong Kong. Many agreements between undertakings in the economy might be said to restrict the freedom of action of the parties. That does not, however, necessarily mean that all such agreements are prohibited.

3.2. Once the Commission has established that undertakings have made an agreement, it must consider if the agreement was made with the object or effect of preventing, restricting or distorting competition.

The "object" test

3.3 "Object" refers to the objective purpose of the agreement considered in the economic context in which it is to be applied, and means not the subjective intention of the parties when entering into the agreement.

3.4 The Commission must identify the object which was sought to be achieved by the relevant agreement. The assessment of whether an agreement has the object of restricting competition requires the agreement to be viewed within its economic context. An important consideration will be any evidence found in records of meetings between the undertakings. The undertakings usually will not have expressed the object of the arrangement neatly, or expressly acknowledged that their intention was to act anti-competitively. More usually they will have expressed the end they have in mind more generally, such as acquiring any spare manufacturing capacity in the market to avoid "ruinous price competition" (i.e. keeping prices high) or to ensure "an orderly market" (i.e. keeping out additional competitors).

3.5 In practice, it usually will be necessary to infer the object from the facts underlying the agreement and the specific circumstances in which it will operate or does operate (c.f. Clause 7(2) of the Bill). These surrounding circumstances may indicate that the agreement has an anti-competitive object even though the formal agreement does not contain an express provision to that effect or the evidence is ambiguous about the object the undertakings had in mind.

3.6 If an agreement has more than one object, it will breach the first conduct rule if one of its objects is to prevent, restrict or distort competition (c.f. Clause 7(1) of the Bill).

3.7. Where an agreement has as its object to prevent, restrict or distort competition in Hong Kong, it is not necessary for the Commission to prove that the agreement would have an anti-competitive effect in order to find an infringement of the first conduct rule. Nevertheless, the restriction of competition must be appreciable. If an agreement having an anti-competitive object would be likely to have only a minimal effect on competition if it were carried out, then the first conduct rule may be held not to apply. More details on appreciable adverse impact on competition are discussed below.

The "effect" test

3.8 If an agreement does not have an anti-competitive object, it will nevertheless infringe the first conduct rule if it has an appreciable anti-competitive effect.

3.9 In assessing whether conduct resulted in the effect of preventing, restricting or distorting competition, the Commission will consider whether there has been an appreciable adverse effect on competition in the relevant market. One way of doing this is by assessing what the market conditions would most likely have been, in the absence of the conduct (i.e. the counter-factual) and comparing these anticipated market conditions with the conditions resulting where the conduct is present (i.e. the factual). The Commission will assess the effects of specified conduct on a case-by-case basis in the light of available evidence.

3.10 By way of example, prohibited effects might include:

- anti-competitive foreclosure of competitors;
- raising of barriers to entry; and

- withdrawal of products or services from the market or a reduction in the quality of the services offered.

3.11 Importantly, for an effect to be detrimental to competition, it must harm the processes of competition, or the consumers of products, and not simply be damage to an individual competitor. Competition by its own nature is a robust process. Consumers benefit when competitors have strong incentives to win the competitive battle against its competitors. In a highly competitive market, individual competitors inevitably will enter and leave the market over time as they take their chances and as they fail. The Bill instead is concerned with the health of the process of competition.

3.12 The effect on competition must be more than minimal. An agreement must have appreciable adverse effect before the Commission will be concerned.

Appreciable Impact on Competition Test

As explained in our previous written responses to the Bills Committee, case laws and regulatory guidelines available in other major competition jurisdictions suggest that a competition law should only catch conduct which has an appreciable adverse impact on competition. An agreement will fall within the scope of the first conduct rule if it has as its object or effect the appreciable adverse impact on competition. Indeed, the notion of appreciable impact forms part and parcel of the "de minimis" principle.

The "de minimis" principle applies to both agreements whose object and agreements whose effect is to restrict, prevent or distort competition. Agreements below the pre-determined thresholds of the "de minimis" arrangements are generally considered not to have as their object or effect an appreciable adverse impact on competition. However, some forms of conduct between the competitors are so inimical to the process of competition that they are usually carved out from the "de minimis" arrangements in other jurisdictions. These types of conduct are typically labelled as "hardcore" conduct. Examples of such hardcore conduct include price-fixing, bid-rigging, market sharing or output limitations, which will be discussed in section 5 below.

We note Members' views and comments raised at previous Bills Committee meetings on the "de minimis" arrangements for Hong Kong (such as the level of thresholds and whether the thresholds should be provided in the Bill). We will brief Members on the way forward in relation to the "de minimis" arrangements in due course.

4 EXAMPLES OF AGREEMENTS THAT MAY INFRINGE THE FIRST CONDUCT RULE

4.1 This part contains a discussion of the various types of agreements which might adversely affect competition appreciably.

4.2 Clause 6(2) of the Bill specifies three types of conduct (i.e price fixing, output control and market allocation) that may constitute a breach of the first conduct rule. Apart from those types of conduct, there will be other agreements which are prohibited because of their particular conditions or restrictions. The facts and circumstances of each case and all elements of the first conduct rule will need to be considered. There are no automatic breaches of the first conduct rule in Hong Kong, unlike in some other jurisdictions. The following is a non-exhaustive list of examples of conduct that may breach the first conduct rule, depending on the circumstances -

- Directly or indirectly fixing prices;
- Bid-rigging (collusive tendering);
- Sharing markets;
- Limiting or controlling production or investment;
- Fixing trading conditions;
- Joint purchasing or selling;
- Sharing information;
- Exchanging price information;
- Exchanging non-price information;
- Restricting advertising;
- Setting technical or design standards;
- Terms of membership and certification

Directly or Indirectly Fixing Prices

4.3 There are many ways in which prices can be fixed. It may involve fixing either the price itself or the components of a price such as a discount, establishing the amount or percentage by which prices are to be increased, or establishing a range outside which prices are not to move.

4.4 Price-fixing may also take the form of an agreement to restrict price competition. This may include, for example, an agreement to adhere to published price lists or not to quote a price without consulting potential competitors, or not to charge less than any other price in the market. An agreement may restrict price competition even if it does not entirely eliminate it. Competition may, for example, be restricted despite the ability to grant discounts or special deals on a published list price or ruling price (i.e. last recorded sale price).

4.5 Recommendations of a trade association in relation to price, or collective price-fixing or price co-ordination of any product may be considered to be price-fixing, regardless of the form it takes. This could include any recommendation on prices and charges, including discounts and allowances.

4.6 An agreement may also fix prices by indirectly affecting the prices to be charged. It may cover the discounts or allowances to be granted, transport charges, payments for additional services, credit terms or the terms of guarantees, for example. The agreement may relate to specific charges or allowances or to the ranges within which they fall or to the formulae by which prices or ancillary terms are to be calculated.

4.7 Agreements that have the object to fix or effect of fixing prices of any product will, by their very nature, be regarded as restricting competition appreciably.

Bid-rigging

4.8 Tendering procedures are designed to provide competition in areas where it might otherwise be absent. An essential feature of the system is that tenderers prepare and submit bids independently.

4.9 Bid rigging occurs when two or more undertakings agree that they would not compete genuinely with each other for particular tenders, allowing one of the participants in the agreement to "win" the tender. Participants may take turns to be the winner. Examples of bid rigging that may be illegal include conduct by tenderers to -

- agree to submit higher prices than the business that has been chosen to win;

- submit a tender containing terms that will be unacceptable; or

- agree not to tender or withdraw their tender.

4.10 Any tenders submitted as a result of collusion or co-operation between tenderers (such as described above) will, by their very nature, be regarded as restricting competition appreciably.

4.11 Bid rigging can also occur in circumstances where the bidders do not directly agree in advance on a "winner" but take actions which reduces the competitive tension in the bidding process (e.g. winner reimburses other bidder's bid costs; bidders agreeing on maximum or mimimum bidding prices).

Agreements to Share Markets

4.12 Market sharing refers to agreements between undertakings that divide up the market so that the undertakings are "sheltered" from competition. For instance, participating undertakings may agree not to -

- compete in the production of each other's goods;

- sell in each other's geographic "territories";

- solicit or sell to each other's customers; or

- expand into a market in which another participant is an actual or potential rival.

4.13 Undertakings may agree to share markets, whether by territory, type or size of customer, or in some other ways. This may be as well as or instead of agreeing on the prices to be charged, especially where the product is reasonably standardised. Such agreements will, by their very nature, be regarded as restricting competition appreciably.

Agreements to Limit Output or Control Production or Investment

4.14 Output controls can occur in the form of production or sales quota arrangements which involve agreements between undertakings to limit the

volume or type of particular goods or services available on the market.

4.15 Competitive pressures may be reduced if undertakings in an industry agree to limit or at least to coordinate future investment plans.

Agreements to Fix Trading Conditions

4.16 Undertakings may agree to regulate the terms and conditions on which products are to be supplied. If an association imposes on its members an obligation to use common terms and conditions of sale or purchase, this may restrict competition.

4.17 Associations may also be involved in the formulation of standard terms and conditions to be applied by members. Depending on the facts of the case, this may be no more than a useful simplification of what might otherwise be complex and, to the buyer, potentially confusing conditions. Standard conditions are less likely to have an appreciable adverse impact on competition where members remain free to adopt different conditions if they wish.

Joint Purchasing/Selling

4.18 Joint purchasing agreements are often concluded by small and medium-sized enterprises to achieve volumes and discounts similar to their bigger competitors. Competitors grouping together to exercise more leverage against sellers generally should not be regarded as adversely affecting competition because this conduct usually results in lower prices and better conditions of purchase. In particular, agreements between small and medium-sized enterprises to allow them to obtain favourable buying conditions matching their much larger competitors in the market will normally give rise to no concerns under the Bill.

4.19 However, the cooperation of competing purchasers through a joint purchase agreement can create buying power if the purchasing agreement accounts for a sufficiently large portion of the total volume of a purchasing market. There will be a concern on the impact on competition if the purchasers to the joint purchasing agreement are exercising the buying power to foreclose competitors or to raise rivals' costs. An example is to limit the access of competing buyers (i.e. competitors which are not part of the buying group) to suppliers.

4.20 There will also be a concern on the impact on competition where joint selling agreements are, in substance, agreements to restrain competition between the parties. For example, joint selling agreements to coordinate

pricing policies of participating undertakings will eliminate price competition between the parties. .

Information Sharing

4.21 As a general principle, the more informed buyers are, the more effective competition is likely to be and so making information publicly available to buyers does not usually harm competition.

4.22 In the normal course of business, undertakings exchange information on a variety of matters legitimately and with no risk to the competitive process. Indeed, competition may be enhanced by the sharing of information, for example, on new technologies or market opportunities, particularly where consumers are also informed.

4.23 Generally, there is no objection to the exchange of information between competitors or the exchange of information under the aegis of a trade association or otherwise.

4.24 On the other hand, competitive pressure in a market is often driven by uncertainty amongst competitors about how each other proposes to compete and their likely responses to each other. The exchange of information may have an appreciable adverse impact on competition, where it serves to reduce or remove uncertainties inherent in the process of competition. The fact that the information could have been obtained from other sources is not necessarily relevant – it is the process of exchange directly between competitors which builds up a level of predictability and certainty between them. Whether or not an exchange of information has an appreciable adverse impact on competition will depend on the circumstances of each individual case: the market characteristics, the type of information and the way in which it is exchanged. As a general principle, it is more likely that there would be an appreciable adverse impact on competition the smaller the number of undertakings operating in the market, the more frequent the exchange, the more sensitive and confidential the nature of the information that is exchanged, and where access to information exchanged is limited to certain participating undertakings to the exclusion of their competitors and buyers.

Exchange of Price Information

4.25 The exchange of information on prices is usually of more concern because it may lead to price co-ordination and therefore diminish competition, which would otherwise be present between the undertakings. This will be the case whether the information exchanged relates directly to the prices

charged or to the elements of a pricing policy, for example, discounts, costs, terms of trade and rates and dates of change. A price announcement made in advance to competitors may be anti-competitive where it facilitates collusion. Price announcements made directly to buyers, on the other hand, may be pro-competitive.

4.26 The more recent or current the information exchanged, the more likely that exchange could have an appreciable adverse impact on competition. There is unlikely an appreciable adverse effect on competition where the exchange forms part of a structured scheme of inter-business comparison intended to spread best industrial practices such as in a benchmarking exercise, where the information is collected and disseminated by an independent body. Exchanges of purely historical information that is aggregated, and which cannot be disaggregated is also unlikely to have an appreciable adverse impact on competition.

Exchange of Non-Price Information

4.27 The exchange of information on matters other than price may have an appreciable adverse impact on competition depending on the type of information exchanged and the structure of the market to which it relates. For example, the exchange of historical, aggregated statistical data, market research, and general industry studies are unlikely to have an appreciable adverse impact on competition, since the exchange of such information is unlikely to reduce individual undertakings' commercial and competitive independence.

4.28 In general, the exchange of information on output and sales should not affect competition provided that it is aggregated and historical. Even if it enables participants to identify individual undertakings' competitive behaviour, if it is sufficiently historic, it would be unlikely that an agreement to exchange such information would influence the participants' competitive market behaviour. There may however be an appreciable adverse impact on competition if the information exchanged is current or recent, or concerns future plans, and if it can be ascribed to particular undertakings, whether because it is broken down in this way or because it can be disaggregated.

Advertising

4.29 Restrictions on advertising, whether relating to the amount, nature or form of advertising, have the potential to restrict competition. Whether the impact is appreciable depends on the purpose and nature of the restriction, and on the market in which it is to apply.

4.30 Decisions, for example by associations, aimed at curbing misleading advertising, or at ensuring that advertising is legal, truthful, honest and decent, are unlikely to have an appreciable adverse impact on competition.

Standardisation Agreements

4.31 An agreement on technical or design standards may lead to an improvement in production by reducing costs or raising quality, or it may promote technical or economic progress by reducing waste and consumers' search costs. The agreement may, however, have an appreciable adverse impact on competition in particular, if it includes restrictions on what the parties may produce or is, in effect, a means of limiting competition from other sources, for example by raising entry barriers. Standardisation agreements which prevent the parties from developing alternative standards or products that do not comply with the agreed standard may also have an appreciable adverse impact on competition.

Terms of Membership and Certification

4.32 Rules of admission as a member of an association of undertakings should be transparent, proportionate, non-discriminatory and based on objective standards. Terms of membership will have an appreciable adverse impact on competition where the effect of exclusion from membership is to put the undertaking(s) concerned at a competitive disadvantage. Similarly, procedures for expelling members of an association may have an appreciable adverse impact on competition, particularly where they are not based on reasonable and objective standards or where there is no proper appeals procedure in the event of refusal of membership or expulsion.

4.33 An association of undertakings may certify or award quality labels to its members to demonstrate that they have met minimum industry standards. While such a scheme has benefits for consumers in the form of quality assurances, it may lead to a restriction of competition. A scheme is unlikely to have an appreciable adverse impact on competition where certification is available to all manufacturers that meet objective and reasonable quality requirements. Where manufacturers must accept additional obligations governing the products which they can buy or sell, or restrictions as to pricing or marketing, the scheme will likely have an appreciable adverse impact on competition.

5 GENERAL EXCLUSIONS AND EXEMPTIONS FROM THE FIRST CONDUCT RULE

GENERAL EXCLUSIONS

5.1 The first conduct rule does not apply to any of the cases in which they are excluded by or as a result of Schedule 1 to the Bill. The exclusions in Schedule 1 apply to an agreement if the agreement meets the requirements of the exclusion, without the need for a formal decision from the Commission applying the exclusion. Undertakings can, therefore, raise the exclusion as a defence to enforcement proceedings brought by the Commission or third parties. This also provides an opportunity for undertakings to self assess their conduct against the statutory exclusions.

5.2 Three types of cases are listed in Schedule 1 of the Bill –

(a) agreements enhancing overall economic efficiency;

(b) agreements made for compliance with legal requirements;

(c) an undertaking entrusted by the Government with the operation of services of general economic interest in so far as the first conduct rule would obstruct the performance, in law or in fact, of the particular tasks assigned to it.

(a) Agreements Enhancing Overall Economic Efficiency

5.3 Each of the criteria set out in Schedule 1 to the Bill for agreements enhancing overall economic efficiency are set out and explained below.

"Contributes to improving production or distribution; or promoting technical or economic progress"

5.4 The purpose of the above criteria is to define the types of efficiency gains that can be taken into account. This involves a net economic benefit analysis – whether the economic benefits of the agreement outweigh the detriments from the restriction on competition. The aim of the analysis is to ascertain what are the objective benefits created by the agreement and the economic importance of such efficiencies. The efficiencies are not assessed from the subjective viewpoint of the parties.

5.5 The undertakings to the agreement must therefore show the following -

- The claimed efficiencies must be objective in nature;

- There must normally be a direct causal link between the agreement and the claimed efficiencies;

- The efficiencies must be of a significant value, enough to outweigh the anti-competitive effects of the agreement.

5.6 The undertakings must do more than assert the claimed efficiencies. They must be able to demonstrate the likelihood and magnitude of each claimed efficiency. As the efficiencies have to outweigh the anti-competitive effects, the evidence of substantial efficiency gains will need to be strong where the undertakings involved in the agreement account for a substantial proportion of competition in the relevant market.

5.7 The types of efficiencies stated in the criteria are broad categories intended to cover all objective economic efficiencies. There is considerable overlap between the various categories. There is no need therefore to draw clear and firm distinctions between the various categories.

5.8 Examples of improvements in production or distribution include lower costs from longer production or delivery runs, or from changes in the methods of production or distribution; improvements in product quality; or increases in the range of products produced. Examples of the promotion of technical or economic progress include efficiency gains from economies of scale and specialisation in research and development with the prospect of an enhanced flow or speed of innovation.

"Does not impose on the undertakings concerned restrictions that are not indispensable to the attainment of those objectives"

5.9 This criterion implies a two-fold test. Both the agreement itself, and the individual restrictions of the agreement, must be reasonably necessary to attain the efficiencies.

5.10 The first consideration is whether more efficiencies are produced with the agreement in place than in its absence. The agreement will not be regarded as indispensable if there are other economically practical and less restrictive means of achieving the efficiencies, or if the parties are capable of achieving the efficiencies on their own.

5.11 Where the agreement is deemed necessary to achieve the efficiencies, the second consideration is whether more efficiencies are produced with the individual restriction(s) in place than in their absence. A restriction is indispensable if its absence would eliminate or significantly reduce the efficiencies that flow from the agreement, or make them much less likely to

materialise. Restrictions relating to price-fixing, bid-rigging, market sharing and output limitation agreements are unlikely to be considered indispensable.

5.12 The assessment of indispensability is made within the actual context in which the agreements operate and must in particular take account of the structure of the market, the economic risks related to the agreements, and the incentives facing the parties. The more economic risks related to the agreements, the more restrictions may be required to ensure that the efficiencies will materialise. Restrictions may also be indispensable in order to align the incentives of the parties and ensure that they concentrate their efforts on the implementation of the agreement.

"Does not afford the undertakings concerned the possibility of eliminating competition in respect of a substantial part of the goods or services in question"

5.13 As economic efficiency is generally enhanced by competition, this criterion requires an assessment of the degree of competition *prior* to the agreements, and also the *reduction* in competition that the agreements bring about. Accordingly, in a market where competition is already relatively weak, this factor may be more important.

5.14 Evaluation under this criterion may require an analysis of the degree of market power that parties enjoy, before and after the agreements. This involves a study of the various sources of competitive constraints, such as other competitors (using market share as an indicator), entry barriers and buyer power etc. Where the products sold by the parties to the agreements are viewed to be close substitutes, the agreements would be more likely to result in a substantial elimination of competition.

Block Exemption Order

5.15 Clause 15 of the Bill provides that if the Commission is satisfied that a particular category of agreement is excluded from the application of the first conduct rule by or as a result of section 1 of Schedule (i.e. agreements enhancing overall economic efficiency), the Commission may issue a block exemption order in respect of that category of agreement.

5.16 The Commission may issue such block exemption order on its own initiative or on application by an undertaking or an association of undertakings. The Commission may impose conditions or limitations to a block exemption order and must specify a date in the block exemption order

(not more than 5 years after the date of the order) upon which it will commence a review of the block exemption order.

(b) Agreements Made for Compliance with Legal Requirements

5.17 Agreements are excluded from the first conduct rule to the extent that they are made to comply with a legal requirement that is any requirement imposed by or under any written law in Hong Kong.

(c) An Undertaking Entrusted by the Government with the Operation of Services of General Economic Interest in so far as the First Conduct Rule would Obstruct the Performance, in Law or in Fact, of the Particular Tasks Assigned to It.

5.18 We expect that the Commission will interpret this exclusion strictly. The onus is on the undertaking seeking to benefit from the exclusion, to demonstrate that all the requirements of the exclusion are met. The undertaking will have to (i) satisfy the Commission that it has been entrusted with the operation of a service of general economic interest; and (ii) show that the application of the first conduct rule would obstruct the performance, in law or in fact, of the particular task entrusted to it.

Entrusted

5.19 The undertaking will need to demonstrate that it has been entrusted with the service in question by the Government. The act of entrustment can be made by way of legislative measures such as regulation, or the grant of a licence governed by public law. It can also be done through an act of the Government. However, mere approval by the Government of the activities carried out by the undertaking will not suffice.

5.20 The exclusion applies only to the particular tasks entrusted to the undertaking and not to the undertaking or its activities generally. Further, the exclusion applies only to obligations linked to the subject matter of the service of general economic interest in question and which contribute directly to that interest.

Services of General Economic Interest

5.21 The definition of services in this context is broad and may include the distribution of goods as well as the provision of services. Services of general economic interest are different from ordinary services in that public authorities consider they should be provided in all cases, whether or not

there is sufficient economic incentive for the private sector to do so.

5.22 The term **economic** refers to the nature of the service itself, rather than the interest. For examples, services of an economic nature may include activities in the cultural, social, public health and educational fields if their aim is to make an economic profit.

5.23 Further, to be considered a service of **general** economic interest, the service must be widely available and not restricted to managing private interests or to a certain class, or classes, of customers. However, this does not exclude selective criteria in the supply of service.. For example, a service of general economic interest may include the provision of services which aids regional development and are restricted to certain geographical areas.

Restrictions on Competition

5.24 Restrictions on competition from other economic operators must be allowed only insofar as they are necessary to enable the undertaking entrusted with the service of general economic interest to provide the service in question. It would be necessary to consider the economic conditions in which the undertaking operates and the constraints placed on it, in particular the costs which it has to bear.

5.25 It would not be sufficient for the undertaking to show that it has been entrusted with the provision of a public service in order to benefit from this exclusion. An undertaking seeking to benefit from this exclusion would have to show that the application of the first conduct rule would require it to perform the task entrusted to it in economically unacceptable conditions. For instance, the undertaking may be required to meet a ”universal service obligation”[2]. Without the benefit of the exclusion, competition would allow new entrants to target profitable customers (so called “cherry-picking”), while leaving unprofitable customers to the incumbent. Such a risk may compromise the incumbent’s economic viability and thus obstruct the performance of its obligations.

EXEMPTIONS FROM THE FIRST CONDUCT RULE

5.26 Unlike exclusions, exemptions require a positive decision to apply the exemption to particular agreements or classes of agreements.

[2] This refers to an obligation to provide a minimum set of services of specified quality to all users at an affordable price, independent of their geographical locations. This includes guaranteeing services to non-profitable areas.

Exemption on Public Policy Grounds

5.27 Clause 31 of the Bill provides that the Chief Executive in Council may, by order published in the Gazette, exempt specified agreements or specified classes of agreements from the first conduct rule, if he is satisfied that there are exceptional and compelling reasons of public policy for doing so.

Exemption to Avoid Conflict with International Obligations

5.28 Clause 32 of the Bill provides that the Chief Executive in Council may, by order published in the Gazette, exempt specified agreements or specified classes of agreements from the first conduct rule, if he is satisfied that it is appropriate to do so, in order to avoid a conflict between the Ordinance and an international obligation that directly or indirectly relates to Hong Kong.

5.29 Clause 33 of the Bill requires every order made under Clauses 31 or 32 to be published in the Gazette and laid on the table of the Legislative Council at the next sitting of the Council after its publication in the Gazette.