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11 July 2011

VIA FACSIMILE – 2185 7845

The Honorable Andrew Leung Kwan-yuen, GBS, JP
Chairman
Bills Committee on Competition Bill
c/o Legislative Council Secretariat
3/F Citibank Tower
3 Garden Road
Central, Hong Kong

Dear Sirs,

RE: Bills Committee on Competition Bill – Invitation for Submissions on Proposed Competition Guidelines (Market Definition, First Conduct Rule and Second Conduct Rule)

On behalf of Cathay Pacific Airways Limited ("Cathay Pacific"), and in response to your invitation to give views dated 30 June 2011, I am pleased to provide Cathay Pacific's comments on the proposed Guidelines on Market Definition, the First Conduct Rule and the Second Conduct Rule (collectively the "Guidelines") that are to accompany the Competition Bill (the "Bill"). This letter incorporates by reference our previous correspondence on the Bill.[1]

In our 19 November 2010 letter, you will recall that we stated "the current Bill lacks sufficient clarity and detail to allow Cathay Pacific to provide its complete views. Many of the essential details are not addressed in the Bill, but instead are likely to appear in guidelines to be issued by a yet-to-be named Competition Commission. While this Competition Commission may issue guidelines and otherwise provide direction to those entities subject to the competition law, as enacted, we simply cannot state with any degree of certainty if this will happen. *We trust that the guidelines, which are likely to form much of the substantive regulation and enforcement policy of the Competition Commission, will be drafted with substantial input from all Hong Kong stakeholders*" (emphasis provided). Given the critical importance of the Guidelines, we had anticipated having more than five business days to provide our views. However, subject to the difficult time constraints, we provide the following *preliminary* views:

[1] See letters dated, 5 February 2007, 1 August 2008, 16 December 2008, 17 July 2009, 25 March 2010 and 19 November 2010.

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General Observations:

1. The Guidelines should be a clear statement of the Commission's interpretation and enforcement policies rather than an abstract set of observations. For example in the United States, the 2010 Horizontal Merger Guidelines state at the outset "[t]hese Guidelines outline the principal analytical techniques, practices, and *the enforcement policy* of the Department of Justice and the Federal Trade Commission." (emphasis provided). This statement makes clear that while the U.S. guidelines are not law, they state the enforcement policy of the regulating agency – in other words, if undertakings act in a manner consistent with the U.S. guidelines, the U.S. regulatory agencies will not bring enforcement actions.

2. The benefit of the Commission clearly stating its guidelines represent enforcement policy is that stakeholders, in this case undertakings, should be able to reasonably conclude that if they engage in activities that under the Guidelines do not give rise to competitive concern, the enforcement policy (or presumption) of the Commission will not commence an investigation. In other words, there will be a presumption (which can be rebuttable) that the conduct is legal or consistent with the competition law. This is not the case with the current Guidelines.

3. Absent a clear statement of policy accompanied by a presumption that the Commission will not initiate an investigation if conduct stays within a safe zone (sometimes called "safe harbours"), the Guidelines fail to provide the necessary tangible comfort to undertakings that they can engage in lawful economic activities without fear of an expensive investigation or inquiry. It is little comfort to say there will be an investigation, but that "it may normally be closed at an early stage." This language is too ambiguous and leaves too much room for subjective interpretation. Guidelines should, to the fullest extent possible, provide tangible and transparent guidance and clear expectations to all stakeholders.

4. Recognising the Guidelines are still preliminary at this stage, we are nonetheless surprised at the degree to which critical issues, such as the extent to which vertical conduct will be captured by the First Conduct Rule, are left without conclusion. Guidelines that say issues will be decided in the future fall short of being guidelines. We will discuss this issue in greater detail below.

Proposed Guidelines on Market Definition:

1. We agree that "market definition provides a framework for competition analysis." (¶1.2) However, the Guidelines miss an opportunity to provide substantive guidance, in the form of presumptive market share thresholds, on market share amounts below which the Commission would have no concerns. At ¶1.4, the Guidelines make a non-committal observation that "undertakings with low market shares will usually not possess market

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2. This statement (¶1.4) provides undertakings no guidance, as the Guidelines are intended to do. Specifically, it uses the terms "low market shares", "usually not possess," "may normally be closed," and "at an early stage." Each of these terms lacks the specificity necessary to make them useful for undertakings. Indeed, this section of the Guidelines raises more questions than it answers.

3. We note that for market definition, the Guidelines appear to have adopted the approach set forth in the former U.S. Department of Justice and Federal Trade Commission Horizontal Merger Guidelines (issued 2 April 1992 and modified 8 April 1997), including the use of the "hypothetical monopolist test" and its equally conceptual "small but significant non-transitory increase in price test."[2]

4. While the above-referenced tests are useful tools for defining markets for purposes of competition law analysis, the Commission must ensure that staff not apply the test mechanically but instead use it as an analytical tool, as is stated in ¶2.11. In particular the Guidelines should give greater prominence and clarity to the following clause: "[i]n cases where it may be apparent that an activity is unlikely to have an appreciable effect on competition, or that the undertaking under investigation does not possess substantial market power within any sensible market definition, it would not be necessary to formally establish a definition of the market."

5. The Guidelines should also give more attention and prominence to the role of new or potentially new entrants. Hong Kong is an open and dynamic marketplace and there are few barriers to entry. While the Guidelines make some reference to supply-side substitution in the sense of current market participants switching to new production lines, there should be more emphasis on the ability of timely, likely and sufficient new entry, and the ability of that new entry to constrain prices.

6. The Guidelines correctly point out that with respect to geographic market, given the relatively small size of Hong Kong, it will be common to have geographic markets that go beyond the Territory. In particular for many products and services, imports or services provided outside Hong Kong serve as competitive constraints on economic activity within Hong Kong. In subsequent Guidelines, greater emphasis should be given to the role of imports and/or products and services provided outside the Territory.

Proposed Guidelines on the First Conduct Rule:

1. While it is clear that the First Conduct Rule applies to agreements, as opposed to unilateral or single-firm conduct, we expected some clarification as to whether it applies to vertical agreements, or agreements between or among undertakings at different levels of the supply or distribution chain. We believe that vertical agreements should be

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[2] See 1992 (amended. 1997, revoked 2010) U.S. Department of Justice and Federal Trade Commission Horizontal Merger Guidelines , available at http://www.justice.gov/atr/public/guidelines/hmg.htm.

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expressly excluded from the competition law and that the Guidelines should make this point very clearly.

2. Instead, while the Guidelines correctly acknowledge that "[g]enerally, a vertical agreement should be viewed simply as a legitimate way of influencing how a supplier's product is distributed and marketed," they fail in that they address hypothetical circumstances in which vertical agreements "may give rise to some competitive concerns." (¶2.5)

3. We see that the Commission "would consult the stakeholders and the public on how vertical agreements should be dealt with under the first conduct rule." However, that process is unnecessary and that the Commission should simply "issue a block exemption order to exempt vertical agreements from the application of the first conduct rule in light of their pro-competitive effects[.]" Indeed, the trend in modern antitrust and competition policy is to move away from restricting vertical agreements, particularly those not involving pricing, because such agreements usually promote and stimulate intra-brand competition.

4. Even for vertical pricing agreements, the international trend is clearly moving in the direction of relaxed or diminished enforcement. For example in the United States, its Supreme Court in 2007 overruled almost 100 years of precedent and held that vertical resale pricing agreements are non illegal *per se*, or automatically illegal.[3]

5. The direction is similar in Europe. In 2010, the European Commission issued its Guidelines on Vertical Restraints.[4] These guidelines provide, among other things, a number of block exemptions for various types of vertical agreements. While some vertical agreements are still captured within the purview of Article 101 of the Treaty on the Functioning of the European Union (the European equivalent of the First Conduct Rule) the international enforcement trend is clear: vertical agreements are almost always pro-competitive and should fall outside competition law restrictions.

6. Hong Kong should follow international best practice and focus its enforcement efforts on horizontal agreements, particularly those that fix prices, allocate markets and rig bids, as it is uncontroverted that these practices distort competition and do not contribute to consumer welfare. In many jurisdictions, the guidelines and/or underlying regulations specifically distinguish between "hardcore" conduct and conduct that may or may not be anti-competitive depending on the circumstances. Instead, the Guidelines lump together all forms of collaborative conduct into a "catch-all" (¶4.2), which has a "non-exhaustive list of examples of conduct that may breach the first conduct rule, depending on the circumstances."

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3 *See Leegin Creative Leather Products v. PSKS, Inc.*, 127 S. Ct. 2705 (2007).

4 Available at http://ec.europa.eu/competition/antitrust/legislation/guidelines_vertical_en.pdf.

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7. For example, to include bid-rigging and directly fixing prices in the same set of examples as setting technical standards and terms of certifications provides very little tangible guidance to undertakings and does not give any statement of enforcement policy. While the same section states "there are no automatic breaches of the first conduct rule in Hong Kong," there should be some ability on the part of the Commission to distinguish between activities that always or almost always distort competition and those practices that are presumptively legal and pro-competitive, but may, in unusual circumstances, constitute a breach.

8. In ¶4.18 *et seq.* the Guidelines discuss joint purchasing and selling as if they are the same conduct. We recommend the topics be addressed separately. In particular, all other variables being equal, agreements to jointly purchase inputs inherently create less antitrust risk than joint selling agreements. Indeed, for joint purchasing agreements, absent the exercise of monopsony power (buyer market power), there is little risk associated with joint purchasing arrangements, and the Commission has an opportunity to provide specific safe harbours under which joint purchasing agreements would be presumptively legal.

9. Block exemption orders (¶5.15 *et seq*) will play an important role in application of the Bill. While the current Guidelines set forth some useful general principles, they lack specificity as to the application process, review standard and other objective measures. Instead the current language seems very general and to a degree subjective.

Proposed Guidelines on the Second Conduct Rule:

1. The Second Conduct Rule governs single-firm and/or unilateral conduct. We welcome the Guidelines' acknowledgment of the role of potential competitors – something we feel is missing from the Market Definition Guidelines.

2. We also appreciate the Guidelines' clear statement that "market power is not absolute" (¶2.4) but would appreciate some presumptions or safe harbours under which an undertaking is presumed not to have market power. This would remove certain conduct that gives rise to competitive concerns only in instances in which the undertaking has market power from the ambit of regulatory investigation. This would be particularly beneficial to small and medium size enterprises or instances in which an undertaking has a small market share in a properly defined market.

3. The Guidelines' discussion of "object or effect" is confusing, and combines elements of subjective and objective measures. Instead of attempting to distinguish between these subjective and objective elements, we recommend the Guidelines address the more universally accepted standard of "substantially lessening competition," which is an objective test and one almost universally adopted in common law jurisdictions. We believe the combination of the objective standard and common law precedent makes this formulation easier to apply and understand.

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4. To the extent the Second Conduct Rule applies to so-called "predatory behavior" (*see* ¶8.2 *et seq.*), we urge the Commission to proceed with caution. If the Commission seeks to bring enforcement actions against undertakings for charging prices that are *too low*, these will not be well received by the consumer public. In such circumstances, the Commission should apply the "not below average variable cost" (*see* ¶8.4 *et seq.*) rigidly and state, as a matter of policy, that any pricing above average variable cost (strictly construed) is presumptively legal.

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Cathay Pacific recognises that the draft Guidelines are in a preliminary stage and the Commission anticipates further refinements and work. Since the Commission has placed a great (and arguably too great) an emphasis on the role of the Guidelines in shaping competition law enforcement in Hong Kong, we urge the Commission to adopt more tangible and specific Guidelines that set forth, when applicable, appropriate safe harbours and/or safety zones under which undertakings can operate free of regulatory investigation. It is not enough to say conduct below a certain threshold "may" be legal, or that an investigation "will likely" be short. Even "short" investigations can carry with them significant costs. Moreover, regulations without clear boundaries or guidance can cause innovative and dynamic companies to stifle development due to perceived regulatory concerns. As the Hong Kong economy is based upon open markets and dynamic innovation, the Commission should take all steps to ensure these hallmarks of our economy are not hindered by regulatory uncertainty.

Yours sincerely,

Ivan Chu
Chief Operating Officer