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11 July 2011

The Hon Andrew Leung, GBS, JP
Chairman
Bills Committee on Competition Bill
Legislative Council Secretariat
Legislative Council Building
8 Jackson Road, Hong Kong

Dear Andrew

Comments on Government's "Guidelines" on the Competition Bill

By notice posted on Legco's website on Thursday 30 June, the Bills Committee requested comments from stakeholders by 11 July on three sets of Government "guidelines" on the Competition Bill. Taking account of the public holiday on 1 July and the weekend immediately thereafter, this effectively amounts to a consultation period of just one week.

Although these documents are expressed to be only a guide as to what may be contained in future Commission guidelines, they will inevitably influence the content of future Commission guidelines, and hence the way in which the Conduct Rules are interpreted and applied. They are therefore extremely significant documents. This being the case, we believe that a consultation period of only one week is much too short to allow stakeholders to give these documents the full attention they deserve, and to submit considered comments to the Bills Committee on them.

While we can understand that the Committee would find it helpful to receive some initial feedback before the public hearings it has scheduled for 20 July, we would urge you to make it clear publicly that the Committee will consider submissions on the Guidelines received after that date, or even better, conduct a fresh round of consultation after 20 July, followed by further public hearings. We would suggest that a period of no less than two months would be appropriate, given the significance and complexity of the matter, i.e. until 20 September 2011. It is vitally important for Hong Kong that this matter is given this level of attention: the implications are too serious if mistakes are made at this stage.

In the short time available, we have been unable to consult our members and prepare a detailed point-by-point response to the Guidelines, and we are sure that other stakeholders are in the same position. However, even from our rapid review, it is clear that the documents strongly reinforce the Chamber's recommended approach to non-hardcore conduct, namely conduct other than price-fixing, market-sharing or bid-rigging. Hardcore conduct is relatively straightforward to define, and easy for businesses to avoid, and it is surprising that a greater focus is not placed on such conduct in the Guidelines, since it is usually the first priority of any new competition regime. .Moreover, the Guidelines do not assist businesses in assessing whether conduct in the non-hardcore category will be prohibited. This is because:

- according to the Guidelines, the assessment involves matters of hypothesis and conjecture, which are necessarily subjective;
- to the extent that the assessment involves empirical evidence, evidence which the Guidelines say will be relevant may be available to the authorities after the event in assessing the effects of the conduct, but will not be available to the businesses in advance in deciding whether to enter into it;
- the Guidelines provide lists of relevant indicative factors in assessing whether certain key criteria are satisfied (such as what the relevant market is, or when a business has a significant degree of market power) but does not indicate what 'mix' of which factors in which amounts will prove decisive in making these determinations;
- the Guidelines (and the Bill itself) use imprecise concepts which are not verifiable and therefore impossible for businesses to apply in practice with any degree of certainty that the authorities will share their view, such as what the "competitive" price level is, what constitutes a "substantial degree" of market power, and when a given practice will deem to be an "abuse";
- to the extent that the Guidelines identify certain types of conduct as being potential infringements, they give no clear indication of when they will and when they will not.

We shall deal with each of these problems in turn, giving examples.

Before doing so, we would like, firstly, to clarify a matter relating to the scope of the First and Second Conduct Rules. There seems to be a misconception that SMEs only need to be concerned about the First Conduct Rule, not the Second Conduct Rule. This is far from being the case, and would be a dangerous assumption for SMEs to make, as the Guidelines demonstrate. Professor Richard Whish, who has frequently commented on Hong Kong's competition proposal has stated: "Given that the relevant market may be drawn very narrowly, small companies may be found guilty of an abuse of Article 82 [the EU equivalent of the Second Conduct Rule]". He cites the case of a manufacturer of a machine, which was not dominant in the market for those machines, but was found to be dominant in the market for the supply of spare parts for its own machine. The company was fined for abusing its position in that market.[1] The Guidelines also graphically demonstrate the fact that the Second Conduct Rule can apply to SMEs, by defining the relevant market, and market power, simply in terms of the ability to profitably increase the price of a particular product or service (as noted below). Clearly many SMEs in Hong Kong would be able to do this.

Hypothesis and Conjecture

The definition of the relevant market is a critical starting point in any competition assessment. Many stakeholders are fully aware of this, and have called on the Administration to clarify how the relevant market will be defined. However, the methodology put forward in the Guidelines is a cause for concern. It is based on the reactions of customers, and other suppliers or potential suppliers, to what a "hypothetical monopolist" would do. This is, by definition, a matter of speculation and hence subjective opinion. In defining the market, as part of making the assessment of whether its conduct will infringe the rules, a business will be required to assess what the reactions of customers and potential suppliers of a particular product or service would be, if a hypothetical monopolist in that product were to impose and be able to sustain a "small but significant" price increase of 5% to 10% in the price of that product or service for a non-transitory period of time. The matter is made even more hypothetical, and further removed from reality, because, unless there is evidence that the market is already distorted by the existence of market power, the hypothetical monopolist is deemed, for the purpose of the hypothesis, to be supplying the product in a competitive market, a contradiction in terms.

[1] Whish *Competition Law* 6ed p 187.

For the purpose of assessing whether a price increase of this kind would be sustained, the business will be obliged to speculate as to whether, in this scenario, customers would switch, or new suppliers could and/or would enter the market, to such an extent as to make the price increase unsustainable.

Clearly, it seems unreasonable to expect a business not only to make such an assessment, but to be exposed to a potential breach of the law if its assessment does not coincide with that of the authorities looking at the market *ex post facto*, perhaps five or more years later.

What Mix of Which Factors is Decisive?

In a number of areas the Guidelines provide lists of factors which are relevant in assessing whether the criteria for liability are satisfied. For example, for a breach of the Second Conduct Rule to occur, the business must first be deemed to have a "substantial degree of market power". In assessing this, the Guidelines list a number of factors which are relevant, such as market share, the existence and extent of barriers to entry, production capacity of competitors, and responsiveness of customers. But there is no indication of what mix of which of these factors in what amounts will trigger a finding of market power, far less substantial market power.

Evidence unavailable to Businesses

The Guidelines suggest that the hypothetical assessments involved in determining whether a given agreement or conduct will infringe the Conduct Rules may be backed up by empirical evidence, if such evidence is available. The problem is that, while such evidence may be available to the authority in assessing the conduct after the event, it may not be available to the business in deciding whether to enter into the conduct in the first place. There is therefore an "inequality of arms" between the authorities and the business(es) concerned if the conduct in question is challenged. For example:

- the Market Definition Guidelines states that, in determining what the relevant market is, "buyers can be interviewed to determine their reaction to a hypothetical price increase" and "information from undertakings active in the market and their commercial strategies may also be useful".[2] We presume this is referring to the authorities' role in scrutinizing the conduct after it has taken place under the so called SSNIP test. Clearly a business cannot be expected to have access to this information in assessing its prospective conduct under the competition rules;

- in assessing whether a business has market power, the Guidelines on the Second Conduct Rule ("CR2 Guidelines") state that information about the market shares and production capacity of competitors is relevant.[3] Although the Commission would have power to require businesses in the market to provide this information, how can the business be expected to have access to this information about its competitors and potential competitors which may even be off-shore?

Imprecise Concepts

The Guidelines do not offer businesses any meaningful guidance on what certain key concepts actually mean. A good example is the phrase "competitive levels". This is a critical one. For example, the definition of the relevant market depends on the reaction of buyers and other suppliers to a 5 to 10% non-transitory increase in price above "competitive levels", and a finding of market power depends on whether a business can sustain prices above "competitive levels". But no indication is given as to what "competitive levels" actually means, or how businesses are supposed to ascertain what such levels actually are. Another example is "substantial degree" of market power. Even if a business can conclude on the basis of the CR2 Guidelines that it has market power, no guidance is given as to the point at which there will be deemed to be a "substantial degree" of market power. And if a business believes that it may have market power where it does not, then it will be less aggressive in the market to the detriment of consumers.

Perhaps the most dramatic example is the concept of "abuse". Remarkably, there is no definition of this concept in the Bill itself. The Guidelines define it in terms of being commercial practices which are different from "normal competition".[4] This concept has clearly been imported from EU case law. But as one leading EU commentary states:

[2] Paragraph 3.7.
[3] Paragraphs 3.1 and 3.3.
[4] Paragraph 6.2.

" 'Normal competition', as per *Hoffman - La Roche*, is a vague phrase, not least because the Commission has rejected the notion that a common practice within an industry would necessarily constitute 'normal competition' if carried out by a dominant firm".[5]

To import this uncertainty consciously into Hong Kong is clearly unacceptable.

When will certain types of conduct breach the rules?

If the Guidelines were to be of any value in guiding future business conduct, it would be in pointing to certain types of conduct which will breach the rules. However, although certain types of conduct are identified, no guidance is given as to when those types of conduct will breach the rules and when they will not. A careful reading of the Guidelines does little to assist a business understand what will be competitive conduct and what will be anti-competitive conduct. The examples are abundant, but we cite just a few below from the Guidelines on the First Conduct Rule ("CR1 Guidelines") (emphasis added):

- "competitive pressures may be reduced if undertakings in an industry agree to limit or at least coordinate future investment plans";[6]
- "there will be a concern on the impact of competition if the purchasers to the joint purchasing agreement are exercising the buying power to foreclose competitors or raise rivals' costs";[7]
- a price announcement made in advance to competitors may be anti-competitive where it facilitates collusion";[8]
- "restrictions on advertising, whether relating to the amount, nature or form of advertising, have the potential to restrict competition";[9]
- "standardization 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 effect on competition".[10]

[5] O'Donoghue and Padilla *The Law and Economics of Article 82 EC* 2006 p 198.
[6] Paragraph 4.15.
[7] Paragraph 4.19.
[8] Paragraph 4.25.
[9] Paragraph 4.29.
[10] Paragraph 4.31.

Moreover, the discussion of the various types of conduct is too brief and cursory to be of any practical guidance. This may be because the Administration, as it has said to the Bills Committee, does not wish to "tie the hands" of the future Commission and Tribunal. However, it is unacceptable to expect Legco to pass a Bill like this while leaving Members- as well as businesses and other stakeholders- guessing as to what types of conduct will be prohibited. For example, the focus of any new competition law should be on hardcore conduct, yet there is only a few brief paragraphs in the CR1 Guidelines on this area, and other agreements which are likely to be benign in most cases are given just as much focus. The discussion of predatory pricing in the CR2 Guidelines is also too brief for what is a very complex area. Perhaps most importantly, there is no real indication of how vertical agreements- hugely important in practice- will be treated, to the extent that the Administration even proposes to give the future Commission the choice of exempting them from the law, or keeping them within the scope of the law but issuing guidelines.[11]

Intellectually incoherent/self-contradictory

There are a number of areas in which the Guidelines simply do not make sense. For example:

- In the CR1 Guidelines, it is stated that "there are no automatic breaches of the first conduct rule in Hong Kong...".[12] Yet, the same Guidelines go on to state that price-fixing, bid-rigging and market-sharing "will, by their very nature, be regarded as restricting competition appreciably".[13] This is a direct self-contradiction;
- in the CR2 Guidelines, it is stated that "the ability to make decisions on pricing and quality without regard to the reactions of customers and other suppliers is the essence of market power".[14] Yet it goes on to give as an example of an abuse of market power "targeted price cuts against a competitor".[15] A company cannot increase prices without constraint from competitors, yet at the same time feel the need to compete aggressively on price with them: this is self-contradictory.
- as noted above, one of the two criteria for conduct to constitute an abuse is that it does not comprise methods which condition "normal competition". Yet the CR2

[11] CR1 Guidelines pp 5-6.
[12] Paragraph 4.2.
[13] Paragraphs 4.7, 4.10 and 4.13.
[14] Paragraph 2.3.
[15] Paragraph 8.6.

Guidelines go on to state that tying and bundling can constitute an abuse even though they are "common commercial practices" (a phrase which sounds very much like "normal competition");[16]

- under the CR1 Guidelines it is stated that "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".[17] So what is the difference in effect between this situation, and arrangements of the type in the Tai Po Hui Market case, where the stall owners colluded on bidding with the same objective in mind, i.e. to keep costs down, and which the same Guidelines state "will, by their very nature, be regarded as restricting competition appreciably?";
- the CR1 Guidelines state that agreements which restrict competition appreciably will nevertheless be excluded from the prohibition if the efficiencies of the agreement outweigh its anti-competitive effects, and the other conditions in Schedule 1 paragraph 1 are satisfied.[18] Yet there is no equivalent reference to countervailing efficiencies in the CR2 Guidelines. (Admittedly this may be because the Bill does not explicitly contain an efficiency exclusion for conduct under the Second Conduct Rule: this is a deficiency in the Bill which should be rectified).

Conclusions

The Guidelines clearly underline the Chamber's main point, namely that it is not appropriate to deal with non-hardcore conduct through the general prohibition approach currently contained in the Bill, because it is simply too difficult to determine in advance what the borderline will be between practices which will be prohibited and those which will be permitted.

One approach is therefore to limit the law simply to prohibiting hardcore conduct. However, the Chamber has been prepared to acknowledge that there may be circumstances- albeit impossible to define in advance with sufficient certainty- in which certain types of non-hardcore conduct could substantially lessen competition, without any countervailing efficiency benefits or other justification. So, instead of the current blanket, general

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[16] Paragraph 8.8.
[17] Paragraph 4.18.
[18] Paragraphs 5.3 to 5.14.

prohibitions in the Bill, which may well deter businesses from engaging in potentially beneficial conduct, the Chamber has suggested a fairer, and economically more sensible way of addressing them.

Do Guidelines still have a role to play under the Chamber's proposal? The answer is a definite "yes". It would still be useful, under the Chamber's approach, for businesses, and the authorities themselves, to have general guidelines pointing to the circumstances in which the Commission might feel it appropriate to intervene against certain types of conduct. With that in mind, we have included some more detailed suggestions for improvement to the Guidelines in the Appendix to this letter.

We hope these comments are of assistance to the Bills Committee.

Sincerely

Alex Fong
CEO

APPENDIX

Specific comments on the Guidelines

The guidelines are silent or confusing in several important areas.

First, there has been much discussion, most of it quite confusing, whether the merger provisions relate only to telecommunications (which is unacceptably discriminatory) or via the First Conduct Rule over all mergers. This lack of clarity is the worst possible result. Certainly, the first application of CR1 to a merger situation will result in a court case which by itself will have (while pending) a chilling effect on the market. The law and guidelines should be: (a) non-discriminatory as to sectors; (b) absolutely clear on this point; and (c) include merger guidelines if mergers are to be included in the law. Businesses should not have to guess as to the law and guidelines.

Second, as to CR1, there are three key themes that are treated inconsistently or at least unclearly.

a. The guidelines are unclear as to under the CR1 whether per se violations can occur, or whether a rule of reason will apply. That is, whether or not appreciable adverse effect needs to be shown before a breach can occur.
b. The guidelines are unclear whether hardcore conduct will be treated differently from non-hardcore conduct.
c. The guidelines are unclear as to the treatment of the two limbs of the conduct rule (ie, "object" or "effect") are consistent or inconsistent.

In short, sections 3.7, 3.8, 3.12, 4.2, 4.7, 4.10 and 4.13 send out very mixed signals.

Section 3.7 on the "object" limb states:

"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."

The first sentence above presents a *per se* strict liability approach. The second and third sentences take the opposite "rule of reason" approach. It may also be that in a per se case, the undertaking has the burden of proof to demonstrate absolutely no unseemly intent (see section 3.6)

Section 3.8 indicates that under the "effect" limb, the conduct must have an appreciable effect on competition (ie, a rule of reason and not a per se approach), creating the result that "object" per the first sentence of 3.7 could be a per se violation but an "effect" can only be a violation under the rule of reason. Of course, under the remaining/contrary sentences of 3.7, both the object and effect tests would be rule of reason tests, which makes perfect sense.

Section 3.12 repeats the rule of reason approach (and the de minimis principle) but then suggests that hard core conduct are per se unlawful and fall outside of the de minimus safe harbour.

Paragraph 4.2 quite clearly states there are no per se violations even for hardcore conduct:

> " There are no automatic breaches of the first conduct rule in Hong Kong, unlike in some other jurisdictions".

Paragraph 4.7 then states as to "object":

> "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."

Paragraph 4.10 and 4.13 mimic Paragraph 4.7. All of which leaves the reader confused and no doubt concerned.

Third, the Guidelines are silent on how the Commission will interpret, implement or enforce (via the Tribunal) the controversial penalty provision. This is unfortunate.

Fourth, the Guidelines do indicate that its focus of enforcement will likely not be vertical agreements, but does not indicate what will be its focus. The guidelines thus miss an opportunity to state clearly that its priorities will be (for example horizontal cartels, hardcore conduct and local markets). Afterall, it was the concern over local (not international) hardcore cartel activity that was the underlying rationale of the competition bill when it was proposed and drafted.

Fifth the Second Conduct Rule (CR2), is not described in substantial detail. For example, the SSNIP test is vaguely described in section 2.3 but with enough depth and without giving any information on the amount of time (ie, the non-transitory time period) during which MP must exist before an undertaking is viewed to have SMP.

Further, in the CR2 guidelines, market share is presented as a short cut to determining SMP. As appealing as that might be, market share is a notoriously poor indicator of market power and should not be substituted for a comprehensive market analysis. Demand side and supply side substitution analyses must be undertaken, with all that entails.

Also: predatory pricing is noted but without the recoupment requirement; CBP is mentioned but only weakly; CR2 section 7.5 repeats the same confused/contradictory message found in CR1 section 3.7…"object" may or may not be a per se violation., and 7.4 mimics 3.6; the effect limb is based on the rule of reason, whereas the object limb may be per se (7.7);