

2008

Fair competition under Laissez-Faireism : policy options for Hong Kong

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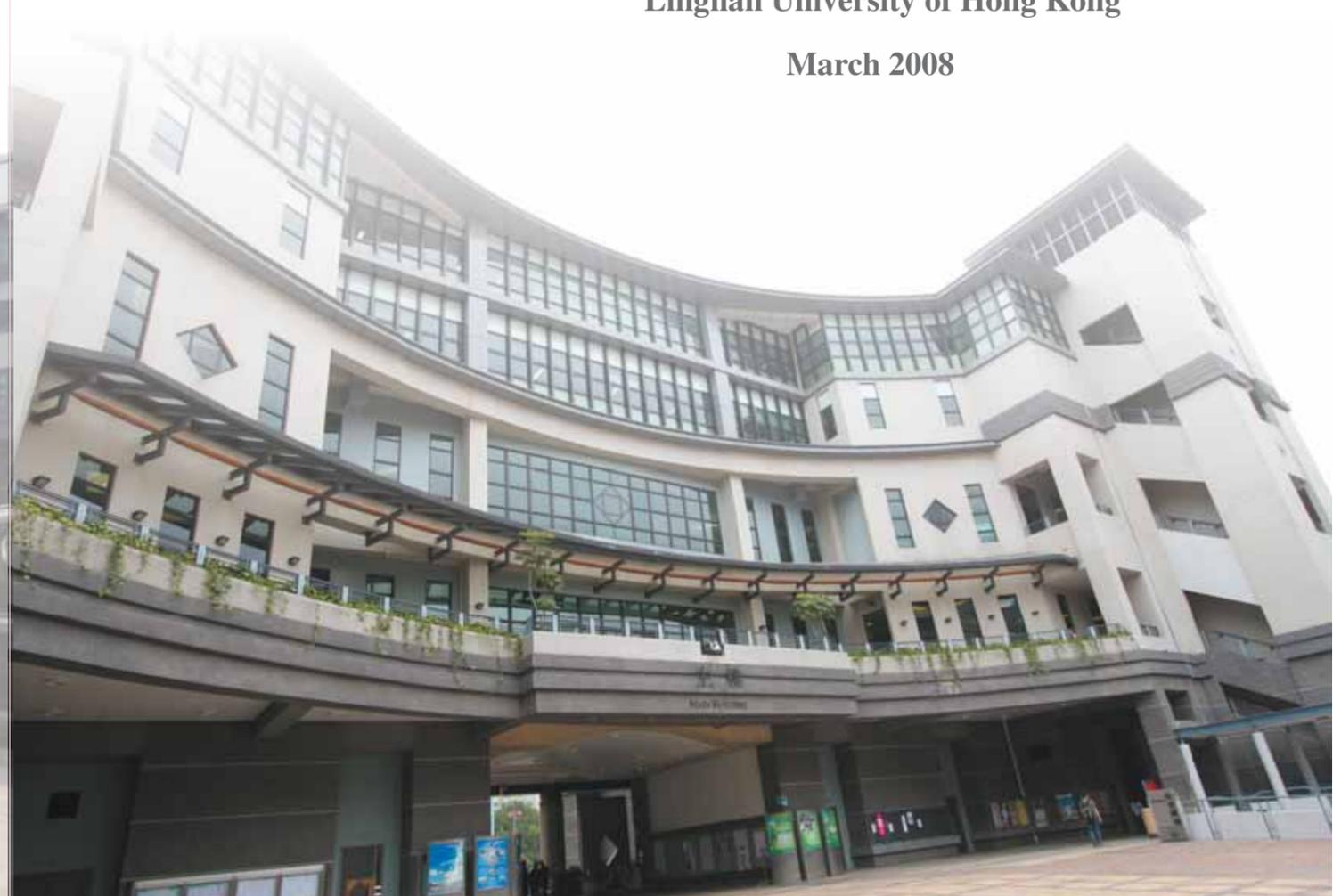
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Fair Competition under Laissez-Faireism:

Policy Options for Hong Kong

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* The authors would like to thank Catherine C. Y. Fung for excellent research assistance and contribution to the paper. Financial support from the Research Grants Council Public Policy Research Scheme (RGC Reference No.: LU 3002-PPR-2) is acknowledged.

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Executive Summary

We review the decade-long development of competition policy in Hong Kong since its inception in 1998, critically examine the major arguments for and against introducing a cross-sector competition law, and evaluate various policy options for Hong Kong.

Following the pioneering approach of Gal (2003), we identify the special characteristics of small economies that may affect competition differently from large economies. Having examined and identified the deficiencies of Hong Kong's sector-specific competition policy, we pay particular attention to the debate on merger control and the resistance of small and medium sized enterprises (SMEs) towards an all-embracing competition law. The two issues loom large in the minds of policymakers since the release of the Competition Policy Review Committee's recommendations in 2006 and the subsequent consultation exercise of the government. In formulating our analysis and recommendations, we derive significant insights from economic principles, relevant cases and practices of other jurisdictions.

Our main findings and recommendations are as follows:

1. We have no hesitation to say that a competition law for Hong Kong is necessary, if not long overdue. Contrary to what some may believe, small market economies can be more prone to anti-competitive conduct, due to their unique features of high industry concentration, substantial entry barriers, and high level of aggregate concentration.
2. Laissez-faire does not guarantee fair competition. Given the tremendous costs and detriments of anti-competitive behaviours to social welfare, a reasonable amount of evidence on such practices will justify a law, which sets up the rules of the game and provides the necessary means to correct market distortion. A competition law will also protect Hong Kong consumers from international cartels originated from other countries, whose damages are estimated to far outweigh the costs of setting up and enforcing a law.
3. An unbiased competition regime should be extended to all sectors of the economy, in light of the deficiency of a sector-specific approach. We see two main drawbacks of the latter approach: misallocation of resources of the economy in the long run due to the different rules set for different sectors; and a credibility problem that arises when the very same agency acts as both the traditional industry regulator and competition policy enforcer. Nor is it fair to target certain industries of the economy.
4. We recommend a broad approach covering anti-competitive conduct as well as market structure. Mergers and acquisitions can be motivated by market power considerations as well as efficiency gains, and can harm competition even in small economies. Type II error in policy design (i.e., falsely not regulating harmful practices) should not be ignored in one's attempt to avoid Type I errors (i.e., falsely regulating non-harmful practices). Reduced competition as a result of a merger cannot be reversed by regulating the behaviour of the merged firm ex post.
5. We recommend a light-touched merger control regime with the adoption of large safe harbours, on the justifications that the importance of scale economies in Hong Kong sometimes necessitates a certain degree of rationalisation. We propose an improved version of safe harbours over the existing scheme in the telecommunications industry.

6. With regards to treatment of SMEs, we recommend a “partial exemption” of SMEs from the new law: Exemptions of SMEs from regulations of mergers and abuse of dominant position can be justified on economic efficiency grounds. However, hardcore cartels (price-fixing, bid rigging, production and sale quotas, and market allocation) should be prohibited against all players, be they small or big. Hardcore cartels hurt consumers more than they benefit the cartel participants, and they corrode the culture of competition.
7. The safety zone provided by the partial exemption scheme would help reduce SMEs’ compliance costs and protect them from excessive litigation. At the same time, the law would enable SMEs to sue other players, an option not feasible absent the law, thereby making them better off.
8. On the enforcement front, we recommend that punitive fines and director disqualification be imposed on offenders of hardcore cartels and monetary fines, civil or administrative, on all other competition infringements. This is to balance the severity of sanctions against the gravity of harm, and to achieve the necessary deterrent effect against blatant behaviour.
9. We strongly recommend that a leniency program be included in the competition law to encourage whistle blowing. Whistle blowing is more effective (if not the only possible means) to detect and lead to successful prosecution of hardcore cartels, as demonstrated clearly by the recent experiences in the US and the EU.
10. No adverse presumption in law should be construed against any type of enterprises, small or big, domestic or foreign. A competition law should neither penalise big players if they are efficient, nor protect small players if they are inefficient. The law is to protect the competition process, not competitors. The government is recommended to do more to educate the public about the nature and benefits of competition law.

Introduction

Whether Hong Kong needs a cross-sector competition law has been hotly debated during the past decade, and especially controversial since the government set up the Competition Policy Review Committee in 2006 to evaluate the effectiveness of its competition policy. While the government public consultation exercise in early 2007 reveals a general support for introducing a cross-sector competition law, concerns still remain about the necessity of a competition law and the scope of its coverage.

In Part I, we begin with a review on the government's long-held philosophy of non-intervention on market competition, the Consumer Council's study on anti-competitive practices and the decade-long road to the adoption of a sector-specific competition framework. We then examine the triggering events that impact on the government's thinking, that set the scene for change. At the close of Part I, we identify the two most controversial issues – merger control and SMEs' concerns – which loom large in the minds of policymakers after the recent consultation exercise on competition policy conducted by the government.

In Part II, we seek to answer the question why Hong Kong needs a cross-sector competition law. We first rebut various misconceptions about competition policy: that a small market economy does not need a competition law, or that competition law leads to intervention that will reduce Hong Kong's reputation as the world's freest economy. We then examine the widely criticised sectoral competition regime and how it is deficient in different aspects. We close Part II by presenting a catch-22 situation: that the lack of concrete evidence on anti-competitive behaviour is not because problems do not exist, but rather it results from an inadequate legal framework to investigate and reveal the gravity of problems. We conclude that a cross-sector competition law for Hong Kong is long overdue.

In Part III, the focus is to address the two most controversial debates identified in Part I, on merger control and SMEs' concerns. We first provide detailed discussions of the economic motivations for mergers and acquisitions and their potential effects on market competition (the unilateral effect and the coordination effect). By appealing to the notion of Type I errors (falsely regulating non-harmful practices) and Type II errors (i.e., falsely not regulating harmful practices) in policy design, we argue that the potential costs of not controlling mergers and acquisitions could be substantial for Hong Kong, both on theory and in practice. A case study of the proposed merger in the office product retailing market in the US (between Staples and Office Depot) illustrates the magnitude of the negative effects a merger can have on competition and consumers. The importance of the economies of scale in small economies does not imply that there is no need to regulate market structure. At the minimum, mergers that lead to monopoly should be regulated. We see no economic justifications for the claim that it is too intrusive to regulate market structure and that decisions for mergers and acquisitions should be left to the marketplace.

Given the nature of Hong Kong's small economy, we recommend a light-touched regime with large safe harbours for merger control. Based on a comparison of merger safe harbours in several economies, including such small economies as Canada, Australia, New Zealand and Singapore, as well as those in large economies such as the US, the EU and the UK, and a careful analysis of the merger policy in the telecommunications industry, we propose viable merger policy options for Hong Kong in the implementation of a cross-sector competition law. In particular, two modified versions of the existing telecommunications merger safe

harbour thresholds are provided. One utilizes the current Four-firm Concentration Ratio (CR4) test only, and the other combines the current CR4 test and a more relaxed Herfindahl-Hirschman Index (HHI) test as alternative. We are more inclined to recommend the modified HHI test, as it is more consistent with the CR4 test and the two independent filters will serve as true alternatives. It will then expand the effective coverage of the safe harbour mechanism to be applied cross-sector, making the tests among the most permissive in the world.

The government public consultation exercise in early 2007 reveals that SMEs in Hong Kong are not fully convinced of the necessity of a competition law and how it would benefit them. They are worried about the compliance costs of a new law and that the law would possibly provide a convenient venue or even a battlefield for large corporations to exploit them. To alleviate the concerns of SMEs, we propose a “partial exemption” of SMEs from the new law: SMEs be exempted from competition provisions governing mergers and acquisitions and abuse of market dominance. However, hardcore cartels should be prohibited against all players, be they small or large.

Such a partial exemption scheme can be justified on economic efficiency grounds because SMEs in general do not possess market power. However, hardcore cartels will hurt consumers more than they benefit the firms and hence should be banned. In addition, cartels also corrode the culture of competition. Our proposal is also in line with the policy in the US towards cooperation among SMEs. The partial exemption scheme would also help reduce SMEs’ compliance costs and protect them from excessive litigation. At the same time, the law would enable SMEs to seek justice if victimized by other firms, an option not available to them in the absence of the law, thereby making SMEs better off.

Part III of the paper also contains our recommendations about law enforcement. There is strong evidence that a leniency program is the most effective way to combat against hardcore cartels, which is the “supreme evil of antitrust” according the Supreme Court of the United States.¹ We strongly recommend a leniency program be included in the cross-sector competition law of Hong Kong.

Some brief concluding remarks are provided in Part IV. We sincerely hope that our analysis and findings in this paper will contribute to policymaking in the formulation of a competition law for Hong Kong.

¹ See, e.g., U.S. Department of Justice, 2006.

Part I. Development of Competition Policy in Hong Kong

Decade-long Development since the Birth of Sectoral Competition Policy

It was the Consumer Council of Hong Kong that took the lead in bringing to the attention of the government and the public the existence and consequences of monopolistic market structures in Hong Kong. In October 1992 the Council launched a series of studies on market competition and its impact on consumer welfare. The sectors covered included the markets for bank deposits, groceries, gas supply, telecommunications, radio broadcasting, and residential property. “Low levels of competition” were found in most of the sectors. In November 1996, the Council published a report entitled *Competition Policy: The Key to Hong Kong’s Future Success*. Here, it strongly recommended the adoption of a comprehensive competition law, which at a minimum should contain the following:²

- Article 1: to prohibit explicit agreements between firms that are intended or have the effect of preventing, restricting or distorting competition. These include horizontal agreements such as those involved in price-fixing cartels, bid rigging, etc., and vertical agreements such as retail price maintenance, exclusive dealership, tie-in sales, long-term supply contracts, etc.
- Article 2: to prohibit any abuse by one or more undertakings of a dominant position that prevents, restricts or distorts competition. This would address monopoly pricing, and vertical restraints such as tie-in sales enforced through market dominance.

Triggered by the findings and recommendations of the Hong Kong Consumer Council, the Hong Kong SAR government promulgated its competition policy in May 1998, by issuing a formal policy statement and establishing the Competition Policy Advisory Group (COMPAG)³. The May 1998 formal policy statement stated that instead of introducing a general competition law, it would adopt a sector-specific competition policy framework. It contended that an overall law banning anti-competitive practises “would not be able to take into account the specific requirement of the individual sectors,” and that having such a law would “overkill”.⁴ It also argued that setting up an overall competition authority would be too expensive and would duplicate the functions of existing regulatory bodies, and that for Hong Kong, a small and externally-oriented economy that was already highly competitive, there was no need to enact an all-embracing competition law.

The government also adopted a sectoral approach in its policy statement, the essence of which was to identify anti-competitive behaviour and to initiate pro-competitive measures through administrative or legislative measures. Put differently, instead of establishing an overall legal competitive framework for the entire economy, the government proposed to set different rules for different sectors to govern competition, with the sector-based rules administrated by sector-specific agencies. It was in 2000 and 2001 respectively that

² The proposed competition law also included an article controlling the abuse of collective dominance, and an article for the control of mergers and acquisitions. The Council, however, conceded that it might be desirable to defer the introduction of these two articles, arguing that “the issues raised in cases involving complex monopoly are best addressed when experience has been cumulated. Decisions relating to mergers and acquisitions also raise difficult technical issues, which must be resolved within a strict time table if the ordinary conduct of business is not to be impeded.” (Consumer Council (1996, p.76)).

³ COMPAG was established in December 1997, chaired by the Financial Secretary. The Consumer Council has since been commissioned by COMPAG to conduct various studies into anti-competitive behaviours for its review.

⁴ *South China Morning Post*, November 4 1997.

competition provisions were written into the telecommunications and the broadcasting ordinances. While the sectoral approach is unique⁵ in comparison with other countries that have competition laws, the promulgation of an official competition policy was already a big step forward for Hong Kong.

During the ensuing years, the sectoral approach was tested in the telecommunications industry. The Office of the Telecommunications Authority has dealt with over 100 competition cases, including price-fixing, merger and acquisitions, predatory pricing, and others relating to consumer protection. The COMPAG has also received various complaints and reviewed various cases. The nature of complaints to the COMPAG during 2001-2007 is summarised in Table 1. As can be seen, almost 100 cases have been brought to the attention of COMPAG during the said period, a few of which concern the broadcasting industry.⁶

Table 1
Nature of Complaints to COMPAG from 2001-02 to 2006-07

Alleged Anti-competitive conduct	No. of cases
Unfair or restrictive government practices	30
Abuse of dominant market position (including predatory pricing)	20
Miscellaneous Restrictive practices ¹	9
Price-fixing	10
Bundling of services	3
Unfair or discriminatory standards	6
Market allocation	1
Exclusive arrangement	4
Joint boycott	3
Others ²	6
Total :	92

1. Includes: obstructing market entry, providing inferior service or charging competitors unreasonably high prices and creating artificial barriers to discourage customers from switching to competitors.

2. Studies initiated by COMPAG on the situation in certain sectors and alleged conflict of interest of publicly-funded organizations.

Source: COMPAG annual reports, Competition Policy Review Committee (2006).

⁵ For a detailed description and analysis of the sectoral approach of Hong Kong, see Chen and Lin (2002).

⁶ For example, one complaint received in 2005 was on the subscription fees charged by Hong Kong Cable Television Limited for the provision of a general entertainment television channel. The Broadcasting Authority found the case unsubstantiated (see <http://www.compag.gov.hk/report/2005.pdf>).

Cross-sector Competition Law Recommended by CPRC

In July 2005, the government set up the Competition Policy Review Committee (CPRC) to evaluate the effectiveness of Hong Kong's existing competition policy. More drastically, the Chief Executive specifically discussed the issue of fair competition in his Policy Address in October 2005, in which he stated that "as Hong Kong enterprises grow in strength, with some acquiring world-class status, coupled with an increased presence of multinational enterprises, it is possible that forces capable of cornering the market may emerge in Hong Kong". It must be the first time that the government has openly admitted that a real threat of anti-competitive practices in Hong Kong warrants some serious study and monitoring mechanism. It is also noteworthy that the Chief Executive, Donald Tsang, pointed out in his speech that the newly created CPRC will "draw on international experience and discuss the need to introduce in Hong Kong a comprehensive and cross-sector law on fair competition."

In June 2006, the CPRC completed its review and released a report in which it recommends that a comprehensive competition law be introduced in Hong Kong (Competition Policy Review Committee, 2006) to guard against anti-competitive conduct that would have an adverse effect on economic efficiency and free trade in Hong Kong. The new legislation should apply to all sectors, rather than targeting individual sectors of the economy. The CPRC also recommends that provision should be included in the legislation to allow the government to grant exemptions to the application of the law in defined circumstances on public policy or economic grounds (para 66), and that the new law would not target market structures, nor seek to regulate "natural" monopolies or mergers and acquisitions (para 67). Regarding conduct, the CPRC recommends that the following seven types of business practice be regulated, noting the nature of complaints that have been received by the COMPAG:

- Price-fixing
- Bid rigging
- Market allocation
- Sales and production quotas
- Joint boycott
- Discriminatory standards
- Abuse of a dominant market position

2007 Public Consultation and Responses

In November 2006, following the recommendation of the CPRC, the government issued a public consultation document, entitled "Promoting Competition – Maintaining our Economic Drive" and invited responses from the general public. At the close of the three-month consultation period, the government received 114 written submissions, 60 pro forma submissions, and a signature petition. (See Economic Development and Labour Bureau, 2007). Respondents included political parties, private companies, academia⁷, the Hong Kong Consumer Council, and trade organisations.

As summarised by the government, while the majority of the respondents supported the introduction of a cross-sector competition law in Hong Kong, there are some concerns in the business sector, especially among some SMEs, at the possible effects a competition law

⁷ We also submitted our response (Chen and Lin, 2007).

might have on their business operations. For example, members of the Federation of Hong Kong Industries “are concerned that enacting such a law would impose hefty compliance burden on SMEs to the detriment of their competitiveness vis-à-vis large corporations.” (See Federation of Hong Kong Industries, 2007). The Federation states that:

“Contrary to the popular belief that introducing a cross-sector competition law would benefit SMEs, there is evidence that the law would provide a convenient avenue for large corporations to sue their smaller counterparts for anti-competition. Since many SMEs cannot afford to pay the huge legal costs involved, not to mention the time and energy required of management in such lawsuits, large corporations could eliminate competitors in the courtrooms without having to competing with them in the market place.”

Some other organisations of SMEs are of the view that the Hong Kong economy is working well and a competition law would only impose unnecessary constraints on their business (Economic Development and Labour Bureau, 2007, p.6). In view of the resistance from SMEs, the government decided to postpone submitting a draft law for discussion at the Legislative Council, as originally planned, but instead to launch another round of consultation in early 2008 (Ma 2007).

Among those who supported the introduction of a cross-sector competition law, many concurred with the CPRC’s recommendation that the new competition law should not regulate market structure, i.e., mergers and acquisitions. It was argued that “there was no justification for regulating market structures in Hong Kong given that there is perceived to be relatively little large-scale merger and acquisition activity in the local market” (Economic Development and Labour Bureau, 2007, p.2). Citing the small and open nature of Hong Kong’s economy, several respondents maintained that mergers and acquisitions are an important way for enterprises to achieve economies of scale through expanding their scale of operation. The objective might not necessarily be anti-competitive (Economic Development and Labour Bureau 2007, p.8). In its response to the consultation paper, the Hong Kong General Chamber of Commerce stated that “...it is important to prescribe that the competition law must not cover regulation of market structure...”. “It is a legitimate business objective to grow one’s business, and the efficiencies from economies of scale bring benefits to consumers as well. For a small economy like Hong Kong, therefore, it is not unusual to find market concentration in some sectors of the economy, as the natural outcome of market competition. Thus, “market dominance” per se must not be a cause for regulation” (Hong Kong General Chamber of Commerce, 2007).

Part II. Why a Cross-sector Competition Law for Hong Kong?

While it has been ten years since Hong Kong established a formal competition policy, misconceptions still exist in Hong Kong regarding the nature and roles of competition law and policy. As reflected in the responses to the government's consultation exercise in 2007, it appears that some hold the belief that competition law is not needed in small and open economies such as Hong Kong. For a long time, some tend to confuse free competition (*laissez faire*) with fair or perfect competition. Others believe that introducing a competition law is inevitably a form of government intervention on a free market. Still others hold that since Hong Kong's economy has been regarded as one of the most successful economies in the world, anti-competitive practices cannot be a serious problem in Hong Kong.

In this part of the report, we first argue that competition laws are needed for any economies, whether they are large or small. Following the approach of Gal (2003), we first argue that special features of a small economy in fact imply a greater need for competition laws. Next, we address the specific worry that introducing a competition law may lead to greater government intervention in the marketplace and hence hurt Hong Kong's image as the freest economy in the world. Finally, we examine the pros and cons of a sectoral approach, and apply the logic of decision theory to policy design in uncertain situations with limited information about the future and the associated error costs.

Greater Need for a Competition Law in Small Economies

Some commentators often ask, "Why is there a need to introduce a competition law in a small place like Hong Kong?" The implicit assumption is that small market sizes in small economies, with an inherent need for economies of scale, usually do not permit a large number of active competitors. Hence it does not make sense to set up a law to artificially increase the number of players so as to promote competition. While right in emphasising the effects of economies of scale, this argument is misguided in that it treats the goal of competition policy as increasing the number of competitors, rather than increasing competition.

In fact, in the main areas that are covered in a competition law – anti-competitive agreements, abuse of a dominant position, and mergers and acquisitions – the former two involve the control of market conduct, only the latter one change the number of players in a market. Having a given number of competitors in a market, no matter how small the market is, does not mean that these competitors choose to compete. If firms engage in anti-competitive conduct, a competition law is needed to correct such conduct and ensure that competitors do compete, and compete rigorously, with one another.

Contrary to the implicit belief that anti-competitive behaviour is less common in small economies, it can in fact be argued, quite forcefully, that the need for a competition law is greater in small economies. Specifically, factors such as scale economies influence industrial structures and market environments to such an extent that anti-competitive behaviours are more prone to occur in small economies. The risk of distorted competition is even more pronounced and the need for a competition law more crucial in these economies.

Economic Characteristics of Small Market Economies

In her pioneering work, Gal (2003) defines a small economy as “an independent sovereign economy that can support only a small number of competitors in most of its industries” (p.1) because of its small market size. According to Gal, market size is influenced by three main factors: population size, population dispersion, and openness to trade. She argues, quite convincingly, that small economies have the characteristics: high industrial concentration levels, high entry barriers and high level of aggregate concentration.

High industrial concentration levels

Due to small market sizes, industrial structures in small economies are likely to be highly concentrated with only a few active firms where economies of scale are present. We further argue that even when there are a large number of competitors in an industry, the incentive to realise scale economy will lead firms to undertake mergers and acquisitions, raising the concentration level of the industry and leading it to an oligopolistic market.

High entry barriers

Industries in small economies can also be characterised by high entry barriers. The main reason for this is that the presence of economies of scale implies that new entrants must operate at large scale in order to be profitable. Yet, small market size prevents firms from producing a large quantity. Inherent difficulties in reaching a large scale reduce or eliminate the incentive to entry by new firms. This scale effect was recognised in the early work of Bain (1956).

Small size imposes a supply constraint on factors of production (such as land, which is especially a scarce resource in Hong Kong). New comers must secure necessary factors of production before they can enter and compete with the incumbents, but this is constrained by limited supply of factors of production. In the case of Hong Kong, labour input (including skilled workers) has not been too restrictive to Hong Kong’s development, thanks to its open and free labour markets and immigration policies. Land, as scarce as it is in Hong Kong, is owned by the government and in theory is open to all firms conducting business in Hong Kong. However, incumbents benefit substantially from first-mover advantage by obtaining the right to use certain land, thereby securing strategic advantage in the downstream markets (e.g. retailing) over subsequent players who may encounter difficulty in finding land, or may not be able to gain access to land in prime locations.⁸

Moreover, small size may create additional entry barriers if vertically integrated markets are concentrated and controlled by incumbents. This is so because existing firms may deny new entrants access to their supply and/or distribution channels or only allow their access to these channels under onerous terms. That undoubtedly put entrants at a competitive disadvantage, as it certainly raises entry costs for one to establish one’s own distribution channels.

⁸ The experience of Carrefour helps illustrate this. The French-based company entered the Hong Kong market in 1996, and managed to open only four hypermarkets in Hong Kong by 2000. Having suffered big losses, it withdrew from Hong Kong in September 2000. The company blamed the restrictive behaviour of incumbent firms, as well as the government’s land policy, for its departure (*South China Morning Post*, 31 August 2000).

Finally, as argued by Gal (2003), “small size may make competition too personal, for example, when business elite is small and businessmen are careful not to enter one another’s domain” (p.22-23).

High level of aggregate concentration

The percentage of economic activity accounted for by the largest firms in the economy is often substantially higher in small economies than in large ones. One consequence of high level of aggregate concentration is that economically powerful enterprises can influence government policy by sheer economic force. It follows that anti-competitive conducts will even cause greater social loss in small economies because of high level of aggregate concentration.⁹

The Need for a Competition Law in Small Economies

Unlike what some may have believed, Gal (2003) does not claim that small economies do not need a competition law. To the contrary, she advocates strongly for setting up a competition law in such economies, given their above-mentioned general characteristics. In fact, according to Gal, “market forces alone cannot achieve efficiency in small markets ... In the absence of appropriate regulation, market forces will not, in many cases, sustain a desirable degree and form of competitive discipline among firms in the economy” (p. 45). She therefore concludes that “competition policy in a small economy is thus a critical instrument with respect to determining domestic market structure and conduct and the intensity of competition” (p.45). The main part of Gal’s systematic study is to explore how small economies should take market size into account when designing and implementing their competition laws, there being no question that small economies should also establish competition laws.

In fact, the above characteristics of small economies imply that the firms therein enjoy greater market power, as there are not many competitors around. Markets are not readily contestable because of the inherently high entry barriers. Collusion among firms tends to be easier due to low co-ordination costs among competitors, less threat of entry which would otherwise upset the existing cartels, plus repeated interactions among the same firms that penalise cheating on cartel agreements. All these give rise to a greater need for competition laws in small economies.

Competition Law is Not Market Intervention

Competition law, in setting up the rules of the game, is not intervention. Rather it is to safeguard the competitive process through which to reduce social loss and maximise welfare. Social welfare is not a zero sum game. Increasing consumer surplus does not necessarily reduce producer surplus. Economic efficiency can be improved continuously, comprising allocative efficiency – optimal allocation of available resources, productive efficiency – efficient utilisation of inputs, and dynamic efficiency – innovation in technology. In its quest for economic efficiency, pro-competition policy can be both pro-consumer and pro-business.

⁹ Hong Kong was ranked 28th in the World Economic Forum’s 2005 Competitiveness Ranking among 110 economies. A main contributing factor for the disappointing rating is government favouritism in policy making.

Some are concerned that establishing a competition law will adversely affect Hong Kong's ranking in economic freedom, and hence damages its reputation as the freest economy in the world. A closer look at the oft-cited indicator of economic freedom the Index of Economic Freedom compiled by the Heritage Foundation, however, will dismiss this worry. Rather than dampening its image, introduction of a competition law may actually further enhance Hong Kong's international reputation as a free economy.

Economic freedom is defined as encompassing “all liberties and rights of production, distribution, or consumption of goods and services”, and the Index of Economic Freedom is estimated on the basis of 10 broad individual freedoms, as laid out in Beach and Kane (2008).¹⁰

- *Business freedom* is the ability to create, operate, and close an enterprise quickly and easily. Burdensome, redundant regulatory rules are the most harmful barriers to business freedom.
- *Trade freedom* is a composite measure of the absence of tariff and non-tariff barriers that affect imports and exports of goods and services.
- *Fiscal freedom* is a measure of the burden of government from the revenue side. It includes both the tax burden in terms of the top tax rate on income (individual and corporate separately) and the overall amount of tax revenue as a portion of gross domestic product (GDP).
- *Government size* is defined to include all government expenditures, including consumption and transfers. Ideally, the state will provide only true public goods, with an absolute minimum of expenditure.
- *Monetary freedom* combines a measure of price stability with an assessment of price controls. Both inflation and price controls distort market activity. Price stability without microeconomic intervention is the ideal state for the free market.
- *Investment freedom* is an assessment of the free flow of capital, especially foreign capital.
- *Financial freedom* is a measure of banking security as well as independence from government control. State ownership of banks and other financial institutions such as insurer and capital markets is an inefficient burden, and political favouritism has no place in a free capital market.
- *Property rights* is an assessment of the ability of individuals to accumulate private property, secured by clear laws that are fully enforced by the state.
- *Freedom from corruption* is based on quantitative data that assess the perception of corruption in the business environment, including levels of governmental legal, judicial, and administrative corruption.
- *Labour freedom* is a composite measure of the ability of workers and businesses to interact without restriction by the state.

The Index of Economic Freedom is a simple average (i.e., equal weighting) of the above 10 individual freedoms. Technically, the only possibility that the presence of competition policy directly and negatively affect a country's economic freedom is if competition policy is used to impede international trade and thus affect the second category, i.e., trade freedom. In particular, competition policy can affect the freedom index only if it serves as a non-tariff barrier to international trade, i.e., if it is used to discourage or prevent foreign competitors from entering a country's domestic market.¹¹ Therefore, introducing a competition law per se

¹⁰ Available at http://www.heritage.org/research/features/index/chapters/pdf/Index2008_Chap4.pdf.

¹¹ The trade freedom score for country *i* (TF_{*i*}) is based on two inputs: the trade-weighted average tariff rate and non-tariff barriers (NTBs), using the formula:

does not affect a country's economic freedom score.¹² Establishing a competition law will not adversely affect Hong Kong's score in economic freedom provided that the law will not serve as a means to impede international trade. Thus, there is no solid ground to form the view that competition law is equivalent to government intervention and will automatically lower Hong Kong's ranking in economic freedom.

We would argue that a government who promotes economic efficiency by way of introducing a competition law, as opposed to one who takes no action to create and maintain a level playing field, in fact contributes to economic freedom and prosperity. First, introducing a competition law can improve a country's business freedom by safeguarding the competition process, protecting all market players' right to compete, so that all can compete on equal footing. It can also promote free flow of capital (including foreign capital) by preventing anti-competitive conduct, thereby enhancing investment freedom. A competition law can also improve trade freedom, by removing potential trade barriers arisen from anti-competitive practices such as the formation of international cartels, and the incumbent's abuse of dominance position, etc.¹³ As stated in the government's policy statement, the objective of the Hong Kong's competition policy is "to enhance economic efficiency and free flow of trade, thereby also benefiting consumer welfare."¹⁴ Thus, a well-crafted competition law can surely enhance economic freedom, rather than lower it, as some may have believed. Furthermore, some major trading partners of Hong Kong (e.g., the EU) and the WTO have reiterated explicit concerns over the lack of competition in Hong Kong and recommended establishing a competition law. It indicates that a competition law will help promote international trade and secure Hong Kong's reputation as the freest economy in the world.

Deficiency of the Sectoral Approach

When the Hong Kong Government first promulgated its competition policy in 1998, it still maintained its long-held philosophy of "positive non-intervention". While the government's view has changed after the CPRC recommended a cross-sector competition law in 2006, some still hold the view that every economic sector is unique and a cross-sector competition law would lack the flexibility to deal with sector specific anti-competitive practices (Economic Development and Labour Bureau, 2007, p. 2).

$$TF_i = \frac{Tariff_{max} - Tariff_i}{Tariff_{max} - Tariff_{min}} - NTB_i,$$

where $Tariff_{max}$ and $Tariff_{min}$ represent the upper and lower bounds for tariff rates, and $Tariff_i$ represents the weighted average tariff rate of country *i*. A NTB penalty is then subtracted from the base score, by the percentage points of 5, 10, 15, or 20, depending on whether the extent to which NTBs are used to impede international trade. E.g., The penalty of 20 percentage point is assigned if NTBs are used extensively across many goods and services and/or act to impede a significant amount of international trade, and a penalty of 5 percentage point is assigned if NTBs are uncommon, protecting few goods and services and/or have very limited impact on international trade. NTBs include the following categories (all with respect to international trade): Quantitative restrictions, price restrictions, regulatory restrictions, restrictions on exchange and other financial control, customs restriction, and direct government intervention (subsidies, industrial policy, regional development policy, government financed R&D, national taxes and social insurance, competition policies, immigration policies, state trading, government monopolies, exclusive franchises (Beach and Kane, 2008).

¹² Singapore's score in trade freedom actually increased from 85.0 for 2005 to 90.0 for 2006 and 2007, after its competition law came into effect in January 2005 and its merger regulation regime took effect in July 2007. See <http://www.heritage.org/Index/>.

¹³ For example, a competition law will help remove import monopolies such as the one in live-pig wholesaling in Hong Kong.

¹⁴ See <http://www.compag.gov.hk>.

The reality is that Hong Kong's competition policy framework has aroused various criticisms since its inception. Many commentators regard the sectoral approach as piece-meal and hence inconsistent across sectors (Cheng and Wu 1998 and 2000, Consumer Council 1996 and 1999, Chen and Lin 2002). Over time, more questions have been raised about the suitability of the sectoral approach. For example, some telecommunications operators still complain of the sector being over-regulated; and some are amenable to the idea of introducing a general competition law in Hong Kong rather than being singled out as subjects for competition regulation. Some auto-fuel companies also prefer a general competition law to sector-based competition rules in the fuel supply sector, should the government subject them to competition law regulation (Hong Kong General Chamber of Commerce, 2005).¹⁵ Williams (2005) raised the concern that the sectoral regulator has no jurisdiction to act outside his designated area.¹⁶ In the telecommunications sector for example, the authority simply cannot deal with the conduct of non-licensees, even if they tie-in with a particular licensee to exclude other telecommunications services providers from competition.¹⁷

In its response to the government's public consultation in November 2006, the European Commission states that "Competition law must extend to all sectors of the economy in order to ensure a coherent approach. Leaving certain sectors outside the scope of a competition law is likely to create imbalances as the oversight of a sector by a specific administration is likely to develop its own dynamics without due regard to competition principles" (Economic Development and Labour Bureau, 2007). Cheng (2007) forcefully argues that a sectoral regime has severe limitations, and that it is not logical to single out some sectors but to spare others from competition law enforcement, especially those that have been alleged to have the prevalence of anti-competitive conduct (e.g., supermarket and petrol retailing).

From the perspective of economic efficiency, Chen and Lin (2002) argue that a fundamental drawback of a sectoral approach is that it tends to lead to distortion of resource allocation across sectors of the economy in the long run. This is because different rules set for different sectors will generally affect the business environment in different sectors and thus the incentives for investment across sectors.¹⁸ Moreover, a sectoral approach may lead to

¹⁵ According to Dr. K.C. Chan, Chairman of Hong Kong Consumer Council, a policy that targets only a few sectors is no policy (Hong Kong Competition Policy Forum, 21 November 2006).

¹⁶ See the Banyan Garden case T261/03, available at OFTA website, for an illustration of the limited jurisdiction in a sectoral approach that weakens the effectiveness of the pro-competition provisions. However, COMPAG has concluded in its press release of 24 September 2004 that a comprehensive competition law is not the answer to resolving the issues identified.

¹⁷ The Banyan Garden case was rightly dealt with under section 7K(3)(c) of the Telecommunications Ordinance. Unfortunately, the problem was not resolved due to the limitation that the Ordinance could not be extended to cover non-telecommunications licensees in tackling similar cases. Prohibition against the act of the licensee alone ends up having an inelegant solution, if at all. An individual licensee can substantially restrict competition by obtaining an advantage from a related party transaction. It is noteworthy that the Banyan Garden residents are deprived of the selection for service providers for telephone and Internet access services. Citybase Property Management Ltd made the choice for them. Regardless of their usage (even if nil), the residents have to pay for the service fees via monthly management fees. The divorce of decision making between the buyer and end-user is detrimental to consumer welfare and not conducive to competition, when the buyer is affiliated with the service providers.

¹⁸ For instance, Hong Kong CSL Limited and the New World PCS Limited strongly argue that (see Economic Development and Labour Bureau, 2007) "Anti-competitive conduct can occur in any sector and therefore it is imperative that a legal framework is in place to investigate and sanction that conduct. While the consequences of applying a general competition law to particular conduct may vary across sectors (due to the particular characteristics of a given sector), it is important that the same legislative environment applies to all sectors. The

strategic responses by business enterprises that might lead to welfare losses in both regulated and unregulated sectors. As the Consume Council argues, “a sector-specific competition law may let firms sustain their market power through anti-competitive practices in unregulated sectors, which in turn give them a competitive advantage in their businesses in regulated sectors, unsettling the general desire to have a level-playing field”(Consumer Council 2007, p.4).

Chen and Lin (2002) also point out that there is a credibility problem of competition decisions of the regulatory agencies which are both a traditional regulator and competition rule enforcer. As effective enforcement of competition rules requires fair and independent decisions regarding competition complaints and litigation, merely acting fairly and independently does not necessarily mean being able to convince the concerned parties and the public that one, who is wearing two hats, has done so. The ruling of a competition case affects not only the parties concerned in the case, but also impacts on future behaviour of other firms¹⁹. It is therefore extremely important for the enforcer to ensure that not only justice is done, but also “justice is seen to be done”. However, when the very same agency is responsible for two inter-related duties, checks and balances are lacking to convince outsiders that agency’s decisions concerning one duty are made independently from considerations of the other duty. Performing the dual roles, the regulator under a sectoral approach faces an informational problem in communicating with the public about its impartiality (See Chen and Lin, 2002 for some anecdotal evidence of this informational problem in Hong Kong).

The Catch-22 Situation

One objection to setting up a competition law in Hong Kong is that anti-competitive behaviour does not seem to be a serious problem in Hong Kong, as some argues. While it is widely accepted that Hong Kong’s economy enjoys the most freedom in the world, external pressure has also been mounting from international organisations and trading partners in relation to competition issues. For instance, the WTO has raised concerns about the adequacy of Hong Kong’s competition policy (see WTO’s 1998 Report). In 2000, the EU in its parliamentary report expressed strong concerns about fair competition in Hong Kong. In particular, it was concerned about an environment possibly tilted against foreign companies,

promotion of a more favourable legislative environment in certain sectors could skew investment decisions and distort economic activity, leaving other sectors of the economy at a disadvantage. It is therefore the view of the CSL&NWM Group that, in order to improve the business environment and attain the long term advantages that come with a competitive market, any competition law proposed by the government should be applicable to all sectors of the economy.”

¹⁹ The early surrender of Hong Kong Telecom International Ltd (HKTi) licence in 1988 can illustrate why competition policy should be separated from regulatory measures. The case is about de-monopolisation to extend competition to external services, such as International Simple Resale (ISR) of voice services and International Direct Dial (IDD) voice telephony service. The outcome is increased competition on the supply side, which is welcomed by users of long-distance telephony services. To achieve the ends, the means are through cash compensation to and cessation of royalty payments payable by Hong Kong Telecommunications Ltd (HKT), and rebalancing local tariffs by removing cross-subsidy from external services to local services. Residential exchange line tariffs of HKT are then subject to price control until the end of 2001, and ex ante approval requirement thereafter as long as HKT remains dominant in the local residential market. The basis of regulating prices is to cover the costs of the utilities and to provide a “reasonable” rate of return on investment. However, price regulation provides few incentives for efficiency, which is the objective of competition. On the contrary, it promotes the incentive for overspending on capital facilities. It is not difficult to see the tension and conflicts between regulatory and competition policies.

citing that “a number of tycoons have an undue and dominant influence in certain sectors of Hong Kong’s economy” (South China Morning Post, 26 October 2000).

Exactly how level the playing field is may be debatable. The Consumer Council’s studies ten years ago found that there is a lack of competition in important sectors in Hong Kong. As mentioned in Part I, COMPAG has received a total of ninety-two anti-competitive allegations from 2001 to 2007. Further evidence of various types of anti-competitive conduct in Hong Kong was reported recently in local media.

In countries with a well-established competition law, one has witnessed persistent violations of competition provisions, despite the severe civil and/or criminal sanctions. Unable to resist the gains that anti-competitive practices would bring, some businessmen elect to act against the law, even after taking into consideration the expected penalties they would face if caught. Given the strong financial incentive on the part of players, it would be naïve to believe that anti-competitive practices are not a problem in economies that do not have a competition law. It runs counter to logic to anticipate that free competition (e.g. no regulation of blatant acts) would eliminate anti-competitive conduct.

It is impossible to determine or even estimate the exact percentage of total business activity that involves anti-competitive conducts in Hong Kong. In fact one faces a Catch-22 situation. On the one hand, one cannot gather enough evidence of undue behaviour unless a competition law is set up which gives the enforcement agency the power to investigate and collect evidence of suspicious practices.²⁰ On the other hand, without sufficient amount of evidence it is argued that there should not be a competition law. Sophisticated businessmen will not publicise their restrictive practices such as price-fixing and bid rigging, even when such conduct is legal, for fear of negative publicity. Weak competitors or suppliers/customers may not come forward to disclose unfair plays, for fear of retaliations by powerful counter-parties. Absent a law, the internal mechanism and incentives are lacking for the market to generate evidence of unfair plays on its own.

The logic in decision theory may be useful in addressing whether there is a need for a competition law, given the Catch-22 situation.²¹ In deciding whether measures need to be taken to protect its citizens from a potential natural disaster (e.g., an earthquake, or SARs), a society does not and should not wait until it is 100 per cent certain that such a disaster will take place in the near future. Actions and preventive measures are justified as long as the probability of the occurrence is high enough. Strong evidence would lead to immediate action, but its absence should not necessarily imply that no action should be taken. In the case of competition law, as long as the community as a whole is sufficiently worried about anti-competitive practices (based on a reasonable amount of evidence), action will be justified, given the high social costs such practices can impose on society.²² It would not be sensible public policy to delay action in such circumstances.²³

²⁰ Without legal investigative power, any attempt to detect undue behaviour would turn out to be futile, as demonstrated by recent government investigation into the fuel-retailing sector in Hong Kong. A “no-dirty play” conclusion from such investigations would not be credible, even if the “defendant” is indeed innocent, because the public knows the case was not thoroughly scrutinised due to the lack of legal power of the investigation team.

²¹ See also Chen and Lin (2006).

²² The social costs of price cartels, e.g., can be huge. According to the Department of Justice of the United States, the vitamin global cartel raised the prices three folds (see Carlton 2003). Studies on the interest rate cartel that existed in Hong Kong’s banking industry during the 1980s - 1990s estimated that the monopoly rents earned by Hong Kong’s banks were about HK\$5.17 billion for 1991, representing about 0.8% of the GDP (see Consumer

Finally, a competition law would also protect Hong Kong consumers from anti-competitive conduct by companies outside of Hong Kong. For instance, the jurisdiction would be available for suing international cartels that impact on Hong Kong markets. In the absence of a competition law, it will be surprising if international cartels do not exploit the legal loopholes by expanding their cartel activities to Hong Kong. Clarke and Evenett (2002) have studied the effect on international trade flows of the formation of the vitamins cartel during the 1990s. Their findings reveal that the vitamins cartel raised prices even more in nations without active cartel enforcement regimes, hence caused greater harm. The overcharges from the vitamins cartel are estimated to be US\$178.48 millions on Hong Kong's imports alone, during the conspiracy from 1990 to 1999.

Such tremendous costs and damages to social welfare far outweigh the costs of setting up and enforcing a competition law. To conclude, a cross-sector competition law for Hong Kong is long overdue.

Council 1994). For the period of 1987-1994, the estimated rents were 1.05% of the respective GDP (Chan and Khoo, 1998).

²³ The issue of competition law, of course, is different from the case of protecting society from a natural disaster. For one thing, "bad guys" would be worse off once a competition law is introduced, and the net gain to society would be positive.

Part III. Coverage of Hong Kong's Competition Law

Merger Control

A competition law generally covers three main areas: anti-competitive agreements (horizontal agreements and vertical restraints), abuse of a dominant position, and mergers and acquisitions. Due to the nature of small and open economy, and the view among some that it is too intrusive to regulate market structure, many maintain that Hong Kong's cross-sector competition law should not cover mergers and acquisitions. In particular, the CPRC holds that

“In Hong Kong, there is no clear indication that merger and acquisition activity is currently a threat to competition in most sectors, and having regard to the submissions received, the CPRC has concluded that there is little justification at this time for regulation of mergers and acquisitions outside the existing provisions in sector specific laws covering areas such as broadcasting and telecommunications. Rather, in developing proposals for any new legal framework, the focus should be primarily on sanctioning specific types of anti-competitive conduct that affect normal business operations and jeopardise the free market economy”.²⁴

In this section, we set out the standard economic analysis of mergers and acquisitions and draw implications to small open economies. We introduce the notions of Type I and Type II errors in policy design. Specifically, a Type I error occurs if the new policy prevents socially beneficial mergers whereas a Type II error occurs if the new policy fails to prevent socially harmful mergers from taking place. We argue that the small and open nature of Hong Kong's economy does not imply that Hong Kong could ignore Type II errors or should not regulate mergers. Reference is made to a proposed merger in the office supply supermarket sector in the United States, so as to highlight the potential magnitudes of the social costs of anti-competitive mergers.

We maintain that leaving mergers and acquisitions 100 percent unregulated is not logical, even for small economies, and can have significant detrimental effects on Hong Kong's economy and consumers. We then propose a light-touched merger control regime, to improve on the existing merger evaluation system in the telecommunications sector.

Economic motivations for mergers

Mergers occur for good and bad reasons. The oft cited reasons for mergers are to reap economies of scope and scale. Scale economies will enhance efficiency by lowering the unit cost of business operations and minimising the duplication of resources.²⁵ The need to achieve the minimum efficient scales is especially compelling for firms in small market economies, hence further concentration in an already concentrated market. While mergers may sometimes be inevitable, they can also give rise to entrenched monopoly, with or without anti-competitive outcomes.

The real motivations behind mergers are many. They can be driven by the firms' desire to increase the combined market share and to lessen competition, especially in case of horizontal mergers. After a merger, competition between the merging parties is eliminated,

²⁴ Competition Policy Review Committee (2006), para 34.

²⁵ See Williamson (1968-69) for an analysis of the social costs and benefits of mergers.

leading to increased prices and profits of the combined firm. Corporate goal aside, a merger may be driven by the acquiring managers' desire for empire building, to be leader of a larger company. On the other hand, pressure from potential take-overs by more efficient firms may motivate managers to run the businesses more efficiently. As such, mergers can be catalysts for efficiency.

In case of vertical mergers, the reduction of transaction costs and assurance of input supply are two major underlying motives, both fair and reasonable. First, upon integration of the upstream and downstream operations, it will improve logistics along the different stages of the supply chain and reduce transaction costs. Second, through acquisition of an upstream supplier, a downstream operator can ensure a guaranteed supply of the requisite inputs, thereby reducing the likelihood of supply interruption.²⁶

Conglomerate mergers are very often motivated by the desire for diversification. Firms seeking diversification generally prefer acquisition to organic growth, because it takes less time to venture into new businesses by way of merger.

The unilateral effect

In theory as well as in practice, mergers can be a means by which the merged parties increase the combined market power or even monopolise a market. With greater market power, a combined firm post-merger potentially has greater influence on market prices, and has the ability to act unilaterally without significant competitive constraints. The unilateral effects give rise to reduction of total surplus if the dead-weight losses are not offset by efficiency gains to the firms. More often, they give rise to reduced consumer surplus because the efficiency gains, even if realised, may not be passed entirely on to consumers. Quite the reverse, unilateral effects enable firms to charge higher prices, and surplus is transferred from consumer to producer.²⁷

The co-ordination effect

Furthermore, by reducing the number of competitors, at least in the short run, a horizontal merger may enhance the interdependence among the remaining firms in the market. With increased market concentration, it may increase the likelihood of collusive behaviour among

²⁶ Possible motives for vertical mergers include reduction of transaction costs, assurance of supply of inputs, elimination of negative externalities among distributors, and increase in market share or power, etc (See Carlton and Perloff, 2005).

²⁷ Ordoover and Willig (1993) provide a stylised example of the unilateral effects. Suppose that three firms, A, B and C, compete in the market. Each firm has set its own prices so as to maximise its own profits. An important constraint on each firm's pricing is whatever elasticities of product substitution among consumers. Now suppose that A merges with B. The merged company would now find that a higher price for product A would be profitable because some of the lost consumers switch to product B, and so the merged company AB gains (internalises) some profits from these consumers, which a stand-alone company A would not have gained. Similarly, a higher price for product B is profitable for AB where it is not profitable for the stand-alone company A. Therefore, the combined company AB has a stronger incentive to raise prices than the individual pre-merger companies. Furthermore, as AB raises its prices, company C will likely raise its, leading to dead-weight loss and a reduction in consumer surplus. Note that the competitive harm from this merger does not result from collusion or co-operation. Rather, it results from the ability of the merged company to internalise more of the benefits of the price increase. Obviously, this result depends heavily on the pattern of demand elasticities and cross-elasticities among all products in the differentiated product setting. An illuminating merger simulation based on such elasticities can be found at www.antitrust.org.

competitors by facilitating co-ordination. The impact of co-ordination effects is especially large in oligopolistic markets. With enhanced interdependence and co-ordination, the firms may compete less aggressively.

Game theory shows that in multi-period games where the endpoint is uncertain, co-operation is always a Nash equilibrium strategy. As there are repeated interactions, a player who deviates from co-operation in one period risks punishment in subsequent periods. Modern oligopoly theory, as contributed by Stigler (1964), identifies three crucial elements for co-ordination – the ability to reach agreement, to detect cheating, and to punish deviations. Mergers, while increasing market concentration, and coupled with other factors that facilitate enforcing collusive behaviour, enhance the incentives and abilities of firms to collude.

Beaton-Wells (2006) finds it possible to generalise from the approach of Australian Competition and Consumer Commission (ACCC) that its merger analysis places a focus on the potential for co-ordinated conduct if the merger involves homogeneous market, and on unilateral effects in case of differentiated products market. In Hong Kong, different industries exhibit some variations on the oligopoly models, and differ in degree between the impacts of unilateral and co-ordination effects as a result of mergers.

Potential competition doctrine

It is recognised that most vertical or conglomerate mergers do not raise anti-competitive concerns, because they do not involve combination of firms in direct competition. But if such transactions increase new competitors' entry costs or reduce potential competition, they can be anti-competitive. To reduce the likelihood of entry by a new competitor, a wholesaler (upstream) may elect to acquire the only distributor in town (downstream). This has the effect of making it more costly for a new firm to enter the upstream market, as the latter may have to set up its own distribution outlet if it does enter.

Alternatively, conglomerate mergers may reduce competition by the elimination of a potential competitor. The anti-competitive potential with conglomerate mergers is based on the potential competition doctrine. The Clorox²⁸ case is illustrative of the reasoning behind the doctrine. Procter & Gamble did not compete against Clorox in the liquid bleach market. But by merging with Clorox, Procter would remove itself as a potential independent entrant. The detriments were the losses of both "actual potential competition" – the competitive pressure placed on Clorox by Procter's waiting in the wings, and "potential competition benefit" – to be realised in the future when Procter later entered independently and competed against Clorox.²⁹

The above considerations suggest that horizontal mergers pose real threats of unilateral and co-ordination effects while the effects from potential competition doctrine in case of vertical or conglomerate mergers are more ambiguous. Therefore, the justifications for regulating

²⁸ Federal Trade Commission v Procter & Gamble Co (Clorox) 386 US 568 (1967).

²⁹ Hylton (2003) raises three criticisms against the potential competition doctrine. First, the doctrine is speculative. It is uncertain if independent entry enhances more effective competition than entry by merger. Second, the doctrine does not have a firm statutory basis. The test for merger control is a substantial lessening of competition, not a failure to maximise competition. Third, the doctrine may be counterproductive if it seals off entry by merger, which in some cases is the least costly route of entry.

mergers are more compelling in case of horizontal than vertical or conglomerate mergers. In terms of the potential for error and the associated error costs, a false acquittal is more costly and a false conviction less costly in case of horizontal mergers.

Conduct regulation non-substitutable for merger control

One may argue that effective competitive safeguards dispense with the need for merger control, since a firm abusing market dominance or engaging in anti-competitive conduct would in any event be caught by conduct regulation. In our view, conduct regulation is no substitute for merger control, because competition lessened as a result of a merger cannot be restored by regulating the behaviour of the combined firm ex post.

Consider a hypothetical case of a duopoly where two firms serve an industry and entry barriers are high. A merger between the two duopolists would transform the industry to a monopoly. The firms would no longer compete in prices, services, R&D, advertising, or any aspect of their business operations. No competition authority can force the firm to increase its levels of advertising, R&D, or the quality of services. Nor can it regulate excessive prices of a single firm. Market competition between the two firms would simply be lost, which cannot be restored by conduct regulation.

Without a proper framework to regulate mergers, it would leave a lacuna in law that can be exploited by companies seeking monopoly rent. Regulation against anti-competitive conduct cannot compensate for the deficiency.

Balancing Type I and Type II errors in policy design

Given Hong Kong's characteristics of a small and open economy, it is sensible for policymakers to elect not to over-regulate mergers, i.e., not to commit the error of preventing efficiency-enhancing mergers (Type I error). However, this does not imply that Hong Kong's competition law should not regulate mergers at all. One has to accept that mergers can be pro-competitive or anti-competitive. It is not logical to go so far as to claim that mergers in small economies are all pro-competitive. A policy option of not controlling mergers runs the risks of falsely letting go anti-competitive mergers (Type II error) and harming consumers.

A case study

A proposed merger in the office product retailing market in the United States in 1996 offers insight to the debate in Hong Kong.³⁰ On 4 September 1996, the two largest office superstores in the United States, Office Depot and Staples, announced their agreement to merge. The proposed merger was blocked by the Federal Trade Commission on the ground that it was likely to harm competition and lead to higher prices in "the market for the sales of consumable office supplies sold through office superstores". Statistical data showed that, on average, both Staples and Office Depot priced significantly lower when they competed with one another in local markets. As shown in Table 2, Staples' office supplies prices were 11.6 percent lower in cities occupied by Staples and Office Depot than in cities where Staples was the only supplier. They were 4.9 percent lower in cities with the top three office supplies superstores (Staples, Office Depot and OfficeMax) than in cities where Staples faced only OfficeMax. These data were used to infer the likely increases in prices should the merger be

³⁰ See Kwoka and White (2004) for a detailed analysis of this case.

allowed: about 8.6 percent to 11.6 percent for the markets where there was a Staples-Office Depot duopoly pre-merger, and about 2.5 percent to 4.9 percent for the markets where all the three superstores were present pre-merger.

Table 2
Average Price Differentials for Office Superstore Products, Differing Market Structure

Benchmark OSS Market Structure	Comparison OSS Market Structure	Price Reduction
Staples only	Staples + OfficeMax	11.6%
Office Depot only	Office Depot + Staples	8.6%
Staples + OfficeMax	Staples + OfficeMax + Office Depot	4.9%
Office Depot + OfficeMax	Office Depot + OfficeMax + Staples	2.5%

Source: Kwoka and White (2004), p.62.

This case provides concrete evidence that a horizontal merger can harm consumers by substantially raising prices. From this case, one can also draw implications for the debate about whether Hong Kong needs to have merger control in its competition law. Should mergers of this kind occur in Hong Kong (say between the leading supermarket chain stores), how can one be sure that consumers would not suffer?³¹ A policy of excluding merger control from Hong Kong's competition law is difficult, if not impossible, to justify on economic grounds.

Mergers to monopoly – subject to scrutiny

Based on the above reasoning and arguments, we strongly believe that merger control is necessary and even compelling in Hong Kong's already concentrated market. Without merger control, the government would not be in a position to effectively prevent structural changes that are potentially detrimental to competition and consumer interests. While greater weight should be given to avoidance of Type I errors in policy design for small economies such as Hong Kong, the harm of Type II error should not be overlooked. We believe that the minimum level of merger control Hong Kong must have is to review carefully at least those mergers that would transform an industry into monopoly. More generally, Hong Kong may adopt a merger control regime that is more lenient than those in large economies, but it should not do without merger control altogether.

³¹ It is interesting to note that Staples and Office Depot defended their proposed transaction mainly by appealing to economies of scales. Within three years following the merger's abandonment, Staples and Office Depot each achieved the size (about 1,000 stores) that they would have been achieved as a single firm had the merger been approved by the US government (Balto, 1999). And most of the new stores were in the overlapping markets. Thus, most of the efficiency gains arising from scale economies were achieved without much delay and without the detrimental price effects from a merger.

Lenient merger control for Hong Kong

Prohibition against anti-competitive mergers differs from other competition provisions that directly regulate market conduct in that merger control addresses questions of market structure to prevent the acquisition of market power and the creation of collusion-prone market conditions. Gal (2003) recognises that merger control, by examining market structure from the outset, is one of the most effective tools for regulating anti-competitive conduct. She observes that unique market characteristics in small economies influence the design of optimal merger policy. She argues that a set of flexible instruments, as opposed to rigid rules, is necessary for optimal merger control, given the limited efficiency of conduct-related measures in small economies.

Merger policies in most countries provide safe harbours (defined in terms of the market shares of the merging parties) whereby certain mergers falling within the safe harbours are regarded as unlikely to harm competition. Appendix 1 provides an overview of international comparison of selective economies – including such large economies as the US, the EU, and the UK, as well as small economies such as Canada, Australia, New Zealand, and Singapore. The comparison is summarised in Table 3.

Table 3
Safe Harbours for Horizontal Mergers in Various Jurisdictions

Jurisdiction	CRn Test	HHI Test
The United States	n.a.	HHI<1000; or $1000 \leq \text{HHI} \leq 1800$, with $\Delta\text{HHI} < 100$ or $\text{HHI} > 1800$, with $\Delta\text{HHI} < 50$
The United Kingdom	n.a.	HHI<1000; or $1000 \leq \text{HHI} \leq 1800$, with $\Delta\text{HHI} < 100$ or $\text{HHI} > 1800$, with $\Delta\text{HHI} < 50$
The European Union	n.a.	HHI<1000; or $1000 \leq \text{HHI} \leq 2000$, with $\Delta\text{HHI} < 250$ or $\text{HHI} > 2000$, with $\Delta\text{HHI} < 150$
Canada	No challenge on grounds of unilateral effects if $s_i + s_j < 35\%$; No challenge on grounds of co-ordination effects if $s_i + s_j < 10\%$ or $\text{CR4} < 65\%$	n.a.
Australia	$s_i + s_j < 15\%$; or $15\% \leq s_i + s_j \leq 40\%$ and $\text{CR4} < 75\%$	n.a.
New Zealand	$s_i + s_j < 20\%$; or $20\% \leq s_i + s_j \leq 40\%$ and $\text{CR3} < 70\%$	n.a.
Singapore	$s_i + s_j < 20\%$; or $20\% \leq s_i + s_j \leq 40\%$ and $\text{CR3} < 70\%$	n.a.

Note: $s_i + s_j$ refers to the combined market share of the merged parties post merger; ΔHHI represents the change in HHI caused by the merger.

For example, in the US³², a large economy, it is presumed that the market is unconcentrated if the Herfindahl-Hirschman Index (HHI)³³ is below 1,000, moderately concentrated if between 1,000 and 1,800, and concentrated if above 1,800. The merger falls within the safe harbour if post-merger market is unconcentrated, or if the merger increases the HHI by less than 100 points in a moderately concentrated market, or by less than 50 points in a concentrated market. In Singapore, a small economy, the safe harbour thresholds³⁴ indicate that intervention is unlikely unless the merger will result in (1) the merged entity having a market share of at least 40%; or (2) the merged entity having a market share of between 20% and 40% and the post-merger combined market share of the three largest firms (CR3) at least 70%. Loosely speaking, the safe harbours in the selected small economies are wider than those in the large economies.

There are no precise economic reasons for picking out particular thresholds as safe harbours. Setting the trigger levels too high has the risk of allowing too many anti-competitive mergers. Setting the trigger levels too low will mean unjustifiable use of resources to conduct full merger analysis on almost every individual case. Notwithstanding that, the thresholds when applied sensibly are useful screening devices to filter out mergers that should be allowed without further investigation. This will save valuable resources and give rise to regulatory efficiency and predictability.

It appears that the HHI methodology adopted by the US is the most stringent, and rightly so. As the US is such a large economy, a firm holding 10% market share in a particular industry may be of such large scale of operation that any scale economy should be exhausted. But in small market economies, it is always argued that the need to achieve minimum efficient scales necessitates merger activities, and hence a concentrated market.

The two filters adopted by Canada are based on sound logic. Market share alone, if less than 35%, precludes only challenge on the ground of unilateral effects. As regards interdependence, i.e. co-ordination effects, the safe harbour threshold is CR4. When the thresholds are exceeded and there are barriers to entry, other factors will be evaluated.

It is observed that the CR3 thresholds adopted by New Zealand and Singapore represent wide safe harbours. As to how wide the thresholds should be for Hong Kong, we would argue that they need not be among the widest, but definitely not stringent ones. The small market doctrine should be applied with caution in Hong Kong, given that Hong Kong is a very densely populated economy with a high per capita GDP, an efficient transport system and a high-tech infrastructure. These factors will bring down the logistic costs per dollar earned. In fact, more players can be accommodated in Hong Kong than in other truly small market economies. Size is not a prerequisite for scale economies in some industries. Many small and medium sized enterprises can survive and thrive in Hong Kong without the need for large-scale operations.

³² See US DoJ & FTC 1992 Horizontal Merger Guidelines.

³³ The HHI methodology is used as a screening device. It involves summing up the squares of the market shares of each individual firm in the relevant market. HHI ranges from 0 to 10,000 moving from atomistic competition to single monopoly.

³⁴ See the Guidelines on Merger Procedures 2007 issued by the Competition Commission of Singapore.

Safe harbours for telecommunications mergers

Currently in Hong Kong, only the telecommunications sector is subject to merger control³⁵. In the Telecommunications Authority Guidelines for Mergers and Acquisitions in Hong Kong Telecommunications Markets, two safe harbours are set out as screening devices to filter out mergers that are unlikely to substantially lessen competition, hence do not warrant further investigation. The two safe harbours are independent, based on CR4 test and HHI methodology respectively. Satisfaction of either test will escape further investigation.

The CR4 test has two limbs. It satisfies the first limb if the combined market share of the merged entity is less than 15%. Alternatively, for the merged entity between 15% and 40% combined share, it still falls within the safe harbour on the second limb if the post-transaction combined market share of the largest four market participants (CR4) is less than 75%. The two limbs mirror the thresholds adopted in Australia.

The HHI methodology presumes the market to be unconcentrated if the HHI is below 1,000, moderately concentrated³⁶ if between 1,000 and 1,800, and concentrated if above 1,800. The merger falls within the safe harbour if post-merger market is unconcentrated, or if the merger increases the HHI by less than 100 points in a moderately concentrated market, or by less than 50 points in a concentrated market. As such, the HHI methodology mirrors exactly the US thresholds.

When the thresholds are exceeded, the Telecommunications Authority (TA) will conduct a full investigation to look into the dynamic as well as structural factors. The criteria for analysis are very wide ranging, including unilateral and co-ordination effects, counterfactual, removal of maverick, barriers to entry, countervailing buying power, import competition, technological change and efficiency defence etc.

The two screening devices adopted in the Hong Kong telecommunications sector have in theory widened the safe harbours, because satisfaction of either test will escape further investigation. We consider the CR4 threshold sufficiently wide for Hong Kong. Yet the HHI methodology just mirrors that of the US, and is likely to block many transactions³⁷ that pass through the CR4.

In fact, as depicted in Figure 1, in concentrated industries ($HHI > 1,800$, or $CR4 > 70\%$), mergers between two firms of similar (or identical $s_i + s_j = 2s_i$) market shares will fail the HHI test but pass the CR4 test if $10\% < 2s_i < 15\%$, because the increment in HHI will exceed 50, i.e., $\Delta = 2s_i s_j > 50$. In moderately concentrated industries ($1,000 < HHI < 1,800$, or $50\% < CR4 < 70\%$), mergers between two firms of similar (or identical $s_i + s_j = 2s_i$) market shares

³⁵ Under Hong Kong's current competition policy, Section 7P of the Telecommunications Ordinance regulates certain mergers involving telecommunications carrier licensees.

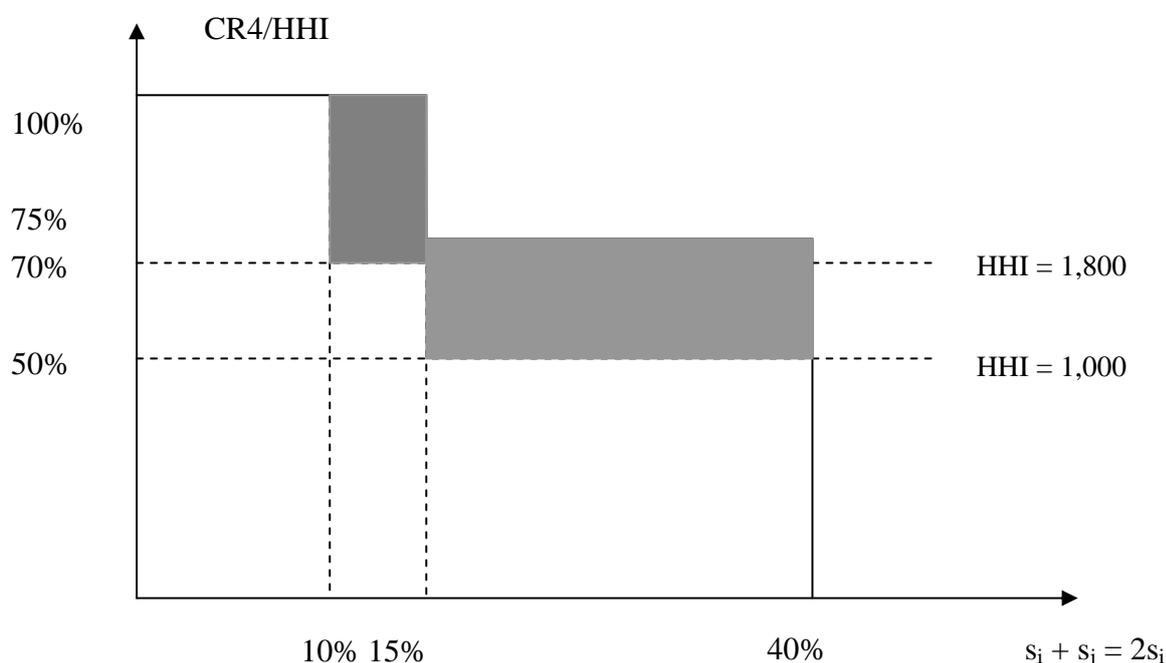
³⁶ HHI points of 1,000 and 1,800 translate empirically (on the basis of simple correlation) to CR4 of approximately 50% and 70% respectively (Kwoka, 1985).

³⁷ Take an example of a market evenly distributed among 11 firms, its CR4 is roughly 36% and HHI 900, hence unconcentrated. Intuitively, a firm holding 9% market share is unlikely to be a sizeable operation in Hong Kong, hence scope for merger activities to reap the benefit of scale economies. A merger between any two firms in this market will give rise to a post-merger CR4 of 45%, still well within the safe harbour on the second limb of the CR4 test. But it fails the HHI test by increasing over 160 points on HHI scale and moving the market to moderate concentration post-merger.

will fail the HHI test but pass the CR4 test if $15\% < 2s_i < 40\%$, because the increment in HHI will exceed 100, i.e., $\Delta = 2s_i s_j > 100$.

The shaded areas in Figure 1 represent (a portion of) the set of those mergers that fail the HHI test but pass the CR4 test under the existing merger policy in the telecommunications sector of Hong Kong. Given that the CR4 test is comparable to that in such small economies as Australia and Singapore and that the HHI test is identical to that of the world largest economy, the United States, there is a need to relax the HHI test in the telecommunications sector, so as to make it more compatible with the CR4 test.

Figure 1
The Merger Safe Harbours in the Telecommunications Industry of Hong Kong



Note:

HHI points of 1,000 and 1,800 translate empirically (on the basis of simple correlation) to CR4 of approximately 50% and 70% respectively (Kwoka, 1985).

Proposed merger thresholds for Hong Kong's cross-sector regime

Based on the above analysis, we suggest the government to consider adopting one of the following two options in designing its merger control policy in the cross-sector competition law, both are modified versions of the existing merger control regime in the telecommunications sector.³⁸

³⁸ See Lin and Fung (2007) for some related discussions.

Option 1

Remove the HHI test altogether and use only the CR4 test as the one adopted in the telecommunications sector.

This would put Hong Kong more or less in line with other small economies such as Singapore, New Zealand, Australia and Canada.

Option 2

Maintain the CR4 test and relax the HHI test in the telecommunications sector. Specifically, we suggest that a market should be presumed unconcentrated if the HHI is below 1,500, moderately concentrated if between 1,500 and 2,500, and concentrated³⁹ if above 2,500. In applying the HHI test, we propose to proceed with full investigation only on those mergers raising the HHI by at least 250 points⁴⁰ in a moderately concentrated market, or by at least 150 points⁴¹ in a concentrated market. Satisfaction of either test alone will spare the merger further investigation.

Under option 2, Hong Kong's safe harbours for merger control will be larger than those in those economies reviewed in Table 3, and arguably the most lenient worldwide, as satisfaction of either test alone will spare the merger full investigation. These filters will serve as true alternatives to expand the effective coverage of the safe harbour mechanism. We are more inclined to recommend this option.

Consistency in enforcement: A review of cases under OFTA's analysis

As of December 2007, there have been seven completed cases analysed by the TA since the enactment of merger regulation in 2004 in the Hong Kong telecommunications sector. All such transactions were approved. (See Table 4 below.) The cases are outlined in some detail at Appendix 2.

³⁹ As examples, an evenly distributed 4-firm market with each firm having a share of 25%, or a 5-firm market with firms having shares of 35%, 25%, 20%, 15% and 5% will give rise to HHI of 2,500.

⁴⁰ Consider some examples under the proposed criteria in a moderately concentrated industry. A merger between two firms each with pre-merger market shares of 8% will escape investigation on both the HHI and CR4 tests, if the post-merger CR4 is less than 75% (the second limb). Given its increment of HHI of 128, this merger still escapes investigation on the HHI criteria, if the post-merger CR4 exceeds 75%. Another merger between two firms with pre-merger market shares of 11% and 10% will escape investigation on the CR4 tests, if the post-merger CR4 is less than 75%, though it fails the HHI test with a delta increment of 220. If the post-merger CR4 exceeds 75%, this merger fails both tests and will proceed to a full investigation. The above shows that the widened HHI and the current CR4 are more or less comparable. They lead to the same outcome under certain conditions, and different outcomes under other conditions, but neither is more stringent

⁴¹ Consider some examples under the proposed criteria in a concentrated industry. A merger between two firms with pre-merger market shares of 8% and 6% will escape investigation on both grounds. It satisfies the HHI test with an increment of HHI of 96, and the CR4 criteria on the first limb with a combined market share of 14%. Where HHI is above 2,500 (proposed threshold for concentrated market), a merger of firms with pre-merger market shares of 8% and 7% (or more) is likely to lead to post-merger CR4 higher than 75%, hence fails both limbs of the CR4 test. It also fails the widened HHI with a change of HHI of 112 (or higher), and need to proceed to a full investigation. The above again shows that the widened HHI and the current CR4 are more or less comparable. They are accommodating to mergers between players with small shares, but hostile to mergers between players with high market shares in a concentrated market.

Table 4
Recent Merger Cases Considered by the Telecommunications Authority

Case	Year	Outcome
Acquisition of 20% shares in PCCW by China Netcom	2005	Approved
Acquisition of SUNDAY by PCCW	2005	Approved
Acquisition of Peoples by China Mobile	2005	Approved
Joint Ownership of CSL and NWPCS	2006	Approved
Change of ownership of Asia Netcom and its potential consolidation with C2C	2006	Approved
Acquisition of Interest in PacNet by the Parent Company of Asia Netcom	2007	Approved
Acquisition of Interest in AsiaSat Holdings by General Electric Capital Corporation	2007	Approved

Source: Office of the Telecommunications Authority

In his merger analysis, the TA did not simply mechanically apply the market share and concentration thresholds to decide whether the cases would warrant a full investigation. In addition, the TA took into account the prevailing market scenario and considered the possibility of unilateral and co-ordination effects, the extent of entry barriers or any loss of potential competition by independent entry or re-entry. On the whole, we find the TA's analysis quite thorough and consistently applied to the cases, and his approach appeared to be generally permissive.

In the PCCW/China Netcom, Asia Netcom and PacNet transactions, all involving the wholesale external bandwidth services market, the TA's main consideration in allowing the acquisitions was the level of excess capacity in the market. In PCCW/China Netcom, the downward price trends observed in 2003 and 2004 were specifically mentioned as indication of a competitive market. In PacNet, the TA took into account PacNet HK's business focus on the downstream market, and considered the transaction more of a vertical integration than horizontal. This demonstrated that the TA was accommodating to case specifics, and was permissive in a factual analysis.

In the SUNDAY/PCCW, Peoples/China Mobile acquisitions and the horizontal CSL/New World Mobility merger, all involving the mobile telephony market, the TA's approach was again permissive. In SUNDAY/PCCW, the merger narrowly fell within the CR4 safe harbour on a widely defined fixed-line and mobile telephony market⁴². Alternatively on a narrowly defined market, SUNDAY's overwhelming focus on mobile telephony where PCCW no longer had operation⁴³ might indicate a conglomerate merger, which normally would not raise competition concerns.

⁴² Satisfaction of CR4 alone spared the merger further investigation. The post-merger HHI of 1,678 indicated a moderately concentrated market, but the delta change was not calculated to assess if it fell within the 100-point threshold.

⁴³ PCCW has sold its CSL mobile telephone business to Telstra in 2002.

In Peoples/China Mobile, there was no competitive overlap in the geographic markets, as China Mobile operated on the mainland but not in Hong Kong. The TA then considered the vertical integration effect on roaming services, and concluded that any preferential advantage that Peoples might acquire would sharpen (rather than lessen) competition between MNOs in the local market.

In the CSL/New World Mobility merger, both CR4⁴⁴ and HHI⁴⁵ fell outside the safe harbours, even by the merging parties' own calculation. Another licensee provided a higher prediction of the merging parties' derived market power from an estimate of their combined market share⁴⁶ on the basis of retail revenue. The TA disregarded the safe harbour thresholds because the application for consent obliged him to conduct a full investigation. In allowing the merger, the TA gave weight to the evidence that the merging parties had divergent business focus in the past with few competitive overlaps.

In AsiaSat Holdings, involving the market for the provision of satellite transponder capacity, the TA was convinced by a global competition scenario to allow the transaction without proceeding to a full investigation. The TA noted that competition was not limited to local satellite operators, but included over 90 satellites in operation with coverage over Hong Kong, under the "open sky" policy.

In summary, the TA's analysis of the seven merger cases so far exhibits a generally permissive approach with several observable characteristics. First, the mergers are not challenged unless there is likely to be overwhelming anti-competitive effects. In fact, all the seven transactions are cleared – five in the preliminary stage, two upon detailed merger review which is necessitated by the merging parties' application for consent. In those two cases, consent is granted without conditions or directions, including the CSL/New World Mobility merger where both safe harbour thresholds are exceeded. Second, the TA does not mechanically apply the screening devices. Instead, he adopts a very systematic approach, considering a broad range of economically meaningful factors including market definition, market share and concentration, potential independent entry, market foreclosure, entry barrier, technological change and efficiency defence. Finally, the TA has applied consistently this systematic approach, which is in accordance with the merger regulation.

We are of the view that the TA's permissive approach is intentional, and with good reasons. The telecommunications sector is very dynamic, undergoing such rapid technological change that the TA would tilt the balance against excessive regulation, but in favour of innovation by allowing mergers as far as possible.

Implications for a cross-sector regime

To learn from the telecommunications cases, we concur with the TA's generally permissive approach in merger control. Especially in the initial years of exercising control, mergers

⁴⁴ Post-merger CR4 was 85.48% with the merged firm having a market share of 32.61%, falling outside both limbs of the safe harbour.

⁴⁵ Post-merger HHI was 2,189 with an HHI increment of 531 in a market moving from "moderately concentrated" to "highly concentrated".

⁴⁶ In response to the TA's consultation, Hutchison Telephone Company Ltd argued that true market power of an operator would better be reflected by its customers' actual service consumption than by subscriber number. It further submitted that the merging entity would derive significant market power from the enormous combined market share, which according to its estimate would reach 38% based on retail revenue.

should not be challenged if there is no genuine probability of anti-competitive effects. It is impressive that the TA does not mechanically apply the market share and concentration thresholds to decide whether to proceed with a full investigation. Even in his preliminary review, the TA adopts a very systematic approach, taking into account wide-ranging factors and specific market characteristics in light of commercial realities.

As argued before, the real threats of unilateral and co-ordination effects, especially in case of horizontal mergers, warrant merger control in a competition law regime. We would reiterate that merger control is especially important for small market economies. In Hong Kong, the fact that only the telecommunications sector is subject to merger control is incidental, peculiar to its current sector-specific competition regime. There is no logical, economic or legal reason why particular sectors should be singled out for merger control but other sectors are exempted.

The current regulation of mergers in the telecommunications sector provides a good framework for setting up a cross-sector regime on merger control. In the existing regime, it does not require ex ante notification to the TA on intended mergers. Nevertheless, the TA retains the power to investigate specific mergers on its own initiative or in response to third party complaints. Notification being non-mandatory, merging parties may voluntarily request the formal or informal consent of the TA before proceeding their deal. Such flexibility is certainly beneficial to the industry.⁴⁷ Light-touch and responsive, the control regime will balance the need for clearing non-problematic mergers and blocking anti-competitive mergers.

In the telecommunications regime, no adverse presumption is construed against the merging parties. The burden is on the TA to establish the effect of substantially lessening competition and the absence of outweighing public benefit, on the balance of probabilities. The term “public benefit” is not defined in the Ordinance. The TA is in principle able to consider any benefit at his discretion. It is noteworthy that the public benefit defence, if construed widely, will be too inclusive to accommodate non-competition related policy concerns. We consider this undesirable. First, incorporating policy considerations into merger analysis taints the role of competition law. Second, it tends to subject the competition authority to substantial lobbying efforts by special interest groups.

We would argue that public benefit defence should be accorded only a very limited role (if any role at all) in merger analysis. Public benefit, if not based on economic or competition issues, should not be given weight. Otherwise it will tamper with competition analysis, with adverse consequences. Cheng (2007) points out quite rightly that non-competition related concerns should be addressed on a broader policy level and not by bending competition law.

The way forward: our recommendations

We strongly believe that merger control is necessary to ensure the effectiveness of a competition law regime, for large or small economies. In a small market economy such as Hong Kong, the need for scale economies sometimes necessitates a certain degree of rationalisation. The objective of merger control is not to arbitrarily avoid reducing the number of competitors. Rather, it is to ensure that market competition does not lessen consequential to a merger.

⁴⁷ As demonstrated by the experience of Australia with informal review process, very few cases are litigated.

We do not regard having a merger control system as too intrusive. The real threats of unilateral and co-ordination effects post-merger will undermine the competitive process. Mergers may also adversely affect dynamic efficiency in the long run because merged entities may not have as a strong incentive to innovate as in a more competitive market pre-merger. The importance of scale economies does not imply that one should completely leave anti-competitive merger unregulated (Type II error in policy design). A policy that completely ignores the Type II error in an attempt to avoid the Type I error (preventing pro-competitive mergers) is difficult to justify. The right balance should be achieved by optimal design of merger control. Moreover, merger control should be applied cross-sector in Hong Kong. There is no logical, economic or legal justification for singling out some sectors.

The optimal merger control regime would differ across various economies. In order to avoid causing hindrance to welfare-enhancing mergers, the control regime should be light-touched, and applied flexibly in light of commercial realities. Based on our review of safe harbours in other jurisdictions, particularly that of small economies, and the existing thresholds in the telecommunications sector, we recommend that Hong Kong adopt a merger control policy that is even more lenient than the existing one in the telecommunications sector – with the current CR4 test and a widened HHI methodology. This proposed merger policy is arguably the most lenient in the world.

That said, the screening device does not preclude case-by-case analysis for complex cases. In a merger review, sound tests for efficiency are necessary, and public benefit defence should be limited to economic or competition considerations, so as not to tamper with competition analysis.

Treatment of Small and Medium-sized Enterprises

One of the most debated and politically sensitive issues in Hong Kong is whether its new competitive law should allow for exclusions or exemptions of SMEs from the applications of some or all aspects of the law. As mentioned earlier, the members of the Federation of Hong Kong Industries claims that (Federation of Hong Kong Industries, 2007)

“Contrary to the popular belief that introducing a cross-sector competition law would benefit SMEs, there is evidence that the law would provide a convenient avenue for large corporations to sue their smaller counterparts for anti-competition. Since many SMEs cannot afford to pay the huge legal costs involved, not to mention the time and energy required of management in such lawsuits, large corporations could eliminate competitors in the courtrooms without having to competing with them in the market place.”

Some other organisations of SMEs are of the view that the Hong Kong economy is working well and a competition law would only impose unnecessary constraints on their business (Economic Development and Labour Bureau, 2007, p.6). Concerns of the SMEs are the main reason why the government decided to undertake another round of consultation before preparing and submitting a draft competition law to the Legislative Council as originally planned.⁴⁸

⁴⁸ According to a sample survey conducted by the Census and Statistics Department, as of December 2000, there were approximately 290,000 SMEs in Hong Kong, accounting for 98 percent of local enterprises. They

The views of SMEs in Hong Kong are seemingly in sharp contrast with those of SMEs in other countries.⁴⁹ In most countries, SMEs normally support a competition law because they are often the victims of anti-competitive practices of larger or dominant firms (including their suppliers, customers, or competitors). A 2005 survey by the Office of Fair Trade of the United Kingdom showed that nearly a quarter of SMEs believe they have been a victim of anti-competitive practices. Only a minority would report it (for fear of retaliations by large companies).⁵⁰ Tables 5 and 6 provide information about the perceived impact of anti-competitive or informal practices on SMEs in over 80 countries surveyed by the World Bank in its Investment Climate Private Enterprise Survey.⁵¹ As can be seen, about 50 percent of the SMEs in manufacturing regard anti-competitive or informal practices by their competitors as either moderate, major or severe obstacles to their business operations. Of those enterprises, about 14.5 percent regard them as very severe obstacles to their business. In the services sector, about 43 percent of the SMEs view the anti-competitive practices of their competitors as moderate, major or very severe obstacles to their business operations.

Table 5**Anti-Competitive/Informal Practices as an Obstacle to SMEs in Manufacturing, 2002-05***

Anti-competitive/ Informal practices	Frequency	Percentage (%)	Cumulative distribution	Manufacturing as a whole (%)
0 No obstacle	6,241	33.11	33.11	33.74
1 Minor obstacle	3,136	16.64	49.75	17.39
2 Moderate obstacle	3,417	18.13	67.88	18.08
3 Major obstacle	3,225	17.64	85.52	17.17
4 Very severe obstacle	2,730	14.48	100.00	13.61
Total	18,849	100.00		100.00

Table 6**Anti-Competitive/Informal Practices as an Obstacle to SMEs in Services, 2002-05***

Anti-competitive/ informal practices	Frequency	Percentage (%)	Cumulative distribution	Services as a whole (%)
0 No obstacle	3,615	36.11	36.11	36.04
1 Minor obstacle	2,148	21.46	57.57	21.67
2 Moderate obstacle	2,175	21.73	79.30	21.77
3 Major obstacle	1,872	18.70	98.00	18.34
4 Very severe obstacle	200	2.00	100.00	2.17
Total	10,010	100.00		100.00

employed more than 1.36 million people, which accounts for about 60 percent of the private sector employees. Nearly 90 percent of the SMEs had fewer than 20 employees (Trade and Industry Department, 2001).

⁴⁹ SMEs are usually defined in terms of assets or number of employees, which are not good measures for the purpose of competition law. The better criterion is market share, but which is difficult to establish. According to the Trade and Industry Department in Hong Kong, SMEs are defined as follows: manufacturing firms employing fewer than 100 persons in Hong Kong; or non-manufacturing firms employing fewer than 50 persons in Hong Kong.

⁵⁰ See <http://www.oft.gov.uk/news/press/2005/129-05>.

⁵¹ The survey covered over 50,000 firms in about 80 countries from 2002 to 2005. Informal practices refer to such practices as tax evasion, employing child labour, etc. From the entire survey results, we extracted the information in the tables for those enterprises with fewer than 100 employees in manufacturing and those with fewer than 50 employees in services sectors, which corresponds to the official classification of SMEs in Hong Kong.

* Tables 5 and 6 are based on the responses to the question:

“If the following issues pose a problem for the operation and growth of your business, judge its severity as an obstacle on a four-point scale where: 0=No obstacle, 1=Minor Obstacle, 2=Moderate obstacle 3=Major obstacle, 4=Very severe Obstacle.

.....

Anti-competitive or informal practices

.....”

SMEs refer to establishments with fewer than 100 employees in manufacturing and those with fewer than 50 employees in services sectors.

Source: The World Bank, Productivity and the Investment Climate Private Enterprise Survey

The Hong Kong SMEs’ concerns are understandable, broadly in terms of three reasons. First, SMEs get used to operate in a free business environment for decades and do not trust or welcome new governmental regulation. Second, it is believed that any new law would inevitably raise the costs of doing business by creating compliance costs. Third, SMEs seem reluctant to confront big players in court, even if victimised, for fear of prohibitive litigation costs and/or retaliation.

However, it does not follow that SMEs, or any other enterprises/sectors for that matter, should be exempted from all provisions of a competition law. Automatic exclusions will dilute the effectiveness of the law. There is no compelling reason why blanket exceptions should apply to certain sectors or groups of players. The better position is for proposed exemptions to be tested under economic analysis, and if considered fit, be exempted from particular aspects of the law only.

Given that SMEs do not normally possess market power, not to mention market dominance, and that mergers between SMEs are very unlikely to harm competition due to their mere size, it is justifiable on the ground of economic efficiency that SMEs are exempt from competition provisions governing mergers and abuse of market power.⁵² However, no firms should be exempted from prohibition of hardcore cartels (price-fixing, market allocation, production and sales quotas, and bid rigging). While SMEs in certain sectors may have adopted price-fixing as a means to avoid cut-throat price competition, such practice is harmful to consumers.⁵³ It is well established in economics that the harm to consumers exceeds the gain to the sellers, so price-fixing generates net social losses and should therefore be prohibited per se whether the firms involved are small or big.

We recommend that SMEs be exempted from certain prohibitions under Hong Kong’s new competition law based on efficiency considerations. Specifically, we recommend that

- SMEs be exempted from provisions governing mergers and acquisitions;
- SMEs be exempted from prohibitions of abuse of market power; and
- SMEs be liable for hardcore cartel violations (price-fixing, market allocations, production and sales quotas, and bid rigging).

⁵² A possible drawback of the exemption scheme is that market structure may be distorted in certain circumstances, for example, when some big companies set up a subsidiary (within the protection of safe harbours) simply to carry out certain practices which would otherwise be caught under the anti-competitive provisions.

⁵³ Certain anti-competitive practices may have been perceived as legal ways of doing business simply by convention.

There is now strong international consensus on the harmfulness of hardcore cartels. The U.S. Supreme Court has characterised cartels as the “supreme evil of antitrust” since its early stage of antitrust enforcement (see, e.g., U.S. Department of Justice, 2006). In fact, because they have no plausible economic efficiency justification, as demonstrated by economic theory, hardcore cartels are considered per se unlawful in many countries.⁵⁴ Cartels also devoid of competition value and corrode the competition culture. It is because of the tremendous economic and social costs cartels generate to society, prevention of cartels is given the highest priority by the antitrust authorities in the United States, and elsewhere.⁵⁵

Despite the SMEs' resistance against a competition law, it is surprising if most SMEs in Hong Kong would not have been victimised by anti-competitive conduct. One possibility is that they may not have a correct perception of anti-competitive practices, or simply have not fully realised their impacts.⁵⁶ The likelihood and costs of anti-competitive practices are underestimated by enterprises in Hong Kong, especially SMEs, because the notions of competition law are relatively new and people do not yet have a good understanding of what constitute anti-competitive practices. It should also be pointed out that some SMEs may oppose to establishing a competition law because the law would compel them to cease certain anti-competitive practices such as price-fixing.⁵⁷ An appropriate remedy is obviously to promote good understanding through education, about the social costs of anti-competitive practices and how to realise the benefits of a competition law.

With regard to SMEs' worries about compliance costs, a competition law can be introduced without periodic filing requirements. With the above “partial exemption” scheme we propose, compliance burden of the SMEs will be kept at a minimum and an acceptable level. In fact, the only compliance costs SMEs have to incur is in the case of hardcore cartels (whether facing public or private litigation), should there be such allegations.

Moreover, SMEs should not resist a competition law simply because they are reluctant to confront big players in court. Even if litigation costs can be high, SMEs are still better off with a competition law than without, at least they have the option to sue big players (if the case is meritorious). Without a law, they have nowhere to seek justice. If SMEs are in fear of retaliation or any jeopardy to their business relationship with big players, a competition law with an enforcement authority will shield them from direct confrontation with big players. SMEs only need to provide evidence and co-operate with the authority in the investigation process, and the authority will take up the task of checking on big players.

⁵⁴ Enforcement against cartels thus carries no risk of harming the market through erroneous intervention.

⁵⁵ See, e.g., Chemtob (2007).

⁵⁶ Certain anti-competitive practices may even be regarded by some enterprises as legitimate. For example, facing rising price levels of imports (due partly to a weakening US dollar and thus Hong Kong dollar), the Hong Kong and Kowloon Vermicelli and Noodle Manufacturing Industry Merchants' General Association published a newspaper advertisement recently, calling on businesses using flour to increase wholesale prices by 20 percent and retail prices by 25 percent. The Association shortly withdrew such a suggestion after being told by the government and the Hong Kong Consumer Council that its advice breached the principles of fair competition (South China Morning Post, 30 January, 2008).

⁵⁷ Some SMEs' representatives and an invited speaker once admitted that it had been a convention among certain groups of small service providers to set prices collectively and that a competition law would compel them to change their ways of doing business and possibly drive some of them out of the market (Hong Kong Competition Policy Forum, 21 November, 2007).

To support the growth of SMEs, competition laws in some countries provide special protection to SMEs. In Singapore, some presumptions are construed to exempt certain market participants from Section 34 prohibition (involving agreements or concerted practices) of the Competition Act 2004. Specifically, agreements (except hardcore cartels) between SMEs⁵⁸ or other participants below certain market share thresholds⁵⁹ are generally presumed to have no appreciable adverse effect⁶⁰ on competition, hence not caught by Section 34 prohibition.

In the United States, collaboration between competitors⁶¹ will normally not be challenged if the market shares of the collaboration and its participants collectively account for no more than 20% of each relevant market. It is noteworthy that such safety zone does not apply to hard core-cartels, similar to what we recommend for Hong Kong.

In sum, it is justifiable on efficiency ground that SMEs be exempted from competition provisions of mergers and acquisitions and abuse of market power. However, hardcore cartels are harmful to economic welfare and corrode the culture of competition, and should be strictly prohibited, regardless of the size of the participants. A competition law will do justice to SMEs by setting up the rules of the game without imposing onerous legal burden (especially as SMEs are likely to fall within the safe harbours provided by law), and enabling SMEs to sue big players for anti-competitive practices.

Enforcement

On the enforcement structure and penalty design for Hong Kong's cross-sector competition law, our views are as follows.⁶²

Sanctioning policy

The aim of a sanctioning policy is focused on its deterrent effect from an economic perspective. Yet non-economic goals should not be ignored, in particular corrective and proportional justice.

Criminal fines are certainly more effective in terms of deterrence.⁶³ From the perspective of corrective justice (compensatory), one may consider it "just" to disgorge the profits gained by the infringement. In the notion of proportional justice, one should also observe the "penalty

⁵⁸ SMEs in Singapore are defined as – manufacturing SMEs if they have Fixed Assets Investments of less than S\$15 million, and services SMEs if they have less than 200 workers.

⁵⁹ For participants not within the definition of SMEs, exemption is subject to market share thresholds – competing parties with total relevant market share not exceeding 20%, or non-competing parties each not exceeding 25% relevant market share.

⁶⁰ See Ong (2007) for an analysis on how the concept of appreciability is applied in practice.

⁶¹ Section 4.2 of the Antitrust Guidelines for Collaborations among Competitors, issued jointly by the Federal Trade Commission and the Department of Justice of the United States, April 2000.

⁶² The part is drawn heavily from our response to the government's consultation paper, Chen and Lin (2007).

⁶³ The effective leniency program of the US is attributable to the availability of criminal sanctions. In the UK, the Enterprise Act 2002 introduced a criminal hardcore cartel offence punishable with imprisonment and director disqualification and/or fines on individuals, to supplement its national law regime of administrative fines on companies for breach of anti-competitive provisions. In Ireland and Estonia, price-fixing and related hardcore cartel behaviour have been criminalized. In Germany and Austria, imprisonment is specifically provided for bid rigging, plus non-criminal fines on individuals and derivatively on companies (Germany) or only on companies (Austria).

fits the offence” principle. Policymakers must make choices depending on a balance of the policy objectives.

In Hong Kong's culture, the society may not readily accept that violations of competition law warrant criminal sanctions (especially when the notions of competition law are still relatively new in Hong Kong). Notwithstanding the experience of the US and Europe, it has not yet been tested locally whether heavy financial penalties will be sufficiently deterrent. Imprisonment of corporate executives for anti-competitive behaviours (essentially economic transactions) may appear very harsh, likely to be rigorously resisted in Hong Kong.

To balance the severity of sanctions against the gravity of harm, we would propose that fines and director disqualification be imposed on offenders of hardcore cartels (price-fixing, market allocation, production and sales quotas, and bid rigging), and monetary fines, civil or administrative, on all other competition infringements.⁶⁴ This however does not rule out the possibility of reviewing the policy option in future to institute criminal sanctions if warranted by circumstances.

Level of fines

Sanctions must have sufficient deterrent effect. It is well reasoned in Van den Bergh and Camesasca (2006) that crimes will be committed⁶⁵ if the expected gains exceed the expected costs, which equal the penalties discounted by the probability of detection and punishment. The economics of law has established that the level of fines must exceed the actual amount of illegal gains to be deterrent, since the probability of detecting a violation is less than one.

Fines can be calculated either on the basis of turnover or by referring to the gains of the offenders or the losses caused by the infringement of the competition rules. Fines based on turnover are relatively easy to assess and will simplify the task of law enforcement, though it is not established that turnover has a direct bearing on the payoff by which the players are tempted to run the risk of punishment. The harm of anti-competitive infringements⁶⁶ is most difficult to measure. By comparison, the calculation of illegal gains is a bit simpler, but must still be subject to vigorous economic analysis. Camilli (2006) argued that the deterrent effect was specifically linked to the gain from infringement, to the affected commerce and the mark-up.

Different jurisdictions adopt divergent fining policies. These policies seem to be convergent towards quantitative criteria and predictability. In the US, the formula for criminal fine is based on twice the gain to the cartel, or twice the loss suffered by the victims. Fines can be imposed on corporations as well as individuals, and individuals can also face imprisonment. In addition, civil (often “treble”) damages are also well established. By comparison,

⁶⁴ Williams also proposed to impose punitive fines on the company coupled with director disqualification (The Second Asian Competition Law & Policy Conference, December 2006). He argued that sanctions must be “personal” for the law to bite. Imposing financial penalties on the companies alone does not guarantee that the chief executives who have violated the law get penalised, especially when these executives are controlling shareholders, as is the scenario of many conglomerates in Hong Kong. Additionally, financial penalties can easily be passed on in reduced dividends and higher prices.

⁶⁵ Taking calculated risks in decision-making is based on the assumption of rational behaviour associated with white-collar crimes, as opposed to a different scenario for irrational crimes (such as murder).

⁶⁶ It consists of the consumer surplus transferred to the producer, the dead-weight loss, the losses in productive and dynamic efficiencies and the costs of rent seeking efforts.

administrative fines are imposed by the European Commission with quantitative measure to fix the maximum and qualitative criteria to classify infringements in different categories (very serious, serious and minor).

In September 2006, the European Commission has refined its fining policy, and adopted the new 2006 Guidelines⁶⁷, which exhibit some novelties. First, the basic fine (up to 30 per cent of the sales value to which the infringement “directly or indirectly relates” in cartel cases) multiplied by the number of years of participation in the infringement. Second, the “entry fee” equal to 15 to 25 per cent of the relevant sales value, untied from the duration of the infringement and is specific to hardcore cartels. One of the Commission’s goals in revising the Guidelines is to increase the predictability of fines.

As for Hong Kong, we propose that hardcore cartels should carry the penalties of heavy fines coupled with director disqualification, and other lesser infringements carry more discretionary fines. Given that illegal gains may be difficult to measure, fines may be linked to the turnovers of the offenders.

Leniency program

We strongly recommend that a new competition law include a leniency program to encourage whistle blowing.⁶⁸ Whistle blowing is more effective (if not the only possible means) to detect and lead to successful prosecution of hardcore cartels⁶⁹.

First of all, cartelisation is difficult to establish because the evidence is circumstantial. The prosecution usually has to make possible inferences from telephone calls, meetings, pricing patterns and other circumstantial evidence. Such inferences seldom meet the standard of proof in a criminal court. In jurisdictions where hardcore cartels are criminalized, leniency programs are increasingly implemented to encourage whistle-blowing. Leniency policy can be an effective means of detecting, investigating and prosecuting or adjudicating cartel conduct.

To quote Monti (2004), “[t]he so-called leniency programme has proved to be a formidable tool for encouraging firms which have infringed competition rules to co-operate with the Commission. Not only does this allow cartels to be uncovered, but more generally the risk that a member of the cartel might go to the authorities to secure immunity tends to destabilise the activity of the cartel itself and to discourage the formation of cartels in the first place.”

Under a leniency program, the first cartel member to report to the enforcement agency about the existence of the cartel is awarded amnesty.⁷⁰ In his presentation before the ICN Workshop,

⁶⁷ Available at: <http://ec.europa.eu/comm/competition/antitrust/legislation/fines.html>.

⁶⁸ See Lin and Ma (2006) for a game-theoretical analysis of leniency program and a comparison of leniency programs in selected countries.

⁶⁹ Cartelisation is difficult to establish because the evidence is circumstantial. The prosecution usually has to make possible inferences from telephone calls, meetings, pricing patterns and other circumstantial evidence. Such inferences seldom meet the standard of proof in a criminal court.

⁷⁰ In the United States, the terms corporate immunity, corporate leniency, and corporate amnesty are all synonymous, referring to a company that is the first to report anti-competitive activity and that is seeking a pass from prosecution and a 100% reduction in fines. Informally, when the EU uses the term “immunity” it refers to full immunity (or 100% reduction in fines), and a reference to “leniency” includes cases where a company is not awarded full immunity, but earns a reduction in fine (50% or less). See Hammond (2004).

Hammond (2004) shared the experience of the Department of Justice of the United States that introduced the first leniency program in the world in 1978, in an effort to combat cartels. There was only one leniency application per year, and the original program did not lead to the detection of a single international cartel. The program was dramatically expanded in 1993, increasing the opportunities and raising the incentives for companies to report criminal activity and co-operate with the justice department in fighting international cartels. Since then, 40 international cartels were detected and prosecuted in the US from 1995 to March 2003, and the total industry fines amounted to US\$2,250 millions.

Hammond argued that three major elements are indispensable for an effective leniency program – severe sanctions, heightened fear of detection and transparency in enforcement policies. He mentioned also that it is possible to have effective leniency program outside a criminal antitrust regime. Without criminal sanctions, financial penalties must be severely punitive to attract leniency applicants. To be deterrent, the fines must not simply be viewed as a cost of doing business. All else equal, criminal sanctions coupled with individual liability will be more effective at inducing leniency applications.

Hammond suggested in his presentation that uncovered cartels which operated profitably in Europe, Asia and elsewhere did not expand to the US because of being deterred by the risk of US sanctions. Undoubtedly criminal sanctions have important deterrent effects, which may lie in instilling a genuine fear of detection among cartel members. To quote Hammond's illustrative example, an empty seat in a scheduled cartel meeting fuels speculation that a missing cartel member has abandoned the cartel, or worse, has blown the whistle. This turns on the race for leniency among cartel members. Moreover, if employees also have individual exposure, the company will tend to put itself in a race for leniency with its own employees. The fear of detection mentality reinforces the argument that criminal sanctions coupled with individual liability will be effective at inducing leniency applications, in order to deter, detect and counter cartelisation.

Veljanovski (2006) has conducted an empirical analysis of the fines imposed under the EC Treaty Art. 81 in 39 cartel cases. Over the period 1999-2004 there were 30 fully reported cartel decisions involving 43 cartels. But the prosecution of four vitamins' cartels was time-barred, leaving 39 cartels resulting in the conviction of 207 firms for separate offences. The EC Commission imposed fines of €6.3 billion before leniency. However, the Commission's leniency program reduced these by 40% to €3.76 billion, subject to further reduction by the courts. In his analysis, Veljanovski raised concerns and doubts on the deterrent effect of the fines imposed, which are set according to the EC Penalty Guidelines 1998, and subject to substantial discounting under the leniency program and on appeal. It is unjustifiable why the fines imposed are not based on estimates of offenders' gain or victims' losses.

Leniency program works because it creates genuine fear of detection among cartel members. To quote Hammond's illustrative example, an empty seat in a scheduled cartel meeting fuels speculation that a missing cartel member has abandoned the cartel, or worse, has blown the whistle. This turns on the race for leniency among cartel members. The fear of detection mentality reinforces the argument that severe sanctions coupled with individual liability will be effective at inducing leniency applications. See Wilson and Rowe (2007) for a price-fixing cartel relating to fuel surcharges for passenger long-haul flights, where Virgin Atlantic qualified for full immunity under the leniency programs in both the UK and the US, hence escaped financial penalty. In that event, British Airways was fined £121.5 million by the OFT and \$300 million by the DoJ.

Given the anecdotal evidence that cartels are prevalent in many sectors in Hong Kong (construction, petrol retailing etc), a leniency program would help detect existing cartels and prevent future cartels once a law is in place. In addition, a leniency program would help shield Hong Kong from harms of international cartels.

In sum, we highly recommend that a leniency program be introduced alongside heavy fines and director disqualification to combat hardcore cartels. After all, cartels are the “supreme evil of antitrust” and have no plausible economic efficiency justification. Furthermore, the culture of competition has been at the core of Hong Kong’s economic success and should be protected.

Part IV. Concluding Remarks

We have analysed the special features of small market economies, and how these features exacerbate the problems of anti-competitive conduct. We conclude that a competition law is necessary in Hong Kong to cure market distortion and promote social welfare.

We maintain that a competition law should not selectively target or protect specific enterprises, be they small or big, domestic or foreign. A competition law is not anti-monopoly. It is to protect the competition process, rather than competitors. We recommend a light-touched approach in the implementation of a competition law. This approach comes with a legal exception regime in merger control, partial exemption of SMEs via safety zones, and the set-up of a self-standing competition authority with investigative function and a specialist tribunal with independent adjudicative function.

In terms of sanctions, we propose heavy fines and director disqualification on hardcore cartels and monetary fines on all other competition infringements, to balance the severity of sanctions against the gravity of harm.

It must be emphasised that a competition law will not hurt Hong Kong's reputation as the world's freest economy. To the contrary, it will signal to the world that Hong Kong is serious in levelling the playing field, thereby enhancing the confidence of overseas investors.

Finally, the government is recommended to foster education among the public about the nature, roles and benefits of competition law.

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Appendix 1

Jurisdictional Comparison of Safe Harbours

In traditional merger analysis, a two-step approach is usually adopted that starts with market delineation and then employs mechanistic measures of market shares and concentration. Some thresholds are adopted to create safe harbours for proposed mergers that do not indicate high risks of anti-competitive effects.

United States

The US antitrust authorities have previously relied to a large extent on the application of concentration measures. The measures take into account the concentration pre-merger and the predicted change in concentration post-merger. The thresholds serve to determine which cases should be investigated, creating safe harbours within which the merger will not be challenged.

As articulated in the Horizontal Merger Guidelines⁷¹, the Herfindahl-Hirschman Index (HHI) methodology is used as a screening device. The HHI⁷² methodology involves summing up the squares of the market shares of each individual firm in the relevant market. In the US Guidelines, it presumes the market to be unconcentrated if the HHI is below 1,000, moderately concentrated if between 1,000 and 1,800, and concentrated if above 1,800. The merger falls within the safe harbour if post-merger market is unconcentrated, or if the merger increases the HHI by less than 100 points in a moderately concentrated market, or by less than 50 points in a concentrated market.

When the concentration thresholds are exceeded, a combined share of at least 35% will be considered to be indicative of adverse effect by the merger (see s.2.211 of the Horizontal Merger Guidelines). If numerical thresholds are not crossed, the merger will still be challenged if justified by other factors, such as recent history of conspiracy, likely removal of a maverick, and market characteristics of unusually difficult entry coupled with homogeneous product and price transparency.

The tension between economic reasonableness (high hurdle) and administrative concerns has influenced enforcement agencies to adopt structurally triggered per se (mechanical) tests. Lande and Langenfeld (1997) observe however that the US antitrust authorities have recently supplemented mechanistic structural analysis with theory-based evidence.

While the HHI thresholds are stringent in the US, the application is not simply mechanistic. The actual enforcement trends are more permissive than the HHI levels articulated in the US Guidelines. Kolasky (2002) demonstrates with statistics that successful merger challenges are generally brought where the post-merger HHI levels are in the 2,000 – 3,000 ranges, often on grounds of co-ordinated effects.

⁷¹ US DoJ & FTC 1992 Horizontal Merger Guidelines.

⁷² HHI ranges from 0 to 10,000 moving from atomistic competition to single monopoly.

European Union

The EC Commission articulates slightly wider HHI thresholds than those in the US Guidelines. It is unlikely to identify horizontal competition concerns for mergers with a post-merger HHI below 1,000, or a post-merger HHI between 1,000 and 2,000 and a delta (increase in HHI post-merger) below 250, or a post-merger HHI above 2,000 and a delta below 150, in the absence of special circumstances. The following factors can amount to special circumstances: merger involving potential entrant, merging with innovators, significant cross-shareholdings among merging parties, merging with a maverick, presence of past or ongoing co-ordination or facilitating practices, or one merging party with at least 50% market share.

United Kingdom

In the UK, no particular market share threshold⁷³ is presumed by the Competition Commission (CC) to denote the likelihood of a merger resulting in substantial lessening of competition. Notwithstanding that, it is indicated that a merger which results in a market share below 25% is unlikely to raise competition concerns.

The Office of Fair Trading (OFT), according to the OFT guidelines, is likely to regard any market with a HHI in excess of 1,800 as highly concentrated, and any market with a HHI in excess of 1,000 as concentrated. It also states that in a highly concentrated market, a merger which increases the HHI by more than 50 may give rise to potential competition concerns; in a concentrated market a change in HHI of 100 may give rise to potential competition concerns. In fact, this mirrors exactly the US Guidelines. It is indicated in the CC guidelines that regard will be made to the above thresholds when the HHI is used as one factor in the wider assessment of competition.

Canada

The Canadian Competition Bureau's approach to mergers is articulated in its Merger Enforcement Guidelines. Section 2.2 of the Guidelines states that "[a] merger can lessen competition in two different ways. The first is where it is likely to enable the merged entity to unilaterally raise price in any part of the relevant market. The second is where it is likely to bring about a price increase as a result of increased scope for interdependent behaviour in the market".

Before proceeding with a full merger analysis, the Bureau applies two filters to determine market shares and the degree of concentration in the relevant market. First, it will not normally be concerned about unilateral effects if "the post-merger market share of the merged entity would be less than 35 percent". Second, a merger will normally not be challenged on grounds of interdependence (i.e. co-ordination effects) if the four-firm concentration ratio post-merger would be less than 65% or if the merged entity would have a share of less than 10%. When these thresholds are exceeded and there are barriers to entry, the Bureau will then evaluate other factors to decide if there is a prima facie case.

⁷³ See Merger References: Competition Commission Guidelines June 2003.

Australia

According to the ACCC Merger guidelines 1999, a merger is presumed to be unlikely to substantially lessen competition if certain safe harbour thresholds are met, hence do not require further investigation. Investigation is only required where the merger will result in (1) the merged entity having a market share of at least 40%; or (2) the merged entity having a market share of between 15% and 40% and the post-merger combined market share of the four largest firms (CR4) at least 75%.

In practice, merging parties usually apply to ACCC for informal review⁷⁴ pre-merger because mergers challenged in the Federal Court of Australia carry heavy penalties. Because of the informal review process, very few cases are litigated and hence case law is very limited. Effective 1 January 2007⁷⁵, merging parties can also seek ACCC's formal clearance, or otherwise apply to the Australian Competition Tribunal for authorisation⁷⁶ of a proposed merger.

New Zealand

The Commerce Commission of New Zealand indicates in its New Zealand Merger and Acquisition Guidelines January 2004 that substantial lessening of competition is unlikely if (1) the merged entity will have a market share below 20%; or (2) the merged entity will have a market share of between 20% and 40% and the post-merger CR3 below 70%.

It is stipulated further in the guidelines that the safe harbour thresholds are indicative only. Clearance may be declined or intervention made even in case of lower levels of market concentration.

Singapore

The Competition Commission of Singapore provides the safe harbour thresholds in the Guidelines on Merger Procedures 2007. It indicates that intervention is unlikely unless the merger will result in (1) the merged entity having a market share of at least 40%; or (2) the merged entity having a market share of between 20% and 40% and the post-merger combined market share of the three largest firms (CR3) at least 70%. This mirrors the New Zealand thresholds.

⁷⁴ There is no ex ante notification requirement, but the ACCC will entertain applications for informal clearance.

⁷⁵ The two processes are introduced in the Trade Practices Legislation Amendment Act (No. 1) 2006.

⁷⁶ Authorisation is the process of granting protection, on public benefit grounds, for mergers and acquisitions which would or might otherwise contravene merger provisions.

Appendix 2

Cases under the Telecommunications Merger Analysis

As of end-2007, there have been seven completed cases analysed by the Telecommunications Authority, since the enactment of merger regulation in the Hong Kong telecommunications sector in 2004.

Acquisition of 20% shares in PCCW by China Netcom

The case⁷⁷ involved the acquisition of 20% shares in PCCW by China Netcom and related contractual arrangements. The only material overlap between their businesses was in external facilities (the supply of overland cable and submarine cable capacity). PCCW operated external facilities through its 50% interest in Reach Networks and Reach Cable. As of 31 December 2004, China Telecom and PCCW held 43% and 19% respectively of the activated capacity, and 46% and 16% respectively of the equipped capacity in external bandwidth services market. The combined shares post-acquisition appear to fall outside the safe harbours set out in the Merger Guidelines.

In the TA's analysis, the wholesale external bandwidth services market was taken as a whole, not on a route-by-route basis. While the discrete measures of activated and equipped capacity indicated that China Netcom and PCCW would hold over 60% of the relevant market post-acquisition, it was noted that their activated capacity was just over 16% of the total equipped capacity. The level of excess capacity in the relevant market indicated that competitors were able to constrain their pricing decisions. OFTA's market surveillance also indicated downward price trends, with prices falling across the board by an average of 56% in 2003 and by a further 23% in 2004. As such, the TA did not consider that the transaction was likely to substantially lessen competition, and decided not to proceed with a full investigation.

Acquisition of SUNDAY by PCCW

The case⁷⁸ involved the acquisition by PCCW of a controlling interest in SUNDAY, which would further trigger a mandatory offer to acquire all the remaining shares. SUNDAY was a provider of mobile voice and data services, and PCCW the incumbent operating fixed-line telephony, Internet access and pay TV in Hong Kong.

In his findings, the TA found it immaterial whether to define the markets for fixed-line and mobile telephony as combined or separate, as no competition concern arose under either scenario. In a combined market analysis, a merged PCCW/SUNDAY would have less than 30% market share and the post-merger CR4 would be 72% based on subscriber numbers, hence within the CR4 safe harbour. When assuming a distinct fixed-line and mobile telephony markets, the TA considered the possibility of PCCW's independent re-entry absent the acquisition. He concluded that independent re-entry would not change the market structure, nor improve the competition scenario, as the number of mobile licensees was limited by the available spectrum for 2G or 3G mobile services. A re-entry had to be effected

⁷⁷ OFTA, Case CDN0190 "Report on the Competition Impact of the Acquisition of Shares in PCCW by China Netcom", Apr 2005.

⁷⁸ OFTA, Case CDN0196 "Report on the Competition Impact of the Acquisition of Shares in SUNDAY by PCCW", Jul 2005.

by acquisition of an existing licensee or its mobile licences. In conclusion, the TA did not consider that the acquisition was likely to substantially lessen competition, and decided not to proceed with a full investigation.

Acquisition of Peoples by China Mobile

The case⁷⁹ involved the acquisition of Peoples by China Mobile through a subsidiary, resulting in Peoples becoming an indirect wholly-owned subsidiary of China Mobile. China Mobile was one of the two licensed mobile telephony services providers on the mainland. Peoples was one of six mobile network operators (MNOs) in Hong Kong, holding relevant licences for the provision of 2G mobile services and various related value-added services in Hong Kong. China Mobile sought the TA's formal consent⁸⁰ for the proposed acquisition. The application for consent obliged the TA to give all carrier licensees and interested parties a reasonable opportunity to make representations before the TA made a decision. The opportunity for representations was provided by way of consultation. The TA sought and received information relating to the arrangements for mobile roaming services between Hong Kong and the mainland.

On the facts, there was no competitive overlap between the merging parties. However, there was potentially a vertical integration effect. Post-acquisition, China Mobile might preferentially direct its inbound roaming to the Peoples network, reducing all the other Hong Kong MNOs' roaming revenue derived from China Mobile's mainland subscribers⁸¹. The TA conducted a counterfactual analysis to gauge the potential change in future competition with or without the acquisition. He concluded that any advantage that Peoples might acquire, by a lower outbound roaming cost, or even exclusive access to the China Mobile network on the mainland, represented a sharpening (rather than a lessening) of competition between MNOs in the local market. MNOs and their Hong Kong customers had the alternative of using the China Unicom network on the mainland. In the downstream level, there was a wide range of alternative services available to users, substitutable for roaming services, such as local or hybrid subscriber identity module (SIM) cards and international call forwarding services. In his decision, the TA granted consent to the acquisition without conditions or directions.

Joint Ownership of CSL and NWPCS

The case⁸² involved a horizontal merger, resulting in CSL and NWPCS⁸³ becoming common wholly owned subsidiaries of Telstra CSL Ltd⁸⁴, and the number of MNOs reducing from six to five. CSL was a MNO operating both 2G and 3G services in Hong Kong, and NWPCS a MNO operating only 2G services. The merging parties sought the TA's formal consent⁸⁵ for the joint ownership. Before reaching his decision, the TA conducted a consultation to provide interested parties the opportunity to make representations.

⁷⁹ OFTA, Case CDN0197 "Decision granting consent under the Telecommunications Ordinance to the acquisition of Peoples by China Mobile", Dec 2005.

⁸⁰ The application for consent is made under Section 7P(6) of the Telecommunications Ordinance.

⁸¹ In the TA's finding, inbound roaming revenue from China Mobile customers is around 3% of total revenue for Hong Kong MNOs.

⁸² OFTA, Case CDN0200 "Decision granting Consent under the Telecommunications Ordinance to Joint Ownership of CSL and NWPCS", Mar 2006.

⁸³ NWPCS traded under the name "New World Mobility".

⁸⁴ Telstra CSL Ltd was to be renamed as CSL New World Mobility Ltd.

⁸⁵ The application for consent is made under Section 7P(6) of the Telecommunications Ordinance.

While the competition issue arose from the parties' overlapping 2G services, the TA considered that the pricing of 2G was constrained by 3G services, and adopted a wide market delineation inclusive of 2G and 3G services. The competition process covered both post-paid mobile services and pre-paid SIM cards, with post-paid services contributing to higher average revenue per user (ARPU). Demand side substitution from post-paid to pre-paid services was not evident, but in the supply side MNOs could easily change the mix of the two services. As such, the TA took also into account the competitive constraints between the two.

The TA regarded safe harbour thresholds as irrelevant in this case, given that a full investigation had to be completed pursuant to a formal request for consent. In his investigation, the TA considered the possibility of the merging parties' competition foreclosure and the increased risk of collusive behaviour among the remaining MNOs.

The porting information reviewed by the TA indicated that CSL and NWPCS had divergent business focus, and were not in direct competition across all market segments. In the TA's opinion, their position would not be strengthened significantly under joint ownership, apart from rationalisation of retail outlets and realisation of 2G related efficiencies. On the competition foreclosure issue, there was no specific evidence to establish that the merger was likely to cause price rises or output reduction.

All porting data were legitimately collated and distributed among all MNOs, to facilitate mobile number portability. With pricing information readily available in the marketplace, MNOs could have deep insight into each other's businesses. The TA nevertheless concluded that the merger itself would not alter the way subscriber information was exchanged, nor substantially change the climate for covert collusion, and the reduction from six to five MNOs only marginally improved the prospects for co-ordination. The TA concluded that the transaction was unlikely to substantially lessen competition, and granted his consent without conditions or directions.

Change of ownership of Asia Netcom and its potential consolidation with C2C

The case⁸⁶ involved the purchase of Asia Netcom by a consortium of investors, who would become the common owners of Asia Netcom and C2C after completion of the transaction.

Asia Netcom and C2C were both fixed carriers licensed to provide external cable-based facilities and services to and from Hong Kong. Their businesses overlap materially in the supply of external bandwidth services. The investors indicated that they did not have a concrete plan to merge the assets or businesses of the two entities, yet the two entities could not be logically regarded as competitors by reason of their common ownership.

In the TA's finding, cable capacity was a homogeneous product and route-by-route supply-side substitutability was readily available. Fifteen land cables and nine submarine cables were linked with Hong Kong with abundant equipped capacity. Circuits established over these cables to hubs outside Hong Kong could provide close supply-side substitutes. In the market for external bandwidth services, customers were typically sophisticated and price-sensitive

⁸⁶ OFTA, Case CDN0204 "Report on the Competition Impact of the Change of ownership of Asia Netcom Hong Kong Limited and its Potential Consolidation with C2C (Hong Kong) Limited", Sep 2006.

buyers. In terms of unilateral effect, it was unlikely that Asia Netcom or C2C could sustain price increases without significant restraint from competitors and customers.

There was also not much risk of collusive activities among the remaining competitors, in the presence of a large number of service providers. Moreover, the prices for external bandwidth were not transparent, with agreements concluded by commercial negotiation or auctions. Competitors would have less incentive to collude, as pricing was confident to the contracting parties only, hence difficult to detect and sanction deviating behaviour. Having regard to the above considerations, the TA decided not to proceed with a full investigation.

Acquisition of Interest in PacNet by the Parent Company of Asia Netcom

The case⁸⁷ involved the acquisition of Pacific Internet Ltd (PacNet) by Connect Holdings, parent company of Asia Netcom. Pacific Internet (Hong Kong) Ltd (PacNet HK) was wholly owned by PacNet. The owners of Connect Holdings also owned C2C. After completion of the acquisition, PacNet HK, Asia Netcom and C2C would all be under common ownership.

PacNet HK, Asia Netcom and C2C were all carrier licensees providing external communications facilities and services, so their businesses would potentially overlap. Though PacNet HK was a cable-based external carrier, its business focus was on Internet communications services, a downstream service. Both Asia Netcom and C2C were on the upstream market of wholesale network and capacity services.

The TA had reviewed the carriers' capacity data, and found that PacNet HK's cable capacity was so insignificant that it did not even add any percentage, activated or equipped, to the combined cable capacity of Asia Netcom and C2C. The TA considered the possibility that PacNet HK might increase its cable capacity in the foreseeable future, and found no evidence to suggest that it had directly invested in cable infrastructure. In view of PacNet HK's little presence in the external bandwidth market, minimal overlap of businesses post-acquisition did not raise any competition foreclosure concern.

In view of the large number of service providers in the provision of external bandwidth connectivity and the non-transparent pricing, the TA also considered it unlikely that the acquisition would increase the risk of collusive activities.

Given that the transaction was more of a vertical integration than horizontal, the TA also examined the possibility of market power leverage post-acquisition. In the upstream external bandwidth service market, both Asia Netcom and C2C did not appear to possess market power due to the abundant supply of readily available cable capacity and low barriers to entry. In the downstream broadband business market, PacNet also lacked market power. In fact, it was competing neck-and-neck with other operators, and there existed an obvious market leader.

Based on the above analysis, the TA did not consider that the acquisition was likely to substantially lessen competition, and decided not to proceed with a full investigation.

⁸⁷ OFTA, Case CDN0208 "Report on the Competition Impact of the Acquisition of Interest in Pacific Internet (Hong Kong) Limited by the Parent Company of Asia Netcom Hong Kong Limited", Feb 2007.

Acquisition of Interest in AsiaSat Holdings by General Electric Capital Corporation

The case⁸⁸ involved the acquisition of interest in Asia Satellite Telecommunications Holdings Ltd (AsiaSat Holdings) by General Electric Capital Corporation (GECC). AsiaSat Holdings would be privatised, resulting in it being jointly owned by GECC and CITIC Group on a 50.5%/ 49.5% share basis with equal voting rights.

Asia Satellite Telecommunications Co Ltd (AsiaSat) was wholly owned by AsiaSat Holdings. As holder of a number of carrier licences, AsiaSat operated three satellites for broadcasting and telecommunications, that provided access to more than 50 countries and regions across Asia. GECC was a global and diversified financial services company. GECC or its affiliates did not hold any Hong Kong telecommunications licences.

In his assessment, the TA focused on the market for the provision of satellite transponder capacity. Only AsiaSat and APT Satellite Co Ltd (APT) held space station carrier licences in Hong Kong. Between them, they operated a total of eight satellites. Under the “open sky” policy adopted in Hong Kong, there was no restriction prohibiting overseas satellite operators from providing satellite transponder capacity to Hong Kong customers, be they telecommunications operators, broadcasting stations or private users. The supply side was therefore not limited to AsiaSat and APT, but included over 90 satellites in operation with coverage over Hong Kong.

According to the data in OFTA’s possession, Hong Kong customers employed more than 30 satellites, including the three operated by AsiaSat. The total transponder capacity available from AsiaSat represented less than 10% of the total capacity of the satellites providing service to Hong Kong. In view of the above, the TA accepted that there was overcapacity in the relevant market. Given that AsiaSat held only a small market share, it did not possess substantial market power.

Prior to the transaction, GECC’s involvement in telecommunications in Hong Kong did not extend beyond holding an indirect interest in AsiaSat. Post-acquisition, GECC’s increased interest in AsiaSat did not alter the competition landscape, as the number of operators in separate competitive ownership was not reduced. In any event, there was no competitive overlap between GECC and AsiaSat.

The possible loss of independent entry by GECC did not arise from the acquisition, as there was no evidence to suggest that GECC had any interest ever in actively engaging in telecommunications services as an independent carrier licensee.

Based on the above analysis, the TA did not consider that the transaction was likely to substantially lessen competition, and decided not to proceed with a full investigation.

⁸⁸ OFTA, Case CDN0209 “Report on the Competition Impact of the Acquisition of Interest in Asia Satellite Telecommunications Holdings Limited by General Electric Capital Corporation”, May 2007.