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15 April 2004

The Honourable Sin Chung Kai
Legislative Councillor
601, 6th Floor
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3 Garden Road
Central
Hong Kong

Dear Mr Chairman

Re: Guidelines to Regulate Merger and Acquisition Activity in the Hong Kong Telecommunications Market

As you are aware, an informal industry group of fixed and mobile carriers has worked together on an ad hoc basis over the last two years on both the M&A legislation and now the M&A Guidelines. It should be clear that input from this group and its individual members substantially improved both the enacted legislation and the draft Guidelines.

This letter is written to express the view that the draft Guidelines still have room for significant improvement. Industry members met with OFTA officials as recently as 1 April and this view is therefore stated based on the most recent information available. Specific issues of major concern are discussed below.

Allow me to raise four preliminary matters. First, it should be emphasized that the primary objective of the Guidelines is to assist interested parties (e.g. the industry) in making informed decisions as to whether a proposed merger will likely be approved or not approved by the TA. Thus, certainty and predictability are the overarching goals. While the legislation has established the specific provisions to protect the competitive structure of the market (and consumers), the Guidelines serve a slightly different purpose.

Second, unlike other markets, M&A regulation in Hong Kong is industry specific. This allows any Guidelines to be specifically tailored to existing and anticipated telecommunications markets. Thus, the Guidelines may start with a global best practices approach but can then be modified to best serve the unique Hong Kong economy and its telecommunications market.

Third, unlike other markets, M&A regulation will be undertaken by a sector specific regulator rather than a general competition authority. I raise this point not in order to revisit the entire legislative scheme, but to re-inforce the view that in such an environment it is even more important to have specific and well tailored Guidelines which provide certainty and predictability (on the one hand) and which narrow the opportunity for the regulatory authority to make mistakes in undertaking complex economic and legal analysis. In addition, the Guidelines need to be well written and clear. Readers whose first language is not English should find the Guidelines to be both readable and understandable.

Fourth, the Guidelines which are now proposed to be gazetted have not been shared with the public. Therefore, this letter is written without the author being able to read the most recent version of specific provisions in the Guidelines which may include some minor language improvements but may also include substantive changes.

Specific issues of major concern:

1. Safe Harbors. There is no disagreement that merger activity which is below a certain 'size' raises no issue as to 'substantially lessening competition'. There is also no disagreement that merger activity below this 'size' should burden neither the entities involved in the merger nor the regulatory authority with the costs, time, effort or uncertainty of an M&A investigation and review. The disagreement which exists relates to the 'size' of the 'safe harbours' for Hong Kong.

   The Guidelines, as I understand them to be presently drafted, will apparently now adopt an approach that may be consistent with global best practices. That is, there are two safe harbours measuring tools used in off-shore markets and the TA has now apparently suggested that if a merger falls into either of these safe harbours, then the merger will not <u>likely</u> be subject to review. [This either/or test is unusual but not objectionable]. Two problems arise with the TA's approach. First, it remains unclear whether the safe harbour in practice is actually a safe harbour or whether the TA will merely 'not likely' review a merger that falls below the 'size' measurement. The latter approach is not a safe harbour in practice.

Second, a global best practices approach should be only the starting point. When applying an approach to one specific industry (rather than across all industries/markets in a jurisdiction), there is an opportunity to tailor the approach to fit the industry. This process therefore offers the opportunity to fine tune and tailor Guidelines for the telecom industry in Hong Kong. This opportunity should not be lost when such a tailoring is both desirable and practical.

To illustrate, while the Guidelines may refer in theory to safe harbours, in practice there would be no safe harbour for a telecoms merger in Hong Kong. This would be the case because the thresholds adopted in the Guidelines do not take into account the unique characteristics of the telecommunications markets in Hong Kong (e.g., their relatively small size and small number of participants): all mergers would be subject to inquiry by the regulator despite the Government's desire to provide for safe harbours consistent with its light-handed policy approach to regulating telecommunications generally.

For example, under the draft Guidelines the merger of the two smallest mobile licensees (i.e. number 5 and 6 in size) would be viewed as 'likely to create or enhance market power…'. Under such a test it would be difficult to provide guidance to the licensees that the regulatory authority would approve such a merger. Certainly, such a proposed merger would be subject to a full scale investigation which by itself could deter a merger.

PCCW therefore proposed in the Guidelines consultation that these globally accepted safe harbor tools be modified to fit the Hong Kong market. The PCCW proposal was outlined in the second consultation paper released 23 December but has apparently not found favor with the regulatory authority.

The PCCW 'common sense' approach modified these safe harbour tools so that the above example would fall within the safe harbour. The PCCW approach took the global best practices Herfindahl-Hirschman Index (HHI) used in the US, UK and EU and modified it for use in the Hong Kong telecommunications market. This modification would expand the size of the safe harbour and allow at least some level of merger activity to easily occur in a market in which most observers see a need for some level of consolidation. This approach is not a simple green light for any carrier and any merger, and certainly not for PCCW, but would allow some mergers to proceed that common sense indicates would not create problems.

Our letter dated 9 December 2003 to the TA describing this approach is attached for your reference. PCCW would strongly suggest that this modified HHI approach be adopted.

2. Scope

It has been represented that the law (and the Guidelines) cover a narrow set of licensees (i.e. FTNS and mobile licensees). That is, the 'carrier licensee' described in Section 7P are fixed and mobile licensees only.

Yet, this is not the case. I would refer you to Section 2 of the TO. The definition of a 'carrier licensee' is any holder of a 'carrier license'. The definition of a carrier license is a 'license issued for the establishment or maintenance of a telecommunications network … '. A telecommunications network is defined in terms of 'a system or series of systems'. A system is defined in terms of any 'installation, or series of installations'. An installation is defined in terms of 'apparatus or equipment'. Apparatus or equipment are not defined but can be interpreted per their normal usage.

The point here is that a broad group of licensees have networks with apparatus or equipment (which may be owned or even leased). This includes both ETS and PNETs licensees. The legislation should therefore be amended (or the panel and LegCo should be made fully aware that the reach of the law and the Guidelines are much broader than previously represented). It is the case that the Telecommunications Regulations in describing carrier licensees are narrower than the above TO definitions, but the Regulations cannot limit the Ordinance.

3. Burden of Proof

It is now clear from Section 1.14 that the TA has the burden of proof to demonstrate that a proposed merger would substantially lessen competition; that the standard of proof is the civil standard of a balance of probabilities; and that if a party wants to raise a 'defence' or other claim the party must substantiate that defence/claim.

This last point remains unclear in several respects. While it is logical to place a burden on the party raising a defense/claim to present a prima facie case, the Guidelines appear to demand much more.

For example, claims of efficiency gains will need to demonstrate that the gains must [only] occur as a direct result of the merger, must be clearly identified and verified, and must translate into a more effective level of competition. The gains must also be demonstrated to be otherwise not obtainable. Finally, efficiency gains (although difficult to verify and quantify) must be substantiated by the merging parties with great particularity. (See paragraphs 4.79-4.85).

This appears to be a very harsh test where the parties are asked to prove and guarantee a future event/result. Certainly good faith estimates supported by reasonable data should be sufficient. Otherwise, applicants may in fact need to essentially prove a negative. If this high burden of proof is not satisfied, the TA will be able to reject the defence/claim.

4. Overseas Precedent and Examples

Recalling that merger regulation is new to Hong Kong and is intended to generally reflect off-shore practices, and that the Guidelines are intended to promote predictability, it has been consistently suggested by the industry that off-shore case law be referenced as much as possible. That is, there is a substantial body of EU, UK, US, etc merger case law which covers the definition of markets, substitutability, elasticities, lessening of competition, failing firms, efficiencies, public benefits, burden of proof, barriers to entry, etc. To provide parties more predictability it would be extremely helpful to site this case law where it reflects LegCo's views on the proper merger policy for Hong Kong.

Such case law is found in other merger and competition guidelines, law review articles and text books. Case law has been supplied to OFTA, and the industry group has indicated that it will provide additional case law to OFTA (although why OFTA has not been able to do this research itself is troubling). There is no downside in including such case law and this should be included.

5. First Party Mover

Telecoms in Hong Kong is an industry where substantial entry and network buildouts have already occurred. The entire section on strategic behaviour and first mover advantages should therefore be deleted as it presumes a market with little or no entry. To the extent any concerns arise, they are 'conduct' concerns (suitable to be addressed in conduct related Competition Guidelines). They should not be covered in M&A Guidelines.

Thank you for your continued interest in this matter. Hopefully, we will end up with more usable and predictable Guidelines, consistent with LegCo's desire for light-handed regulation which protects competition and promotes efficient markets.

Yours sincerely,

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December 9 2003

Mr Edward Whitehorn
Head of Competition Branch
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Dear Edward

Re: Draft Merger Guidelines and the HHI

We have been considering the HHI issue and how this index could be employed in the Hong Kong market. We continue to share the belief of the UK, US, EU, other markets, the rest of the industry and other commentators that a concentration index can create a high degree of M&A predictability for all stakeholders. We therefore support the inclusion of such an index in the guidelines now being further refined.

Two issues arise with the use of this index. First, the numerical ranges for unconcentrated, moderately concentrated and concentrated markets. Second, the delta or "2ab" increases that would likely not raise a competition issue under the substantially lessening of competition standard (i.e. where market power would not be created or enhanced). These are addressed further below.

Concentration Ratios As a preliminary matter, it should be noted that the comments below focus specifically on the Hong Kong network markets, and cover the major possible markets (i.e. the cellular, fixed and cellular/fixed converged markets). The stand alone cellular and fixed markets are likely to be seen as concentrated due to the small number of players. The opposite applies to the cellular/fixed converged market. While an unconcentrated market is unlikely to have a carrier with market power, concentrated markets do not necessarily have such a carrier. That is, high market share does not necessarily equate to market power. Your letter dated 24 September 2003 contains pre-merger HHI estimates that make this point with several markets which are generally viewed as competitive having high HHI figures (e.g. broadband retail at 2950 and external bandwidth at 3250).

Allow me to now turn to the cellular and fixed network markets in Hong Kong. The post-merger 1000 and 1800 sign posts used in the UK, US and other markets would place both markets in the concentrated category. This would create a presumption against all mergers unless the delta/2ab calculation was relatively small (below 100). Looking at specific market shares, it would appear that all cellular market merger activity and almost all fixed market merger activity would be presumed to create or enhance market power. The HHI in a market continually changes but the cellular market currently has an HHI total of between 1800 and 2000 which reflects a concentrated market. The fixed market has an HHI total well above 1800 which also reflects a concentrated market. A chart of the cellular market HHI calculation is found in the attached Table 1. This chart contains pre and post merger data, including the delta/2ab calculation for all merger combinations based on existing market shares. Table 2 contains the same information for the fixed market; Table 3 reflects HHI data for the converged cellular/fixed market.

Cellular Market HHI The cellular market is generally viewed to be extremely competitive with very low prices and margins. Yet, a merger of two of the smallest mobile carriers would appear to be presumptively barred even though most observers would see this possible merger and other mergers in this market as beneficial to users and not raising competition concerns.

If most mobile merger combinations shown in Table 1 were seen to be in principle permissible given the competitive state of the market, all else being equal, there would appear to be three solutions to fitting such mergers within an HHI approach: raise the 1000 and 1800 concentration sign posts, raise the delta/2ab number, or both.

We note that the new EU guidelines maintain the lower US/UK HHI sign post at 1000 but move the upper sign post from 1800 to 2000, with the upper delta moving from 100 to 150. The UK, the US and other markets retain the 1000/1800 approach.

We propose modifying the delta/2ab to make predictable a realistic level of merger activity among operators where market power is not being created or enhanced. We do not propose moving the sign posts above the US/UK levels of 1000 and 1800. (We are somewhat concerned about moving multiple variables and there is no experience yet with the higher 2000 sign post).

Delta/2ab Changes As to the critical delta/2ab amounts, working backwards from Table 1 to 'predict' that a merger between the two smallest cellular operators "5" with "6" would be permitted, there would need to be a delta/2ab of 300. A "2", "3", or "4" merger with "6" would require a delta/2ab of 320. A "2", "3", or "4" merger with "5" would require a delta/2ab of 480. A "2" with "3" or "4" would create a delata/2ab of 512. A "1" with "6" would create a delta/2ab of 540.

It does not appear that any of these possible mergers, all else being equal, would create or enhance market power. The post-merger market share of the new entity would in all the above specific cases be below 40%, with all except one being below 32%. We therefore propose once a post merger HHI exceeds 1800, a delta/2ab below 550 would presumably not cause significant competitive concerns. A merger generating a delta/2ab above 550 may raise competitive concerns and a negative presumption could attach. In a moderately concentrated market, (i.e. a post merger HHI below 1800), we suggest that any merger would presumably not raise competition concerns.

Fixed Market HHI Applying this post merger (over 1800 and 550) approach to the existing fixed line market, or more accurately to the BDEL and RDEL markets, all mergers would likely be allowed with one exception. The one exception to this would be for all practical purposes a merger involving PCCW and any carrier with more than a very small market share. The attached Table 2 contains the current/estimated market shares and HHI calculations for the fixed RDEL and BDEL markets.

Converged Market HHI Of course, evidence is that the fixed and cellular markets are converging and, if it is not already, the time will come soon when these two markets will become effectively one market in terms of substitutability and merger regulation. In such a market there would be at least eleven competitors (absent any mergers or provider exists in the meantime). No competitor has a market share above 25%. Only two have market shares between 20-25%. Applying the post merger signposts above, almost all mergers would be between competitors with small market shares and all else being equal, no negative presumption would attach. Table 3 shows that the HHI in a converged market would be less than 1800, and that almost all mergers would not push the HHI above 1800. A proposed merger which took the HHI above 1800 would then be subject to the delta/2ab of 550 described above.

Conclusions/summary

In conclusion, the adoption of a modified HHI and delta/2ab along the lines suggested above would provide greater predictability and certainty to all stakeholders in the industry (operators, consumers and Government) about merger activity. Importantly, it would signal that the majority of mergers (which would not create or enhance market power), would presumably not raise significant competition concerns. We ask consideration to the proposal outlined in this letter and include it for discussion in the

second round of consultations on the draft merger guidelines. Of course, we and other stakeholders would be happy to work further with OFTA and the bureau on developing the proposal.

What we have tried to create by this indexing approach is more predictability as has been adopted in other markets, although modified in our case to reflect the realities of a more concentrated but no less competitive market. Of course, the index only creates a presumption, not a guarantee, but even this is an important contribution and step forward.

For transparency, I have copied the industry members and other interested parties as noted below.

Yours truly,

Stuart Chiron
Director of Regulatory Affairs

c.c. Hutchison Global Communications)
SmarTone)
New World) without attachments
Telstra/CSL)
Consumer Council)
Sin Chung Kai)
Marion Lai)

SAFE HARBOURS

- Global Best Practices (HHI and/or CR4 tests) should be the starting point.
- But these tests should be modified to reflect the regulation of only one industry (telecom).
- Without modification all mergers in the current HK telecoms market would be presumed to be anti-competitive and fully investigated. No actual safe harbour would exist.
- This is not the intent of the Government.
- The industry proposal strikes the right balance - a large enough safe harbour for mergers that would not ‘create or enhance a dominant position’.

SCOPE

- Law (Section 7P) covers all ‘carrier licensees’ which, under the definitions found in the TO, covers any licensee employing apparatus or equipment to provide service to the public.

- This is broader then just fixed and mobile licensees. It includes almost all licensees who employ apparatus or equipment, no matter how limited in nature.

- Telecom regulations and guidelines cannot limit the TO.

- This drafting error needs to be fixed before any guidelines become effective.

BURDEN OF PROOF

- Overall burden of proof on TA is now clarified and is correct.
- However, burden of proof on merger proponents when raising a ‘defense’ or other claim remains too harsh.
- E.g. efficiency claims by merger proponents are required to be proved to be otherwise not obtainable, fully substantiated and fully verifiable. (See paras 4.79 - 4.85).
- A prima facia case made in good faith with reasonable assumptions and date should suffice to meet a proponent’s burden of proof.
- Otherwise, bar is too high and defence/claims easily dismissable by TA.

PREDICTABILITY FOR ALL INTERESTED PARTIES IS OF ULTIMATE IMPORTANCE

Improvements that should be made:

- Clear and well written guidelines needed.
- Global best practices (improved to fit the HK telecoms market when practical).
- Use of overseas case law to provide examples of positions/views of the Regulatory Authority.

STRATEGIC BEHAVIOUR (1ST MOVER) ISSUES

- Appropriate for conduct guidelines (i.e. Competition Guidelines now being drafted by OFTA).

- Not appropriate for M&A guidelines (e.g. not in USA Merger Guidelines).

- Guidelines language appears to penalize those who would or have invested, engaged in R&D, innovated and taken risks. This cannot be Government's intent.