

Telecoms Infotech Forum

Briefing paper

Mergers and Acquisitions: a telecoms policy for Hong Kong?

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Telecoms InfoTechnology Forum

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Mergers and Acquisitions

Introduction

In December 2002 OFTA provided Legco with an *Explanatory Note*¹ of guidelines to its approach to mergers and acquisitions, competition policy and regulation. This comes at a time when telecommunication markets globally have suffered a downturn and the prophets of doom are thick on the ground.² Industry consolidation has been muted for several years in highly competitive markets like Hong Kong, or in other markets in Asia where licences were issued on a somewhat less rational basis than in Hong Kong. Where the state has been actively involved, such as Malaysia or Indonesia, a consolidation of sorts is taking place, usually motivated by the need to rescue ailing companies or safeguard public investments and state revenues. In Hong Kong, with the notable exception of the PCCW-HKT, Reach, CSL and Telstra deals, it has hardly happened,³ partly reflecting no doubt the forms of ownership and control that exist in Hong Kong, but also reflecting the tremendous resilience of the Hong Kong companies involved.

OFTA's paper provides annexes in M&A guidelines in the USA and Australia. This paper takes a look at what's been happening in the EU and the UK and examines the OFTA paper in this light.

European Union Approach

Responsibility for the mergers review process within the European Union falls to Mario Monti, the EU's Competition Commissioner. Unlike the process in the USA where the Anti-Trust Division of the Department of Justice must argue its case before a judge, in the EU the Merger Regulation gives total authority to the Competition Commission to review a proposed merger and judge it. A judicial review process provides an avenue for final appeal and in recent times this has led to some contrary judgements. Europe's Court

¹ OFTA (200) Explanatory Note in the Guidelines on the Competition Analysis of Mergers and Acquisitions in Telecommunications Markets at <http://www.legco.gov.hk/yr01-02/english/bc11/papers/bc110107cb1-597-1e.pdf>

² For example: 'The merger between Hewlett-Packard and Compaq to create a technology behemoth to rival IBM remains the only example to date of serious rationalization... [in the IT sector]. In this case the barrier to restructuring is congenital optimism: an upturn in demand from everything from personal computers to enterprise software was predicted for the first half of 2002 and then again for the second half of 2002, and is now foreseen for the first half of 2003. The tantalizing prospect means overcapacity has still not been tackled in earnest, more than two years after demand for technology products started to sag.' (Simon London and Robert Chow, *Financial Times*, 16 September 2002, p.10) By comparison much of the capacity the telecoms market has been commercially removed or shut down through closures and bankruptcies, if not physically removed.

³ There have been several small changes, for example NTT's purchase of Hong Kong Net and BT selling its shareholding in Smartone, but none requiring an M&A investigation. When HongKong Telecom purchased the Pacific Link cellular network in the mid-90s OFTA accepted the deal on the basis there would be no significant lessening of competition because the network would still operate.

of First Instance in June 2002 accused the Commission of ‘manifest error’ and having ‘exceeded the bounds of its discretion’ when it incorrectly blocked a merger between two British travel agents in 1999.⁴ In response to criticisms of this sort, and of being both judge and jury, Mario Monti has proposed reforms that will include a peer-review process of the Commission’s judgements and bringing in an industrial economist to review complex cases. The judicial review process remains in place, but using it is both lengthy and costly.

A ‘Green Paper on the Review of Regulation’ was issued in December 2001 seeking consultation on three major areas: (i) the operation of turnover thresholds and the case referral mechanism, (ii) substantive test issues, whether to shift from tests of dominance to tests of significant lessening of competition, and (iii) efficiency issues, how to judge whether mergers will enhance efficiency and bring benefits to consumers. The threshold issue was less controversial before a series of court judgements in 2002 overturning the Commission’s findings called into question the Commission’s judgements, hence the reforms mentioned above.

Procedural Issues

The EU’s regulations embrace many independent countries each with their own laws, regulations and judicial systems, and many of the criticisms and reforms concern problems arising out of mergers and acquisitions that cross borders or markets within the EU.^{5 6} These are not directly relevant to Hong Kong, but insofar as Hong Kong companies will become actively engaged in mergers and acquisitions in Mainland China there may be lessons to be learned. (Also see China section below.) One advantage of the Commission is to offer a one-stop shop for companies considering takeover bids or other forms of industry consolidation that cross-frontiers within the EU. Where this involves companies from beyond the EU other problems arise, especially between the USA and the EU.⁷

⁴ See *The Economist*, 15 June 2002, p.61.

⁵ One issue of contention is which M&A proposals should be handled by National Competition Authorities and national courts and which should be handled directly by Brussels and the EU Commission.

⁶ A further example of this problem concerns the powers of Brussels over National Regulatory Authorities (NRAs) in the regulation of telecoms which also raises a question mark over whether strictly competitive criteria are to be used in national telecoms regulation or wider ‘public interest’ criteria are to be imposed from Brussels. According to *The Financial Times* 7 February 2003 (p.16) telecom regulators in the EU’s 15 member states claim that powerful lobbying by telecom companies have influenced the new rules due to come into force in July that give Brussels the power to override NRA decisions. Their classic understatement reads: ‘It is very clear that industry pressure did not leave the Commission untouched.’ They continue: ‘While national regulators have to follow the Commission’s guidelines... The Commission assessment [of national decisions] is based on a much broader set of underdeveloped criteria.’

⁷ Policy and regulatory barriers have hampered efforts by companies from Europe to buy into US companies and US companies to buy into Europe. The latter include problems for Worldcom in the telecoms sector, General Electric’s bid in 2001 to takeover Honeywell, and most recently cross-Atlantic tensions over differences in approach to the trade practices of Microsoft, especially since the change from the Clinton to the Bush Administration in the USA.

In a recent Draft Best Practices paper⁸ the Competition Commission has proposed to speed up the M&A review process, making it also more transparent, and therefore hopefully less contentious. The Commissioner has proposed to give further encouragement to pre-notification of mergers and acquisitions and to the role of early informal discussion to identify potentially contentious issues or to clarify and avoid misunderstandings by either party. It is suggested that even in non-controversial cases this should be encouraged so as to avoid declarations by the Commission of incomplete notifications at the end of the review process. It is further suggested to hold ‘state-of-play’ meetings at decisive points along the review process, again to smooth the process and avoid lengthy delays due to lack of information. Transparency through access to Commission documents is also promised so third party concerns can be addressed earlier rather than later. But the Commission remains judge and jury despite the peer review process (see above) and judicial review remains the final recourse of plaintiffs.

In OFTA’s *Explanatory Note to Legco* a referral can be *ex post* but the TA can only initiate an investigation within 3 months ‘after the transaction is completed or the fact of the completion is made known to the public, whichever is the later.’ (para.82) If an application for consent is made by the parties concerned the TA has to make a decision to initiate an investigation within 1 month. In both cases the investigation must be completed within 4 months of it being initiated. These time limits are comparable to the EU and to the UK. There is no reference to procedure comparable to the reforms proposed by the EU Commissioner above, although OFTA has issued procedural guidelines to other areas of regulation, notably interconnection discussions.

Substantive Issues

The use of dominance tests as the guiding principal for making an assessment of the likely effects of a merger on the level of competition was written into the 1989 Merger Regulation of the European Council as Article 2. In the Commission’s proposal to the Council⁹ published 28 January 2003 the concept of dominance is retained. This is partly because a large body of case law has grown up around it, and partly because the concept is to be explicitly widened to encompass forms of joint dominance where significant market power is exercised by virtue of tacit collusion between oligopolies that are not individually deemed to be dominant. For example, companies may price in parallel. The issue at stake here had been whether a change of words from ‘dominance’ to ‘significant lessening of competition’ implies a real change in principle, or a change in the methodology by which a judgement is reached, and therefore possibly a different judgement at the end of the day. The Commission came to the view that in practice the difference, as defined and confirmed by case law, does not really go beyond the words. This is explained in the Directive 2002/21/EC of the European Parliament and of the

⁸ DG Competition ‘Draft Best Practice on the conduct of EC merger control proceedings’ Brussels 19/12/2002

http://europa.eu.int/comm/competition/mergers/others/best_practices_public_coms.pdf

⁹ At http://europa.int/eur-lex/en/dat/2003/c_02020030128en00040057.pdf

Council which comes into force 24 July 2003,¹⁰ which also flags future changes in policy towards local loop unbundling.¹¹

‘There is need for *ex ante* obligations in certain circumstances in order to ensure the development of a competitive market. The definition of significant market power in the Directive 97/33/EC of the European Parliament and of the Council of 30 June 1997 on interconnection in telecommunications with regard to ensuring universal service and interoperability through application of the principles of open network provision (ONP) has proved effective in the initial stages of market opening as the threshold for *ex ante* obligations, but now needs to be adapted to suit more complex and dynamic markets. For this reason, the definition used in this Directive is equivalent to the concept of dominance as defined in the case law of the Court of Justice and Court of First Instance of the European Communities.’ (para. 25 of the Preamble)

Dominance vs Significant Lessening of Competition (SLC)

The concept of dominance is introduced, and the guidelines for conducting tests of dominance are laid out, in Article 2 of the Merger Regulation, 1989.¹² The Commission is required to take into account:

- (a) ‘the need to maintain and develop effective competition within the common market in view of, among other things, the structure of all the markets concerned and the actual and potential competition from undertakings located either within or without the Community;
- (b) the market position of the undertakings concerned and their economic and financial power, the alternatives available to suppliers and users, their access to supplies or markets, and legal or other barriers to entry, supply and demand trends for the relevant goods and services, the interests of the immediate and ultimate consumers, and the development of the technical and economic progress provided that it is to the consumer’s advantage and does not form an obstacle to competition.’

The actual techniques for carrying out tests of dominance are not specified as these have been subject to trial and error as well as to advances in data collection and statistical analysis, in econometric methods and revisions and additions to the underlying micro-economic theories involved. This implies, as the Commission stated in the consultation Green Paper, that

¹⁰ http://europa.eu.int/information_society/topics/telecoms/regulatory/news_rf/documents/l_10820_020424en00330050.pdf

¹¹ ‘The Commission should monitor the transition from the existing framework to the new framework, and may in particular, at the appropriate time, bring forward a proposal to repeal Regulation (EC) No. 2887/2000 of the European Parliament and of the Council of 18 December 2000 on unbundled access to the local loop.’ (para 43 of the Preamble.)

¹² <http://europa.eu.int/comm/competition/mergers/legislation/regulation/consolidated/en.pdf>

163. ... Merger assessment today can be less reliant on the rather blunt and imprecise market share test than it was 10 years ago.

164. Perhaps the most well-known example of this is the European courts' interpretation of the Merger Regulation's competition test applying to situations of collective dominance, in the judgements of the Court of Justice and the Court of First Instance in the *Kali und Salz* and *Gencor* cases.

165. It has nevertheless been suggested that the SLC-test might be closer to the spirit of the economically-based analysis undertaken in merger control and less (legally) rigid than the dominance test. As such, some consider it better adapted to an effective merger control, in particular in the context of growing industrial concentration...

The term 'collective dominance' in para 164 above refers to the problem of market power arising from mergers between companies that by themselves do not have market shares above 25 per cent and are not deemed to exercise significant market power. Cases of this type are particularly possible in oligopoly markets, as are cases of market power arising from tacit co-ordination and parallel market behaviour that allow firms to raise prices without fear of competition, what are sometimes referred to as unilateral effects of collective dominance. Critics of the dominance criterion argue it is not well suited to handling such cases, but para 164 suggests with flexible legal interpretation it is otherwise. Critics argue that such flexibility leads to legal uncertainty, but others point out that SLC is equally flexible and therefore uncertain as demonstrated by the varying interpretations of the anti-trust laws by the Federal Courts in the US over the years. An argument from international business in favour of SLC is that besides the USA, SLC has been adopted by Australia, Canada, Ireland, New Zealand and the UK (a member of the EU) and this helps harmonize regulations, procedures and methodologies globally, but the point is mute if para 164 is accepted. The real issue, as some of the respondents¹³ to the Green Paper point out, is whether the underlying economic principles and methodologies are harmonized, and as these are to a greater or lesser extent influenced by the political nature of the Government in power absolute harmonization will remain difficult.

Critics of the concept of dominance nevertheless argue that it remains an inherently static concept, placing primary emphasis upon firm sizes and industrial concentration ratios and that Article 2 threatens a legal 'straightjacket' whereby once a firm is declared dominant it has real problems proving otherwise even if the dynamics of the market are otherwise. Proponents of the alternative concept of a signification lessening of competition (SLC) resulting from a merger argue that its tests are much closer to modern micro-economic insights into how markets actually work. OFTA's *Explanatory Note* to the Legco Bills Committee provides a useful review of these tests. (But see below.). Finally we might note that critics see SLC as an inherently 'lower threshold' allowing regulators or competition authorities too broad discretion in the handling of cases – see claims of

¹³ Green Paper on the Review of Regulation No.4064/89: Summary of the Replies Received: http://europa.eu.int/comm/competition/mergers/review/comments/summary_publication.pdf

lobbying and influence. On the contrary some industry commentators see the opposite danger of the regulator or competition authority becoming too interventionist, while fearing the opposite some supporters of the *status quo* in the EU hold that if some cases ‘fall through the net’ because the *ex ante* dominance test sets too ‘high a threshold’ this can be remedied by *ex post* regulation requirements. (For replies to the Green Paper, see Summary of Replies Received paper.¹⁴)

Testing for Dominance or SLC

The traditional test for dominance is whether a firm has the power to significantly raise prices and therefore profits on a sustainable basis within a particular product service market due to the lack of effective competition to lure away customers. This implies lack of any effective substitute supplier, product or service. Therefore the test aims to examine cross-elasticity where a change in the price of one good or service may cause a significant and sustained opposite change in the demand for another good or service signals a close substitute. But in practice these tests are notoriously difficult to do as a leading industrial economist, Professor William Shepherd has pointed out.¹⁵ Shepherd lists other frequently used criteria: of substitutability - the character of the goods or services in question, judgements of industry participants, etc.; of the nature and scale of the market - how many suppliers, evidence of vertical integration, evidence of price gaps between suppliers, etc.; of geographical considerations - the degree of import competition, distances and costs of delivery, etc.

The basis of these tests is the identification of the relevant market. Is it geographically wide or localized? Does it include international services or purely domestic services? What range of services does it cover, many or few? What market segments does it cover, many or few, large or niche, high or low value? The test for defining the ‘product market’ specified in OFTA ‘s *Explanatory Note* to Legco is that of a ‘hypothetical monopolist’ and the concept of a ‘significant and non-transitory increase in price’ or SSNIP, where a price increase leads to a sustained increase in profit that is not competed away in the relevant market. The methodology ideally involves running the test over a small product range and if there seems to be a sustainable profit following a simulated price increase then the test is rerun over a wider product range until sustainability fails. In this way the outer range of the product market is estimated. Professor Shepherd savages this approach.

‘In 1982, Reagan administration officials at the antitrust division of the Justice Department adopted a different technique for defining markets in antitrust cases, as part of their Merger Guidelines. The method was said to be more scientific and reliable than traditional methods. Yet it is actually based mainly on speculation and arbitrary criteria, and so it is often less practical and less reliable than the conventional approach. Its users usually rely, indeed, on the traditional evidence

¹⁴ http://europa.eu.int/comm/competition/mergers/review/comments/summary_publication.pdf

¹⁵ ‘Because cross-elasticities are so impractical, economists (and judges in anti-trust cases) usually resort to a variety of other evidence in defining markets.’ William Shepherd (1997) *The Economics of Industrial Organization*, Prentice Hall: New Jersey, p. 64.

to apply it and confirm its findings.... Speculative: The estimates are speculative, not genuinely scientific. Meaningful tests, using objective data, can rarely be done. If the data actually are available, then they can be used to assess cross-elasticities directly. Arbitrariness: All three of the new method's crucial benchmarks (for the size of price changes, the time periods, and the quantity response) are arbitrary and debatable; they have no special justification either in theory or in practice. And adjusting the benchmarks to plausible other values can make the defined markets much larger or smaller. It too is either arbitrary or an exercise of judgement.' (pp. 66-67)

When the OFTA document is read in detail (paragraphs 30-81) it is clear that just about any feasible test will be used, and it would be surprising to see SSNIP being widely adopted, but the base line will be the 'with-or-without' test.

'To assess whether competition has been substantially lessened by a merger or acquisition, the TA will employ the 'with-and without' test. That is, the level of competition that exists and would exist in a market without the merger or acquisition and compared with the likely level of competition in the future were the merger or acquisition to proceed.' (para 29)

Easier said than done?

'As a starting point, post-merger market shares and concentration ratios will be estimated on the basis of historical trends... The TA will then consider any submissions as to how these trend lines may vary, such as through new transmission capacity coming on stream, the emergence of new technologies, the introduction of new innovative services or the issuing of new telecommunications licences.' (para 34)

But note, an impressive level of foresight is required:

'The telecommunications market is characterised by dynamic and rapid technological changes. In such an industry, market boundaries are not likely to remain constant... The TA will fully take into account the dynamic and technological change occurring in the industry when assessing the effects on competition of mergers and acquisitions involving any licensed telecommunications carriers.' (para. 81)

Efficiency and Mergers

A lengthy paper in 2001 for the EU's Directorate General for Economic and Financial Affairs by Lars-Hendrik Roller, et al.¹⁶ set out to 'answer the two questions of whether

¹⁶ Lars-Henrik Roller, Johan Stennek and Frank Verboven 'Efficiency Gains from Mergers', *European Economy*, No.5 2002, Part 2

EU merger control should allow an efficiency defence, and if so, how it should be designed.’(p38) ¹⁷ The questions arise because the dominance concept in Article 2 of the Merger Regulation has recently been widened to apply to cases of ‘joint dominance’ that may arise in an oligopolistic market (see above). ‘Economic theory’ they point out ‘suggests that cost savings (and other efficiencies) are more likely to dominate anti-competitive effects of a merger, the lower the concentration. Hence, the introduction of joint dominance makes it natural to consider efficiencies today.’ (p.37) It is worth summarizing the findings of the paper.

Traditionally economists identify three broad types of efficiency, allocative and productive (both static) and dynamic. In this case the authors identify five categories of efficiency that can impact upon consumers’ or total surplus¹⁸ and only category (3) is dynamic. They are:

‘(1) rationalisation of production, which refers to cost savings from reallocating production across firms, without increasing the joint technological capabilities; (2) economies of scale, that is, savings in average costs associated with an increase in total output; (3) technological progress, which may stem from the diffusion of know-how on increased incentives for R&D; (4) purchasing economies or savings in factor prices such as intermediate goods or the cost of capital; (5) reduction of slack (managerial and x-efficiency).’

They then go on to argue an important point: ‘that internal efficiencies often need to imply sufficiently large savings in marginal costs for price to decrease. Not all types of efficiencies guarantee that this will be the case.’ Like all quantitative analysis the findings in any given case will heavily rely upon a good supply of recent past and current data, but by definition there is no data for the short and medium term future, so it ‘is important to stress that the precise amount of efficiencies required for price to decrease or total welfare to increase is dependent on the specific assumptions one makes about how firms behave in the market, both before and after the merger.’ The review of the literature reveals that there are surprisingly few studies that have examined in depth the efficiency effects of mergers both before and after the event, so the ‘evidence is not sufficient to draw any conclusion about the likely effects of mergers in different sectors.’ Nevertheless the authors summarize their main findings as follows:

‘First, the empirical literature does provide some support for the fear that horizontal mergers increase market power. Second, there seems to be no support for the general presumption that mergers create efficiency gains. Third, in particular cases, however, mergers do create efficiencies. Moreover, empirical evidence indicates that cost savings are partly passed on to consumers in the form

http://europa.eu.int/comm/economy_finance/publications/european_economy/2001/eers0501_en.pdf

¹⁷ They are quick to add ‘the final choice necessarily involves value judgements. For this reason, this report cannot come to a definitive answer to the above two questions.’ All regulation is policy-based and policy is by definition about value judgements.

¹⁸ In theory total surplus includes producer surplus in the concepts of welfare economics.

of a downward push on price. It appears that there may be a substantial variance in the efficiency gains from mergers. In sum, the empirical evidence suggests that controlling mergers is important, and that the presence and magnitude of efficiency gains may need to be examined on a case-by-case basis.’ (pp.39-40)

In this context it is worth noting that OFTA in the *Explanatory Note* to Legco does allow room for an ‘efficiencies defence’.

‘It must be demonstrated that the efficiencies will be achieved by the merger and would be unlikely to have been achieved without the merger (for example, internal reorganization) or by another means having comparable anti-competitive effects (for example, a joint venture arrangement). (para 72)

But adds in the next paragraph: ‘Efficiencies alone would almost never justify a merger where it would result in an oligopoly or monopoly’.

United Kingdom

As a member of the European Union, the UK follows EU competition regulations, but with its own local flavour. A Monopolies and Restrictive Practices Commission, set up in 1948 under US pressure in return for postwar Marshall aid, used ‘public interest’ criteria to reach its determinations, with the Secretary of State having a major say in the outcomes. The Commission has now been replaced under the Competition Act 1999 and the Director-General of the Office of Fair Trading decides which M&A proposals to submit to the replacement Competition Commission and, what is new, the Commission is now an independent body. This follows the pattern established when the Bank of England’s Monetary Policy Committee was given independence from the Treasury. As Dr Derek Morris, Chairman of the Competition Commission put it during his lecture address at Lancaster University¹⁹ in November 2000:

‘At the most fundamental level it reflects a change of political theory, one traceable in the academic literature back to the 50s and 60s in the US, away from the notion that government, or its public sector agencies, could be assumed to act to mediate private interests and private interest conflicts to promote the wider interests of society – a notion that much political, and it has to be said economic theory utilised – to one in which government is seen in effect as just another form within which private interests, be they short term, sectoral or whatever, exert themselves.’

The UK has also adopted the significant lessening of competition criteria in place of dominance criteria, symbolising a shift of emphasis from the wider concept of ‘public interest’ to the narrower concept of the merger’s effects on levels of competition and consumer’s interests. This leaves open other questions of public interest such as security issues, environmental issues and the like. At this stage the Secretary of State retains a

¹⁹ Speech to be found at: <http://www.competition-commission.org.uk/inquiries/chair.htm>

‘gateway’ power to intervene only if national defence interests are involved. Otherwise the Commission can reach independent findings and come up with its own remedies if it considers anti-competitive or anti-consumer consequences are likely. Appointments to the Commission follow what are known as the Nolan rules whereby an independent assessor is involved to assure that appointments are non-discriminatory and lack political or other bias. Equally important is that as many areas of expertise as possible are represented – economists, lawyers, business professions, consumer representatives. But where does this leave environmental issues?

What are sometimes called ‘complex monopolies’ or ‘collective dominance’ are cases where two or more companies with 25 per cent or more market share act in collusion or in parallel. The provisions of the Fair Trading Act, 1973 in the UK remain in force to cover these cases where divestiture or behavioural regulation are possible remedies. The EU has similarly interpreted its reference to ‘dominance’ as inclusive of ‘collective dominance’ – see above. In many ways therefore the EU and the UK may be seen as influencing each other insofar as merger regulation is passing into the hands of independent commissions and the scope of criteria is narrowing to focus exclusively upon competition and consumer effects, with public interest issues being handled at another, ministerial, level.

One further development in the UK worth noting is the privatization of utilities such as rail and water. The regulation of these private utilities comes mostly through the licensing procedures, as does telecoms in Hong Kong with licences issued by OFTA. However, cases of dispute can be referred to the Competition Commission and while public interest criteria remain in force in the regulation of these utilities, the Commission’s findings and recommendations, while not binding on the regulator, are a major influence. Under the Utilities Act if the regulator does not accept the Commission’s findings then he must at least satisfy the Commission that his own solutions will remedy the problem otherwise the Commission’s findings are determinate.

China

As yet China has no official law governing mergers and acquisitions, nor laws governing competition, although it retains laws restricting the entry of foreign-owner entities or foreign direct investment in prohibited and restricted sectors.²⁰ The first steps to fill this gap were taken on 22 October 2002 when the Ministry of Foreign Trade and Economic Co-operation (MOFTEC) issued draft temporary regulations in the *China Securities Journal*. Government review and approval will be required for any merger or acquisition that: (i) gives a Foreign Invested Enterprise (FIE) more than one-third of the domestic market, (ii) is above US\$30 million – this already requires central government approval - or (iii) brings total investment in China above US\$100 million, or (iv) where the FIE is involved in more than ten mergers or acquisitions within any one year, or (v) where the foreign firm controls more than one-quarter of the domestic market, or (vi) where the

²⁰ The four categories in the Foreign Investment Industrial Catalogue are ‘Encouraged’, ‘Permitted’, ‘Restricted’ and ‘Prohibited’.

assets involved exceed 300 million yuan, or (vii) where the sales involved exceed 500 million yuan.

It is quite usual in China that different ministries and state commissions come out with different and often contradictory draft laws and regulations, and it takes time before clarity emerges with decisions taken or ratified by the State Council. For example, the Ministry of Information Industries (MII) had once floated the idea that foreign investors in the telecoms sector would be required to have annual revenues exceeding US\$10 billion and a representative office in China for at least the previous three years. These highly restrictive requirements did not appear in the subsequent *Interim Provisions on Domestic Investment by Foreign-Invested Enterprises* issued in July 2000 by the State Administration of Industry and Commerce, nor in the January 2002 set of *Administration of Foreign-Invested Telecommunications Enterprises (FITE) Provisions*²¹ which stipulate that there must be a principle China investor holding more than 30 per cent equity in the FIE and a principle foreign investor holding more than 30 per cent equity in the FIE, and that Chinese investors must hold at least 50 per cent equity in basic service companies, which in practice means state owned enterprises. The 2000 *Provisions* also stipulate general rules for FIE investments in subsidiaries in China, while the 2002 *Provisions* stipulate minimum investments of 2 billion yuan in national and inter-provincial basic service telecom FIEs and 200 million yuan in a single province. The equivalent figures for value-added services are 10 million yuan and 1 million yuan.

China's membership of the WTO opens the door to mergers and acquisitions and WTO rules require China to adopt laws or at least regulations ensuring open and therefore competitive markets wherever China has not listed reservations. Telecommunications is one of the areas where reservations were entered²² so foreign investment in acquisitions in this sector will fall under sector specific rules as well as any general laws and regulations that may apply. In the meantime the State Economic and Trade Commission (SETC) is expected to come forward with its own comprehensive draft of M&A legislation that may well supercede MOFTEC's proposals.

Economic Theories

Behind Professor Shepherd's combative stance lies a deeper division among economists that go to the heart of the debate. On the surface the debate is a technical one about meanings of words and concepts (dominance or SLC) and about test methodologies and data-handling techniques. Behind the positions taken in the debate lie very fundamental differences about how markets work. Broadly three economic schools put forward different positions. What may be called the traditional neoclassical view dates back to the end of the nineteenth century when mainstream economists denounced monopolies and supported regulation. This orthodoxy came under challenge in the 1970s with the rise of the New Chicago School of law professors and economists, the latter led by such luminaries as G.J. Stigler and Richard Posner. This school holds that natural monopolies

²¹ See brief power-point summary on p.4 at: http://www.trp.hku.hk/papers/2002/china_hkiebs.pdf

²² For various papers on China and WTO see <http://www.trp.hku.hk/infofile/china.html>

can arise due to efficiencies; that if they overcharge they lose their advantages and therefore only collusion creates real market power. In this idealistic view regulation, as opposed to anti-trust action against illegal collusion, can only impose distorting economic costs resulting in sub-optimal public policy. In the USA the dominant companies of the time, notably IBM and AT&T, agreed. They employed many of these law professors and economists to argue antitrust cases in court, and famously from AT&T's unsuccessful efforts to avoid divestiture in 1984 arose a third distinct school of analysis, contestability theory, formulated by Prof William Baumol along with John Panzar and Robert Willig. Contestability theory argues that conditions of entry are more important than monopoly itself. If the threat of market entry is real then monopolists will behave *as if* they were facing competitors, giving society the best of both worlds. Sounds familiar in Redmond?

Conclusion

This brings us to the crux of the matter. The world clearly changes. One part of that change is the maturing of markets, and things that influence markets such as the invention of new technologies and their diffusion, new products and services, changes in factor costs and so forth. Another part of that change is political and social. Different economic theorists and theories fall in and out of favour with changes of governments, and the importance attached to issues of social concern, such as pollution, equality of opportunity, corporate governance, freedom of information and transparency fluctuates. So where does this leave attitudes to mergers and acquisitions and competition policy?

The economic arguments are not conclusive – see above. Governments influenced by New Chicago will take the laissez-faire route. Governments looking for pragmatic solutions to practical concerns will tend towards mainstream approaches. Governments willing to devote large resources to measuring and monitoring may opt for *ex ante* approaches, those more inclined to wait and see will opt for the *ex post* approaches. In the case of OFTA historically we have seen an active but not heavy handed *ex ante* approach as the market is guided towards full and open competition. Now OFTA is proposing to review this approach, for example OFTA has already flagged a change in interconnection policy²³ in light of full market liberalization from January 2003. But the EU Commission also seems to be changing direction as is the FCC in the USA, so the trend is international. But how far does, or should, this shift in policy stance go?

Is it now time to shift the policy emphasis away from helping the new entrants, or hindering the incumbent, at the retail level? Should perhaps the emphasis shift towards ensuring competition further upstream in the wholesale market, for example in the leasing of broadband capacity? Should OFTA begin taking a stronger view on conditional versus unconditional access in the consumer market? Or should OFTA simply withdraw more and more from regulating market? In which case does M&A policy represent a fallback position? An *ex-post* authorization to intervene if but only when market power, or abuse of market power is significant?

²³ See TA Statement, 18 October 2002 'Publication Under Section 36A (5C) of the Telecommunications Ordinance of Interconnection Agreements Entered into with PCCW-HKT Telephone Ltd', at: http://www.ofta.gov.hk/Interconnection/inter_pub.pdf

Putting it this way almost sees M&A policy as a substitute for regulation. This is clearly an exaggeration, but it does hint at another possibility that Hong Kong could move towards a broad competition policy law, which would give guidance when making judgements about mergers and acquisitions, and retreats from industry-specific telecommunications law and regulations. Yet another possibility is the transformation of the expertise of OFTA as a sector-specific regulator into a competition authority embracing the utility companies as a first step and later setting the guidelines for the whole economy. Under this scenario the sector-specific expertise could be retained to deal with unique issues.

But specifically on the question of OFTA's approach to mergers and acquisitions, should OFTA follow the UK model of narrowing the criteria to competition issues only, or should the criteria be broad enough to include social policy and obligations such as universal service? Is the judicial review process sufficient and satisfactory, or again should OFTA adopt a peer review process as suggested by the EU's Competition Commission? Are the review procedures sufficiently open and transparent and flexible, or again should OFTA follow the reforms proposed by the EU?

And a final thought, following the UK example. Should Government be recast as an 'interested party' in the process of competition law and regulation, or as a party subject to high-powered lobbying by special interest groups? Should a mergers and acquisitions review process, or a future competition authority, be independent not just of industry but also of Government insofar as its decision making powers are concerned? Or does the judicial review process already provide this independence, and is it sufficient? This is a complex and evolving subject. The only near certainty is that whatever provisions are put in place today they will prove inadequate in some way or other at some time or other in the future as the world continues to change.

Check List – issues generally fall under two headings. Here are some possible questions.

1. Procedural issues:

- a) Are these sufficient in the M&A proposed legislation?
- b) Are they sufficiently flexible to allow companies to enter the review process at various stages in an informal way to short-circuit issues of lesser substance?
- c) Will user and consumer interests be directly represented in the review process?
- d) In practice how transparent will be the use of methodologies and data to assess the likely impact of a merger or acquisition upon a significant lessening of competition?
- e) Will there be any use of peer review within the process before decisions are announced?
- f) Will overseas case law or other precedents be available or utilized in any judicial review process?

2. Substantive issues:

- a) Are the thresholds to trigger a review too high, too low or too many?
- b) Which of the many possible criteria are most likely to be used to come to a judgement? And how are they chosen? According to whatever is available?
- c) Should the criteria be confined to competitive effects or include social obligations?
- d) How *ex post* is M&A policy and regulatory supervision? How far is *ex post* really just *fait accompli*? Or how far should it lead to less regulation in a competitive market?
- e) Can OFTA effectively regulate against 'collective dominance' and tacit collusion?