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Draft Guideline on The Second Conduct Rule – 2014

Contents

1	The Second Conduct Rule	2
2	Defining the Relevant Market	5
3	Assessment of Substantial Market Power	13
4	Abuse of Substantial Market Power	22
5	Examples of Conduct that May Constitute an Abuse	25
6	Exclusions and Exemptions from the Second Conduct Rule	35

Guideline on the Second Conduct Rule

*This Guideline is jointly issued by the Competition Commission (the “**Commission**”) and the Communications Authority (the “**CA**”) under section 35(1)(a) of the Competition Ordinance (Cap 619) (the “**Ordinance**”).*

This Guideline sets out how the Commission intends to interpret and give effect to the Second Conduct Rule in the Ordinance. The Guideline is not, however, a substitute for the Ordinance. The Competition Tribunal and other courts are ultimately responsible for interpreting the Ordinance. The Commission’s interpretation of the Ordinance does not bind them.

This Guideline provides general guidance on the application of the Second Conduct Rule and does not address all possible situations in which that rule might apply. Each case will be assessed on its own facts. The examples given in this Guideline are illustrative only.

This Guideline will be applied having regard to changes in market circumstances and prevailing case law. The Guideline may be amended from time to time in light of the experience of the Commission and the case law of the courts.

While the Commission is the principal competition authority responsible for enforcing the Ordinance, it has concurrent jurisdiction with the CA in respect of the anti-competitive conduct of certain undertakings operating in the telecommunications and broadcasting sectors.¹ Unless stated otherwise, so far as a matter relates to conduct falling within this concurrent jurisdiction, references in this Guideline to the Commission are to be read as applying also to the CA.

¹ The relevant undertakings are specified in section 159(1) of the Ordinance. These are licensees under the Telecommunications Ordinance (Cap 106) (the “**TO**”) or the Broadcasting Ordinance (Cap 562) (the “**BO**”); persons who, although not such licensees, are persons whose activities require them to be licensed under the TO or the BO; or persons who have been exempted from the TO or from specified provisions of the TO pursuant to section 39 of the TO.

I The Second Conduct Rule

I.1 Section 21(1) of the Ordinance sets out the Second Conduct Rule:

“An undertaking that has a substantial degree of market power in a market must not abuse that power by engaging in conduct that has as its object or effect the prevention, restriction or distortion of competition in Hong Kong.”

I.2 The Second Conduct Rule therefore applies where the following elements are present:

- (a) the entity engaged in the relevant conduct is an undertaking;
- (b) this undertaking has a substantial degree of market power in a market; and
- (c) the undertaking abuses its market power by engaging in conduct that has as its object or effect the prevention, restriction or distortion of competition in Hong Kong.

I.3 The term “undertaking” is defined in section 2(1) of the Ordinance. An undertaking means any entity, regardless of its legal status or the way in which it is financed, engaged in economic activity, and includes a natural person engaged in economic activity. The term is therefore a broader concept than the term “company” as defined in section 2(1) of the Companies Ordinance, although a company may be an undertaking. An undertaking may also be an individual, or a group of companies to the extent that they constitute an economic unit.²

I.4 The Second Conduct Rule only applies where an undertaking has a *substantial degree of market power* in a market. The most obvious manifestation of market power is the ability of an undertaking profitably to raise prices above the competitive level for a sustained period. Market power can, however, be manifested in other ways. For example, an undertaking with market power may be able to:

- (a) reduce the quality of its products³ below competitive levels for a sustained period without offering any compensatory reduction in price;
- (b) reduce the range or variety of its products below competitive levels for a sustained period;

² For further guidance on the key considerations in assessing whether an entity is an undertaking, see the Commission’s *Guideline on the First Conduct Rule*.

³ References to products in this Guideline include services unless the context dictates otherwise.

- (c) lower customer service standards below competitive levels for a sustained period; and/or
- (d) impair, relative to competitive levels and for a sustained period, innovation or any other parameter of competition in the market.

1.5 The Second Conduct Rule only applies where an undertaking with a substantial degree of market power in a market *abuses* that power by engaging in conduct that has as its object or effect the prevention, restriction or distortion of competition in Hong Kong. Abusive conduct is therefore conduct which has the object or effect of preventing, restricting or distorting competition in Hong Kong. Some typical examples of abusive conduct are discussed in this Guideline. The category of abusive conduct is, however, an open one.

1.6 The Second Conduct Rule is not concerned with preventing firms from gaining market power or being able to exercise it to increase their profits for a time. The pursuit of market power and higher profits through innovation and competition is key to a prosperous free market economy. To remove this profit motive would risk dampening rather than invigorating competition.

1.7 Nonetheless, the pursuit of profit may lead some undertakings with a substantial degree of market power to abuse that power with a view to protecting or increasing their position of power and profits. For example, a powerful undertaking may:

- (a) seek to maintain its substantial market power by abusing it to prevent challenges to its position by existing or new competitors; or
- (b) leverage its substantial market power in one market to harm competition⁴ in a second market instead of competing on the merits for customers in that second market.

1.8 When undertakings with a substantial degree of market power abuse it in this way, the negative effects of that power for the economy and consumers (including businesses acting as customers)⁵ become entrenched. Instead of the profits of market power rewarding competition and innovation, they become a reward for causing harm to economically beneficial outcomes. Undertakings with a substantial degree of market power have a special responsibility not to engage in conduct which harms competition.

⁴ This Guideline uses the shorthand "harm competition" in place of "prevent, restrict or distort competition".

⁵ References to consumers in this Guideline includes businesses acting as customers unless the context otherwise dictates.

- 1.9 Section 21(2) of the Ordinance offers guidance on the types of conduct that might constitute an abuse of substantial market power. Conduct may, in particular, constitute an abuse if it involves:
- (a) *Predatory behaviour towards competitors.* Predatory behaviour includes “predatory pricing” which occurs when an undertaking with a substantial degree of market power lowers its price below an appropriate measure of cost, deliberately incurring losses in the short run so as to eliminate or reduce the competitive effectiveness of one or more of its rivals or to prevent entry into the market by potential rivals.
 - (b) *Limiting production, markets or technical development to the prejudice of consumers.* This category of conduct includes practices such as anti-competitive tying and bundling, refusals to deal and exclusive dealing, which harm the competitive process and consumers.
- 1.10 Section 6(1) of Schedule 1 to the Ordinance provides that the Second Conduct Rule does not apply to conduct engaged in by an undertaking with an annual turnover of not more than HK\$40 million.⁶ Undertakings with annual turnover above this threshold are not presumed to have a substantial degree of market power.
- 1.11 The Ordinance also provides for certain other exclusions and exemptions with respect to the application of the Second Conduct Rule. Further details of these exclusions and exemptions are set out in Part 6 of this Guideline.
- 1.12 The application of the Second Conduct Rule as described in this Guideline does not preclude the possible parallel application of the First Conduct Rule to the same conduct. Abusive conduct which takes the form of an agreement might also infringe the First Conduct Rule depending on the facts of the case.⁷
- 1.13 The Second Conduct Rule applies to conduct that harms competition *in Hong Kong*. Section 23 of the Ordinance provides that this is the case notwithstanding that the abusive conduct takes place outside Hong Kong or the undertaking that engages in the abusive conduct is located outside Hong Kong.

⁶ Turnover in this context is to be assessed for the relevant turnover period, which is defined as either the financial year of the undertaking or, if the undertaking does not have a financial year, the preceding calendar year. Additional rules on the applicable turnover period are to be provided in regulations made by the Secretary for Commerce and Economic Development under section 163 of the Ordinance. These regulations will be made available on the Commission’s website.

⁷ See generally the Commission’s *Guideline on the First Conduct Rule*.

2 Defining the Relevant Market

Introduction

- 2.1 When conducting a competition assessment under the Ordinance, the Commission will use an analytical framework which involves defining the relevant market. The exercise of defining the relevant market is, however, no more than an analytical tool and not an end in itself. The purpose of defining the relevant market is to assist with identifying in a systematic way the competitive constraints that undertakings face when operating in a market.
- 2.2 While market definition is discussed in this Guideline in the context of explaining the Commission's proposed approach to the Second Conduct Rule, the principles of market definition apply also to the First Conduct Rule and the Merger Rule. In particular this is the case in terms of determining if undertakings are competitors or potential competitors and when assessing the anti-competitive effects of conduct in a market.
- 2.3 When defining the relevant market the Commission will not follow mechanically each and every step described in this Guideline in each and every case. Instead, the Commission will look at evidence that is available and relevant to the case at hand.
- 2.4 Moreover, it should be noted that it will not generally be necessary to define precisely the boundaries of the relevant market in a given case. For example, where it is apparent that investigated conduct is unlikely to have an adverse effect on competition or that the undertaking under investigation does not possess a substantial degree of market power on the basis of any reasonable market definition, the question of the most appropriate market definition can be left open.
- 2.5 A market might be commonly understood to mean an area or place where products are bought and sold. However, the term "relevant market" has a more technical meaning for competition law purposes and the manner in which the Commission defines the market may differ from how businesses typically think of a market.

- 2.6 The relevant market within which to analyse market power or assess a given competition concern has both a product dimension and a geographic dimension. In this context, the relevant product market comprises all those products which are considered interchangeable or substitutable by buyers because of the products' characteristics, prices and intended use. The relevant geographic market comprises all those regions or areas where buyers can find substitutes for the products in question.
- 2.7 The way in which the relevant market for a particular product is defined will depend on the specific facts of the case, and may vary from one case to the next based on the preferences of buyers at the point in time under consideration and the particular competition concern for which the analysis is undertaken. For this reason, market definition has no precedential value and a defined relevant market in one case will not bind the Commission in another. That said, the Commission will have regard to previous cases when defining the relevant market and undertakings may wish to use relevant markets defined in past cases as a guide to the Commission's likely approach when assessing the impact of their conduct on competition.

Product market

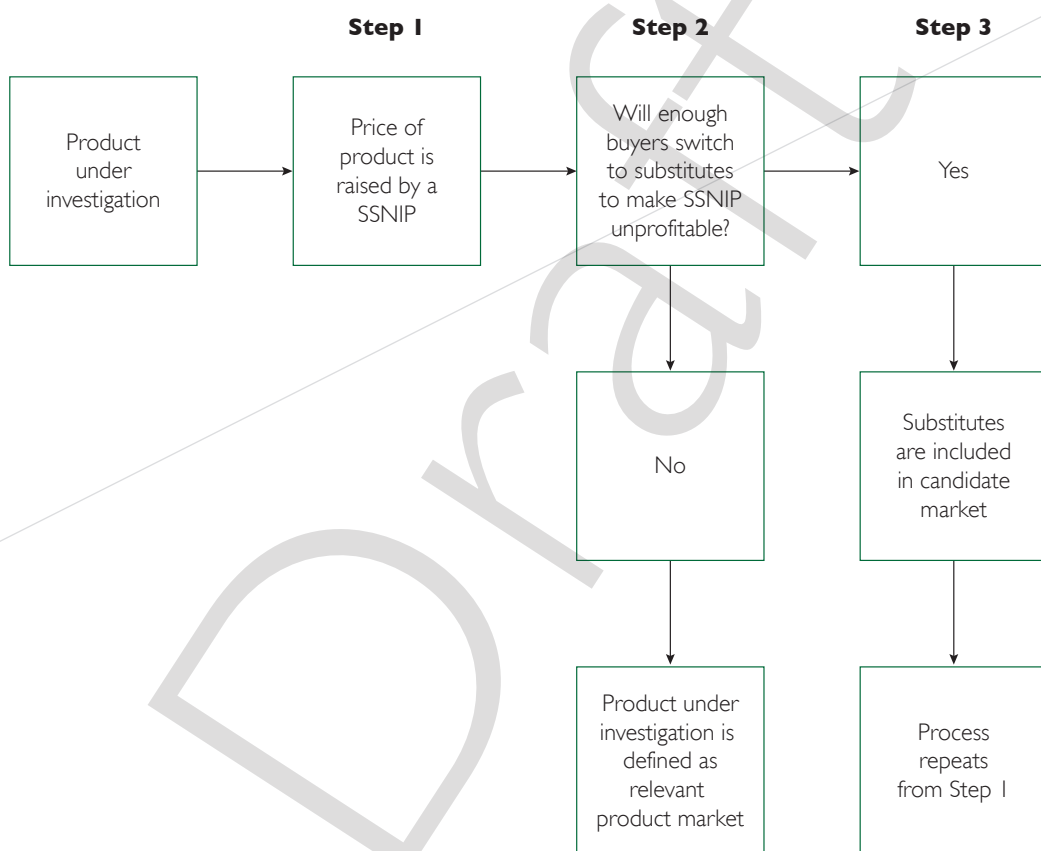
- 2.8 Substitutability from the perspective of the buyer (demand-side substitution) is a central factor for the purposes of market definition. The process of defining the relevant product market will often start by looking at a relatively narrow potential product market definition. This would normally be one (or more) of the products which are the subject of an investigation or, in the case of a merger, offered by the merging parties. The potential product market is then expanded to include those substitute products to which buyers would turn in the face of a price increase above the competitive price.⁸
- 2.9 In this regard, a frequently used method of assessment involves postulating a candidate product market and considering whether a hypothetical firm with a monopoly in that market (a "hypothetical monopolist") would be able profitably to impose an increase in price that is small but significant (typically between 5% and 10%) and non-transitory. Such a price increase, a small but significant non-transitory increase in price, is referred to as a "SSNIP". If enough buyers would switch to substitute products in the face of a SSNIP to make the attempted price increase unprofitable, the candidate product market is too narrow. The candidate market is then expanded to include the substitute products to

⁸ Generally, for the purposes of the analysis, prevailing prices will be considered and this is particularly so in the case of a merger. In Second Conduct Rule cases, however, the fact that the prevailing price might be above competitive levels due to the exercise of existing market power will need to be taken into account.

which buyers would turn, and the same analysis is performed on this broader candidate product market. The relevant product market will be that group of products over which a hypothetical monopolist can profitably impose a SSNIP.

2.10 The approach described in the preceding paragraph is shown below in Figure 1 and in hypothetical example 1.

Figure 1



Hypothetical Example 1

CoffeeCo, the manufacturer of a popular brand of ready-to-drink coffee-based beverages, decides to increase the price of its product by 5% above the competitive level. As a result, a substantial percentage of CoffeeCo's customers switch to a ready-to-drink tea-based beverage produced by TeaCo. CoffeeCo loses enough sales to TeaCo that the price increase is unprofitable and it is forced to lower its price to the original level. The relevant product market in this scenario would include at least both the CoffeeCo and TeaCo products.

- 2.11 When applying the hypothetical monopolist test in the context of a given case, the Commission would consider both quantitative and qualitative evidence of demand-side substitution using appropriate analytical techniques.
- 2.12 In particular, the Commission may:
- (a) undertake an analysis of whether a SSNIP would be profitable;
 - (b) consider evidence of patterns in price changes;⁹
 - (c) consider the characteristics of the product in question and the product's intended use;¹⁰
 - (d) consider evidence from undertakings active in the market and their commercial strategies; and/or
 - (e) consider evidence regarding the past behaviour of buyers (relating to, for example, their tendency to switch between products in response to a price increase).

Geographic market

- 2.13 The relevant geographic market can be defined using the same general process as that used to define the relevant product market.
- 2.14 The geographic market may cover a global or regional area, or be limited to Hong Kong or a part of Hong Kong. For example, depending on the market in question, there may be cases where parts of Mainland China (such as the Pearl River Delta area) could be included in the relevant geographic market. A number of factors will determine the extent of the relevant geographic market. These factors are discussed below.
- 2.15 As in the case of product market definition, buyers' views of available substitutes will drive the Commission's analysis of the relevant geographic market. The objective of this analysis will therefore be to identify all those areas where buyers can find substitutes for the products under examination. To determine the relevant geographic market, the Commission will typically begin by looking at a relatively narrow geographic area (the candidate geographic market). The hypothetical monopolist test may then be applied to this area with a view to establishing whether a hypothetical monopolist of the product at

⁹ If two products show the same pattern of price changes, for reasons not connected to costs or general price inflation, this may be consistent with the two products being substitutes.

¹⁰ Where the intended uses of products are sufficiently similar this would tend to support a conclusion that the products are close substitutes and therefore within the same product market.

issue in the area could profitably sustain a price increase above the competitive level. If not, the test is repeated over wider geographic areas as appropriate until the hypothetical monopolist would find it profitable to sustain a price increase.

- 2.16 Accordingly, like product market definition, the definition of a relevant geographic market may employ a SSNIP analysis to assess the extent to which customers of a product would switch to suppliers located in other areas in response to a hypothetical SSNIP of the relevant product. If, in response to a SSNIP, enough buyers would switch to substitutes in other areas to make the attempted price increase unprofitable, the candidate geographic market is too narrow. The candidate geographic market is then expanded to include the other areas to which buyers would turn, and the same analysis is performed on this broader potential geographic market. Hypothetical example 2 illustrates this approach.

Hypothetical Example 2

The only shop selling a particular type of specialty paint in Lantau decides to increase the price it charges for the specialty paint by 5%. After this price increase, a number of customers of the shop decide to purchase a substitute product from specialty paint shops on Hong Kong Island. Enough customers of the Lantau shop switch to shops on Hong Kong Island that the Lantau shop is not able profitably to maintain its price increase. In this example, the geographic market in which the Lantau shop competes would include at least Lantau and Hong Kong Island.

- 2.17 The extent to which buyers are willing and able to purchase the product from different areas will be relevant. For example, in the case of consumer products, geographic markets may be quite narrow if a significant number of buyers are unlikely to purchase products sold in neighbouring areas. For wholesale or manufacturing markets in which transport costs are low, buyers may be in a better position to switch between suppliers in different regions. Thus, the scope of the geographic market for a particular product might vary depending on whether the buyer is at the end consumer level (in which case the geographic market may be relatively narrow) or the wholesale level (in which case the geographic market may be relatively broad). Hypothetical example 3 illustrates this approach.

Hypothetical Example 3

A milk producer based in Hong Kong increases the price at which it sells a litre of milk by 5%. The retail outlets which buy the milk have sufficient transport capability to source milk easily from a number of different areas around Hong Kong. They decide to obtain milk from an alternative producer with a lower price, which is located 10 kilometres away from the first producer. From the perspective of the retailers, the geographic market includes both areas in which the milk producers are located. If considered from the perspective of the end consumer, however, the same conclusion might not apply. Where a retail outlet increased the price of a litre of milk by 5%, an end consumer might be unwilling to travel to a retail outlet 10 kilometres away in order to purchase milk at a lower price.

- 2.18 When applying the hypothetical monopolist test in the context defining the relevant geographic market, the Commission will consider both quantitative and qualitative evidence using appropriate analytical techniques.
- 2.19 In particular, the Commission may consider evidence of the diversion of orders to other areas, prices in the different areas, the geographic pattern of purchases for buyers, trade flows, barriers and switching costs that might be associated with diverting to suppliers in other areas, transport costs relative to the value of the products concerned, and cultural factors.

Particular issues in market definition

- 2.20 Some markets have specific characteristics which may give rise to particular issues in market definition.

Temporal markets

- 2.21 A factor that may be relevant in some markets is time. Examples of how time might be relevant for market definition purposes include:
- (a) *Peak and off-peak services.* Some buyers may not view peak and off-peak services as substitutable. For example, train tickets for early morning weekday services may not be in the same market as train tickets for weekend services. Conceptually, this time dimension might be regarded as an aspect of product market definition.
 - (b) *Seasonal markets.* It may be appropriate to refer to time as a factor in market definition for certain seasonal products.

Price discrimination markets

2.22 Where suppliers are able to differentiate between groups of buyers in terms of price, it may be appropriate to assess these groups of buyers as separate markets. Undertakings might be able to discriminate between buyers for a variety of reasons including, for example, because some buyers face such high switching costs that they are “locked in” to purchasing a particular product.

Aftermarkets

2.23 An aftermarket is a market for a secondary product, namely a product which is purchased only as a result of buying a primary product. The primary product and the secondary product can be considered to be complementary. For example, a customer might purchase spare parts (the secondary products) for use with a particular machine (the primary product). The appropriate market definition in the case of aftermarkets will depend on the facts of the case. It might be appropriate to define, for example:

- (a) a *single system market* comprising both the primary product and the secondary product (i.e. machine A and its spare parts (system A) competes with machine B and its spare parts (system B));
- (b) *dual markets* where there is a market for the primary product and a separate market comprising all secondary products (i.e. there are two markets, one for all primary products and one for all secondary products); or
- (c) *multiple markets* involving a primary market for the primary product with a separate secondary market associated with each primary product (i.e. there is one market for all primary product but as many secondary markets as there are individual primary products).

Captive production

2.24 Where a particular market includes vertically integrated firms, the question sometimes arises as to whether: (a) production of a product consumed internally by a vertically integrated firm (“captive production”) should be considered in the product market; or (b) only production sold externally to the “merchant market” should be included. Generally, the Commission will not consider captive production to be within the relevant product market but will assess whether captive production imposes a competitive constraint in terms of potential competition. Potential competition is discussed further below.

Two-sided markets

- 2.25 A two-sided market is a market where undertakings compete simultaneously for two groups of customers whose demands are inter-related. In this context the undertakings use a two-sided platform to sell to the two different groups of buyers. Examples of two-sided markets include online auction platforms and video game markets. Because of the two sides of the market and the interaction between the two different groups of buyers, market definition can be more complex than in most traditional one-sided markets. When assessing market power in a two-sided market, all competitive constraints on both sides of the market must be considered.

Dynamic and innovative markets

- 2.26 Some industries are characterised by rapid technological change. For example, new products may be developed, formerly separate functionalities may be integrated in a new product and process innovations may lead to the entry of undertakings into the market increasing the competitive pressure on incumbent undertakings. These developments are often unpredictable, leading to the emergence of new markets or the convergence of formerly separate markets. As a result, market boundaries may shift rapidly over time and this can pose particular challenges when defining the relevant market in the context of a particular investigation. Equally, market shares at a given point in time might be less indicative of market power depending on the facts of the case.

Bidding markets

- 2.27 A bidding market is one in which firms typically compete by submitting bids in response to tenders by buyers. To identify the competitive constraints a particular undertaking faces, more weight must be placed on identifying the (potential) market participants, i.e. those suppliers that have the capacity to compete for the contract and participate in future bidding competitions. In bidding markets, the relevant market will include all undertakings that can be viewed as credible bidders for the product at issue in the geographic area where they can place a credible bid.

Supply-side substitution and potential competition

- 2.28 Products might be regarded as being subject to three main sources of competitive constraint: (a) substitutability from the perspective of the buyer (demand-side substitutability); (b) supply-side substitutability; and (c) potential competition. The assessment of demand-side substitutability involves a consideration of:

- (a) the range of products viewed as substitutes by buyers; and
- (b) the areas where buyers can find substitutes for the products concerned.

As explained in this Part of the Guideline, buyers' views on substitutability will be central for the purposes of market definition in the Commission's practice.

Supply-side substitution

- 2.29 Supply-side substitutability refers to the ability of undertakings to switch production to the product under consideration or to begin supplying the product to the geographic area under consideration, in the event of an increase in the price of the product concerned.

Potential competition

- 2.30 Potential competition refers to the competitive constraint imposed in the market from the potential entry of new undertakings and the potential expansion of existing ones. Where suppliers cannot switch production in the short term with ease, they are considered as a source of potential competition rather than supply-side substitution.

Relevance for market definition

- 2.31 The Commission will not generally consider supply-side substitutability or potential competition when defining the relevant market. Rather, they will be considered at a later stage in the analysis (potential competition is discussed in detail in Part 3 of this Guideline in the context of potential entry or expansion).¹¹ Ultimately, the key issue is whether or not an undertaking has market power. In this context, market definition is only one element of the assessment as undertakings in a market may well be subject to competitive constraints from outside the market no matter how it is defined. The important point is that all sources of competitive constraint are taken into consideration in the assessment of market power.

3 Assessment of Substantial Market Power

Introduction

- 3.1 An undertaking does not operate in a vacuum. There is generally an ongoing rivalry between undertakings in a relevant market in terms of price, service, innovation and quality to which each undertaking must react if its products are to remain attractive to consumers. As a result, undertakings in a relevant market, both big and small, will usually be mutually constrained in their pricing, output and related commercial decisions by the activity or anticipated activity of other undertakings that compete in, or may compete in, that market.

¹¹ In this context, the Commission will generally treat supply-side substitution as an instance of potential competition.

- 3.2 A substantial degree of market power arises where an undertaking does not face sufficiently effective competitive constraints in the relevant market. Substantial market power can be thought of as the *ability profitably¹² to charge prices above competitive levels, or to restrict output or quality¹³ below competitive levels, for a sustained period of time*. Normally a period of two years can be considered to amount to a sustained period. However, the relevant period may be shorter or longer depending on the facts, in particular with regard to the product and the circumstances of the market in question.
- 3.3 The above definition of substantial market power does not preclude the possibility of more than one undertaking having substantial market power in a relevant market, particularly if the market is highly concentrated with only a few large market participants.
- 3.4 By contrast, an undertaking in a competitive market may be able temporarily to raise its price above the competitive level, but it will be unable to sustain such a price increase because customers will switch to cheaper suppliers or additional suppliers will enter the market. Hence, if an undertaking can profitably charge prices above competitive levels over a sustained period, it can be considered to have a substantial degree of market power. An undertaking with substantial market power might also have the ability and incentive to harm the process of competition by, for example, weakening existing competition, raising entry barriers or slowing innovation.
- 3.5 Although this Part of the Guideline mainly deals with market power in terms of the ability to raise prices on the supplier side, market power might equally arise on the buyer side of the market (known as monopsony power). In the latter case, a substantial degree of market power may exist where the *buyer* has the ability to obtain purchase prices below the competitive level for a sustained period of time.
- 3.6 Market power is a matter of degree. The degree of market power possessed by an undertaking will be assessed based on the circumstances of the case. An undertaking may have a substantial degree of market power without being a monopolist. When assessing whether an undertaking has a substantial degree of market power, the

¹² The reference to “profitably” means that the undertaking’s conduct is profitable relative to the competitive level. This does not, however, imply that the undertaking with substantial market power is making a profit in absolute terms or in an accounting sense, which would depend on factors other than the conduct concerned.

¹³ The references to price, output and quality (or references to price alone elsewhere in this Guideline as the context requires) are to be understood as shorthand for the various ways in which the parameters of competition might be influenced to the advantage of the undertaking with substantial market power and to the detriment of consumers.

Commission will consider the extent to which that undertaking faces constraints on its ability profitably to sustain prices above competitive levels.

3.7 Section 21(3) of the Ordinance sets out the following non-exhaustive list of the matters that may be taken into consideration in determining whether an undertaking has a substantial degree of market power:

- (a) the market share of the undertaking;
- (b) the undertaking's power to make pricing and other decisions;
- (c) any barriers to entry to competitors into the relevant market; and
- (d) any other relevant matters.

3.8 An assessment of market power thus comprises an analysis of several factors including market share, countervailing buyer power, barriers to entry or expansion, and market-specific characteristics. These and other factors are examined in more detail below. The factors discussed are not exhaustive and there may be other factors that the Commission will consider in its assessment of market power in a given case.

Market share and market concentration

3.9 In general, an analysis of market shares may be useful as an initial screening device in the conduct of an assessment of substantial market power.

3.10 Undertakings are more likely to have a substantial degree of market power where they have high market shares. However, a high market share does not always imply substantial market power. For example, where undertakings compete to improve the quality of their products, a persistently high market share might indicate persistently successful innovation and so would not necessarily mean that competition is ineffective. A determination of the presence or absence of substantial market power will be made on the facts of the particular case, taking into account all relevant factors, in particular the characteristics of the industry involved, and not merely the market shares of the relevant market participants.

3.11 It is important to consider the evolution of the market shares of the undertakings in the relevant market, as this will often be more informative than a snapshot picture of market

shares at a single point in time. This will be particularly relevant, for example, where the market under consideration is dynamic, characterised by frequent innovation or highly competitive, in which case market shares might be volatile. Frequent changes in market shares may also indicate that barriers to entry or expansion in a market are low and this would tend to suggest an absence of market power. In contrast, an undertaking is more likely to have substantial market power if it has a high market share which it has either maintained or grown over time, while its competitors have relatively weak positions. Relative market share can therefore be an important factor in the analysis. The evolution of shares over a period of years might be particularly relevant for bidding markets, where demand may be lumpy and market share may vary dramatically from one year to the next.

3.12 The appropriate method of calculating market share depends on the case at hand. The following data may be used:

- (a) *Turnover or sales value data.* Market share is often determined by measuring the value of an undertaking's sales to customers in the relevant market.
- (b) *Sales volume data.* In some cases, such as when products are homogenous in nature, it may be more helpful to measure market share in terms of the volume of sales to customers in the relevant market.
- (c) *Capacity.* Market shares may be determined by measuring an undertaking's capacity to supply the relevant market. This measure of market share may be of interest where capacity is an important feature of an undertaking's ability to compete, such as in an industry operating at, or close to, full capacity.
- (d) *Other indicators.* Market share might also be calculated by reference to, for example, product reserves held, customer base, share of new customers etc.

3.13 The indications provided by measuring market shares can be supplemented by measuring the level of concentration in the market. Market concentration in this context refers to the number and size of undertakings in the market. A concentrated market is one with a small number of leading undertakings with a large combined market share.

3.14 Market concentration can provide useful information about the market structure and can be used to assess the relative positions of the undertakings in the market as part of an assessment of market power.

3.15 There are two common methods of measuring market concentration:

- (a) *Concentration ratios.* Concentration ratios measure the aggregate market share of a small number (three or four generally) of the leading undertakings in a market. For example, the three-firm concentration ratio, or “CR3”, shows the proportion of the market supplied by the three leading undertakings.
- (b) *Herfindahl-Hirschman Index.* The Herfindahl-Hirschman Index (“**HHI**”) is a measure of market concentration that takes account of the differences in the sizes of market participants, as well as their number. The HHI is calculated by adding together the squared values of the percentage market shares of all undertakings in the market.¹⁴

Potential entry or expansion

3.16 Barriers to entry are factors that prevent or hinder a prospective new entrant from entering the market or otherwise place it at a significant competitive disadvantage relative to incumbents. Barriers to entry may arise from a variety of sources, including regulatory or legal restrictions, economic or structural factors, the conduct of the undertaking under assessment (so-called strategic barriers) or the conduct of third parties.

3.17 When evaluating whether an undertaking has a substantial degree of market power, the Commission will consider whether entry by potential competitors or expansion by existing market participants (or the threat of entry or expansion) would deter or defeat the exercise of such market power. The relevant question is whether entry or expansion, or the threat of it, pose a credible competitive constraint on the undertaking concerned. Where that is the case, the undertaking under examination will likely not have substantial market power.

3.18 The lower the barriers to entry or expansion, the more likely it will be that potential competition will prevent an undertaking from profitably sustaining prices above competitive levels. Persistently high market shares are a likely indicator of the presence of barriers to entry or expansion. Moreover, an undertaking with a large market share in a market protected by significant entry barriers is likely to have a substantial degree of market power. By contrast, even an undertaking with a very large market share would be unlikely to have a substantial degree of market power in a market where there are very low entry barriers.

¹⁴ Where relevant data is not available in respect of very small firms in the market, these firms can be omitted for the purposes of the HHI calculation.

Hypothetical Example 4

A butcher shop has a 70% market share for the supply of meat in a particular locality. This locality amounts to a distinct geographic market because customers are not willing to travel to other localities to purchase their meat. An assessment of the butcher's market share alone might be taken to suggest the butcher enjoyed a substantial degree of market power. However, given that barriers to entering the market are low (as one would typically expect for an activity such as the retail sale of meat), another butcher shop could easily begin to operate in the area, preventing the first butcher shop from profitably sustaining prices above competitive levels. As such, the butcher shop would not have substantial market power whatever its actual market share might suggest.

3.19 For entry or expansion (or the threat thereof) to be considered an effective competitive constraint, the entry or expansion must be likely, timely and sufficient. "Timely" means that entry or expansion will occur within a reasonable period or within such period as will serve to deter or defeat the exercise of market power. "Likely" refers to the expectation that entry will occur and be profitable. "Sufficient" means that entry will occur on an adequate scale to prevent or deter undertakings from exercising market power.

3.20 Examples of barriers to entry or expansion include:

- (a) regulatory and legal barriers (such as licensing requirements);
- (b) structural barriers (such as significant economies of scale and/or scope, or network effects); and
- (c) strategic barriers intentionally created or enhanced by incumbent undertakings in the market.

Regulatory and legal barriers

3.21 Regulation by a government or an industry sector regulator may give rise to barriers to entry or expansion. For example, regulation may limit the number of undertakings which can operate in a market through a requirement that parties obtain a licence. In this case the licence can be thought of as a necessary input before production can take place. Similarly, planning and licensing laws that impose limits on the number of retail outlets limit expansion and entry possibilities at the retail level, and in turn may make it more difficult for suppliers to gain access to efficient distribution.

3.22 Intellectual property rights (“**IPRs**”) may also amount to legal barriers when they prevent or make more difficult entry or expansion by (potential) competitors. In principle, IPRs are indicative of a substantial degree of market power only when the product or technology protected by the IPR corresponds to a relevant product or technology market. IPRs do not automatically give rise to barriers and do not necessarily imply substantial market power as firms might well be able to invent around the relevant IPR.¹⁵

Structural barriers

- 3.23 Sunk costs of entry or expansion are an example of structural barriers. Sunk costs are costs that are incurred on entering or remaining active in a market, cannot be economically recouped within a short period of time, and are not recoverable on exit.
- 3.24 Sunk costs create entry risks which may in turn create barriers to entry. Examples of sunk costs include investments in product research and development, the construction of a specialised production facility, start-up marketing and on-going advertising expenditures. When considering whether sunk costs give rise to entry barriers, it may be useful to consider the extent to which sunk costs give an incumbent an advantage over potential new entrants. The mere existence of sunk costs in any particular industry, however, does not necessarily mean that entry barriers are high or that competition within the market is not effective, particularly if those costs are not strictly necessary for entry or expansion in a market.
- 3.25 Structural entry barriers may also arise where important inputs or distribution channels are scarce. If an incumbent undertaking has privileged access to these inputs or channels, they may obtain an advantage over a potential entrant, making entry more difficult.
- 3.26 Economies of scale may amount to a barrier to entry or expansion. Such economies exist where average cost falls as output increases. Where a market is characterised by large economies of scale, a potential entrant may need to enter the market on a large scale (in relation to the size of the market) in order to compete effectively. A barrier to entry could arise where entry or expansion requires relatively large fixed costs to be incurred, particularly where these costs are sunk costs. Similarly, where a potential entrant would be able to reach a viable scale of production only after a significant period of time, this may deter entry or expansion. Even where entry or expansion is not

¹⁵ See Part 2 of this Guideline for an explanation of the principles of market definition. While an IPR might confer a legal monopoly, it does not follow that this legal monopoly confers market power in an economic sense or a substantial degree of market power under the Ordinance.

deterred by economies of scale, the incumbent may retain a substantial degree of market power for a significant period of time if new entrants would take time to establish a sufficient operation to be able to compete effectively.

- 3.27 The costs of entry or expansion may also be affected by economies of scope. Such economies arise where the production or distribution of multiple products leads to a reduction in long-run average costs. If economies of scope are significant, an undertaking intending to produce only one product may be at a cost disadvantage relative to the incumbent and therefore a less effective competitor. The existence of scope economies raises the cost of successful entry or expansion as a result.
- 3.28 Closely related to economies of scale are network effects. Network effects arise when the value a consumer places on connecting to a network (such as payment card schemes or online classifieds) depends on the number of others already connected to the network. Network effects may act as a barrier to entry or expansion because an incumbent may have the advantage of significant network effects, which an entrant would lack unless it can displace the incumbent's network.

Strategic barriers

- 3.29 Strategic barriers are barriers which are created or enhanced by incumbents in a particular market, possibly with a view to deterring potential entry or expansion. Strategic barriers can be distinguished from structural barriers, which arise from the characteristics of the market itself. Examples of strategic barriers might include long term contracts concluded by incumbents, strategic brand proliferation engaged in by the incumbent, or where an incumbent decides to build excess capacity to send a signal to potential new entrants that it could profitably push prices down to levels which would not permit new entrants to earn sufficient revenue to cover their sunk costs.

Countervailing buyer power

- 3.30 The strength of buyers and the structure of the buyers' side of the market may prevent a supplier from having a substantial degree of market power. In essence, buyers will have countervailing buyer power if they have a choice between alternative suppliers.

- 3.31 Generally speaking, countervailing buyer power must be supported by a credible threat to bypass the supplier if no acceptable deal can be reached. A buyer will be more likely to have countervailing buyer power where one or more of the following factors apply:
- (a) the buyer could readily, at little cost to itself, and within a reasonable period, switch substantial purchases from the supplier;
 - (b) the buyer could commence production itself, or “sponsor” new entry or expansion by another supplier relatively quickly;
 - (c) the buyer is an important customer for the supplier; and/or
 - (d) the buyer can intensify competition among suppliers by purchasing through a competitive tender.
- 3.32 To prevent a substantial degree of market power from arising, countervailing buyer power must be sufficient to protect the market as a whole and not merely certain buyers.
- 3.33 Buyer power will not be considered a sufficiently effective constraint if it only ensures that a particular or limited segment of customers is shielded from the exercise of market power. For example, an undertaking may still be able to exercise a substantial degree of market power even though certain of its larger customers can secure preferable terms.
- 3.34 Countervailing buyer power should be reasonably foreseeable for some future period, and not merely temporary or transient.

Particular issues in the assessment of substantial market power

- 3.35 Some markets have specific characteristics which may give rise to particular issues in any assessment of substantial market power.

Bidding markets

- 3.36 Sometimes buyers choose their suppliers through procurement auctions or tenders. The main feature of bidding markets is that there is “competition for the market” as opposed to competition in the market. In these circumstances, even if there are only a few suppliers, competition might be intense. This is more likely to be the case where tenders are infrequent (so that suppliers are more likely to bid), and where suppliers are not subject to capacity constraints (so that all suppliers are likely to place competitive bids). If competition at the bidding stage is effective, a high market share at a given point in time would not necessarily reflect long-term market power. For this reason, it may be more appropriate to assess market power over an extended period.

Vertical integration

- 3.37 Vertically integrated firms may be able to prevent an undertaking from having a substantial degree of market power. For example, suppose a supplier produces an input A which is a necessary input for the manufacture of a product B. Suppose also that a vertically integrated supplier that does not supply a substitute for input A on the merchant market supplies a product C which is a substitute for B. The ability of customers to substitute product C for product B may constrain the ability of the non-vertically integrated producer of input A to raise the price of input A. This might therefore preclude the supplier of input A from having a substantial degree of market power in the relevant market which includes input A.

Capacity constraints

- 3.38 Sometimes an undertaking's competitors will not be in a position to respond to the exercise of market power by increasing output in response to higher prices in the relevant market. For example, an undertaking operating in an industry with limited capacity would be in a stronger position to increase prices above competitive levels than an undertaking with a similar market share operating in an industry with substantial excess capacity. Moreover, even existing excess capacity may be so expensive to employ that it will not in practice constitute a competitive constraint. For example, the costs of introducing another shift in a factory with excess capacity might be so high as to hinder a competitor from responding to the exercise of market power.

4 Abuse of Substantial Market Power

Introduction

- 4.1 To contravene the Second Conduct Rule, an undertaking must abuse its substantial market power by engaging in conduct that has the object or effect of harming competition in Hong Kong. Abusive conduct is therefore conduct which has the object or effect of harming competition in Hong Kong. As noted previously, the category of abusive conduct is an open one.
- 4.2 It is possible for an undertaking with substantial market power in one market to commit an abuse in a different market. In this regard, the relevant undertaking might leverage its market power in the first market to harm competition in the second. For

example, it may be an abuse to tie two products together with a view to harming competition in the tied market. This type of abuse is discussed further in Part 5 of this Guideline.

- 4.3 Abusive conduct may particularly result in harm to competition through anti-competitive foreclosure. Anti-competitive foreclosure occurs when effective access of actual or potential competitors to sources of supply or buyers is hampered or eliminated as a result of the conduct of the undertaking with substantial market power. Anti-competitive foreclosure can result in the undertaking with substantial market power being able to charge higher prices or in reduced product quality or choice, to the detriment of consumers.
- 4.4 When investigating cases of alleged abuse of substantial market power, the Commission may consider whether the undertaking is able to demonstrate that the concerned conduct is indispensable and proportionate to the pursuit of some legitimate objective unconnected with the tendency of the conduct to harm competition.

The “object” of restricting competition

- 4.5 The “object” of conduct refers to the objective purpose of the conduct engaged in by the undertaking considered in its legal and economic context and not merely the subjective intention of the undertaking concerned. Whether conduct has the object of harming competition involves an objective consideration of the nature of the conduct in its market setting.
- 4.6 Section 22(1) of the Ordinance provides that if conduct has more than one object, it is sufficient for the purposes of contravening the Second Conduct Rule if any one of its objects is to harm competition. Moreover, section 22(2) of the Ordinance provides that it is possible to ascertain the object of conduct by inference. Accordingly, the anti-competitive object of conduct might be inferred from the facts underlying the conduct or the surrounding circumstances.
- 4.7 Where conduct has the object of harming competition, the Commission is not required to show that it has the effect of harming competition. The Commission is only required to show that conduct has either the object of harming competition or, in the alternative, that conduct has the effect of harming competition.

- 4.8 An example of conduct which may have the object of harming competition is where an undertaking with a substantial degree of market power sets prices below its average variable costs. This type of conduct, known as predatory pricing, is discussed further below.

The “effect” of restricting competition

- 4.9 If conduct does not have the object of harming competition, it may nevertheless infringe the Second Conduct Rule if it has an actual or likely anti-competitive effect.
- 4.10 In assessing whether conduct has the actual or likely effect of harming competition, the Commission may assess what the market conditions would have been in the absence of the conduct (i.e. the counter-factual), and compare these counter-factual market conditions with the conditions resulting where the conduct is present. However, this is not a necessary step. For example, it may not be possible to determine the counter-factual in some cases (such as where an undertaking has held a substantial degree of market power for many years).
- 4.11 Conduct might have the actual or likely effect of harming competition where it results in or is likely to result in:
- (a) higher prices;
 - (b) a restriction in output;
 - (c) a reduction in product quality; and/or
 - (d) anti-competitive foreclosure.
- 4.12 For conduct to have the actual or likely effect of harming competition, it must harm the process of competition causing harm to consumers, and not simply harm an individual competitor. Consumers benefit when competitors have strong incentives to win the competitive battle against one another. In a highly competitive market some competitors will leave the market over time while new ones will enter. The Ordinance is concerned with protecting competition in the market and not the commercial interests of particular market participants.

5 Examples of Conduct that May Constitute an Abuse

- 5.1 The following are non-exhaustive examples of types of conduct that the Commission may, in appropriate circumstances, consider an abuse of a substantial degree of market power:
- (a) predatory pricing;
 - (b) tying and bundling;
 - (c) margin squeeze conduct;
 - (d) refusals to deal; and
 - (e) exclusive dealing.

Predatory pricing

- 5.2 An undertaking with substantial market power may engage in predatory behaviour, in particular by setting prices so low that it deliberately foregoes profits in an attempt to force one or more other undertakings out of the market and/or in an attempt to otherwise “discipline” competitors. In this context, the undertaking may incur losses in the short run in the expectation that it will be able to charge higher prices in the longer term (for example, following the exit of the relevant competitor(s) from the market). Consumers will ultimately be worse off if competition is weakened in this way, leading to higher prices and reduced product quality and choice.
- 5.3 Charging low prices is, however, the very essence of competition, and the Commission will be wary of the risk of applying the Second Conduct Rule in its assessment of alleged predatory pricing conduct in a way which harms the competitive process.
- 5.4 Generally speaking, an adverse effect on competition will arise where there is or is likely to be anti-competitive foreclosure of existing competitors or new entrants. Where reliable data is available, the Commission will therefore seek to demonstrate anti-competitive foreclosure when assessing predatory pricing conduct. It will not, however, be necessary for the Commission to demonstrate that competitors have actually exited the market in order to show a foreclosure effect. The undertaking with a substantial degree of market power may prefer merely to prevent competitors from competing too vigorously rather than seeking to force them from the market. The disciplining of competitors in this way may also amount to anti-competitive foreclosure.

5.5 When assessing whether predation is taking (or has taken) place, the Commission will typically consider whether the undertaking is pricing below an appropriate measure of cost. Although different cost benchmarks may be used to identify predatory behaviour depending on the facts of the case, the following general remarks might be made:

- (a) *Pricing below average variable cost.* Pricing below average variable cost (“**AVC**”) is unlikely to be economically rational, because an undertaking that does this is making losses on each unit of output it produces even with respect only to the costs that it must immediately and unavoidably incur in producing those units of output (i.e., its variable costs). For this reason, where an undertaking with a substantial degree of market power sets prices below AVC, the Commission may consider that this is undertaken for a predatory purpose. In the absence of evidence to the contrary, the Commission is likely to conclude that the conduct has the object of harming competition.¹⁶
- (b) *Pricing below average total cost.* Where an undertaking prices above its AVC (or a comparable measure¹⁷) but below its average total cost (“**ATC**”), the conduct may be entirely rational commercial behaviour because the immediately unavoidable costs of production (the variable costs) are more than met, even if not all costs in the longer term (i.e. fixed costs) are covered. When analysing this type of conduct, evidence of actual or likely anti-competitive effects may be considered or there may be documentary evidence of a predatory strategy. Equally, the Commission may investigate whether the allegedly predatory conduct resulted in losses that could have been avoided or whether the undertaking’s pricing strategy makes commercial sense only because of its tendency to harm competition.

5.6 When considering whether below-cost pricing constitutes predatory conduct, the Commission may, at its discretion, consider the extent to which the predator undertaking is in the longer term able to “recoup” its short term losses stemming from the below-cost pricing by subsequently charging supra-competitive prices as a result of increased market power:

¹⁶ Long run average incremental cost (“**LRAIC**”) is another benchmark that may be used as an alternative to AVC. LRAIC is sometimes considered a more appropriate cost measure than AVC when the alleged predatory conduct involves products that have large fixed costs and low marginal costs of production. Pricing below average avoidable cost (“**AAC**”) is a further benchmark that can be used as an alternative to AVC depending on the facts of the case. AAC is sometimes considered a more appropriate cost measure than AVC when analysing profit sacrificed and avoidable losses. AAC focuses on the costs incurred to generate increased output weighed against the revenues received.

¹⁷ See footnote 16 above.

Hypothetical Example 5

KowloonVend Ltd and New Vending Co are the only two companies that sell vending machines in Hong Kong. KowloonVend has the majority of vending machine sales, while New Vending, a recent entrant in the market, has a much smaller share. KowloonVend was selling its machines at a highly profitable price. When it entered the market, New Vending began selling its machines at a much lower price and KowloonVend's market share began to decline. New Vending gained these lost sales from KowloonVend. In response, KowloonVend cut its prices in half. This low price was not enough to cover any measure of KowloonVend's costs and KowloonVend lost money with each vending machine sold. New Vending could not compete with these low prices and eventually went out of business. Assuming it can be established that KowloonVend has a position of substantial market power, the Commission may assess KowloonVend's conduct as predatory and a violation of the Second Conduct Rule.

Anti-competitive tying and bundling

- 5.7 Tying occurs when a supplier makes the sale of one product (the tying product) conditional upon the purchase of another (the tied product) from the supplier (i.e. the tying product is not sold separately).¹⁸ Bundling refers to situations where a package of two or more products is offered at a discount.
- 5.8 Tying and bundling are common commercial arrangements that generally do not harm competition and often promote competition. Many undertakings, whether or not they have substantial market power, engage in tying and bundling and such arrangements often result in lower production costs, reduced transaction and information costs and increased convenience and variety for consumers.
- 5.9 However, an undertaking with a substantial degree of market power in the tying market can use tying as a means to harm competitors in the tied market. The undertaking with substantial market power leverages its market power in the tying market to foreclose competition in the tied market. By tying, the undertaking with substantial market power may reduce the number of potential buyers that are available for its competitors in the tied market – that is, the tied market is foreclosed. This may in turn cause those

¹⁸ There are many types of tying. For example, technical tying occurs when the tying product is designed in such a way that it only works properly with the tied product, and not with alternatives offered by competitors. Contractual tying occurs when the customer who purchases the tying product undertakes also to purchase the tied product.

competitors to be less effective as competitors or to exit the tied market, with the result that the undertaking with substantial market power can raise prices to the detriment of consumers.

- 5.10 Similarly, in the context of bundling, an undertaking with a substantial degree of market power in the market for one of the products that forms part of the bundle may use bundling to harm competitors in the markets for the other products that are part of the same bundle. This may give rise to foreclosure in the latter markets, with the potential for higher prices for consumers.
- 5.11 When assessing tying and bundling conduct, the Commission will consider whether the tying and tied products (or products in the bundle) are distinct products and, if so, whether the conduct has an anti-competitive effect. An anti-competitive effect may arise in particular when the conduct results in anti-competitive foreclosure.

Hypothetical Example 6

A supplier of medical devices to Hong Kong hospitals and clinics stipulates in its sales contracts that the consumable medical products used with the devices must be purchased exclusively from it. These contractual requirements significantly limit the customer base available to competing manufacturers of consumables. Assuming the medical devices supplier can be shown to have a substantial degree of market power in the relevant medical devices markets, the contractual arrangements (which cause harm to competition in the market for consumable medical products) may amount to an abusive tie in violation of the Second Conduct Rule. A similar anti-competitive effect could arise with respect to the tying of a service. For example, if the medical devices supplier imposed a condition requiring the use of a particular undertaking or firm (including a subsidiary) to provide maintenance and repair services for its devices, this could also raise concerns under the Second Conduct Rule.

Hypothetical Example 7

The manufacturer of a popular brand of toothbrush, CleenTeeth, decides to implement a special offer in Hong Kong stores. Customers buying CleenTeeth toothbrushes can receive a tube of its new toothpaste product, SparkL Advance, at a discounted price. The offer is only for a 3 month period, and is intended to help CleenTeeth raise the profile of SparkL Advance in the market. Even assuming CleenTeeth has a substantial degree of market power in the relevant market for toothbrushes, this bundling arrangement would be unlikely to amount to a violation of the Second Conduct Rule. The discount offered on SparkL Advance is unlikely to have the object or effect of limiting CleenTeeth's competitors' ability to compete in the toothpaste market. The discount is of limited duration and supported by a pro-competitive efficiency (relating to the introduction of a new product in the market).

Margin squeeze

- 5.12 A margin squeeze may arise where a vertically integrated undertaking with a substantial degree of market power supplies an important input in the downstream market in which it also operates.
- 5.13 A margin squeeze occurs where the undertaking with substantial market power reduces or “squeezes” the margin between the price it charges for the input to its competitors on the downstream market and the price its downstream operations charge to its own customers, such that the downstream competitor is unable to compete effectively. A margin squeeze requires that the undertaking supplying the relevant input has substantial market power on the market where it sells the input – that is, the upstream market.
- 5.14 When assessing whether conduct amounts to an abusive margin squeeze, the Commission will consider the following factors:
- (a) *The nature of the upstream input concerned.* An anti-competitive effect is more likely if the upstream product is an indispensable input from the perspective of the participants in the downstream market. Nonetheless, an abusive margin squeeze cannot be excluded even if there are alternatives available for the upstream input.

- (b) *The level of the margin squeeze.* A margin squeeze can be taken to arise where the difference between the downstream prices charged by the firm with substantial market power and the upstream prices it charges its competitors in the downstream market for the relevant input is (i) negative (that is, if the upstream price is higher than the downstream price charged by the undertaking with substantial market power), or (ii) at least insufficient to cover the downstream product-specific costs of the firm with substantial market power.¹⁹

Refusals to deal

- 5.15 As a general matter, an undertaking, whether or not it has substantial market power, is free to decide with whom it will or will not do business. An undertaking might not wish to enter into a trading relationship with another party for a variety of legitimate commercial reasons, such as, for example, because it has concerns about the credit worthiness of the other party. A refusal to deal by an undertaking with substantial market power is likely to be abusive in very limited or exceptional circumstances.
- 5.16 The term “refusal to deal” describes a situation where an undertaking with a substantial degree of market power refuses to supply an input to another undertaking, or is willing to supply that input only on objectively unreasonable terms – known as a constructive refusal to deal. Constructive refusal could, for example, consist of unduly delaying or otherwise degrading the supply of the relevant input or imposing a price for the input that is excessive.
- 5.17 A refusal to deal may harm competition in the downstream market by preventing the undertaking seeking access to the relevant input from: (a) operating in that market; or (b) operating in that market as an effective competitive constraint.
- 5.18 Competition concerns are more likely to arise when the undertaking with a substantial degree of market power competes in the downstream market with the party with whom it refuses to deal (that is, where the undertaking with substantial market power is vertically integrated). Concerns may arise in particular when the refusal relates to an input that is indispensable for undertakings operating in the downstream market. In this context, the Commission will consider whether the undertakings operating in the downstream market are able to duplicate the relevant input or whether they would be able to duplicate it only at unreasonable cost.

¹⁹ The Commission will consider whether a downstream competitor with the same product-specific costs as the downstream operations of the vertically integrated undertaking with substantial market power would be profitable in light of the upstream and downstream prices levied by the undertaking with substantial market power.

- 5.19 In assessing whether a refusal to deal is a violation of the Second Conduct Rule, the Commission may consider as appropriate: (a) whether or not it is technically and economically feasible for the undertaking with a substantial degree of market power to provide the input in question; (b) the past history of dealing between the undertakings (the termination of an existing supply arrangement might more readily be characterised as abusive); and (c) the terms and conditions at which the products in question are generally supplied or are supplied in other contexts.
- 5.20 Given the importance of IPRs in encouraging creative activity and innovation, the Commission will consider an undertaking's refusal to license an IPR as a violation of the Second Conduct Rule only in very exceptional circumstances. In addition to the factors that the Commission would have regard to in any case of a refusal to deal, the Commission may also assess, for example, whether a refusal to licence prevents the development of a secondary market or new product or otherwise limits technical development resulting in consumer harm.
- 5.21 Where an undertaking with a substantial degree of market power holds an IPR which is essential to an industry standard, and the undertaking gave a commitment at the time when the standard was adopted by the industry that it would license the IPR on fair, reasonable and non-discriminatory ("**FRAND**") terms, a subsequent refusal to honour the FRAND commitment may be an abuse. Equally, it may also be an abuse for the holder of a standard essential patent with a FRAND commitment to seek injunctive relief against a willing licensee in certain circumstances.²⁰

Exclusive dealing

- 5.22 An undertaking with substantial market power may seek to foreclose competitors by preventing them from selling to customers through exclusive dealing arrangements. Exclusive dealing in this context includes arrangements requiring a customer to purchase, directly or indirectly, all or a substantial proportion of its requirements of a particular product from a particular undertaking. This may take the form of either an exclusive purchasing obligation or a conditional rebate. These two types of arrangement are discussed further below.

²⁰ Whether or not a refusal to honour a FRAND commitment amounts to an abuse in the form of a refusal to deal will depend on the facts of the case. A failure to honour a FRAND commitment might equally raise issues of excessive pricing or discriminatory pricing. Where the holder of a FRAND obligated standard essential patent seeks injunctive relief against a willing licensee, that may be assessed as a refusal to deal but equally it might be appropriate to assess such conduct as an abusive use of litigation.

- 5.23 Exclusive dealing is a broad category of conduct which also covers exclusive supply obligations or incentive arrangements with a similar effect. Where an undertaking with substantial market power uses such arrangements to foreclose competitors by preventing them from accessing particular inputs, this may amount to an abuse if the exclusive supply or relevant incentive arrangement locks up most of the efficient input suppliers in the market and competitors of the undertaking with substantial market power are unable to secure the inputs concerned from alternative suppliers.²¹
- 5.24 Where exclusive dealing is pursued by an undertaking with a substantial degree of market power, the exclusive dealing conduct may amount to an abuse if it has the object or effect of harming competition.²²
- 5.25 An exclusive purchasing obligation requires a customer to purchase its requirements of a particular product exclusively or to a large extent only from the undertaking with a substantial degree of market power. Other obligations, such as stocking requirements, may have the same effect as exclusive purchasing even though they do not, strictly speaking, entail exclusivity.
- 5.26 The Commission will have particular concerns where: (a) the undertaking with a substantial degree of market power has imposed exclusive purchasing obligations on many customers; (b) where it is likely that consumers as a whole will not derive a benefit; and (c) the relevant obligations, as a whole, have the effect of preventing the entry or expansion of competing undertakings because, for example, the exclusive purchasing locks up a significant part of the relevant market²³ – that is, where there is anti-competitive foreclosure.
- 5.27 In cases where competitors can compete on equal terms for the entirety of each individual customer's demand, exclusive dealing is unlikely to harm competition unless the duration of the exclusivity gives rise to a foreclosure effect. In the case of bidding markets for example, where there is competition for the market, exclusivity might merely be the expression or result of a highly competitive market.

²¹ Other exclusive dealing practices or similar structures which may give rise to concern under the Second Conduct Rule, depending on the facts of the case, include English clauses, slotting allowances paid by suppliers to retailers, incentives in the form of storage or other equipment provided free of charge in return for an exclusive stocking commitment or, in certain limited circumstances, category management arrangements.

²² Where neither of the parties to the exclusive dealing arrangement has a substantial degree of market power, the exclusive dealing may fall to be assessed as a vertical agreement under the First Conduct Rule (see the Commission's *Guideline on the First Conduct Rule* for further details in this respect).

²³ The undertaking with substantial market power might of course simply choose to target customers who are particularly important for competitors in terms of possibilities to enter or expand, thereby increasing the risk of anti-competitive foreclosure. Such conduct could equally amount to an abuse.

- 5.28 Conditional rebates, in particular loyalty or fidelity rebates, involve the grant of a rebate to customers as a reward for particular purchasing behaviour. Typically, a loyalty rebate scheme involves offering a financial incentive to encourage the buyer to commit to purchasing more from the supplier. As a general matter, rebates of this kind are normal commercial arrangements intended to stimulate demand to the benefit of consumers.
- 5.29 However, rebates which are granted by an undertaking with a substantial degree of market power can have foreclosure effects similar in nature to those caused by exclusive purchasing obligations. Usually a loyalty rebate involves the customer being awarded the rebate if the customer's purchases over a defined period exceed a defined threshold. Loyalty rebates may be granted either on all purchases from the undertaking with substantial market power (retroactive rebates) or only on purchases above the relevant threshold (incremental rebates). Retroactive rebates have the potential to foreclose the market significantly since buyers switching portions of their demand to an alternative supplier would lose the rebate in respect of all products purchased and not only the incremental amount for which the buyer is considering alternative suppliers.
- 5.30 Rebates may be individualised in nature (where the relevant thresholds are tailored to each customer according to its particular requirements) or standardised (where the same thresholds apply for all customers). Generally, an individualised threshold allows the undertaking with a substantial degree of market power to set the threshold at such a level as will maximise its foreclosure effect, while a standardised rebate may be too high for some buyers and/or too low for others to have any loyalty enhancing effect. Standardised rebates are therefore less likely to raise competition concerns. General quantity rebates, conditional on the size of a particular order, are also unlikely to raise competition concerns unless they are predatory in nature.

Hypothetical Example 8

A large and popular rice noodle producer in Hong Kong, LargeNoodle Co, offered large rebates to local grocery stores that agreed to purchase a certain volume of rice noodles from LargeNoodle Co. LargeNoodle Co set volume targets for each customer individually and these corresponded roughly to the volume of noodles which the customer usually purchased. The targets were calculated over a period of one year and increased in size, year on year, for a period of 5 years. No rebates were received unless the grocery store hit the volume target, and after that point, the rebate was received in respect of all volumes purchased from LargeNoodle Co that year. The effect of the rebate scheme was that customers would in practice, purchase all of their rice noodle requirements from LargeNoodle Co, as to do otherwise would lead to them losing the entire rebate for a particular year. Other rice noodle producers were effectively 'locked out' from supplying a large portion of the grocery market and could no longer compete effectively with LargeNoodle Co. This suggests that LargeNoodle Co has a substantial degree of market power, and that this rebate scheme may amount to an abuse under the Second Conduct Rule.

Hypothetical Example 9

A Hong Kong glass manufacturer supplies glass for windows to several construction companies in Hong Kong. Where the volume of glass supplied to these companies increases, the manufacturer's cost per unit decreases. This is as a result, among other things, of lower average transport costs. In light of these cost savings and in order to drive sales, the manufacturer offers discounts to customers on reaching certain volume targets. The discounts are granted only on those purchases above the target volume. The same targets and discounts apply to all customers. The glass manufacturer separately offers a small discount in return for early payments.

Even assuming that the glass manufacturer has a substantial degree of market power, these discounts would be unlikely to violate the Second Conduct Rule. The early payment discount would be unlikely to have the object or effect of restricting competition. There may be a number of valid commercial reasons why the manufacturer would wish to encourage early payments. As for the other discounts, the standardised and incremental nature of the discounts means that they would be less likely to foreclose competitors than, for example, individualised and/or

retroactive rebates. The fact that the discounts are linked solely to the volume of the purchases and based on cost savings also suggests they are unlikely to raise concerns under the Second Conduct Rule.

6 Exclusions and Exemptions from the Second Conduct Rule

Introduction

6.1 The Second Conduct Rule does not apply where it is excluded by or as a result of the application of an exclusion in Schedule 1 to the Ordinance. In this respect, Schedule 1 to the Ordinance provides for the following general exclusions:

- (a) compliance with legal requirements;
- (b) services of general economic interest;
- (c) mergers; and
- (d) conduct of lesser significance.

Discussion on each of these general exclusions and other statutory exclusions and exemptions is provided in the paragraphs which follow.

6.2 Undertakings to whom exclusions and exemptions apply will not contravene the Second Conduct Rule. There is no requirement for undertakings to apply to the Commission in order to secure the benefit of a particular exclusion or exemption. It is up to undertakings to assess for themselves whether their conduct complies with the Second Conduct Rule. Equally, undertakings may assert the benefit of any exclusion or exemption as a “defence” to any proceedings before the Competition Tribunal or other courts.

6.3 However, the Ordinance provides that undertakings may elect to apply to the Commission under section 24 of the Ordinance for a decision pursuant to section 26 of the Ordinance as to whether or not the conduct in question is excluded or exempt from the Second Conduct Rule. If an undertaking wishes to seek greater legal certainty, it may wish to apply to the Commission for a decision under section 26 of the Ordinance. However, the Commission is only required to consider applications for such a decision in certain circumstances.

- 6.4 The Commission's *Guideline on Applications for a Decision under sections 9 and 24 (Exclusions and Exemptions) and section 15 Block Exemption Orders* provides information on how undertakings can apply to the Commission for a decision on whether a statutory exclusion or exemption applies.

Compliance with legal requirements

- 6.5 Section 2, Schedule 1 to the Ordinance provides that agreements or conduct are excluded from the First Conduct Rule and Second Conduct Rule to the extent that the relevant agreement or conduct is made or engaged in for the purposes of complying with a legal requirement imposed by or under any enactment in force in Hong Kong²⁴ or imposed by any national law²⁵ applying in Hong Kong.
- 6.6 The Commission considers that for this general exclusion to apply, the relevant legal requirement must eliminate any margin of autonomy on the part of the undertakings concerned compelling them to enter into or engage in the agreement or conduct in question.
- 6.7 Where an undertaking has some scope to exercise its independent judgment on whether it will enter into an agreement or engage in the relevant conduct, the general exclusion for complying with legal requirements will not be available. Accordingly, if the relevant agreement or conduct is merely facilitated or encouraged by an enactment in force in Hong Kong or national law applying in Hong Kong, the exclusion will not apply. Equally, approval or encouragement on the part of the public authorities will not suffice for this general exclusion to apply.

Services of general economic interest

- 6.8 Section 3, Schedule 1 to the Ordinance provides that neither the First Conduct Rule nor the Second Conduct Rule applies to an undertaking entrusted by the Government²⁶ with the operation of services of general economic interest in so far as the Conduct Rules would obstruct the performance, in law or in fact, of the particular tasks assigned to the undertaking.

²⁴ Section 2, Schedule 1 to the Ordinance. An "enactment" is defined in section 3 of the Interpretation and General Clauses Ordinance (Cap 1) (the "**Interpretation Ordinance**") to mean any Ordinance, any subsidiary legislation made under any such Ordinance and any provision or provisions of any such Ordinance or subsidiary legislation.

²⁵ Section 3 of the Interpretation Ordinance provides that the term "national law" means a national law applying in Hong Kong pursuant to the provisions of Article 18 of the Basic Law.

²⁶ Section 3 of the Interpretation Ordinance provides that the term "Government" means the Government of the Hong Kong Special Administrative Region. Section 2 of the Ordinance indicates, however, that Government does not include a company that is wholly or partly owned by the Government.

6.9 The Commission intends to interpret this general exclusion strictly. The onus will be on the undertaking seeking the benefit of the exclusion to demonstrate that all the conditions for application of the exclusion have been met. These are discussed below.

Entrusted

6.10 The undertaking will need to demonstrate that it has been expressly entrusted by the Government with the service in question. The Commission considers that an act of entrustment may be made by way of some legislative measure or regulation, through the grant of a concession or license governed by public law or through some other act of the Government. Mere approval by the Government of the activities carried out by the relevant undertaking will not suffice.

6.11 The exclusion applies only to the particular entrusted tasks and not to the undertaking or its activities generally.

6.12 For obligations imposed on an undertaking entrusted with the operation of a service of general economic interest to fall within the particular tasks entrusted to it, they must be linked to the subject matter of the service of general economic interest in question and contribute directly to achieving that interest.

Services of general economic interest

6.13 The Commission considers that the reference to “services” in this context includes the distribution of goods and not only the provision of services as such.

6.14 Services of general economic interest are services that the public authorities believe should be provided to the public whether or not the private sector would supply the relevant services.²⁷ The reference to “economic” refers to the economic nature of the service provided. For example, services of an economic nature may include activities in the cultural, social, and public health fields where their aim is to make a profit.

6.15 To be considered a service of general economic interest, the service must typically be widely available and not restricted to a certain class, or classes, of buyers. That said, services aimed a particular group or a particular locality, for example a disadvantaged group or a remote locality, could still qualify in so far as such services are in the general interest.

²⁷ The concept of a service of general economic interest might be seen as roughly corresponding to the concept of a public service.

Obstruct the performance, in law or in fact, of the particular tasks assigned

- 6.16 To benefit from the services of general economic interest exclusion, it will not be sufficient for an undertaking merely to provide evidence that it has been entrusted with the performance of a particular service of general economic interest. Rather, the undertaking must demonstrate that the application of the Conduct Rules would obstruct the performance of the relevant entrusted tasks.
- 6.17 An undertaking seeking to demonstrate that the application of the Conduct Rules would obstruct the performance of the entrusted tasks must show with supporting evidence that the application of those rules would require it to perform the entrusted tasks under economically unacceptable conditions. The undertaking will also generally need to show that the entrusted tasks could not be discharged in other ways, which would cause less harm to competition.

Mergers

- 6.18 Section 4(2) of Schedule I to the Ordinance provides that, to the extent that conduct results in, or if engaged in would result in, a merger as defined in the Ordinance, the Second Conduct Rule does not apply to the conduct. The Commission's *Guideline on the First Conduct Rule* provides additional information on the general exclusion for mergers and guidance on the Commission's interpretation of the scope of that exclusion.

Conduct of lesser significance

- 6.19 Schedule I to the Ordinance contains a general exclusion for conduct of lesser significance. Pursuant to section 6 of Schedule I, the Second Conduct Rule does not apply to conduct engaged in by an undertaking the turnover of which does not exceed HK\$40 million for the turnover period.²⁸ Turnover for the purposes of this general exclusion means the total gross revenues of an undertaking whether obtained in Hong Kong or outside Hong Kong.
- 6.20 Additional rules in respect of the general exclusion for conduct of lesser significance will be contained in regulations made by the Secretary for Commerce and Economic Development under section 163(2) of the Ordinance.

²⁸ Pursuant to section 6(2) of Schedule I to the Ordinance, the turnover period of an undertaking is (a) if the undertaking has a financial year, the financial year of the undertaking that ends in the preceding calendar year; or (b) if the undertaking does not have a financial year, the preceding calendar year.

Public policy and international obligations exemptions

- 6.21 Sections 31 and 32 of the Ordinance provide for exemptions on public policy grounds (a “**Public Policy Exemption**”) and to avoid a conflict with international obligations²⁹ that directly or indirectly relate to Hong Kong (an “**International Obligations Exemption**”).
- 6.22 Unlike the Schedule 1 exclusions which are listed in the Ordinance, these two exemptions require that the Chief Executive in Council make an order specifying that a particular agreement or conduct or a particular class of agreement or conduct is exempt from the Conduct Rules.
- 6.23 Sole responsibility for making Public Policy Exemption and International Obligations Exemption orders (and the associated criteria) rests with the Chief Executive in Council. In so far as the Second Conduct Rule is concerned, the Commission’s role in respect of these exemptions, if any, is confined to determining whether they apply in a particular case following an application for a decision under section 24 of the Ordinance.
- 6.24 Public Policy Exemption and International Obligations Exemption orders that have been made by the Chief Executive in Council, if any, will be made available on the Commission’s website.

Statutory bodies and specified persons exclusions

- 6.25 Section 3 of the Ordinance provides that the competition rules (including the Second Conduct Rule) do not apply to statutory bodies.³⁰ Under section 3, statutory bodies are excluded from the competition rules unless they are specifically brought within the scope of those rules by a regulation made by the Chief Executive in Council under section 5.

²⁹ Under section 32 of the Ordinance an international obligation “includes an obligation under – (a) an air service agreement or a provisional arrangement referred to in Article 133 of the Basic Law; (b) an international arrangement relating to civil aviation; and (c) any agreement, provisional arrangement or international arrangement designated as an international agreement, international provisional arrangement or international arrangement by the Chief Executive in Council by order published in the Gazette”.

³⁰ As defined in section 2 of the Ordinance, “statutory body” means “a body of persons, corporate or unincorporate, established or constituted by or under an Ordinance or appointed under an Ordinance, but does not include (a) a company; (b) a corporation of trustees incorporated under the Registered Trustees Incorporation Ordinance (Cap 306); (c) a society registered under the Societies Ordinance (Cap 151); (d) a co-operative society registered under the Co-operative Societies Ordinance (Cap 33); or (e) a trade union registered under the Trade Unions Ordinance (Cap 332)”.

- 6.26 The reference to a statutory body in section 3 includes an employee or agent of the statutory body acting in that capacity. The section 3 exclusion does not, however, extend to legal entities owned or controlled by a statutory body unless those entities are also statutory bodies.³¹
- 6.27 Section 4 of the Ordinance provides that the competition rules (including the Second Conduct Rule) do not apply to persons specified in a regulation made by the Chief Executive in Council under section 5 of the Ordinance or to persons engaged in activities specified in such a regulation.
- 6.28 All regulations as might be made by the Chief Executive in Council under section 5 of the Ordinance will be available on the Commission's website.

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³¹ In any event, the definition of statutory body does not include a “company” as defined in the Ordinance (including a company within the meaning of section 2(1) of the Companies Ordinance).

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