

CHAPTER 7: THE SECOND CONDUCT RULE

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The Hong Kong Competition Commission states on its website that,

The Second Conduct Rule targets businesses with a substantial degree of market power in abusing that power with a view to protecting or increasing their position of power and profits. Competition law is not concerned with the mere possession of substantial degree of market power. It is only when there is an abuse of such power that raises concerns. Certain conduct (see the examples provided below) engaged in by businesses with substantial market power can have the object or effect of excluding competitors from the market, thereby limiting choices available to consumers.¹

Therefore, the second conduct rule is not meant target an undertaking amassing market power because of excellence in its product and services and related economic activities like marketing of its goods and services creating a brand loyalty for repeated customer sales of the goods and/or services. The issue is the abuse of the undertaking's market power. The object of this chapter is to examine the details in the Guideline of the Second Conduct Rule as well the earlier Draft Guideline so as to ascertain the Commission's intend to interpret and apply the Second Conduct Rule in the Ordinance.

¶7-010 The Ordinance

Section 21 of Ordinance states the Second Conduct Rule in the following terms, "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."² As mentioned in Chapter 5, there is no exhaustive definition of the Second Conduct Rule. However, the Ordinance provides that a conduct may amount to an abuse if it involves (1) predatory behaviour towards competitors; or (2) limiting production, markets or technical development to the prejudice of consumers. The Ordinance

1 The Hong Kong Competition Commission, "Overview", https://www.compcomm.hk/en/practices/what_is_comp/overview.html.

2 Section 21(1) of the Ordinance.

further provides the matters that could be taken into considerations as to whether there is any conduct within (1) and (2) (which is non-exhaustive), including (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 specified in the Second Conduct Rule Guidelines.

As with the First Conduct Rule, the analysis should begin with the object of the conduct, and then even where the object is not within the Second Conduct Rule, to then consider the effect of the conduct involving an undertaking with substantial degree of market power, and whether the conduct is abusive in the sense that it prevents, restricts or distorts competition.³ In line with the First Conduct Rule, the objects or effects could be ascertained by inference, and as long as one of the objects or effects could prevent, restrict or distort competition, Second Conduct Rule concerns would be established. Also, in terms of territorial reach, as long as the conduct has its object or effect of preventing, restricting or distorting competition in Hong Kong, it does not matter if the undertaking is outside of Hong Kong, or the conduct, that is, the market abuse of an undertaking's substantial market power took place outside of Hong Kong.⁴

¶7-020 General Exclusions

As the concept under the Second Conduct Rule involves establishing an abuse of substantial market power, the economic efficiency arguments relating to general economic efficiency would in all likelihood have presented themselves during the determination of whether there is an abuse of substantial market power. Accordingly, there is no general exclusion for economic efficiency under the First Conduct Rule in respect of the Second Conduct Rule. However, the general exclusions for compliance with legal requirements;⁵ services of general economic

3 Section 22 of the Ordinance.

4 See Section 23 of the Ordinance. See also Chapter 4 generally.

5 Section 2 of Schedule 1 to the Ordinance.

interest,⁶ and mergers⁷ under the First Conduct Rule are applicable for the Second Conduct Rule; and in relation to conduct of lesser significance, the threshold is reduced from HKD200 million for agreements of lesser significance under the First Conduct Rule to HKD40 million under the Second Conduct Rule. This means that it is easier for an undertaking to potentially fall within the Second Conduct Rule from a turnover perspective⁸ to require the consideration of its market power, and where there was an abuse thereof. It is worth mentioning that the thresholds of HKD40 million and HKD200 million are designed to reduce the impact of the competition law regime upon SMEs. This is provided that they do not engage themselves in agreements, concerted practice or conduct under the First Conduct Rule that amount to Serious Anti-competitive Conduct for which the HKD200 million turnover exclusion is not applicable.⁹ Thus, for SMEs, they should not engage in Serious Anti-competitive Conduct as with all undertakings under a mistaken assumption that the turnover test is not applicable, then there are no competition law concerns. As the Second Conduct Rule Guideline is relevant on the issue of abuse of substantial market power, we now consider the guidance therein.

¶7-030 Guideline on the Second Conduct Rule

The Commission's Second Conduct Rule Guideline runs some 44 pages and represents the interpretation of the Commission in relation to the Second Conduct Rule under the Ordinance.¹⁰ This is supported with some 9 hypothetical examples. As with the First Conduct Rule Guideline, the Second Conduct Guideline states that the Commission is the principal competition authority, albeit, it has concurrent jurisdiction with

6 Section 3 of Schedule 1 to the Ordinance.

7 Section 4 of Schedule 1 to the Ordinance.

8 Paragraph 3.4.4 above.

9 Section 1(5)(2) of Schedule 1 to the Ordinance, which is no equivalent under Section 1(6) of Schedule 1 to the Ordinance in respect of the Second Conduct Rule.

10 Section 35 of the Ordinance, and Commission, "Guidelines under Competition Ordinance", July 2015 <http://www.compcomm.hk/en/guidelines.html> for the Guidelines.

the CA in the telecoms and broadcasting sectors; and that the guideline is not legally binding with the ultimate interpretation being with the Tribunal and other courts.¹¹ Nevertheless, until the jurisprudence is built up from the Tribunal and other courts, like appellate courts, from a risk based approach, it would be useful to assume that the Commission's interpretations are correct, especially in view of the professionalism of the Commission's team. However, the Commission's interpretations are not iron clad until adopted by the Tribunal or other courts. The common themes that would emerge from the Second Conduct Rule Guideline as with the First Conduct Guideline are that price, consumer choices and innovation are important considerations from the Commission's perspective, aside from other competition concerns on a case-by-case basis.

¶7-040 The Second Conduct Rule

The aim of the Second Conduct Rule Guideline is to provide the Commission's interpretations as to whether an undertaking's conduct is within the Second Conduct Rule.¹² The Commission is of the view that the Second Conduct Rule is potentially applicable where the entity engaged in the relevant conduct is an undertaking. As to the concept of undertaking, reference should be taken of the discussions under the First Conduct Rule Guideline¹³ which are equally applicable under the Second Conduct Rule. In addition, the undertaking has to have a substantial degree of market power in a market; and finally, the undertaking has to abuse that power by engaging in conduct with an object or effect that prevents, restricts or distorts competition in Hong Kong. The Commission as a shorthand refers to the preventing, restricting or distorting competition as "harming competition".

11 Introduction, Second Conduct Rule Guideline.

12 Paragraph 1 of the Second Conduct Rule Guideline.

13 Paragraph 4.3.1 discusses the concept of an undertaking in accordance with the Commission's interpretations under the First Conduct Rule Guideline.

Assuming that the entity in question is an undertaking, it is necessary to determine if it has a substantial degree of market power. In this connection, for SMEs, given their size and exclusion for conduct of lesser significance at an annual turnover of HKD40 million, they are unlikely to have the requisite substantial degree of market power to bring them into the operation of the Second Conduct Rule. Further, in respect of undertakings with an annual turnover of HKD40 million or more, the Commission explained that this does not result in the undertaking as having a substantial degree of market power and/or being more likely to contravene the Second Conduct Rule. These matters are fact dependent, and the Commission would consider an undertaking's ability to profitably raise prices above competitive levels for a sustained period as a manifestation of market power along with its ability to:

- (1) reduce the quality of its products below competitive levels for a sustained period without offering any compensatory reduction in price;
- (2) reduce the range or variety of its products below competitive levels for a sustained period; and/or
- (3) lower customer service standards below competitive levels for a sustained period; and/or impair, relative to competitive levels and for a sustained period, innovation or any other parameter of competition in the market.¹⁴

Where the undertaking has substantial degree of market power, for the Second Conduct Rule to be applicable, it is still necessary for the Commission to consider if the undertaking has engaged in market abuse of that power to harm competition. While the Second Conduct Rule Guideline provides some examples of abusive conducts, the Commission makes it clear that this is an open category, and the situation should be contrasted with an undertaking's legitimate gaining of market power and/or increase of profits, including through innovation and competition. The Commission takes cognisance that the removal of profit motive dampens competition. Thus, it is only when the substantial degree of

¹⁴ Paragraph 1.7 of the Second Conduct Rule Guideline.

market power is abused to protect or increase power and/or profits would Second Conduct Rule concerns arise, like where the undertaking:

- (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 competition in second market instead of competing on the merits for customers in that second market.¹⁵

The Commission also explained that in respect of market abuse, it has negative effects for the economy and consumers, including businesses acting as customers. They cause harm to economically beneficial outcomes, and detracts from promoting competition and innovation. An example is “predatory pricing”.¹⁶ This is where prices are lowered below cost, to incur losses in the short run so as to eliminate or reduce the competitive effectiveness of rivals or prevent market entry by potential rivals. There are other examples, like tying and bundling, refusal to deal and/or exclusive dealing, which harm the competitive process and consumers. These are concerns only where the undertaking has substantial degree of market power but not otherwise. Also, it is possible for the conduct to have parallel applications under the First Conduct Rule and the Second Conduct Rule.

¶7-050 An Introduction to “Market” in Second Conduct Rule

To assess whether there is market abuse, requires the Commission to define the market and identify the competitive constraints relating to the undertakings operating within the market.¹⁷ The Commission’s approaches under the Second Conduct Rule are also applicable to the First Conduct Rule and the Merger Rule, particularly as to whether the undertakings are competitors or potential competitors in a market,

¹⁵ Paragraph 1.7 of the Draft of the Second Conduct Rule Guideline – 2014.

¹⁶ Section 21(2) of the Ordinance.

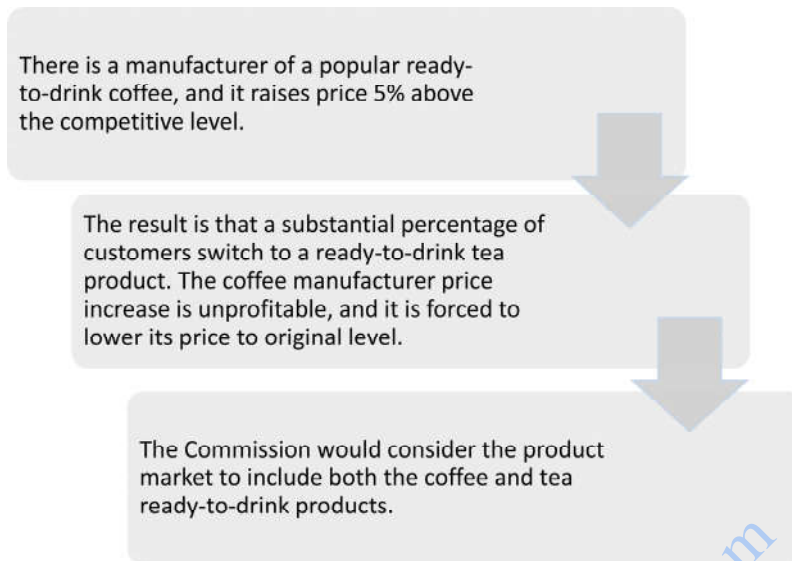
¹⁷ Paragraph 2 of the Second Conduct Rule Guideline.

along with the anti-competitive effects of the conduct in the market. The Commission would consider all evidence and not mechanically determine what constitutes the market, including the market boundaries. It may even assess competition law concerns under alternative market definitions, and may leave the question as to reasonable market definition open where the conduct is unlikely to have an adverse effect on competition or the undertaking under investigation does not possess a substantial degree of market power. That is, the Commission would adopt a practical approach and not determine the market *in abstracto*. The Commission further explains that the definition as to what is a relevant market is technical and may differ from business approaches, and there are both product and geographical dimensions, based on substitutability of buyers and products analysis respectively, in the context of the supply chain that have to be considered. Thus, for assessment of competitive issues at a wholesale level, the wholesale buyers constitute the relevant market, and at the retail level, the retail buyers the retail market. The Commission would also consider approaches adopted in previous cases, and the specific facts and buyer preferences at the point in time on the definition of relevant market.

¶7-060 Product Market

The demand side substitution of buyer's products is the central factor in defining the market.¹⁸ The Commission would approach the narrow potential market for the product or products under investigation, or offered by the merging parties for merger concerns, and then expanded to substitute products that buyers would turn to when price increase over competitive price. The commonly used approach is to postulate a product market and then consider whether a hypothetical monopolist could raise a small but significant non-transitory increase in price (SSNIP) of say 5% to 10%. If buyers are able to switch to substitute products the market is too narrowly defined, and should be expanded to include the substitute products, until a hypothetical monopolist could profitably impose a SSNIP.

18 Paragraphs 2.10 to 14 of the Second Conduct Rule Guideline.

Summary of the Commission's Hypothetical Example 1

The Commission under the hypothetical monopolist test would consider quantitative and qualitative demand-side substitution with appropriate analytical techniques, and the Commission may:

- (1) Undertake an analysis of whether a SSNIP would be profitable;
- (2) Consider evidence of patterns in price changes;
- (3) Consider the characteristics of the product in question and the product's intended use;
- (4) Consider evidence from undertakings active in the market and their commercial strategies; and/or
- (5) Consider evidence regarding the past behaviour of buyers relating to, for example, their tendency to switch between products in response to a price increase.

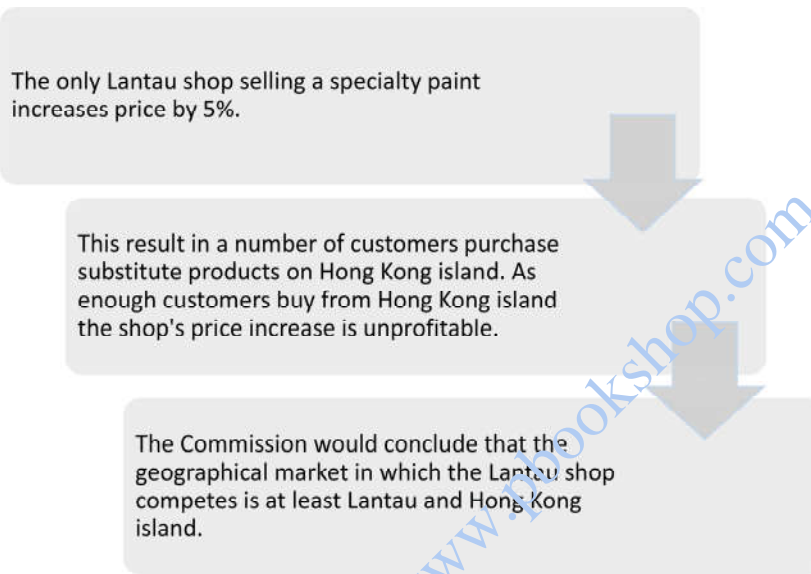
¶7-070 Geographic Market

The same general process to define the relevant product market is applicable.¹⁹ The geographical market could be global, regional or

¹⁹ Paragraphs 2.15 to 21 of the Second Conduct Rule Guideline.

Hong Kong or part thereof. It could also include parts of China like the Pearl River Delta. As with products market the analysis is based on reasonably available substitutes where buyers are willing to find substitutes. The Commission would approach the narrow candidate geographical market, and then expanded to substitute products at a wider geographical market that the hypothetical monopoly could sustain a price increase over competitive levels until a hypothetical monopolist could profitably impose a SSNIP.²⁰

Summary of the Commission's Hypothetical Example 2



The circumstances may differ as to willingness of buyers to buy products in terms of geographical locations, and the market could be narrow where they are unlikely to purchase from neighbourhood areas. However, for wholesale or manufacturing markets where transports costs are low, buyers could switch suppliers from different regions, and there could be a range between the buyers at these consumers to wholesale or manufacturing levels.

²⁰ Also see Chapter 2 about SSNIP.

Summary of the Commission's Hypothetical Example 3

A milk producer increases price of milk by 5%. For retail outlets they have the transport capability to buy from 10km away. The geographical market would include producers from these areas.

From the consumer perspective for the 5% increase in price, it may not be willing to travel 10km, and its market is more narrow.

Thus the nature of the buyer affects the scope of the geographical market.

The Commission would consider both the quantitative and qualitative evidence in defining the geographical market by applying the hypothetical monopolist test using appropriate analytical techniques. These would include geographical pattern of buyer purchases, barriers to switching and related costs like diverting suppliers to other areas, transports costs and cultural factors. There are certain specific characteristics giving rise to particular market definition issues.²¹

(1) Price discrimination markets

There are differential supplier prices to different buyers, based on various reasons like user profiles, for e.g., business and individual users, or "lock-in" created by high switching costs. The different buyers may be assessed as being in separate markets.

(2) Aftermarkets

This is where the primary and secondary products are complementary, like machines and spare part respectively, and the markets could further

²¹ Paragraphs 2.21 to 30 of the Second Conduct Rule Guideline.

be defined as a single system market like machine A and spare part B competes with machine B and its spare parts; or dual or multiple markets like where there is one market for all primary products but many secondary markets.

(3) Captive production

The market includes vertically integrated firms, and the issue is whether the captive production for vertically integrated market should be considered in the product market, or only those sold externally to the merchant market should be included. The Commission would not consider captive markets to be within the general product market except where a competitive constrain is imposed under potential competition.

(4) Two-sided markets

The undertakings compete for two groups of customers whose demands are inter-related, and use two sided-platforms to sell to the customers. This could include online auction platform, with the need to attract those wishing to buy and sell the products. Thus, increases in seller fees could lead to loss of customers on both sides of the market. Also, in this market are video game markers where manufacturers need to attract demand from video game developers and buyers, and newspapers which need to attract readers and advertisers. The analysis of the market requires consideration of the competitive constraints of both sides of the market.

(5) Bidding markets

The undertakings compete by submitting to bids organised by buyers. The competitive constraints require identifying potential market participants as credible bidders in the geographical area where they could place credible bids.

(6) Temporal markets

There is need to consider time as a factor. For example, for peak and off-peak services for train tickets this may not be regarded as substitutes like between weekdays and weekends, and seasonable markets for seasonal products.