

## CHAPTER 4: THE SECOND CONDUCT RULE

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The earlier chapters considered the First Conduct Rule Guideline and competition law developments, mainly around the First Conduct Rule because, as noted, First Conduct Rule cases are relatively low-hanging fruit for the Commission, as will become obvious when you read the Second Conduct Rule Guideline published by the Commission where, on the Commission's interpretation, it needs to assess market power of an undertaking to determine if there is substantial degree of market power and then also whether there was abuse of the power. Perhaps it is useful to mention that the idea is similar in other jurisdictions, where market dominance and abuse of dominant market power are the tests applied. In Europe, fines have reached billions of euros for abuse of dominant market power.

In Hong Kong, there was one case filed in 2020, the Linde case, on the Second Conduct Rule before the Tribunal. The Commission's jurisprudence, investigation and enforcement under the Second Conduct Rule might increase if it obtained a favourable determination, which is yet to be seen. For now, the low-hanging fruit for the Commission remains with First Conduct Rules cases, where complex economic or market analysis have much lesser significance, making investigations and case enforcement easier.

Nevertheless, for the right case, as with the Linde case for the supply of medical gases, where there is a de facto monopoly, which means there must be a substantial degree of market power, the Commission might well commit the resources to investigate, conduct economic analysis, and seek to enforce a Second Conduct Rule case at the Tribunal.

It would be topical to set out some observations of the Commission on the Linde case, remembering that the Tribunal has not handed down any substantive ruling in the case, and these are views, albeit persuasive, of the Commission<sup>1</sup> only:

- The Commission alleges that, between October 2015 and January 2018, Linde HKO Limited and Linde GmbH (collectively referred to as 'Linde') used its monopoly position in the supply of medical gases (upstream market) and engaged in a series of exclusionary acts against MGI (Far East) Limited, the only other potential service provider in the downstream medical

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1 Competition Commission (Hong Kong), 'Competition Commission brings first case on abuse of substantial market power to Competition Tribunal, Questions and Answers', *Press Releases & Announcements*, 21 December 2020. [https://www.compcomm.hk/en/media/press/files/EN\\_SCR\\_QA\\_final.pdf](https://www.compcomm.hk/en/media/press/files/EN_SCR_QA_final.pdf)

gas pipeline systems ("MGPS") maintenance market for public hospitals.

- To the extent that the relevant gases are essential inputs to the provision of MGPS maintenance services, this conduct harmed competition in the MGPS maintenance market, affecting consumers' interest in such services, mostly public hospitals in Hong Kong.
- The Commission explained that the Second Conduct Rule seeks to prohibit businesses with substantial market power from abusing that power to prevent, restrict, or distort competition in Hong Kong. Any conduct by a business with substantial market power which has the object or effect of harming competition is potentially abusive.
- Market power refers to the ability of an undertaking to profitably charge prices above competitive levels or restrict output or quality below competitive levels for a sustained period of time.
- A substantial degree of market power arises where an undertaking does not face sufficiently effective competitive constraints from other market participants (such as its actual or potential competitors as well as customers) in the relevant market.
- In assessing whether an undertaking has a substantial degree of market power, the Commission will consider several factors, including the market share of the undertaking, its power to make pricing and other decisions, countervailing buyer power, barriers to entry or expansion into the relevant market, and other market-specific characteristics.
- While there is no exhaustive list of what may constitute abusive conduct, the Commission's Guideline on the Second Conduct Rule illustrates certain exclusionary types of abuse, e.g. refusals to deal, margin squeeze, predatory pricing, tying and bundling, and how they can have the object or effect of harming competition in the market, thereby ultimately limiting choices available to consumers.
- Only a few large businesses are likely to have substantial market power. Under the Second Conduct Rule, small and medium-sized undertakings may be victims of abusive conduct.

The Second Conduct Rule is not meant to target an undertaking amassing market power because of excellence in its product and services

and related economic activities like marketing its goods and services, creating brand loyalty for repeated customer sales of the goods and/ or services. This chapter examines the details of the Second Conduct Rule Guideline to ascertain the Commission's intent to interpret and apply the Second Conduct Rule in the Ordinance while awaiting the enforcement outcome under the Linde case which is the first Second Conduct Rule case. We suggest, as under Chapter 2 on the First Conduct Rule that you skim the headings and diagrams and then read the text. These headings and diagrams will impress you with the fact that competition law has far more significance and relevance to your business consideration than it might readily be apparent.

#### ¶4-010 The Ordinance

On the issue of what amounts to 'abuse' of a substantial degree of market power, the Ordinance provides that conduct may amount to abuse if it involves: (1) predatory behaviour towards competitors; or (2) limiting production, markets or technical development to the prejudice of consumers. The Ordinance further provides the matters that could be taken into consideration as to whether there is any conduct within (1) and (2) (which is non-exhaustive), including:

- The market share of the undertaking;
- The undertaking's power to make pricing and other decisions;
- Any barriers to entry to competitors into the relevant market; and
- Any other relevant matters specified in the Second Conduct Rule Guidelines.

You can see that the Second Conduct Rule requires much more work for the Commission to establish. At the same time, if your undertaking is the target of an investigation, the costs will include defending the case with professional economic advice, which is an expensive proposition. Again, if you have concerns about competition law, please obtain the necessary competition audit with professional advice. There is already one Second Conduct Rule case with the Tribunal.

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, consider the effect of the conduct involving an undertaking with a substantial degree of market power, and whether the conduct is abusive in the sense that it prevents, restricts or distorts, that

is, harms competition<sup>2</sup>. The considerations are similar to those under the First Conduct Rule. The Second Conduct Rule concerns would be established if one of the objects or effects could prevent, restrict or distort competition. Also, as with the First Conduct Rule, 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<sup>3</sup>. Please refer to the chapter for the First Conduct Rule guideline if you need to revisit any issues.

#### ¶4-020 General Exclusions

As the concept under the Second Conduct Rule involves establishing an abuse of a substantial degree of market power, the economic efficiency arguments relating to general economic efficiency would, in all likelihood, have presented themselves when determining whether substantial market power is abused. 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<sup>4</sup>, services of general economic interest<sup>5</sup>, and mergers<sup>6</sup> under the First Conduct Rule apply to the Second Conduct Rule.

With the conduct of lesser significance, the threshold is reduced from HK\$200 million for agreements of lesser significance under the First Conduct Rule to HK\$40 million under the Second Conduct Rule. This means it is easier for an undertaking to fall within the Second Conduct Rule from a turnover perspective<sup>7</sup> when considering its market power and whether this has been abused.

It is worth mentioning that the thresholds of HK\$40 million and HK\$200 million are designed to reduce the impact of the competition law regime upon SMEs. This is because they do not engage themselves in agreements, concerted practice or conduct under the First Conduct Rule that amounts

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2 Section 22 of the Ordinance.

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

4 Section 2 of Schedule 1 to the Ordinance.

5 Section 3 of Schedule 1 to the Ordinance.

6 Section 4 of Schedule 1 to the Ordinance.

7 Paragraph 3.4.4 above.

to Serious Anti-competitive Conduct, that is, cartel conduct, for which the HK\$200 million turnover exclusion is not applicable<sup>8</sup>.

At the risk of repetition, SMEs should not engage in Serious Anti-competitive Conduct, as with all undertakings, under a mistaken assumption that the turnover test is not applicable and there are no competition law concerns. As the Second Conduct Rule Guideline is relevant to the abuse of substantial market power, we now consider the guidance.

#### **¶4-030 Second Conduct Rule Guideline**

The Commission's Second Conduct Rule Guideline runs some forty-four pages and represents the interpretation of the Commission concerning the Second Conduct Rule under the Ordinance<sup>9</sup>. Some nine hypothetical examples support this. 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 the Communications Authority 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<sup>10</sup>.

Despite this, from a risk-based approach, it would be helpful to assume that the Commission's interpretations are authoritative unless there are contrary rulings by the Tribunal and other courts and there is one case before the Tribunal, meaning that the Commission will investigate appropriate cases under the Second Conduct Rule and bring appropriate cases to the Tribunal. The common themes that 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.

#### **¶4-040 The Second Conduct Rule**

The Second Conduct Rule Guideline aims to provide the Commission's interpretations of whether an undertaking's conduct is within the

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8 Section 1(5)(2) of Schedule 1 to the Ordinance, which is not equivalent under Section 1(6) of Schedule 1 to the Ordinance in respect of the Second Conduct Rule.

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

10 Introduction, Second Conduct Rule Guideline.

Second Conduct Rule<sup>11</sup>. 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 the undertaking, reference should be taken to the discussions under the First Conduct Rule Guideline<sup>12</sup>, 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. 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. As a shorthand, the Commission refers to preventing, restricting or distorting competition as “harming competition”.

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, given their size and exclusion for the conduct of lesser significance at an annual turnover of HK\$40 million, SMEs are unlikely to have the requisite substantial degree of market power to bring them into the operation of the Second Conduct Rule. Further, regarding undertakings with an annual turnover of HK\$40 million or more, the Commission explained that this does not result in the undertaking 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:

- Reduce the quality of its products below competitive levels for a sustained period without offering any compensatory reduction in price;
- Reduce the range or variety of its products below competitive levels for a sustained period; and/or
- Lower customer service standards below competitive levels for a sustained period; and/or impaired, relative to competitive levels and for a sustained period, innovation or any other market competition parameter<sup>13</sup>.

Where the undertaking has a substantial degree of market power, for the Second Conduct Rule to be applicable, it is still necessary for the

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11 Paragraph 1 of the Second Conduct Rule Guideline.

12 Paragraph 4.3.1 discusses the concept of an undertaking following the Commission’s interpretations under the First Conduct Rule Guideline.

13 Paragraph 1.7 of the Second Conduct Rule Guideline.

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

- Seek to maintain its substantial market power by abusing it to prevent challenges to its position by existing or new competitors, or
- Leverage its substantial market power in one market to harm competition in the second market instead of competing on the merits for customers in that second market<sup>14</sup>.

The Commission also explained that market abuse negatively affects the economy and consumers, including businesses acting as customers. They cause harm to economically beneficial outcomes and detract from promoting competition and innovation. An example is “predatory pricing”<sup>15</sup>, where prices are lowered below cost to incur losses in the short run to eliminate or reduce the competitive effectiveness of rivals or prevent market entry by potential rivals. Other examples include tying and bundling, refusal to deal and/or exclusive dealing, which harms the competitive process and consumers. These are concerns only where the undertaking has a substantial degree of market power but not otherwise. Also, the conduct can have parallel applications under the First and Second Conduct Rules.

#### **¶4-050 An Introduction to “Market” in Second Conduct Rule**

The Commission must define the market and identify the competitive constraints relating to the undertakings operating within the market to assess whether there is market abuse<sup>16</sup>. 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

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14 Paragraph 1.7 of the Draft of the Second Conduct Rule Guideline — 2014.

15 Section 21(2) of the Ordinance.

16 Paragraph 2 of the Second Conduct Rule Guideline.

are competitors or potential competitors in a market, 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. It may leave the question of a reasonable market definition open where the conduct is unlikely to affect competition or the undertaking under investigation adversely does not possess a substantial degree of market power. The Commission would adopt a practical approach and not determine the market *in the abstract*. The Commission further explains that the definition of a relevant market is technical and may differ from business approaches. Product and geographical dimensions are based on the substitutability of buyers and product analysis in the supply chain context that must be considered. Thus, to assess competitive issues at a wholesale level, the wholesale buyers constitute the relevant market, and at the retail level, the retail buyers are the retail market. The Commission would also consider approaches adopted in previous cases, specific facts, and buyer preferences on the relevant market definition.

#### ¶4-060 Product Market

The demand side substitution of buyer's products is the central factor in defining the market<sup>17</sup>. The Commission would approach the narrow potential market for the products under investigation or offered by the merging parties for merger concerns and then expand to substitute products that buyers turn to when prices increase over competitive prices. 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%. The market is too narrowly defined if buyers can switch to substitute products. It should be expanded to include substitute products until a hypothetical monopolist can profitably impose an SSNIP.

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<sup>17</sup> Paragraphs 2.10 to 14 of the Second Conduct Rule Guideline.

### Summary of the Commission's Hypothetical Example 1

There is a manufacturer of a popular ready-to-drink coffee, and it raises price 5% above the competitive level.

The result is that a substantial percentage of customers switch to a ready-to-drink tea product. The coffee manufacturer price increase is unprofitable, and it is forced to lower its price to original level.

The Commission would consider the product market to include both the coffee and tea ready-to-drink products.

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

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

#### ¶4-070 Geographic Market

The same general process applies to defining the relevant product market<sup>18</sup>. The geographical market could be global, regional, Hong Kong, or part thereof, and it could also include parts of China, like the Greater Bay Area. As with the products market, the analysis is based on reasonably available substitutes where buyers are willing to find

<sup>18</sup> Paragraphs 2.15 to 21 of the Second Conduct Rule Guideline.

substitutes. The Commission would approach the narrow candidate geographical market and then expand to substitute products at a wider geographical market so that the hypothetical monopoly could sustain a price increase over competitive levels until a hypothetical monopolist could profitably impose an SSNIP<sup>19</sup>.

### Summary of the Commission's Hypothetical Example 2

The following is an example from the Commission.

The only Lantau shop selling a specialty paint increases price by 5%.

This result in a number of customers purchase substitute products on Hong Kong island. As enough customers buy from Hong Kong island the shop's price increase is unprofitable.

The Commission would conclude that the geographical market in which the Lantau shop competes is at least Lantau and Hong Kong island.

The circumstances may differ as to the willingness of buyers to buy products in terms of geographical locations, and the market could be narrow, where they are unlikely to purchase from neighbouring areas. However, for wholesale or manufacturing markets where transport 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.

<sup>19</sup> Also, see Chapter 2 about SSNIP.

### Summary of the Commission's Hypothetical Example 3

This is explained further in the following example from the Commission.

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 quantitative and qualitative evidence in defining the geographical market by applying the hypothetical monopolist test using appropriate analytical techniques. These would include the geographical pattern of buyer purchases, barriers to switching, related costs like diverting suppliers to other areas, transport costs, and cultural factors. There are certain specific characteristics giving rise to particular market definition issues<sup>20</sup>.

- Price discrimination markets. Different supplier prices are to different buyers, based on various reasons like user profiles, 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.
- Aftermarkets. This is where the primary and secondary products are complementary, like machines and spare parts, respectively, and the markets could further be defined as a single system market like machine A. 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.
- Captive production. The market includes vertically integrated firms. The issue is whether the captive production for a vertically integrated market should be considered in the product market

<sup>20</sup> Paragraphs 2.21 to 30 of the Second Conduct Rule Guideline.

or only those sold externally to the merchant market should be included. The Commission would not consider captive markets within the general product market except where a competitive constraint is imposed under potential competition.

- Two-sided markets. The undertakings compete for two groups of customers whose demands are interrelated, and they use two-sided platforms to sell to the customers. This could include an online auction platform, which needs to attract those wishing to buy and sell the products. Thus, increases in seller fees could lead to a loss of customers on both sides of the market. Also in this market are video game makers, where manufacturers need to attract demand from video game developers and buyers, and newspapers, which need to attract readers and advertisers. The market analysis requires consideration of the competitive constraints of both sides of the market.
- Bidding markets. The undertakings compete by submitting 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.
- Temporal markets. Time is a factor that needs to be considered. For example, peak and off-peak services for train tickets may not be regarded as substitutes, such as between weekdays and weekends and seasonal markets for seasonal products.
- Markets characterised by frequent innovations. There are industries with rapid technological change, like new products from functionalities, in which developments are unpredictable, leading to the emergence or convergence of markets. Market boundaries and power could change with time and the facts of the case.

You will appreciate that in an investigation by the Commission, there will be a need to engage market experts on the market definition. They will also consider the matters set out below regarding the market definition.

#### **¶4-071 Supply-side substitution and potential competition**

The three main sources of competitive constraints are demand-side substitutability, supply-side substitutability and potential competition<sup>21</sup>.

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<sup>21</sup> Paragraphs 2.31 to 35 of the Second Conduct Rule Guideline.

The range of product substitutes and geographical areas for the buyer, that is, demand-side substitutability, are relevant for buyers' views on substitutability central to the Commission's market definition practice. Supply-side substitutability relates to the ability of undertakings to switch production to supply products to the geographical area where there is a price increase for the product concerned. Potential competition refers to the competitive constraints against potential new entrants or expansion of existing competitors, including where production suppliers are unable to switch to short-term production. This supply-side substitution and potential competition issues would not define the relevant market. Still, a stage in the analysis by the Commission as all sources of competitive constraints are to be considered in assessing market power.

#### ¶4-080 Assessment of Substantial Market Power

There are rivalries amongst undertakings in terms of price, service, innovation, and quality in the market, with dynamic customer interactions. These rivalries result in mutual constraints on pricing, output, and other competitive commercial decisions. A substantial degree of market power arises where an undertaking is not subject to "[s]ufficiently effective competitive constraints"<sup>22</sup>. That is, prices over or below competitive levels could be charged for a sustained period of time, namely two years, with adjustments for the facts and circumstances relating to the market product under consideration. In a highly concentrated market with a few larger participants, there could be more than one undertaking with substantial market power. In addition to price rises over a sustained period, competition could also be harmed, for example, by weakening existing competition, increasing entry barriers, and decreasing innovation. Aside from the ability of suppliers to raise prices for sustained periods (which the Second Conduct Rule Guideline focuses more upon), the ability of buyers to pay below competitive prices for a sustained period (monopsony power) also amounts to substantial market power and needs to be considered, as appropriate. In all cases, market power is a matter of degree that must be assessed based on the circumstances of the case. The *Competition Ordinance* provides the following non-exhaustive considerations that could be taken into account to assess the issue of an undertaking's substantial market power:

- The undertaking's market share;
- The undertaking's power to make pricing and other decisions;

<sup>22</sup> Paragraphs 3.2 of the Draft Second Conduct Rule Guideline — 2014.

- The barriers to entry by the competitor into the relevant market, and
- Other relevant matters.

The Commission would consider several factors, including market share, countervailing buyer powers, barriers to entry or expansion, and market-specific characteristics which are non-exhaustive. There may be other considerations that the Commission may consider under the facts and circumstances of a case.

#### ¶4-081 Market share and market concentration

The extent of an undertaking's market share is an initial screening device<sup>23</sup> for assessing substantial market power. A high market share may indicate a substantial degree of market power, but not where the undertaking is an effective innovator for quality products for the market share. The Commission would consider the characteristics of the industry involved and the nature of competition in the relevant markets. These would include the evolution of the market share, especially where the market is dynamic with frequent innovation or highly competitive. Also, frequent changes to market share indicate that barriers to entry are low and suggest an absence of market power.

In contrast, a sustained high market share maintained or grown over time may indicate a substantial market share. For a bidding market where demand may be lumpy, the evolution of market shares may have to be considered over the years. The Commission could consider the following data depending on the case:

- Turnover or sales value data relating to sales to customers;
- Sales volume data where products are homogenous in the relevant market;
- The capacity to supply the market, especially where the industry is operating at close to full or full capacity;
- Other indicators include product reserves, customer base, and/or share of new customers.

These indications may be supplemented by measured concentration levels in the market in the context of the number and size of undertakings, with a concentrated market indicated by limited, leading undertakings with a large combined market share. The relative positions

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<sup>23</sup> Paragraphs 3.9 to 14 of the Second Conduct Rule Guideline.

of undertakings under a market structure could be tallied to market concentration positions.

#### ¶4-082 Potential entry or expansion

The barriers to entry, like regulatory, legal restrictions, economic or structural factors or conduct, or “strategic barriers” and other barriers to entry, place new entrants at a significant disadvantage relative to incumbents<sup>24</sup>. On evaluating a substantial degree of market power, the Commission would consider whether potential competitors or market competitors’ expansion or threat thereof could defeat such power as a credible competitive constraint. Where this is likely, the indication is that the undertaking will not have substantial market power. It follows that the lower the barriers to entry or expansion, the undertaking will be unable to profitably sustain prices at competitive levels. Further, persistently high market share indicates the presence of barriers to entry or expansion and a substantial degree of market share, but not where the actual barriers to entry or expansion are low.

#### A Summary of the Commission’s Hypothetical Example 4

A butcher shop supplied 70% of meat at a distinct geographical market because of customer travel preferences. This indicates substantial market power.

However, the typical barrier to entry for a retail sale of meat is low and another butcher can operate and prevent the butcher from sustaining price above competitive levels.

As such, there is unlikely to be substantial market power whatever the actual market power was.

The Commission would consider the effectiveness of the entry, expansion, or competitors’ threat under the likely, timely and sufficient considerations. It is timely in the sense that entry is within a period to deter or defeat the exercise of market power. It is likely in terms of the entry being profitable and sufficient as to the scale to prevent

<sup>24</sup> Paragraphs 3.15 to 28 of the Second Conduct Rule Guideline.

undertakings from exercising market power. The Commission would also consider the barriers to entry or expansion as follows:

- Regulatory and legal barriers (such as licensing requirements). Government and industry sector regulators may create barriers like licensing, which limit the number of competitive undertakings operating in a market. The licence could be thought of as an input before production. Other barriers include planning and licensing laws at the retail level, which also translate to suppliers' difficulties in distribution efficiencies.
- Structural barriers (such as significant economies of scale and/or scope or network effects). The structural barriers include sunk costs that could not be economically recouped over a short period or in case of an exit. Examples include research and development, production facility, marketing and advertising costs. The need to incur sunk costs may be a barrier to entry by new competitive undertakings.

Other structural barriers to entry include scarcity of important inputs or distribution channels and economies of scale driving down average costs with increased output production, dictating new entrants need to be sizeable to be competitive, which could be a barrier to entry.

A related concept is economy of scope with multiple products reducing long-run average costs. This could raise the cost disadvantage for effective competition by a new entrant as a competitor. Also related to economies of scale are network effects on consumers connected to the network, such as payment cards, which could be barriers to new entrants against established incumbents with significant networks.

- Strategic barriers intentionally created or enhanced by incumbent undertakings in the market.

The strategic barriers are those created or enhanced by incumbents to deter new entrants or competitive expansions and do not arise out of the characteristics of the markets, like structural barriers. These include the crowding out of product space with strategic brand proliferation and building up excessive capacity with the ability to maintain potential profitability but to push down prices, signalling new entrants of risk that they may not recover sunk costs.

### ¶4-083 Countervailing buyer power

The strength and structure of the buyer's side market could prevent the supplier side from having substantial market power in terms of buyers' bargaining strength and choice to bypass the supplier. This is especially true when the buyer is well informed of switching choices for substantial purchases within a reasonable period with little cost implications or the ability to integrate or sponsor a new entrant's production vertically<sup>25</sup>. This applies when the buyer is an important supplier-customer and/or can intensify competition through a competitive tender. The Commission explains that the context of "countervailing" of the supplier's market power relates to the market as a whole and not particular segments where only larger customers secure preferential terms. It must be reasonably foreseeable over a future period and not merely temporary or transient. Where the buyer itself has a substantial degree of market power, it could be subject to the Second Conduct Rule.

### ¶4-084 Particular issues in the assessment of substantial market power

Certain specific market characteristics could give rise to particular issues in assessing substantial market power.

- Bidding markets. The characteristic of a bidding market is that it is germane to competition<sup>26</sup>. In these situations, even with limited suppliers, competition may be intense. This is especially true when infrequent tenders and suppliers are not subject to capacity constraints. To assess market power, a high market share at a particular time does not necessarily indicate long-term market power. There may be a need to consider this matter over an extended period.
- Vertical integration. Vertical integration may prevent substantial market power where, e.g., a product requires an input<sup>27</sup>. The vertically integrated firm then supplies another product but not the input. In such a case, the customer has the choice of two products. The input supplier may then be constrained from raising the price, precluding the supplier from having substantial market power.

25 Paragraphs 3.29 to 32 of the Second Conduct Rule Guideline.

26 Paragraph 3.34 of the Second Conduct Rule Guideline.

27 Paragraph 3.35 of the Second Conduct Rule Guideline.

- Capacity constraints. The capacity constraints in the market may limit the ability of a competitor to respond to the exercise of market power. Thus, an undertaking in a market with limited capacity may increase prices over the competitive level against a market with a substantial excess capacity. Other factors, like costs, may contribute to limited capacity. For instance, it may be difficult to add a shift to a factory to increase capacity.

#### ¶4-090 Abuse of Substantial Market Power

There is no issue with an undertaking amassing market power. Only when the undertaking with substantial market power engages in conduct with the object or effect that harms competition is there an issue. Such “abusive” conduct for the second conduct rule is open<sup>28</sup>. It could even have a spillover effect from one market to another because of the leverage of the market power in one market over another, say by tying two products in a tied market. Abusive conduct manifests as anti-competitive foreclosure where actual or potential competitors are denied access to suppliers or buyers because of an undertaking exercising a substantial degree of market power. This contributes to the ability to charge higher prices and reduce product quality or choice for customers, which harms the competition.

When assessing the abuse of substantial market power, the Commission would consider the undertaking with substantial market power’s legitimate objective and if the conduct is indispensable and proportionate to the pursuit thereof. For example, where an input is not supplied to a not creditworthy customer, or below cost pricing for promotional offer during a limited period for product entry launch, or to minimise loss for obsolete or deteriorating products, these may be justified.

While there are no comparable provisions with overall economic efficiency arguments under the First Conduct Rule, such arguments could be introduced to show no net harm to consumers in an undertaking’s exercise of substantial market power. For such arguments to prevail, the Commission will require some of the claimed efficiencies to be passed on to the consumers.

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28 Paragraphs 4.1 to 5 of the Second Conduct Rule Guideline.

#### ¶4-091 The object of harming competition

There are certain undertakings whose conduct under the Second Conduct Rule which *per se* harms normal competition functions and is thus regarded to have the object of harming competition<sup>29</sup>. The Commission would consider the nature of the conduct, such as whether it is under an agreement. If so, its contents and implementation, the context, economic and legal contexts, and the aim and subjective intent are inferred from there. Where the object harms competition, the effect need not be considered. That is, it is sufficient for the Commission to show that the conduct has potential harm or can harm competition.

Further, a defence by the undertaking that the conduct does not have the effect of harming competition is not available where the conduct has the object of harming competition. As with the First Conduct Rule, the Commission will only have to establish that one conduct has the object of harming competition, where there are many conducts. In practice, the Commission will consider the underlying conduct and surrounding circumstances to draw the necessary inference<sup>30</sup>. For example, when an undertaking sets a price below its average variable costs, which amounts to predatory pricing, it may harm the competition. The list of conduct under the Second Conduct Rule is open and, therefore, not exhaustive. It could extend to specific exclusive dealing arrangements or paid delays to suppliers and customers against competitors' products.

#### ¶4-092 The effect of harming competition

Where the object of conduct does not harm competition, it is still necessary to consider the effect of the conduct on the issue of harm to competition<sup>31</sup>. In this connection, the analysis of the Commission does not stop at the actual effect but could extend to the likely impacts flowing from the conduct. On a counterfactual basis, the market conditions where the conduct is not present could be considered along with the resultant market conditions. However, such unwinding could not occur if the conduct had been in the market for several years. The Commission would also be focused on conduct that actually or likely will have the effect of: (1) higher prices; (2) output restrictions; (3) reduction in product quality or variety; and/or (4) anti-competitive foreclosure. The important point is that the harm is to the consumer and not the individual competitor,

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29 Paragraphs 4.6 to 14 of the Second Conduct Rule Guideline.

30 Section 22(2) of the Competition Ordinance.

31 Paragraphs 4.15 to 20 of the Second Conduct Rule Guideline.

as competition would see changes in the competitive landscape. The Competition Ordinance is not to protect particular market participants, but competition in the marketplace.

#### **¶4-100 Examples of Conduct that May Constitute an Abuse**

The Commission lists under the Second Conduct Rule Guideline certain non-exhaustive examples of conduct that may amount to an abuse of substantial market power under appropriate circumstances, namely: (1) predatory pricing; (2) tying and bundling; (3) margin squeeze conduct; (4) refusal to deal; and (5) exclusive dealing<sup>32</sup>. It should be noted that certain abusive conduct could fall into one or more of these categories. These categories are not exhaustive as the Second Conduct Rule-related conducts are open.

#### **¶4-101 Predatory pricing**

There is a need to distinguish predatory pricing from low pricing from the competitive process<sup>33</sup>. This occurs when an undertaking with substantial market power sets prices so low to force one or more competitors out of the market or discipline competitors to toe the line. The profit forsaken from predatory pricing could be recouped when the competitor, for example, leaves the market, and the undertaking can charge higher prices. The consumer will be worse off in the long run with the weakened competition, potentially higher prices, and reduced product quality and choice. When assessing predatory pricing conduct, the Commission would use data to show where there is or is likely to be an anti-competitive foreclosure of existing competitors or new entrants. However, the actual exit of competitors is not necessarily required to be demonstrated as it is the undermining of competition, rather than the exit of competitors that may amount to anti-competitive foreclosure as competition law does not protect individual competitors but rather competition in the marketplace. The Commission's assessment would consider if the pricing is below appropriate cost measures, including whether:

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<sup>32</sup> Paragraphs 5.1 to 2 of the Second Conduct Rule Guideline.

<sup>33</sup> Paragraphs 5.3 to 7 of the Second Conduct Rule Guideline.

- The pricing is below the average variable costs (AVC). The variable costs are not recoverable, and each output item would unavoidably incur a loss. Thus, where an undertaking has substantial market power sales below AVC, the Commission could consider the conduct related to predatory pricing. In all likelihood, it has the object, not just the effect of harming competition. The Commission would not be required to demonstrate any actual or likely anti-competitive foreclosure.
- Where the pricing is below average total costs but above AVC, the conduct may be entirely rational as commercial behaviour as the unavoidable variable costs are recouped, albeit the fixed costs component may not have been recouped. The Commission would need documentary evidence of a predatory strategy to consider whether the conduct is to avoid losses or is part of the strategy to harm competition.

### A Summary of the Commission's Hypothetical Example 5

There are two companies that sell vending machines in Hong Kong, with the later entrant having a smaller market share. However, it sells at a lower price taking away some market share from the dominant company.

The dominant company then cut prices in half which was not sufficient to cover any measure of costs. The new entrant being unable to compete with the low price goes out of business.

If the dominant company has a substantial degree of market power, the Commission would take the view that there is predatory pricing and contravention of the Second Conduct Rule. Also, the conduct is likely to have object of harming competition.

## ¶4-102 Anti-competitive tying and bundling

Tying is when the supplier sells a product conditionally upon purchasing another product, while bundling refers to a package of two or more products at a discount<sup>34</sup>. These arrangements could promote competition where production costs are lowered with reduced transaction and information costs and increased consumer convenience and variety. However, an undertaking with substantial market power could use tying to reduce the number of potential buyers. The tied market may be foreclosed, with reduced competitiveness or the exit of competitors. The undertaking could then raise the price to the detriment of consumers. The analysis applies to bundling for products that form part of the bundle being considered. The Commission would have to consider whether the products are distinct and if the conduct harms competition, especially where the effect may give rise to anti-competitive foreclosure.

### A Summary of the Commission's Hypothetical Example 6

The leading medical device supplier under sales contracts with hospitals and clinics requires consumable medical products to be purchased from it, and thereby significantly limits the customers.

If the medical device supplier has substantial market power, this may amount to an abusive tie in violation of the Second Conduct Rule.

The analysis extends to supply of tying services like use of the supplier or its affiliates for maintenance and repair services over the supplied medical devices.

<sup>34</sup> Paragraphs 5.8 to 5.12 of the Second Conduct Rule Guideline.

### A Summary of the Commission's Hypothetical Example 7

A special offer is provided by the manufacturer of a popular toothbrush who bundles new toothpaste at a discount for three months to raise profile of the new toothpaste.

The bundling arrangement is unlikely to be an abusive bundling in violation of the Second Conduct Rule.

The object or effect of the limited duration discount with the pro-competitive efficiency for introduction of a new product are unlikely to be viewed as being anti-competitive to other competitors.

#### ¶4-103 Margin Squeeze

A margin squeeze refers to when a vertically integrated undertaking supplies input to a competitor operating in the downstream market where it also operates<sup>35</sup>. The squeeze occurs when the undertaking has a substantial degree of market power and squeezes the margin between the supply price to the competitor and its customers, thereby reducing the competitor's ability to compete effectively. The substantial degree of market power relates to the upstream market in the supply of the downstream input. In assessing whether the conduct amounts to an abuse of margin squeeze, the Commission would consider the following:

- The nature of the upstream market for the input to downstream market participants. In this connection, even if there are alternatives, there may still be a margin squeeze; and
- The level of the margin squeeze in terms of the differences between the prices charged after considering the undertaking with substantial market power's downstream product-specific costs.

<sup>35</sup> Paragraphs 5.13 to 15 of the Second Conduct Rule Guideline.

#### ¶4-104 Refusals to deal

Generally, an undertaking can do business with whomever it chooses. Further, there may be legitimate commercial reasons for not entering into any relationship with another undertaking, like concerns relating to creditworthiness<sup>36</sup>. Therefore, when an undertaking with a substantial degree of market power does not deal with another, that is unlikely to be abusive conduct except in limited exceptional circumstances. In terms of refusal to deal, this could extend to both refusals to supply input or the requirement of unreasonable terms amounting to constructive refusal to deal. The latter could include delaying supplies and excessive pricing, which affect competitors' ability to compete in the downstream market, given limited access to the input. The Commission's main concern is that the undertaking cannot compete with the competitor because of an inability to duplicate the input or only with unreasonable costs, making it commercially inviable. The Commission will consider the following:

- The undertaking with a substantial degree of market power to technically and economically supply the input;
- The past histories of dealings between the undertakings; and
- The supply conditions for the input.

With intellectual property rights (IPR) as these are innovations, refusal to provide a license would only be considered a contravention of the Second Conduct Rule in exceptional circumstances. The Commission could consider whether the refusal would prevent or limit the development of a secondary market or new product, harming consumers. Where the undertaking sets the industry standard, and there was a commitment to fair, reasonable, and non-discriminatory (FRAND) terms, which is not honoured, the Commission may view the conduct as abusive.

#### ¶4-105 Exclusive dealing

This is commonly used in commercial agreements and does not necessarily harm competition<sup>37</sup>. However, when an undertaking with substantial market power seeks to foreclose competitors through arrangements that require direct or indirect purchases of all or a substantial portion of a product from it, either through an exclusive purchasing obligation or a conditional rebate, the conduct may be abusive. These extend to exclusive supply obligations or incentive

<sup>36</sup> Paragraphs 5.16 to 22 of the Second Conduct Rule Guideline.

<sup>37</sup> Paragraphs 5.23 to 32 of the Second Conduct Rule Guideline.

agreements with similar effects. Suppose these are tools to foreclose on competitors by preventing access to particular inputs. In that case, the conduct could be abusive, especially where the inputs could not be secured from an alternative supplier. Regarding exclusive dealing, the Commission could consider the object and effect of harming competition as appropriate.

A particular exclusive dealing arrangement is the exclusive purchasing obligation which requires a customer to purchase a product exclusively or to a large extent from an undertaking with a substantial degree of market power. Other arrangements like stocking requirements, even though not exclusive, could have a similar effect. The Commission would be particularly concerned where:

- The undertaking with a substantial degree of market power uses this technique on many customers;
- The consumers as a whole do not derive a benefit; and
- The conduct taken as a whole will have the effect of preventing or distorting competition;

However, where competitors could compete on equal terms for the entirety of individual customer demand, exclusive dealing is unlikely to harm competition or give rise to a foreclosure effect, for example, in the case of a bidding market or where the market is highly competitive.

A conditional rebate is a reward for purchasing behaviours and loyalty schemes with financial incentive purchases from a supplier. These are normal arrangements to increase customer demand and benefit them. However, where an undertaking has substantial market power, these could have foreclosure effects similar to exclusive purchasing agreements. Loyalty rebates will usually require an extended purchase for a specified threshold. Still, retroactive rebates could result in significant foreclosure in the market by preventing switching to an alternative supplier from the resultant loss of rebate, as opposed to incremental benefits under loyalty rebates.

Further, rebates could be individualised or standardised. As individualised rebates are tailor-made, they could have a larger foreclosure effect. In contrast, standardised rebates are less likely to raise competition concerns, including general quantity rebates conditional on order sizes.

### A Summary of the Commission's Hypothetical Example 8

A large popular rice noodle producer offers rebates to local groceries based on volume of usual purchases subject to incremental target increases over 5 years.

There is no rebate for below target purchases. However, if the target is met, there will be rebate for all purchases.

The effect is that other rice noodle producers are "locked-out" and cannot effectively compete. If the large noodle producer has a substantial market share then the rebate scheme could be abusive conduct under the Second Conduct Rule.

### A Summary of the Commission's Hypothetical Example 9

A Hong Kong glass manufacturer supplies construction companies. The per unit costs decreases with increased supply, including by reason of decreased transportation costs.

It thus offers discounts on volume targets to all customers. There is also a small discount for early payments.

Where the manufacturer has substantial market power, the early payment discount does not have the object of harming competition. The standardised incremental discounts based on costs savings are unlikely to foreclose competitors.

## ¶4-110 Summary and Commentary

This chapter examines the Second Conduct Rule Guideline in detail. According to the Ordinance, the Second Conduct Rule requires an undertaking to have a substantial degree of market power in a defined market. However, having a substantial degree of market power would automatically infringe the Second Conduct Rule. Only if the power is

abused to harm competition would there be an infringement of Section 21 of the Ordinance.

In relation to SMEs, the Commission is careful to point out on its website that 'only a limited number of large businesses are likely to have substantial market power. Under the Second Conduct Rule, small and medium-sized undertakings may be victims of abusive conduct'<sup>38</sup>. There is the Linde case which might confirm or impact the Commission's interpretation of the Second Conduct Rule.

Thus far, the chapters have focused on the First and Second Conduct Rules, not the merger ones. This is because the scope of the merger rule under the Ordinance is limited to the telecoms sector in Schedule 7 of the *Competition Ordinance*. The CA has concurrent authority under the *Telecommunications Ordinance* (Cap 106). We will now turn to the Merger Rule, which will be a short reference, as you will undoubtedly have a professional team to advise you where you seek to merge telecom operators.

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<sup>38</sup> The Hong Kong Competition Commission, "Overview", [https://www.compcomm.hk/en/practices/what\\_is\\_comp/overview.html](https://www.compcomm.hk/en/practices/what_is_comp/overview.html).