



# Hong Kong Competition Commission releases proposed liner shipping block exemption

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## **Briefing**

October 2016

On September 14, 2016, the Hong Kong Competition Commission released a proposed block exemption order for public consultation. The Commission proposes to confirm that vessel sharing agreements among shipping lines are excluded from the application of the first conduct rule under the Hong Kong Competition Ordinance (Cap 619), subject to a number of conditions, including: (i) that the parties do not collectively have a share of more than 40 per cent in the relevant market; and (ii) that the agreements do not include any pricing coordination. The Commission also published a Statement of Preliminary Views outlining its rationale for the proposed order based on information collected to date. In the same document, the Commission explains why it does not propose to include voluntary discussion agreements among shipping lines within the scope of the proposed order.

Interested parties are invited to submit comments before December 14, 2016, following which a final decision on the issuance of a block exemption order will be made. If adopted, the order would be valid for a period of five years.

## **A partial success for shipping lines**

The Commission's proposal follows an application made by the Hong Kong Liner Shipping Association on behalf of the shipping industry shortly after the Ordinance entered into force last year. The shipping lines sought a formal order from the Commission that would confirm that two categories of cooperation arrangements do not infringe the Ordinance's first conduct rule on account of the economic efficiencies they produce. The first category relates to vessel sharing agreements, by which shipping lines agree to exchange space on their respective vessels and to coordinate sailing schedules, capacity and other operational matters. The second relates to so-called "voluntary discussion agreements" pursuant to which shipping lines discuss certain commercial matters relating to particular shipping routes, including pricing.

The Commission's provisional views are that vessel sharing agreements, while potentially restrictive of competition, produce sufficient benefits to justify their exclusion from the prohibition on restrictive agreements under the first conduct rule if certain conditions are met. However, based on information so far received, the Commission cannot find sufficient benefits arising from voluntary discussion agreements that would justify their exclusion, particularly in view of the very significant competition restrictions which can arise as a result of pricing discussions among competitors.

### **Relevance of the Commission's proposal beyond the shipping sector**

The public consultation offers an opportunity for shipping lines and their customers and suppliers to provide views to the Commission on the text of the proposed block exemption order. The Commission's very detailed statement of reasons supporting its proposal should help these stakeholders frame their representations. It also signals to parties from other sectors of the economy that any application for similar orders will likely lead to a protracted, in-depth engagement with the Commission that would include an intensive public consultation process. Depending on the results of the public consultation, it appears unlikely that any order in the liner shipping case would be adopted before the first quarter of 2017.

The Statement of Preliminary Views is the most detailed substantive analysis released by the Commission since the adoption of its guidelines on the enforcement of the Ordinance last year. It provides insight into the authority's interpretation of the law and into its enforcement policy.

### **Restriction of competition**

The Statement only briefly discusses whether the relevant agreements would lead to restriction of competition caught by the first conduct rule. This brief discussion however provides some useful insights, particularly as regards vessel sharing agreements.

- The Commission indicates that, in general, vessel sharing agreements are unlikely to result in significant harm to competition in spite of possible diminished service variety and an increase in the commonality of costs between contracting parties. The only real concern appears to be the ability for parties to control capacity in the market through their joint provision of shipping services, a concern which would only arise where parties have some degree of market power. The Commission does not provide an indicative market share threshold above which market power concerns would arise in this context. It is however noteworthy that, in its subsequent analysis of economic efficiencies, the Commission considers that "effective competition" exists if contracting parties have a combined market share of below 40 per cent.
- The Statement's analysis of the restrictive effects of voluntary discussion agreements is equally succinct and does not add to the interpretation already reflected in the Commission's *Guideline on the first conduct rule*. The Commission points out that these agreements may give rise to significant competition concerns, where they involve recommended pricing guidelines and information exchanges on pricing and certain other customer terms.

### Overall economic efficiency analysis

Where agreements and practices have the object or effect of restricting competition, an infringement of the first conduct rule can nonetheless be avoided if efficiency benefits outweigh the competition restrictions. The bulk of the analysis in the Statement of Preliminary Views is devoted to the conditions for the overall economic efficiency exclusion, being the main purpose of the proposed block exemption order.

- Consistent with the methodology outlined in its *Guideline on the first conduct rule*, the Commission is prepared to consider qualitative and quantitative efficiencies. The larger number of destinations offered, the availability of higher frequencies, the ability to contract with a single provider and the overall greater volume of services are all recognised as qualitative improvements which would potentially fall within the overall economic efficiency exclusion. As regards quantitative benefits, the Commission proposes to take account of reduced operational costs as a result of economies of scale and lower costs of expansion. The Commission is however very sceptical that price stability could be regarded as an economic benefit of the type eligible under the overall economic efficiency exclusion. It is also reluctant to consider non-economic benefits, such as those relating to the environment, to employment and to the wider Hong Kong economy to fall within the scope of the exclusion.
- In its review of the evidence adduced by the applicant, the Commission applies a proportionality test. Whereas the *Guideline on the first conduct rule* explains that “convincing” evidence should be adduced, the Statement usefully explains that the more significant the harm to competition, the greater the efficiencies must be, and the more “compelling” the evidence must be in this respect. This explains why the Commission rejects most of the applicant’s arguments in respect of claimed benefits that would outweigh the significant competition restrictions that arise from pricing discussions.
- The Statement of Preliminary Views expands on the Commission’s prior guidance in respect of another aspect of the overall economic efficiency test. Among other conditions, once benefits have been established, parties must also show that a fair share of these benefits accrue to consumers. The Commission considers that parties will have an incentive to pass cost savings on to consumers in the form of lower prices if they are subject to “effective competition”. The Commission proposes a market share limit of 40 per cent as an indicative measure relevant to its assessment of whether effective competition exists. While the Statement does not explain the reasons for this choice, it is the same threshold above which the Commission expects competition concerns to arise in the context of horizontal mergers under its *Guideline on the merger rule*.

### Other matters of broad relevance

Other matters which may be of relevance beyond the shipping sector include the following.

- The proposed block exemption order demonstrates a flexible approach by the Commission. The order is not very prescriptive in respect of the types of covenants and other provisions to be contained in the relevant agreements, and – contrary to what is required in Malaysia and Singapore – there is no obligation for parties to file copies of their agreements with the authority.
- While in its prior guidance the Commission signalled that it would only be prepared to issue sector-specific block exemption orders as an “exceptional measure”, it is convinced that the specific features of the shipping industry call for a greater need for cooperation warranting the adoption of an order.
- On the difficult question of enforcing the Competition Ordinance in a manner that is consistent with other relevant statutory provisions, the Commission proposes to resolve the apparent conflict with the Merchant Shipping (Liner Conferences) Ordinance (Cap 482), which provides that “restrictions in respect of the provision of international liner services” shall not be “unenforceable by virtue of any rule of law about unreasonable restraint of trade”, by considering that this Ordinance has no bearing on the Commission’s ability to seek the imposition of fines for contravention of the Competition Ordinance.

### Consequences of the proposed order for the shipping industry

#### Vessel sharing agreements

If the order is adopted in its current form, parties to such agreements will be able to continue operating provided that they meet certain conditions. The Commission recognises that vessel sharing agreements may differ in scope. Accordingly it lists a certain number of activities which would benefit from the exclusion. All of these activities would be excluded if certain conditions are met.

- The main condition is that their combined market share remains below 40 per cent on the relevant market. This threshold should be calculated by reference to volumes carried or to capacity on the market, and allows for short-term fluctuations up to 45 per cent over a two-year period. Global shipping lines will already be familiar with this market share approach, which is broadly consistent with the methodology adopted in the European Union (where a 30 per market share threshold applies) and Singapore (where a 50 per cent market share threshold applies). While it is the parties’ responsibility to define the relevant markets in each case, the Commission signals in its Statement of Preliminary Views that it would be prepared to consider very broad markets for long-distance trades (such as between the “Far East and the Mediterranean”) and possibly country-wide markets (it cites “Hong Kong to the Philippines” as an example) for shorter routes. More specifically, the Commission recognises accessibility to inland transport and transshipment opportunities as a factor contributing to broader geographic markets.

- In addition to activities essential to the purpose of typical vessel sharing agreements, such as coordination on sailing schedules and destinations and capacity or vessel pooling, other ancillary activities will also benefit from the exclusion. These largely correspond to those listed under the EU block exemption for shipping lines and include the pooling or joint use of office premises, port facilities and container equipment, the joint operation or use of port terminal and related services, as well as any other activities which are considered necessary to the implementation of the agreement. Whilst the pooling of resources and the joint procurement of third-party services clearly fall within the scope of the exclusion, the test of “necessity” leaves some uncertainty as to which other types of ancillary activities might also benefit. In any event, cooperation within the scope of one vessel sharing agreement may well need to remain distinct from that envisaged as part of another, even where they share one or more of the same contracting parties.
- Amongst other conditions, parties cannot discuss or fix prices, limit sales, or introduce capacity limitations other than in the form of adjustments inherent to the operation of the vessel sharing agreement. Parties should also be free to withdraw from the coordination arrangements without the risk of facing onerous consequences. As with the list of excluded activities, these conditions are again broadly consistent with those found in similar block exemption decisions made in the EU and Singapore.

Where the conditions set out in the proposed order are not met, parties have a choice among several options, some of which are outlined below.

- They can make changes to fulfil the conditions, for example, by reducing the number of participants to bring the combined market share below the threshold. This would allow them to benefit from the legal certainty offered by the block exemption order. Note that the relevant market share refers to that of each party to the agreement, irrespective of how many vessels it contributes under the agreement. Accordingly, withdrawing vessels operating within the scope of the agreement while keeping them on the route is not an option that would enable the agreement to bring their collective market share within the safe harbour threshold.
- Another option would be for the parties to assess by themselves whether a particular vessel sharing agreement complies with the Ordinance despite not fulfilling the conditions of the order. For example, where they have a market share higher than 40 per cent on a new or thinly serviced route, they may still be able to show that no restriction of competition arises, or that specific market circumstances enable them to meet the conditions for exclusion.
- Finally, although this may be difficult to achieve operationally, parties could revise the vessel sharing agreement to exclude sailings to Hong Kong from its scope, and seek to exclude the application of the Ordinance on this basis.

### Voluntary discussion agreements

As mentioned, the Commission is so far unconvinced that this type of agreement should benefit from a block exemption. While the Commission does not expressly rule out the possibility, the analysis contained in the Statement of Preliminary Views suggests that the Commission will be unlikely to find room to apply the economic efficiency exclusion to any agreement or practice that contemplates pricing recommendations or discussions on prices and commercial terms among independent operators. The Commission's approach to voluntary discussion agreements differs from that adopted in Singapore, but reflects the same view as those held by competition authorities in the EU and Malaysia.

With little prospect of convincing the Commission that discussions of prices and commercial terms among independent operators would not fall foul of the Competition Ordinance, parties have few options other than to cease their involvement in such discussions, at least to the extent they have the object or effect of restricting competition in Hong Kong markets.

- Given that pricing discussions remain permitted in some other jurisdictions in the Asia-Pacific region, parties could conceivably carve out Hong Kong from their joint recommendations in respect of general rate increases or voluntary contract rate benchmarks. They will however need to be particularly careful to ensure that discussions of rates for services from other ports in North Asia do not have the object or effect of restricting competition in Hong Kong markets.
- The Commission's Statement of Preliminary Views shows a clear concern with those aspects of voluntary discussion agreements that relate to commercial terms and pricing. In contrast, discussions of other matters in relation to particular shipping routes, such as for example forecasts of total demand, could possibly be conducted without violating the Competition Ordinance. The Commission's Guideline on the first conduct rule contains guidance in this respect.
- The Commission proposes to offer a grace period of six months after its final decision on the application for a block exemption order, but thereafter, could well investigate pricing discussions. By then parties will need to have formally withdrawn from pricing discussions that have the object or effect of restricting competition in Hong Kong markets. Going forward, shipping lines will be mindful of recent commitments provided to the European Commission in relation to forward-looking price announcements, as these may well inform the views of the Hong Kong Competition Commission when assessing how prices are communicated to the Hong Kong market.

### Further reading

The following resources are available:

- The Competition commission's press release ([English](#) | [Chinese](#))
- The Competition commission's statement of preliminary views and proposed text of Block Exemption Order ([English](#) | [Chinese](#))
- The Competition commission's public consultation notice ([English](#) | [Chinese](#))
- The Competition commission's website is [www.compcomm.hk](http://www.compcomm.hk)
- Our Briefing on the Competition ordinance ([English](#))

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