Summary

- After a nine month preliminary assessment, the Hong Kong Competition Commission announced its intention to issue a Block Exemption Order in relation to certain agreements between liner shippers.

- As expected, the regulator proposes to exempt Vessel Sharing Agreements. However, the exemption is subject to a market share cap of 40% which is lower than that requested by the applicant and lower than competing shipping hubs such as Singapore.

- More remarkably, the Hong Kong Competition Commission has not proposed to exempt Voluntary Discussion Agreements. Noting the international divergence on how these agreements are assessed, the Hong Kong Competition Commission intends to reject the applicant's claimed efficiencies.

- A three month public consultation period has now begun. The regulator will then assess the submissions and the views of the applicant, and proceed to a final decision. Following a proposed six-month transition period, a Block Exemption Order is unlikely to be effective before Q4 2017.

Introduction

Hong Kong is the fourth busiest container port in the world, and is recognised as a significant global trading hub. Shipping and logistics account for a sizeable portion of the territory's economic activity. The impact of the Competition Ordinance ("CO") on the sector has been the subject of much controversy, with the shipping industry threatening to shift business away from Hong Kong if competition rules do not accommodate its needs.

Nine months after the full implementation of the CO, the Hong Kong Competition Commission ("Commission") last week indicated its intention to adopt a Block Exemption Order ("BEO"), conditionally exempting certain agreements between liners from the new competition regime.
The Hong Kong Liner Shipping Association (“HKLSA”) applied for an exemption covering two main types of agreements among carriers. These were Vessel Sharing Agreements (“VSAs”) under which liners agree on technical and operational arrangements and exchange or charter vessel space; and Voluntary Discussion Agreements (“VDAs”) which allow liners to exchange data about supply and demand and discuss guidelines on recommended rates. Both types of agreements, although a common practice in Hong Kong, risk being in violation of the law if an exemption is not granted by the Commission.

The Commission’s proposed BEO and Statement of Preliminary Views is a watershed moment for the liner shipping industry, as it took the view that VSAs should be exempted, but not VDAs. The industry had asked for an exemption for both types of agreements, modelled after other Asian jurisdictions such as Singapore and Malaysia, where both VSAs and VDAs are legal.

The Commission has now opened a three month consultation period on the proposed BEO. Taking into account the Commission’s review of submissions and consideration of new evidence it receives, a BEO is unlikely to be adopted before mid-2017.

**Proposed conditional exemption for VSAs**

VSAs are agreements between carriers regarding cooperation on operational matters including coordination or joint operation of vessel services and the exchange or charter of vessel space. As VSAs involve capacity sharing and service coordination between competing carriers, VSAs may lead to competition concerns under the CO such as exchange of commercially sensitive information, concerted reduction in service variety and joint control of service capacity in the market.

Whilst the Commission’s preliminary view is that VSAs could potentially harm competition, such effects are unlikely to be significant. Parties to VSAs are not necessarily in a position to control capacity in the Hong Kong market and still compete on price and other competitive parameters such as customer service.

More importantly, the Commission found that VSAs can expand carriers’ range of services offered to customers and increase carriers’ service frequency in the market. The Commission agreed with the applicants that VSAs help maintain Hong Kong’s trans-shipment traffic and status as a hub, and generate further economies of scale.

The Commission considered that the benefits from broader service coverage, higher service frequency and lower freight rates are more likely to be passed onto customers if parties to the VSA are subject to effective competition outside the specific VSA. It considered that a BEO may therefore be permissible if there are sufficient guarantees to maintain competition outside the VSAs, i.e. if VSAs compete against each other. Any conduct that is not indispensable to attain the relevant efficiencies would fall outside the
necessity condition of a BEO.

The Commission has therefore proposed a BEO for VSAs on three conditions:

- The parties to the VSA do not collectively exceed an aggregate market share of 40%;
- The VSA does not authorise or require carriers to engage in cartel conduct; and
- Carriers must be free to withdraw from the VSA with reasonable notice without incurring any penalties.

The exemption for VSAs is relatively uncontroversial. As the Commission itself noted, the VSAs’ role in an efficient operation of the liner shipping industry has been widely recognised internationally (including in the EU, USA, Australia, Japan, South Korea, Singapore and Malaysia). However, the market share threshold required to enjoy the exemption has been more debated. While the HKLSA requested an exemption based on a 50% threshold (following the Singapore model, where the exemption was recently extended for five years), the proposed BEO has set the cursor at 40%, which is likely to be of concern to some of the larger shipping liners.

The Commission notes that the proposed exemption only relates to the First Conduct Rule under the CO. Therefore, Liner shippers will still, need to be mindful of the CO’s Second Conduct Rule in relation to the abuse of substantial market power.

**No exemption for VDAs**

The Commission has taken a tougher stance on the application for exemption for VDAs.

VDAs are agreements between competing carriers in which parties discuss commercial issues relating to particular trade routes. This may include exchange of competitively sensitive information concerning market data and trade flows, supply and demand forecasts and business trends, as well as information concerning pricing and terms of service and other commercial aspects of their activities. Parties to VDAs may also jointly issue non-binding pricing recommendations on freight rates and certain surcharges.

The Commission indicates that pricing guidelines and exchange of information on pricing and service terms could potentially harm competition in contravention of the CO.

In rather strong terms, the Commission rejected the HKLSA’s claimed efficiencies. The regulator further noted that, even if VDAs gave rise to any efficiencies, they would not satisfy the conditions of the economic efficiency exemption as narrowly interpreted by the Commission. In particular, the Commission was of the preliminary view that:

- Rate stability, as claimed in the application, is questionable in practice and is unlikely to amount to an “efficiency” for the purpose of the CO;
While service stability may be accepted as an economic efficiency, there was insufficient evidence to establish a causal link between VDAs and the claimed service stability;

The fact that some pricing recommendations are not implemented in practice was taken by the Commission as a sign of price volatility, and contrary to the applicants’ claim that such recommendations help achieve rate stability; and

Rate and surcharge transparency arising from the pricing guidelines issued pursuant to VDAs is questionable in the circumstances, and generally cannot be considered as an “efficiency” for purposes of the CO.

In addition, it considered that it was difficult to see how customers benefit from the claimed efficiencies and, even if there were any efficiencies, there were alternative economically practicable and less restrictive means of achieving them. For instance, rate stability may be obtained through fixed rate contracts with customers; service stability and rate and surcharge transparency may be achieved through enhancing the scope of publicly available information.

The Commission therefore decided not to include VDAs in the scope of the proposed BEO. Nevertheless, the Commission has proposed a 6-month transition “grace period” starting from the date of the Commission’s final decision on the application. This will give parties a period of time to make the necessary changes to their practices and ensure compliance with the CO.

Next steps

The Commission has called for “substantive information or evidence” in response to the proposed BEO and the Statement of Preliminary Views. In addition to a general call for submissions, the Commission has listed specific areas for further input from interested parties. This includes whether VSAs and VDAs give rise to efficiencies mentioned in the Statement of Preliminary Views and feedback on the terms of the proposed BEO.

The consultation period closes on 14 December 2016 – the first anniversary of the CO coming into force. The Commission will then consider the submissions and any further evidence received – including further meetings with relevant parties. Only then, will the Commission subsequently proceed to adopt a decision. This is a process which is likely to take a number of months running into mid-2017. In addition, as indicated above, the Commission has proposed a transitional period of six months – meaning the BEO is unlikely to be effective before Q4 2017.

Concluding remarks

The proposed BEO is broadly in line with the HKLSA’s application and echoes the approach in a wide range of other jurisdictions where VSAs are permitted. Although the Commission’s position on VDAs appears to be bold, it is not completely at odds with international practice either. For instance, the EU
removed the benefit of a block exemption for VDAs in 2008 following a 2-year transitional period. Similarly, a number of other jurisdictions such as India and Israel have recently concluded that VDAs do not merit exemption from the relevant competition laws. In Australia and New Zealand, VSAs and VDAs may no longer be exempt and may be subject to the general competition law regimes.

Beyond the direct impact to liner shippers and others involved in the sector, the Statement of Preliminary Views is a welcomed development in shedding further light on how the Commission interprets the exclusion for economic efficiency under the CO more generally. The Commission has also shown itself to be willing to take a strong independent stand in such matters – and able to resist significant background noise pushing for a wholesale exemption for the liner shipping sector.

For organisations considering applying for a BEO, it is a salient reminder of the burden of evidence needed to convince the Commission that relevant efficiencies exist. It also highlights the risks of such applications – which may not be as successful as parties wish and can result in burdensome conditions being applied to existing conduct.

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