

**Consultation Paper issued by
The Office of the Telecommunications Authority**

**Draft Merger and Acquisition Guidelines for
Hong Kong Telecommunications Markets**

23 December 2003

Introduction

1. Following the publication of the first consultation paper on 4 August 2003, the Telecommunications Authority (TA) received 10 submissions from interested parties. The submissions are available on the OFTA web site. A number of the submissions received from the industry requested a further round of consultation and the TA has decided to accede to this request.
2. The draft guidelines have been amended to take account of the comments made in the submissions and in meetings which the TA has held with interested parties to discuss their views in greater detail. The TA's comments on the salient points raised in the consultation exercise are to be found in the boxes which have been inserted in the text of the revised guidelines. Other changes which are self-explanatory and not contentious are not referred to in the comments in the boxes. Minor changes have also been made throughout the text.
3. The TA welcomes further comments which will assist him in producing guidelines which will serve the interests of both the industry and Hong Kong consumers.

Timing

4. The TA will allow a period of six weeks for consultation in view of the public holidays in December and January. After consideration of the comments received, the TA aims to issue the guidelines as soon as possible thereafter.

Invitation to Comment

5. Views and comments on this consultation paper should reach the Office of the Telecommunications Authority on or before **3 February 2004**. Any person who submits views and comments should be aware that the TA may publish all or any part of the views and comments received and disclose the identity of the source in such manner as the TA sees fit. Any part of the submission which is considered commercially confidential should be marked, together with the reasons for such claims. The TA will take such markings into account in making his decision as to whether or not to disclose such information. Submissions should be addressed to:

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29/F Wu Chung House
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Office of the Telecommunications Authority

Draft Merger and Acquisition Guidelines For Hong Kong Telecommunications Markets

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1 INTRODUCTION

1.1 These guidelines (“the Guidelines”) are issued by the Telecommunications Authority (“TA”) under sections 6D(1) and 6D(2)(aa) of the Telecommunications Ordinance (Cap 106) (“the Ordinance”) for the purpose of providing practical guidance on section 7P of the Ordinance concerning mergers and acquisitions which are defined as “changes in relation to carrier licensees”. The Guidelines are intended to explain how the TA will apply and enforce the provisions of section 7P and in particular, to specify the matters he will take into account when deciding whether any merger or acquisition has, or is likely to have,

- (a) the effect of substantially lessening competition in a telecommunications market; and
- (b) a benefit to the public and this benefit outweighs any detriment to the public that is, or is likely to be, constituted by any such effect.

The TA will not depart from these Guidelines without providing reasons in writing for doing so.¹

1.2 The Guidelines provide a guide to the approach the TA will take in his analysis of mergers and acquisitions that may raise competition concerns. The analysis of any particular merger or acquisition will require consideration of the merger or acquisition against the particular facts of the case and the specific market circumstances.

1.3 The Guidelines state the TA’s current views and procedures in relation to the enforcement of the merger and acquisition provisions. They may be subject to review in the light of changing market circumstances and the emergence of new analytical approaches. In any event, it is the TA’s intention to review the Guidelines from time to time. The Guidelines should not be seen as a substitute for the Ordinance and anyone who believes that they may be affected by section 7P should consider seeking legal advice.

1.4 In the Guidelines, the terms “mergers and acquisitions”, “mergers” and “acquisitions” will, depending on the context, be used interchangeably to refer to the acquisition by a person, either alone or with any associated person, of the beneficial ownership in, or the voting control of, voting shares in a carrier licensee or the power to ensure that the affairs of the carrier licensee are conducted in accordance with the wishes of that person, under the terms of section 7P(16) of the Ordinance.

¹ Section 6A(3)(b)(ii) of the Ordinance

Statement of competition policy

Industry comments:

- There is a need for a statement of competition policy underlying the new merger laws and their enforcement.
- The Guidelines should not contain a negative presumption about mergers being anti-competitive.

TA response:

- A new section headed “Merger Review Principles” has been incorporated into the Guidelines to address these issues.

Merger Review Principles

- 1.5 Most merger and acquisition activity does not raise competition concerns. Indeed, mergers are normal business activities, and they perform an important function in the efficient operation of the economy. They allow firms to achieve efficiencies such as economies of scale, synergies and risk spreading. However, in some cases a merger will have an anti-competitive effect by changing the structure of the market in such a way that it diminishes the incentives to compete.
- 1.6 The Government sees competition policy as a means to enhance economic efficiency and free trade, thereby benefiting consumers. It is the Government’s objective to have a clear regulatory framework for the industry and investors in order to assist parties concerned to make informed decisions on merger and acquisition activities. When introducing section 7P of the Ordinance, the Secretary for Commerce, Industry and Technology said that “*the regulation of merger and acquisition activities is indispensable in forestalling a market structure not conducive to competition. This is of particular importance to the carrier markets which are limited by high market concentration, radio spectrum constraint and high sunk costs.*” It is the TA’s policy only to intervene in merger and acquisition activities if there is a potential adverse effect on competition. In those circumstances, the TA will only prevent a merger or acquisition from going ahead, or require it to be unwound, where other remedies to address the competitive concerns cannot be devised or are considered unsatisfactory.

Overview of the merger provisions of the Ordinance

1.7 The substantive provisions are sections 7P(1) and 7P(6) and (7) of the Ordinance which read as follows:

- (1) *Where, after the commencement of this section, there is a change in relation to a carrier licensee –*
 - (a) *subject to subsection (1A), the Authority may conduct such investigation as he considers necessary to enable him to form an opinion as to whether or not the change has, or is likely to have, the effect of substantially lessening competition in a telecommunications market; and*
 - (b) *(where the Authority, after conducting such investigation, forms an opinion that the change has, or is likely to have, the effect of substantially lessening competition in a telecommunications market) the Authority may, by notice in writing served on the licensee, direct the licensee to take such action specified in the notice as the Authority considers necessary to eliminate or avoid any such effect, but the Authority may not issue such direction if the Authority is satisfied that the change has, or is likely to have, a benefit to the public and that the benefit outweighs any detriment to the public that is, or is likely to be, constituted by any such effect.*
- (6) *Where there is a proposed change in relation to a carrier licensee, the licensee or any interested person may apply in writing to the Authority for consent to the proposed change.*
- (7) *Where the Authority, on receiving an application made under subsection (6)–*
 - (a) *forms an opinion that the proposed change would not have, or not be likely to have, the effect of substantially lessening competition in a telecommunications market, the Authority shall decide to give consent; or*
 - (b) *forms an opinion that the proposed change would have, or be likely to have, the effect of substantially lessening competition in a telecommunications market, the Authority may decide to–*
 - (i) *refuse to give consent;*
 - (ii) *give consent subject to the direction that the carrier licensee concerned takes the action that the Authority considers necessary to eliminate or avoid any such effect;*
or

- (iii) *give consent without issuing a direction under subparagraph (ii) if the Authority is satisfied that the proposed change would have, or be likely to have, a benefit to the public and that the benefit would outweigh any detriment to the public that would be, or would likely to be, constituted by any such effect.*

1.8 A “merger or acquisition” is thus defined within the terms of section 7P(1) or 7P(6) as a “change” in a carrier licensee. The “change” is defined in section 7P(16) as follows:

- (16) *For the purposes of subsections (1) and (6), there is a change in relation to a carrier licensee if –*
 - (a) *subject to subsection (17), a person, either alone or with any associated person, becomes the beneficial owner or voting controller of more than 15% of the voting shares in the licensee;*
 - (b) *a person, either alone or with any associated person, becomes the beneficial owner or voting controller of more than 30% of the voting shares in the licensee; or*
 - (c) *a person, either alone or with any associated person –*
 - (i) *becomes the beneficial owner or voting controller of more than 50% of the voting shares in the licensee; or*
 - (ii) *acquires the power (including by the acquisition of voting shares), by virtue of any powers conferred by the memorandum or articles of association or other instrument regulating the licensee or any other corporation or otherwise, to ensure that the affairs of the licensee are conducted in accordance with the wishes of that person.*
- (17) *Subsection (16) (a) does not apply if the person referred to in that subsection, when becoming the beneficial owner or voting controller of more than 15%, but not more than 30%, of the voting shares in the carrier licensee concerned –*
 - (a) *either alone or with any associated person, is not, or does not concurrently become, the beneficial owner or voting controller of more than 5% of the voting shares in any other carrier licensee; and*

(b) either alone or with any associated person, does not have the power (including by the holding of voting shares), or does not concurrently acquire the power (including by the acquisition of voting shares), by virtue of any powers conferred by the memorandum or articles of association or other instrument regulating any other carrier licensee or any other corporation or otherwise, to ensure that the affairs of such other carrier licensee are conducted in accordance with the wishes of that person.

- 1.9 The provisions of section 7P come into operation when the “change” in a carrier licensee crosses one of the thresholds set out in the subsection above. There are three tiers of control. The first threshold is the acquisition of more than 15% but not more than 30% of the voting shares of a carrier licensee. However, this will only constitute a change for the purposes of section 7P if the acquirer already holds, or simultaneously acquires, more than 5% of the voting shares in any other carrier licensee or has or simultaneously acquires the power to ensure that the affairs of any other carrier licensee are conducted in accordance with its wishes. The threshold is only crossed when the acquirer “becomes” the beneficial owner or voting controller of the shares and therefore if the acquirer is already the owner or controller of more than 15% of the voting shares, and acquires further shares up to the limit of 30%, there is no “change” in the carrier licensee and section 7P does not apply.
- 1.10 The second threshold is the acquisition of more than 30% but not more than 50% of the voting shares in a carrier licensee. The provisions of section 7P will only apply if the acquirer is not already the owner or controller of more than 30% of the voting shares.
- 1.11 The third threshold is the acquisition of more than 50% of the voting shares or the acquisition of the power to ensure that the affairs of the carrier licensee are conducted in accordance with the wishes of the acquirer. Once again, the threshold is only crossed if the acquirer does not already own or control more than 50% of the voting shares or does not already have the power to determine the affairs of the carrier licensee.
- 1.12 In all cases, the acquisition of shares will be assessed by taking account of the shares held by the acquirer and any “associated person” as defined in subsection (18) (by reference to section 2(1) of the Ordinance).

Carrier licensees only

- 1.13 It should be noted from section 7P(1) that the merger regime will only apply to carrier licensees. “Carrier licensee” is defined in section 2 of the Ordinance. Carrier licensees are in essence network operators that establish and maintain

transmission facilities (by wired or wireless means) that carry “communication” (also defined in section 2 of the Ordinance) between locations that are separated by public streets or unleased land. They include the local and external fixed network operators² and mobile network operators.

Burden and standard of proof

Industry comments:

- The Guidelines should state that the TA has the burden to show a merger is anti-competitive.
- The Guidelines should clarify the standard of proof required for various factors, ie whether it be “beyond reasonable doubt” or “balance of probabilities”.

TA response:

- The Guidelines have been amended to clarify the onus of proof on various parties during the assessment process contemplated under section 7P. The Guidelines accord with the TA’s clear legal responsibilities and international best practice in these areas.

Burden and standard of proof

1.14 The burden of proving that there is a substantial lessening of competition under section 7P rests with the TA. The civil standard of proof applies: the TA is required to decide on a balance of probabilities. However, when the parties to a transaction raise an issue which, in their view, shows that there is no substantial lessening of competition, then it is for them to substantiate their claim. The TA will consider any such claims and verify them to the extent possible, but it is not for the TA to “prove” that the claims are unfounded, in the event that they are rejected.

1.15 If the parties wish to argue that there are countervailing benefits to the public arising from a merger, the TA will evaluate the claimed benefits. Ultimately it is for the TA to decide whether any such benefits to the public outweigh any detriments resulting from a substantial lessening of competition.

Actions of the TA

² Including operators of fixed networks under Fixed Carrier (Restricted) Licences held by television programme services licensees for the transmission of their own programmes, and satellite operators.

- 1.16 Without limiting the general nature of the action the TA may direct, section 7P(4) empowers the TA to direct a carrier licensee to modify the changes in ownership or control that are of concern. Failure to take any directed action would constitute a contravention of the Ordinance. Administrative sanctions available under the Ordinance (including directions, financial penalties, and cancellation, withdrawal or suspension of licences) may be imposed upon the carrier licensee.

No requirement to notify mergers

- 1.17 There is no requirement to notify changes of ownership or control, under the merger provisions of the Ordinance, although there may be an obligation to inform the TA under the conditions of a licence, for example. However, it is always open to the parties to a proposed merger to approach the TA to discuss the implications of the transaction and obtain informal advice (which would not be binding on the TA) on the transaction, on a confidential basis if necessary, or to submit a formal request for the TA's consent to the proposed change under section 7P(6).
- 1.18 The application of section 7P(1) is *ex post* in that it is applied after the merger or acquisition has been completed. While an *ex post* regime minimises the compliance burden, there are difficulties in "unscrambling" a completed merger under such a regime if action is required to overcome any anti-competitive effects. Accordingly, section 7P(6) provides for the licensee to seek on a voluntary basis *ex ante* consent to a proposed merger or acquisition before it is progressed. Under section 7P(7), the TA may give consent, refuse to give consent, or give consent subject to the direction that the carrier licensee takes such action that the TA considers necessary to eliminate or avoid any anti-competitive effect. The powers of direction are similar to those under section 7P(4).

Appeals

- 1.19 An opinion, direction or decision made by the TA under section 7P(1) or 7P(6) is subject to appeal to the Telecommunications (Competition Provisions) Appeal Board. Any appeal must be lodged not later than 14 days after the opinion, direction or decision became known (or ought reasonably to have become known) to the person making the appeal. However, only the parties to the transaction in question have the right to appeal. These include the carrier licensee in respect of which the opinion, direction or decision was formed, issued or made, the acquirer and the applicant for consent under section 7P(6). The TA's opinions, directions and decisions are also subject to judicial review.

Financial transactions and corporate restructuring

Industry comments:

- In *pro forma* transactions or corporate restructuring, where the ultimate ownership of the relevant entities remains unchanged, the TA should not seek to apply a section 7P review to such transactions and should therefore include them in his list of “excluded” transactions.
- The TA should clarify the position of financing transactions that could fall within the ambit of section 7P.
- Charge over the securities in a carrier licensee for securing a loan should be excluded from regulatory review.

TA response:

- The TA has provided further comfort in the Guidelines for those involved in transactions that section 7P was not intended to cover. In this regard, specific amendments have been made to the section headed “Financial transactions which do not raise competition concerns.”

Financial transactions which do not raise competition concerns

1.20 The TA will normally take the view that the following transactions do not give rise to competition concerns:-

- (a) the acquisition of the securities in a carrier licensee or any of its associated corporations on a temporary basis by -
 - (i) an authorized institution within the meaning of the Banking Ordinance (Cap. 155);
 - (ii) an insurer who is authorized within the meaning of the Insurance Companies Ordinance (Cap. 41); or
 - (iii) an exchange participant within the meaning of the Securities and Futures Ordinance (Cap. 571), or a person licensed or exempt to carry on a business in dealing in securities or securities margin financing under Part V of that Ordinance,

if:

- (iv) the securities are acquired with a view to reselling them; and
- (v) the authorized institution, insurer, or exchange participant, registered institution or licensed corporation (as the case may be) -
 - (A) does not exercise voting rights in the securities; or
 - (B) exercises the voting rights in the securities only with a view to preparing the disposal of all or part of the securities of the carrier licensee or associated corporation (as the case may be), or of the assets of the carrier licensee or associated corporation (as the case may be), and the disposal takes place -
 - (I) within one year of the date of the acquisition; or
 - (II) where the TA is satisfied that the disposal is not reasonably possible within one year of the date of the acquisition, within such further period as the TA considers appropriate;
- (b) the acquisition of the voting control of the voting shares in a carrier licensee by the liquidators and receivers of the carrier licensee by virtue of their offices;
- (c) the acquisition of holdings in a carrier licensee or any of its associated corporations by a financial holding company if -
 - (i) the sole object of the financial holding company is to acquire and manage holdings in any corporation and to turn them into profit without involving itself directly or indirectly in the management of such corporation; and
 - (ii) the voting rights in respect of the holdings in the carrier licensee or associated corporation (as the case may be) are exercised, in particular in relation to the appointment of members of the management and supervisory bodies of the carrier licensee or associated corporation (as the case may be), only to maintain the full value of those investments and not to determine directly or indirectly the competitive conduct of the carrier licensee or associated corporation (as the case may be);
- (d) the charge over the securities in a carrier licensee or any of its associated corporations to -
 - (i) an authorized institution within the meaning of the Banking Ordinance (Cap. 155);

if:

- (ii) the securities are charged pursuant to a deed or instrument with a view to securing a loan to the chargor, the carrier licensee or its associated corporations or otherwise, and
- (iii) the authorized institution,
 - (A) does not exercise voting rights in the securities or has not given notice in writing to the chargor under the charge of an intention to exercise the right to vote attaching to such voting shares; or
 - (B) having given notice in writing to the chargor under the charge of an intention to exercise the right to vote attaching to such voting shares, exercise the right to vote only to maintain the full value of the security and without directly or indirectly affecting or influencing the competitive conduct of the carrier licensee or associated corporation (as the case may be);

where

“charge” (押記) means

- (i) a debenture within the meaning of the Companies Ordinance (Cap 32);
- (ii) a mortgage;
- (iii) a bill of sale;
- (iv) a lien; or
- (v) any document,

under or pursuant to which a business or any assets thereof are charged as security by the chargor for the payment of money or the performance of an obligation, and includes an equitable charge;

“securities” (證券) has the meaning assigned to it by section 1 of Part 1 in Schedule 1 to the Securities and Futures Ordinance (Cap. 571);

- (e) the acquisition of holdings in a carrier licensee or any of its associated corporations by the former’s holding company if -
 - (i) the sole object of the holding company is to acquire and manage holdings in a carrier licensee or any of its associated corporations as part of a *bona fide* corporate reorganisation exercise or *pro forma* transaction without involving any change of ultimate ownership or

control of the licensee or itself directly or indirectly in the management of such carrier licensee; and

- (ii) the voting rights in respect of the holdings in the carrier licensee or associated corporation (as the case may be) are exercised, in particular in relation to the appointment of members of the management and supervisory bodies of the carrier licensee or associated corporation (as the case may be), only to facilitate the implementation of its *bona fide* corporate reorganisation exercise or *pro forma* transaction without directly or indirectly affecting or influencing the competitive conduct of the carrier licensee or associated corporation (as the case may be).

1.21 In general, the TA will not be concerned about changes in the beneficial ownership in, or the voting control of, voting shares in a carrier licensee, which are not of a lasting nature. Changes in control which are purely transitory and effected only to facilitate the merger agreement, will not normally have any effect on competition in the market.

Overlapping provisions

1.22 It is the TA's intention, as far as possible, to provide a clear merger framework and to remove uncertainties about the potential application of other provisions that might apply to mergers and acquisitions. Consequently the TA will rely primarily on the provisions of section 7P of the Ordinance when considering mergers and acquisitions. When a transaction falls within the scope of section 7P, the TA will not apply any of the following provisions to the same transaction:

- sections 7K and 7L of the Ordinance;
- equivalent provisions to sections 7K and 7L in licences issued under the Ordinance prohibiting anti-competitive conduct and abuses of dominance.

1.23 However, these provisions remain in force and licensees remain obliged to comply with the provisions. While not applying the provisions to the merger transaction itself, the TA will continue to enforce the provisions in respect of any subsequent conduct of the licensees.

1.24 In respect of non-carrier licensees, the TA takes the view that mergers are unlikely to raise any competition concerns and therefore he would not normally consider applying the above provisions to the transaction.

Ancillary restraints

- 1.25 A merger transaction can involve the acceptance of restrictions which go beyond the merger agreement itself. Such restrictions could include non-compete covenants, licences for intellectual property or purchase and supply agreements.
- 1.26 Where the restraints are directly related and necessary to the implementation of the merger agreement, they will be treated as ancillary restraints and will be assessed as part of the merger transaction under section 7P. Any other restrictions which are agreed at the same time as the merger, even if expressed to be part of the merger transaction, will be liable to assessment under section 7K as potentially anti-competitive conduct.

2 ANALYTICAL FRAMEWORK

Specific guidance and industry examples

Industry comments:

- More specific guidelines can and should be formulated, and more examples of how the analytical framework will be applied should be provided.

TA response:

- The Guidelines are more specific than similar guidelines in other jurisdictions, and include a number of examples based on the TA's previous decisions. Unlike other countries, the competition law regime in Hong Kong is relatively new and there are fewer past decisions on which to draw.
- The TA is also mindful of a recent decision by the Appeal Board which emphasized the importance of Hong Kong developing its own jurisprudence in the competition law area.
- The TA has not received any response to a request to the industry to provide specific examples for consideration and possible inclusion in the Guidelines. It is not appropriate, however, for the TA to attempt to provide answers to hypothetical questions, or to provide answers to questions related to a specific market situation before facts about the situation are known and submissions from interested parties are received and considered.

2.1 Section 7P(1) of the Telecommunications Ordinance provides for regulatory control over a merger or acquisition that "...has, or is likely to have, the effect of substantially lessening competition in a telecommunications market". The promotion of competition has an economic objective to increase economic efficiencies and, ultimately, consumer welfare (typically in the form of lower prices, higher output, wider choice, better quality or more innovation). Given the economic objective, an economically meaningful framework for the assessment of a merger is needed.

2.2 It follows that an assessment of a merger or acquisition for any anti-competitive effects requires:

- an identification of the relevant market; and
- an assessment of whether the transaction has, or is likely to have, the effect of substantially lessening competition in that market.

- 2.3 However, the two issues identified above are not distinct and separate aspects of the analysis since many of the factors affecting the identification of the relevant market will also be relevant to the assessment of the state of competition. Market definition is not an end in itself, but only a tool for identifying the competitive constraints faced by the parties to the merger. This is an analytical framework that has been widely adopted by competition authorities.
- 2.4 Under section 6D(2)(aa) of the Ordinance, the TA is required to issue these Guidelines specifying the matters which he will take into account before forming an opinion on a merger. The matters to be taken into account are to include the factors set out in Schedule 2 to the Ordinance, which lists the following:
1. *The height of barriers to entry to a telecommunications market.*
 2. *The level of market concentration in a telecommunications market.*
 3. *The degree of countervailing power in a telecommunications market.*
 4. *The likelihood that the change would result in the carrier licensee or interested person being able to significantly and substantially increase prices or profit margins.*
 5. *The dynamic characteristics of a telecommunications market, including growth, innovation and product differentiation.*
 6. *The likelihood that the change would result in the removal from a telecommunications market of a vigorous and effective competitor.*
 7. *The extent to which effective competition remains or would remain in a telecommunications market after the change.*
 8. *The nature and extent of vertical integration in a telecommunications market.*
 9. *The actual and potential level of import competition in a telecommunications market.*
 10. *The extent to which substitutes are available in a telecommunications market.*
- 2.5 When the TA forms an opinion that a completed merger has, or is likely to have, the effect of substantially lessening competition, the TA may not issue a direction to the parties to take any action in relation to the merger if he is satisfied that the merger has, or is likely to have, a benefit to the public which outweighs any detriment to the public resulting from the substantial lessening of

competition. Similarly, on an application for prior consent to a proposed merger, the TA may decide not to issue a direction to the parties to eliminate or avoid the effect of a substantial lessening of competition, if he is satisfied that there is an overall benefit to the public.

Safe harbours

Industry comments:

- The Guidelines should provide certainty as to when the TA will intervene under section 7P and set out clear benchmarks for such interventions.
- The Guidelines should refer to the Herfindahl-Hirschman Index (HHI) which is used as a benchmark screening device in some jurisdictions such as the USA and the UK.
- The Guidelines should use a modified Australian approach of considering mergers resulting in a combined market share below 40% only when the combined market share of the three largest firms in the market is greater than 75%.
- Mergers between businesses with turnover of less than HK\$2 billion should not be investigated under section 7P.

TA response:

- A “safe harbour” cannot provide absolute certainty – only the legislation can do that. The TA cannot fetter his discretion unconditionally.
- Reference to the HHI based on the US Horizontal Merger Guidelines has been added to the Guidelines. Similar thresholds have been adopted in the guidelines published by the Office of Fair Trading in the UK.
- The “safe harbour” has been redefined, and instead of relying only on market shares, it now uses the four firm concentration ratio, following the practice of the Australian competition authority.
- The TA does not consider that section 7P needs to be augmented by a turnover threshold, particularly given the other screening and threshold mechanisms that will be applied.
- The TA invites comments on whether more than one screening threshold should be adopted, and if only one is appropriate, which one is to be preferred.

Scope of application and “safe harbours”

- 2.6 The objective of specifying “safe harbours” is to give guidance as to which mergers and acquisitions are unlikely to substantially lessen competition. They provide a screening device and are not intended as a replacement for case-by-case analysis. The TA has adopted the safe harbours specified below.
- 2.7 If the post-merger combined market share in the relevant market of the four (or fewer) largest firms (CR4) is less than 75%, and the merged firm has a market share of less than 40%, the TA takes the view that it is unlikely that there will be a need to carry out a detailed investigation or to intervene. Where the CR4 is 75% or more, the TA is unlikely to investigate the transaction if the combined market share of the merged entity is less than 15% of the relevant market. The calculation of the relevant market shares is explained in detail in the following sections.
- 2.8 While the TA is unlikely to further assess any mergers which fall below these thresholds, he does not categorically rule out intervention. Occasionally, but not often, such mergers may still raise competition concerns, for example where it involves a firm with vertical relationships into another market where the firm has market power. In any event, where the post-merger market share of the parties to the transaction is 40% or more, it is likely that the TA will wish to make a detailed investigation of the transaction.
- 2.9 The TA notes that some competition authorities (such as the USA and the UK) use the Herfindahl-Hirschman Index (“HHI”) to indicate “safe harbours”. The HHI measures market concentration. It is calculated by summing the squares of the market shares of all the firms operating in the market. The increase in the HHI resulting from the merger is calculated by subtracting the pre-merger index from the expected value of the HHI following the merger. Both the absolute level of the HHI and the expected change resulting from the merger can provide an indication of whether a merger is likely to raise competition concerns.
- 2.10 The generally accepted benchmarks, which the TA intends to adopt, are as follows. Any market with a post-merger HHI of less than 1,000 will be regarded as unconcentrated. Mergers resulting in unconcentrated markets are unlikely to result in a substantial lessening of competition and normally require no further investigation.
- 2.11 Markets with a post-merger HHI of between 1,000 and 1,800 will be regarded as moderately concentrated. Mergers producing an increase in the HHI of less than 100 in these markets, are unlikely to result in a substantial lessening of competition and normally require no further investigation. However, mergers producing an increase in the HHI of more than 100 potentially raise significant competitive concerns.

- 2.12 Markets with a post-merger HHI of more than 1,800 will be regarded as highly concentrated. Mergers producing an increase in the HHI of less than 50 are unlikely to substantially lessen competition, even in a highly concentrated market. Mergers producing an increase of more than 50 in the HHI will potentially raise competitive concerns and will normally require further investigation. An increase in the HHI of more than 100 will indicate that the merger is likely to create or enhance market power and therefore may result in a substantial lessening of competition.

Alternative proposal on HHI thresholds submitted by PCCW

- On 10 December 2003, the TA received a proposal from PCCW to modify the HHI thresholds which are used as a screening device to exclude mergers which do not require further investigation.
- PCCW has examined existing market shares in the fixed line and mobile markets in order to derive the proposed thresholds.
- The proposal is as follows:
 - (i) in markets where the post-merger HHI is less than 1800, and
 - (ii) in markets where the post-merger HHI is more than 1800, but the increase in the index is less than 550,the merger would be presumed not to substantially lessen competition and would not require further investigation.
- PCCW estimates that if the above thresholds were to be adopted, any merger between two existing operators in the mobile market would not merit investigation. Any merger between two existing operators in either the residential or business fixed line markets would likewise not be investigated, save for a merger involving PCCW and another operator with more than a very small market share.
- The TA invites comments on this proposal.

3 MARKET DEFINITION

Market definition

Industry comments:

- Market definition should be forward looking and take into account technological trends and rapidly changing market boundaries. More information on what markets are covered should be provided.

TA response:

- The TA acknowledges that technological trends can affect market boundaries, which is one of the reasons why he does not consider it appropriate to attempt to define markets in the Guidelines. Rather he has adopted the more usual approach of explaining the processes he will follow in actual cases. This is consistent with the approach followed in similar guidelines in other countries.
- It is not appropriate for the TA to attempt to define markets or to indicate his likely approach to particular hypothetical transactions. The Guidelines are provided to give the industry guidance on the TA's approach, not his views on possible arrangements. This is consistent with the approach adopted in other similar guidelines. It also comports with the TA's view, based on clear international precedents, that previous market definitions should not be automatically applied in new cases.

- 3.1 The concept of a market is a term of art in competition analysis. Competition is a process of rivalry between firms, where each firm constrains the prices of other firms by supplying closely substitutable products: if a firm attempts to raise its price, consumers will switch to the cheaper alternative and make the price rise unprofitable.
- 3.2 Firms that constrain each other through the supply of close substitutes are said to compete in the same market. The process of market definition thus involves the identification of close substitutes, from both the supply side and the demand side. However, as noted above (paragraph 2.3) market definition is not an end in itself: it is only a step on the way to deciding whether there is a substantial lessening of competition.
- 3.3 The market will generally be defined in four dimensions:
- product or service, i.e., the goods and/or services supplied and/or purchased;

- geographic, i.e., the geographic area from which the goods and/or services are supplied or purchased;
- functional, i.e., the level in the production or distribution chain at which the goods and/or services are supplied or purchased; and
- temporal, i.e., the supply and purchase of goods and/or services with reference to time.

3.4 The described approach to market definition is a conceptual framework and is not intended to be applied mechanically. Accordingly the TA will not necessarily follow each step indicated below in each case. The TA will look at the evidence which is relevant to the case in question (and, to an extent, will be constrained by the evidence available). In particular it may be clear in certain cases that, although there is potentially more than one market definition, on any sensible market definition, the merger or acquisition would not give rise to a substantial lessening of competition. In such cases, it will not normally be necessary to establish which of the potential market definitions is correct.

The hypothetical monopolist test

3.5 The “hypothetical monopolist” test is generally accepted to be an appropriate tool for defining a market for competition law purposes. Under this approach, a market is defined as a product (or group of products) supplied in a particular geographical area such that a hypothetical profit-maximizing firm that was the only present and future supplier of that product (or group of products) in that area would be able to impose a small but significant and non-transitory increase in price (“SSNIP”).

3.6 This is commonly referred to as the “SSNIP” test. Under this test, a price increase of five to ten per cent lasting for the foreseeable future has been widely used as the standard for measuring the magnitude of a small but significant and non-transitory increase in price. Depending on the circumstances of each merger case, however, a higher or lower figure than five to ten per cent may be used. It is difficult to quantify in a general sense how long is the “foreseeable future” but one year is considered to be a reasonable period. In other words, substitution responses that would undermine a price increase would be expected to take place before one year was out. This period is only a rule of thumb however, and may vary depending on the circumstances of the case.

3.7 The market can be viewed as the narrowest product category, supplied in the smallest geographical area, over which a hypothetical monopolist could exercise market power (that is, profitably maintain a SSNIP). This would only be possible if all sources of close substitutes have been included in the definition of the market. Substitutes do not have to be identical products to be included in the same market.

- 3.8 The process of establishing the relevant market boundaries in respect of a merger or acquisition starts with:
- those products (either goods or services) supplied by one or both of the merging firms over which there is some competition concern; and
 - the geographical area within which the products are supplied.
- 3.9 The product is described in terms of particular characteristics or features from which one can assess the extent of its substitutability with other products. This usually includes a description of the functionality or the purpose for which it is supplied (for example, a local circuit to carry telecommunications services) and the functional level in the supply chain at which it is supplied (for example, at the wholesale level to service providers or at retail level to end-customers). Products may be defined by reference to time (for example, telephone calls at peak and off-peak hours) or particular groups of customers (for example, business and residential customers). The geographical area of supply will vary depending on the circumstances of the case but may, for example, be on a wide global or regional basis or limited to supply within the Hong Kong Special Administrative Region.
- 3.10 This description establishes the initial market boundary in both the product and geographic dimensions. In determining whether a hypothetical monopolist would be in a position to impose a price increase or otherwise exercise market power in relation to the product so described, it is necessary to assess two types of responses:
- the likely response of consumers to a price increase (“**demand-side**” responses): a price increase could be made unprofitable by consumers switching to other products; and
 - the likely response of suppliers to a price increase (“**supply-side**” responses): a price increase could be made unprofitable by other firms switching their production lines at relatively short notice to supply switching customers.
- 3.11 If in response there is a level of substitution that is large enough to make the price increase unprofitable, these products are considered to be close substitutes and are identified as being in a group of closely substitutable products that are supplied in the same market. The responses to a price rise by a hypothetical monopolist supplier of this new expanded group of products are then assessed.
- 3.12 In this iterative fashion, the initial market boundary is progressively extended to include all those sources of close substitutes that would make it non profit-maximizing for a hypothetical monopolist to impose a price increase. The TA

will typically then consider the relevant market to be the smallest group of products that satisfies the SSNIP test.

- 3.13 The market should not normally be expanded beyond this group of products. If the market is defined too broadly then any anti-competitive effect of a merger is likely to be understated because of the inclusion in that market of firms and products that do not effectively constrain the exercise of market power. Conversely, a market defined too narrowly is likely to overstate the anti-competitive effect. This is particularly relevant in the telecommunications sector where services may be bundled together which cannot economically be provided separately. Attempts to define such individual services as separate markets could over emphasise any anti-competitive effects (this is further discussed in the section on “cluster markets” below).
- 3.14 The process described above focuses on defining the boundaries of the market in its product/service dimension. An analogous process is used for defining the geographic boundaries: the market boundaries are gradually expanded to include those geographic areas where consumers may source close substitutes and from where firms may supply close substitutes in the event of a price increase.

Functional Level

- 3.15 The production, distribution and sale of goods and services typically occur through a series of functional levels. It is useful to identify the relevant markets at each functional level, e.g., manufacturing, wholesale or retail, that is affected by a merger or acquisition, to assess the competitive impact, especially in relation to any vertical integration.

Temporal markets

- 3.16 A market may also be defined by reference to time. Temporal markets might include the provision of peak and off-peak services (for instance, where customers are not able to substitute between the time periods), seasonal products (where the demand arises only during certain time period) or inter-generational products (where customers defer expenditure on present products because they believe innovation will soon produce better substitutes). Temporal markets are, to a certain extent, an extension of the product market, e.g. the supply of product X at a certain time.

Evidence of substitution responses

- 3.17 Being a hypothetical test, the necessary evidence is unlikely to be available from the market on demand-side and supply-side responses to a small but significant

and non-transitory increase in price by a hypothetical monopolist. However, the importance of the SSNIP test is that it imposes a disciplined objective framework on the analysis of market definition in which the inquiries are focussed upon and relevant to the objective of assessing whether certain conduct substantially lessens competition.

3.18 Despite the hypothetical nature of the test, evidence can be obtained from which one can draw reasonable inferences about substitution possibilities and, hence the boundaries of the relevant market. In applying the SSNIP test and assessing substitution possibilities, the TA will take into account relevant evidence, including:

- past evidence that customers have switched between telecommunications service suppliers in response to relative changes in price or in other competitive dimensions (such as quality, service levels, innovation, etc);
- past evidence that suppliers of telecommunications services have responded to the prospect of customers switching suppliers in response to relative changes in price or in other competitive dimensions;
- evidence that potential suppliers of telecommunications services can rapidly respond and supply a close substitute service in response to relative changes in price or in other competitive dimensions without incurring significant investment costs (see discussion below on supply-side substitution and market entry);
- evidence on the timing and costs of switching, as incurred by both consumers and potential suppliers;
- in relation to wholesale markets, evidence that a reseller is influenced by downstream competition to switch between wholesale suppliers because a wholesale price increase cannot be passed on to end-customers; and
- views from competitors, suppliers and customers on their likely response to a price increase.

Price discrimination – different consumer groups

3.19 Price discrimination is defined as the practice of charging customers different prices for the same service when the price differences are not attributable to differences in cost. Profitable price discrimination is only feasible under the following conditions:

- the supplier must have some market power in at least one market for, in a competitive market, prices would be driven down to a uniform competitive

level;

- the supplier must be able to divide its customers into groups (for example, by different price elasticities of demand or by different geographic locations); and
- the supplier must be able to prevent or limit resales by customers who pay the lower price to those who pay the higher price (in other words, arbitrage must not be possible).

3.20 In effect, a price discriminator is taking advantage of the fact that he can increase price in one market above the price for the same product in another market without losing sales in the former market.

3.21 The logic and language of successful price discrimination is very much the logic used in the SSNIP test to determine relevant markets. Indeed, the existence of the ability to successfully price discriminate is generally taken as evidence that the separate customer groups in question correspond to separate relevant markets on the basis that a price increase in one is not constrained by switching to the other.

3.22 Accordingly, the TA will presume that, where price discrimination would be profitable for a hypothetical monopolist, it is indicative of separate markets corresponding to the separate groups of customers targeted by the hypothetical monopolist.

3.23 The TA accepts that price discrimination may not always be profitable when the necessary conditions are lacking. The presumption can therefore be rebutted by the presentation of evidence that there is no market power over a separate group of customers, customers cannot be divided into groups, and resale is possible.

Product differentiation

3.24 The SSNIP test does not require that all close substitute products included in a market should have the same price. It is possible for a low-quality product with a relatively low price to be an effective demand-side substitute for a high-quality product that is offered at a relatively high price. Where they are effective substitutes, this is referred to as product differentiation within a market.

3.25 It is a feature of telecommunications markets that some basic services such as telephony have tended to become commoditised. To differentiate such services and add value, firms have increased quality, added innovative new services and charged an appropriate premium.

- 3.26 The relevant issue under the SSNIP test is the degree of constraint imposed on the pricing decisions of the hypothetical monopolist. If a price increase relative to another product's price is made unprofitable because of switching responses, then that other product is considered to be a close substitute despite the product and price differentiation. Indeed, the SSNIP test should be more precisely described as an increase in "relative" price test.

Cluster markets

- 3.27 A "cluster" market is a market where competition revolves around the joint supply by one firm of economically distinct but complementary products because of consumer convenience in acquiring them jointly and economies of scope in supplying them jointly in a bundle. An efficient firm supplying the components separately would not be able to compete on a cost basis.
- 3.28 Retail bundling strategies are often the basis on which cluster markets are identified. These strategies are typically aimed at specific customer classes such as corporate, small to medium enterprises or residential customers. For residential customers, for instance, bundled packages of fixed telephony with internet and cable TV may indicate a single "cluster" market in some circumstances, particularly if a single, common technology can be used to provide those services.³
- 3.29 For small businesses, telecommunications operators may seek to provide a full-suite of services to satisfy their typical electronic communications needs. By creating a "one-stop shop" expectation amongst these users, it may be possible to identify an acceptance of bundled services that suggests that operators capable of providing these services will form the core of the market, with niche players being pushed to the fringes. In these circumstances, the focus of any competition analysis may well be on the core "full-service" players.
- 3.30 In deciding whether a "cluster" market exists, the TA will have regard to a number of factors, including whether:
- unbundling imposes identifiable costs on consumers;
 - unbundling costs are substantial relative to the price paid for a bundle;
 - demand for the components in a bundle is correlated among consumers or, alternatively, is focussed on one core component; and
 - a supplier's market share for one component responds in accord with the market share for the other in response to a price change.

³ These and other bundling and cluster market concepts are discussed in the Australian Competition and Consumer Commission's Information Paper *Bundling in Telecommunications Markets*, August 2003.

- 3.31 The concept of “cluster” markets was used by the TA in his Statement of 1 June 2002 on the Application by PCCW-HKT Telephone Limited for Declaration of Non-Dominance in the Market for External Bandwidth Services. The issue was whether the market for external bandwidth services should be considered a “cluster” market that included local connectivity to customer premises in Hong Kong, or whether they should be considered to be separate markets.
- 3.32 In forming the view that it was not a “cluster” market, the TA took into account the following factors:
- PCCW was offering a “mixed” bundle where there is a choice between taking the bundle or taking the component of external connectivity only (or even deciding to not take the bundle or the component);
 - the two services were offered to corporate businesses where it was considered that the costs of unbundling them was likely to be relatively small compared to their total outlays for telecommunications and there were incentives to “shop-around” for the separate components if the price of the bundle is not “right”; and
 - the core component of external bandwidth services is obviously the external circuit. Business customers were essentially demanding this component, with local connectivity being a necessary but secondary consideration after the external core. Accordingly, demand and hence competition were considered to be focused more around the external component than the local component.

The competitive price level and the “cellophane fallacy”

- 3.33 Under the SSNIP test, an increase in price is assumed to be an increase above the competitive price level prevailing in the market. Of course, not all markets are perfectly competitive. In monopolistic or oligopolistic markets characterised by co-ordinated activities (which can occur in deregulated telecommunications markets), the prevailing market price is likely to be higher than competitive levels and may approach the limit of what the market will bear.
- 3.34 In such circumstance, it may not be possible for even a hypothetical monopolist to further increase prices. This lack of an ability to increase prices does not reflect the availability of close substitutes around which the market boundaries should be drawn. Such a market would be inappropriately broad in view of the market power already present in a more narrowly defined market.
- 3.35 The dangers of using current prices as the base price for market definition where that price reflects limit pricing was highlighted by a US case involving

cellophane products⁴. Mistakenly applying current prices that are above competitive levels as a base price has become known as the “Cellophane fallacy” after the case.

- 3.36 Bearing in mind the Cellophane fallacy, the TA will exercise care in determining the appropriate base price in markets that are already less than competitive. Telecommunications markets can raise particular issues due to the fact that prices or other related prices may be regulated. Nevertheless, even if pricing controls are in place, it may still be the case that some prices are above competitive levels. In particular, the TA will not automatically adopt the current prices in the market as the base price where there is a concern that the current prices may reflect market power. If there is considered to be market power, the TA will use a price more reflective of a competitive price. Where future prices can be predicted with reasonable reliability, the TA may use the likely future price without the merger as a relevant base price in defining the appropriate market.

Convergence

Industry comments:

- The Guidelines do not provide sufficient discussion of the issue of convergence between different technologies and markets, particularly in relation to an FTNS operator acquiring a television programme services licensee.

TA response:

- Issues of convergence are relevant to market definition and general competition analysis, and as such will be considered by the TA as a factor in the analytical process described in the Guidelines. In the light of rapid technological advance, it is not appropriate for the TA to make statements in the Guidelines about these matters prior to having assessed them in an actual case. When such an assessment has been made, that case can be used as an illustrative example within the Guidelines.

Sufficiency of demand-side substitution effect

- 3.37 A product is considered to be in the same market as another product if there is a sufficient level of switching to or substitution of that first product to make a price increase in the second product unprofitable.

⁴ *United States v E.I. du Pont de Nemours & Co* [1956] 351 US 377

- 3.38 An effective substitution effect does not depend on all customers switching. Some may remain loyal to the brand, some may even be unable to switch for various reasons. Such customers are often referred to as “captive” customers. However, there may be another group of customers who are prepared to switch in response to a price increase. Such customers are sometimes referred to as “marginal” customers in that they are close to the margin in relation to switching.
- 3.39 So long as there is a sufficiently large enough group of marginal customers who, through the switching of their custom to another product make a price increase unprofitable, that substitution effect is sufficient to conclude that the products being switched to are in the same market.

Chains of substitution

- 3.40 In certain circumstances, apparently distinct products which are not considered to be close substitutes by customers may be considered to be in the same market through a chain of substitution effects (also referred to as “ripple effects”).
- 3.41 For example, while A and C may not be close substitutes, the price of A may constrain the price of C because A and B are substitutable and B and C are substitutable. If there are a sufficient customers at the margin (the “marginal” customers referred to above) between A and B and the margin between B and C who consider the respective products close substitutes, then the price of A will constrain the price of C and A, B and C would be considered to be in the same market.
- 3.42 Where relevant, the TA will look at possible chains of substitution when defining markets so as to ensure that markets are not defined too narrowly (for example, by mere reference to the descriptive labels “wholesale” and “retail”). However, the TA will also look carefully to ensure that markets are not defined too widely (for example, by mere acceptance of claims that there are no breaks in a chain when in fact there is no significant substitution between two adjacent products in the chain).

Supply-side substitution v. market entry

- 3.43 Confusion sometimes arises between what is considered to be a supply-side substitution (a factor relevant to market definition) and entry into a market (a factor usually taken into account in competition analysis once the market has been defined).
- 3.44 Supply-side substitution concerns the ability of firms to switch their production lines at relatively short notice in response to a price increase and supply a close substitute to the product in question. Firms with this ability may not actually be

in the market. However, if they are considered likely to enter rapidly in response to a price increase, they are considered to be market participants because of the constraints that their rapid entry places on a hypothetical monopolist.

- 3.45 On the other hand, market entry may involve significant sunk costs of entry and exit. Sunk costs are capital costs that can only be used in the production of the product in question and which, once incurred, cannot easily be recouped. An example in telecommunications is the cost of network facilities, which cannot easily be recouped if the investing firm decides to exit the market.
- 3.46 It is acknowledged that there can be a fine line between supply-side substitution and new entry. Both are forms of market entry and both represent a constraint on market power. The important consideration is to take them both into account at some stage in the analysis. In the interests of consistency of analytical approach, the TA will assess the constraining effect of any potential market entry when assessing the effect on competition between closely substitutable products in the market once that market is defined by reference to, *inter alia*, supply-side substitution possibilities.

Previous cases

- 3.47 In many cases, a market may already have been investigated and defined by the TA or another competition or regulatory authority. Sometimes, earlier definitions can provide a useful shortcut. However, in the light of the dynamic nature of telecommunications markets, although previous cases can provide useful information, the market definition used may not always be the correct one for future cases. Technological changes may make substitution between products easier or more difficult and, therefore, broaden or narrow the market definition.
- 3.48 In this regard, the TA notes the comments of the European Court of First Instance and its clearly stated view that “... *a market definition in an earlier decision of the European [Commission] could not be binding in the case of a subsequent investigation, ... each case must turn on the particular facts and circumstances at the time.*”⁵ The TA takes the view that while previous cases can be informative, they should not be regarded as binding with respect to future decisions.

⁵ *Coca-Cola v Commission* [2000] 5 CMLR 467

4 COMPETITION ANALYSIS

- 4.1 Having defined the market by using the analytical concept of the hypothetical monopolist, the next issue is to assess the level of competition following the merger or acquisition.
- 4.2 The level of competition in a market is very much influenced by the structural features of the market such as market shares, market concentration, barriers to entry, vertical integration, buying power and import competition. A merger, by its nature, will change the market structure (for example, by changing market shares).
- 4.3 A non-structural factor that may be particularly relevant is sometimes termed the “strategic behaviour” of firms. Such strategic behaviour is directed at altering the market structure itself (for example, by raising barriers to entry) and in this sense goes beyond the normal competitive rivalry between firms.
- 4.4 Accordingly, the TA will take into account these structural factors, and other factors such as strategic behaviour, when assessing the level of competition in a market and the likely effect the merger would have on that level of competition. In this light, merger regulation under section 7P can be seen as regulating market structure. It does not directly regulate market conduct or behaviour, which is the province of sections 7K (anti-competitive conduct) and 7L (abuse of dominance).

Relevant Analytical Issues

- 4.5 Before entering into a discussion of the particular merger factors that the TA will take into account in analysing the competitive effects of a merger, four analytical issues that are considered relevant to any merger analysis are discussed.

Protection of the process, not the competitor

- 4.6 Competition is essentially a dynamic process in a market rather than a static situation where particular conduct may competitively disadvantage a particular competitor at a particular time. Competition by its very nature is a deliberate and ruthless process as competitors jockey for position and seek to injure each other by taking sales away. This is as true for mergers as it is for any other forms of market conduct.
- 4.7 That a particular competitor may be injured or competitively disadvantaged at a particular time does not necessarily lessen competition in a market, let alone substantially (the test of substantiality is discussed below). Indeed, it may be the epitome of the competitive process. As part of the process, disadvantaged competitors would be expected to respond to any competitive initiatives in the

market. It is only when they are unable to respond as a direct consequence of the conduct in question that concerns arise about the effects on the competitive process in a market.

Substantial lessening of competition

Industry comments:

- Further guidance should be provided on what, in the TA's view, constitutes a "substantial" lessening of competition.

TA response:

- The Guidelines contain references to the meaning given to the substantial lessening of competition test in a number of other jurisdictions. They now also contain the most authoritative statement on this issue in the Hong Kong context as recently stated by the Appeal Board.

Substantiality test – creation or enhancement of market power

- 4.8 The TA is required to form an opinion whether a merger substantially lessens competition. While it is not possible to remove the exercise of judgment from merger analysis, substantiality is a test which requires both a quantitative and a qualitative assessment.
- 4.9 The term is useful in avoiding application of the regime to *de minimis* situations where there are barely any discernible effects on the competitive process, such as may occur when there is day-to-day injury to individual competitors but the competitive process remains strong.
- 4.10 However, beyond distinguishing the *de minimis* situations, the TA will interpret a substantial lessening of competition in terms of the creation or enhancement of market power.
- 4.11 Market power manifests itself when there is a firm (or a group of firms in coordination) that is not constrained by other firms in its (or their) ability to increase its price above competitive levels for a significant period of time (or to reduce output or quality). Indeed, this scenario reflects the standard definition of market power used by competition authorities: a firm has market power if it is able to act without competitive constraint in a market⁶.

⁶ This definition was formulated by the European Court in Case 27/76 *United Brands v Commission* [1978] ECR 207

- 4.12 This approach finds precedent in the US 1992 Horizontal Merger Guidelines. Under section 7 of the Clayton Act, a merger is prohibited if its effect may be “...*substantially to lessen competition*”. In full knowledge of this substantial lessening test, the US Department of Justice and the Federal Trade Commission state in the Guidelines (in section 0.1) that the unifying theme of the Guidelines is that mergers should not be permitted to create or enhance market power or facilitate its exercise.
- 4.13 Article 2(3) of the European Commission’s Merger Regulation deals with mergers that “...*create or strengthen a dominant position as a result of which effective competition would be significantly impeded*”. The concept of dominance is similar to that of market power in the sense that they both relate to the ability to act independently without competitive constraint.
- 4.14 In the UK, the Competition Commission guidelines state that the Commission, when deciding whether there is a substantial lessening of competition, will assess whether the merger would increase the market power of firms in the market. Market power is then described as the ability to raise price consistently and profitably above competitive levels.
- 4.15 The Australian Merger Guidelines view market power and a substantial lessening of competition as different sides of the same coin. Australia also has a “substantial lessening” test. The Guidelines state that competition is inhibited where the structure of the market gives rise to market power. “Substantial” in the Australian context has been defined as meaning “*an effect on competition which is real or of substance, not one which must be large or weighty*”⁷ and, accordingly, is regarded as a relatively low threshold.
- 4.16 In the context of section 7N of the Ordinance which prohibits discrimination having the effect of preventing or substantially restricting competition, the Telecommunications (Competition Provisions) Appeal Board has held that the word “substantially” means “*large enough to be worthy of consideration for the purpose of the particular section*”⁸. The Appeal Board went on to observe that for an effect on competition to be substantial, it “*must be at least ‘significant’ but need not be ‘big’*”⁹.
- 4.17 The TA will be mindful of these definitions when considering the facts of a particular case. As explained above, the TA will consider whether a merger creates or enhances market power. If there is a reasonable likelihood that prices in the relevant market will be maintained at a significantly greater level than would be the case in the absence of the merger, or where competitive outcomes would be otherwise distorted, the TA will consider that the merger substantially lessens competition in terms of section 7P of the Ordinance.

⁷ Trade Practices Legislation Amendment Bill 1992: Explanatory Memorandum, para 12, p 4

⁸ Following a UK House of Lords case, *R v Monopolies Commission* [1993] 1 WLR 23.

⁹ PCCW-HKT v TA, Appeal No. 4 of 2002, paragraphs 19-20.

Co-ordinated conduct

Industry comments:

- Notwithstanding international practices, the TA should not take into account how the remaining competitors may co-ordinate with each other in the exercise of market power.
- More guidance is needed on how the TA will assess concerns about post-merger co-ordinated conduct.
- Invoking section 7P because of concern over potential co-ordinated conduct without firm evidence is inappropriate.

TA response:

- The Guidelines reflect international best practice in this area. The TA is not aware of any factor peculiar to the Hong Kong telecommunications industry that indicates he should take any other approach. The Guidelines discuss the relevant issues in some detail, and now includes an example of a decided case from the EU to provide further elaboration.
- The TA will only invoke section 7P where he is satisfied that there is sufficient evidence to justify his intervention. As is made clear elsewhere in the Guidelines, this is a statutory requirement.

Non co-ordinated v. co-ordinated exercise of market power

4.18 A merger may lessen competition in two ways:

- Through non co-ordinated effects, including not only the effects on the merging parties, but also the effects on other firms; or
- Through co-ordinated effects, particularly in oligopolistic markets, by increasing the likelihood of the co-ordinated exercise of market power, either overtly or tacitly, by the remaining competitors.

4.19 The former case represents the typical case of the creation of market power. In the latter case, with a reduction in the number of firms operating in a market, the market power is created by overtly reaching agreement on the terms of co-ordination, by tacitly signalling intentions to other market participants, or by engaging in conscious parallelism. A single merger may raise both types of

concern.

- 4.20 An example of co-ordinated effects is provided by the European case of Vodafone/Airtouch¹⁰. In that case, the European Commission found that the merged entity would have joint control of two of the four mobile operators present on the German mobile market. Given that entry into the market was highly regulated, in the sense that licences were limited by reference to the amount of available radio frequencies, and that market conditions were transparent, it could not be ruled out that such factors could lead to the emergence of a duopoly conducive to co-ordinated effects. The outcome was that the merging parties agreed to divest their interest in one of the mobile operators.
- 4.21 Non co-ordinated effects, which are sometimes referred to as unilateral effects, may be seen where the merger makes it profitable for the merged firm to raise prices (or reduce quality or output) as a result of the loss of competition between the merged parties.
- 4.22 The exercise of co-ordinated market power depends on reaching profitable terms of co-ordination and being able to detect and punish “maverick” firms which have an economic incentive to not follow co-ordinated action. Conditions conducive to co-ordination typically include concentrated markets, product homogeneity and visible pricing.
- 4.23 On the other hand, a firm is more likely to be a “maverick” if it has excess capacity (currently a feature of some telecommunications markets) and low incremental costs (thus making it profitable to charge low prices). It is a feature of network industries, including telecommunications, that services which are provided over networks tend to have low incremental costs. However, any excess capacity amongst the remaining co-ordinated firms may be used as an effective weapon to “punish” a “maverick” firm.

With-and-without test

- 4.24 By its nature, an assessment of whether a merger substantially lessens competition is concerned with the likely effect of the merger on competition in the future.
- 4.25 To assess whether competition has been substantially lessened by a merger, the TA will employ a “with-and-without” test. That is, the level of competition that exists and would be likely to exist in a market without the merger will be assessed and compared with the likely level of competition in the future were the merger to proceed.

¹⁰ Case No IV/M.1430

Market share and market concentration

- 4.26 Market share refers to the share of a market that a particular firm has. It is usually measured in terms of sales volume or revenue. The latter is a particularly useful indicator of market shares in markets characterised by product differentiation and brand loyalty. In telecommunications, the number of subscribers, call minutes, data volume, etc. are obvious measures of sales volume. Transmission capacity or bandwidth may be a relevant form of volume measurement particularly when the transmission service is largely commoditised or undifferentiated. Capacity or reserves may also be useful as a measure of market share in markets where there is volatility in market shares measured in terms of sales volume or revenue.
- 4.27 Market concentration refers to the degree to which a market is dominated by a small number of large firms or made up of many small firms. In theory, the more evenly spread the market shares and the greater the numbers of firms, the more competitive the market. A merger which combines market shares and increases the level of market concentration is likely to lessen the level of competition. The question is: by how much?
- 4.28 High market shares and concentration levels as a result of a merger are generally necessary but not sufficient conditions for the creation or enhancement of market power. On the other hand, a merged firm with only small market share in a relatively un-concentrated market would not normally be able to exercise market power.
- 4.29 As information on market shares and concentration levels, for a variety of market definitions, is obtainable for a pre-merger situation, thresholds on market shares and concentration levels are a relatively low-cost means of screening-out mergers that are not likely to lessen competition (see the section on “safe harbours” at paragraphs 2.6 - 2.13). Post-merger information by its nature is going to be more subjective. As a starting point, post-merger market shares and concentration ratios will be estimated on the basis of historic sales patterns and trends. This is more informative than considering market shares at a single point in time (which might hide the dynamic nature of the market). The TA will then consider any submissions as to how these trend lines may vary, such as through new transmission capacity coming on stream, the introduction of new, innovative services or the issuing of new telecommunications licences.
- 4.30 The actual volume or revenue measure used for market share will depend on the characteristics of the product in question. For example, retail revenues, call minutes or numbers of fixed telephone lines or subscribers are possible measures for measuring market share of fixed public switched telephone network operators, if that is the relevant market. As another example, the TA in his Statement of 15 March 2002 on the Application by Reach Ltd for Declaration of

Non-Dominance in the Market for External Bandwidth Services identified the following potential measures of market share:

- revenue;
- activated capacity (the capacity of external circuits actually being used by customers);
- equipped capacity (the capacity of external circuits, equipped with the necessary termination equipment so that the capacity is readily available);
- total available capacity (activated, equipped and remaining capacity – for example, unlit fibre); or
- upgradable capacity (available capacity after upgrading – for example, by installing dense wavelength division multiplexing (DWDM) transmission technology).

4.31 The TA did not consider that it was necessary to be conclusive on the appropriate measure but noted that a revenue measure was not appropriate for a market characterised by bulk sales of an increasingly commoditised product. The TA further noted that the measures of activated or equipped capacity can be subject to volatile swings due to the signing of new large capacity contracts and, accordingly, undue weight should not be put on market share information at a given point in time. The choice of measure may also be constrained by the availability of reliable data.

Guidance on vigorous and effective competitor

Industry comments:

- More guidance should be given on the concept of ‘vigorous and effective competitor’.
- The TA should elaborate what constitutes “a vigorous and effective competitor”, particularly in the mobile sector.

TA response:

- The Guidelines now include further information on this factor and explain when it will be applicable.

Removal of a vigorous and effective competitor

- 4.32 By its nature, a horizontal merger will usually remove a competitor. However, the resulting higher market shares and concentration levels are generally necessary but not sufficient conditions for the creation or enhancement of market power. A factor which may provide guidance on whether market power is created or enhanced is whether the merger results in the removal of a vigorous and effective competitor.
- 4.33 Not every market will contain a vigorous and effective competitor. There may be no such operator, or it may be the case that all the operators in a market are competing vigorously and effectively. It is only where one particular participant in the market appears to be acting differently to the other players, that this factor will become relevant.
- 4.34 A vigorous and effective competitor may exhibit some of the following features:
- A history of aggressive and independent pricing behaviour rather than being the price follower;
 - A record of being the price leader or superior innovator; or
 - A growth rate that constantly exceeds that of the market.
- 4.35 The more significant the competitive conduct of one or both of the parties to the merger, the greater the likely anti-competitive effect of the merger. If one or both of the parties have been particularly competitive in the market, the TA will be concerned about the likely adverse effect on competition if one of the parties disappears from the market.
- 4.36 Beyond simply removing a vigorous and effective competitor, the merger may create a market structure which is conducive to co-ordinated action or tacit collusion. Vigorous and effective competitors, otherwise known in this context as “maverick” firms, serve to undermine attempts to co-ordinate conduct in a market. The role of “mavericks” has been discussed above in respect of the unilateral and co-ordinated exercise of market power.

Effective competition remaining

Industry comments:

- More elaboration is needed on the factors that indicate ‘effective competition remaining’.

TA response:

- The question of whether there will be ‘effective competition remaining’ constitutes a second order of analysis used to assist in the broader assessment of post-merger

competition. It is therefore not an issue that should be over-emphasised. It is one of a number of relevant factors, and as such is dealt with in the Guidelines in a similar way to those other factors.

Extent of effective competition remaining

- 4.37 In deciding whether a merger has or is likely to have the effect of substantially lessening competition in a telecommunication market, the TA will consider the extent to which effective competition remains or would remain in the market after the merger. In particular, the TA will consider the potential impact of the merger on factors such as price levels, the number of suppliers in the market and the level of product innovation. The extent to which effective competition remains after the merger will be dependent upon the change in the structure of the market brought about by the merger.

Barriers to entry

Industry comments:

- The TA should provide detailed analysis as to how barriers to entry are deemed to affect competition in relation to each type of carrier licence.
- The TA should state how interconnection obligations could reduce apparent barriers to market entry, and how important the availability of spectrum is likely to be in this context in the mobile sector.

TA response:

- The assessment of barriers to entry demands the detailed analysis of factors at the time a particular transaction is being considered by the TA. Like market definition, it is neither possible nor helpful for the TA to attempt to provide *pro forma* guidance on these kinds of issues.
- The TA will consider interconnection and spectrum availability issues in the context of an actual merger, but outside that context it is not possible for him to make useful remarks beyond what already is stated in the Guidelines.

Barriers to entry – Structural

- 4.38 An important structural factor influencing the level of competition in a market is the height of barriers to entry, for the threat of entry is often viewed as the

ultimate regulator of competitive conduct even if the merged firm currently has a high market share.

- 4.39 Barriers to entry are essentially any market features that place an efficient prospective new entrant at a significant competitive disadvantage to incumbents. They include sunk costs, economies of scale and scope, network effects, strategic behaviour, product differentiation and brand loyalty, essential facilities and regulatory barriers. Sunk costs and economies of scale and scope are particular features of telecommunications. These will be discussed in turn before discussing other types of barriers to entry. In view of the importance of strategic behaviour as a barrier to entry, this will be discussed separately in the following section.
- 4.40 As discussed in relation to supply-side substitution, market entry in telecommunications involves significant sunk costs of entry and exit. Sunk costs are the costs of acquiring capital and other assets that:
- are uniquely incurred in entering the market and supplying the services in question;
 - once incurred, cannot easily be physically recovered and redeployed in another market; and
 - cannot be economically recouped within a short period of time (at least one year in view of the time period allowed for supply-side substitution but considerably longer for large infrastructure investments).
- 4.41 Because of their sunk nature, sunk costs create entry risks which increase with the significance of the costs. In turn, significant risks can create significant barriers to entry. The extent of sunk costs depends on a number of factors such as the proportion of capital involved, how that capital is sourced (for example, equity ownership or lease), the requirements for advertising and promotion to create brand awareness, etc.
- 4.42 An example of significant sunk costs typically incurred in telecommunications is the cost of network roll-out, a cost which cannot be recovered nor can it easily be recouped if the new entrant decides to exit the market within a short period. Accordingly, firms considering entry into the market with significant sunk costs must assess the profitability of entry on the basis of long-term participation in the market until the “sunk” capital and assets are economically depreciated. In certain circumstances, the cost of providing a new service may also involve costs which cannot be recovered or easily recouped.
- 4.43 With economies of scale and scope, average costs fall as the supply of services or range of services supplied increases respectively. Falling costs are likely to increase barriers to entry where there are minimum efficient scales of entry.

- 4.44 When combined with sunk costs and excess capacity, the effect of economies of scale in particular can create significant barriers to entry. Having “sunk” the infrastructure costs, there are incentives for incumbents in situations of excess capacity to reap the economies of scale to drop prices and gain necessary revenue flows. Even without any strategic purpose, such action can significantly deter new entrants (as discussed below, such action may indeed be accompanied with that strategy in mind).
- 4.45 Closely related to economies of scale are network effects. By its nature, telecommunications is essentially a network industry and a feature of networks is that they generate network effects (or externalities). Network effects arise when the value a consumer places on connecting to a network (as measured by the price one is willing to pay) depends on the number of others already connected to it. They are a form of economies of scale, but on the demand side.
- 4.46 Network effects generate positive feedback whereby the bigger networks get bigger (and, on the negative side, the weak get weaker). Unrestrained positive feedback can result in the market “tipping” in favour of one competitor and a dominant “winner-takes-all” market outcome. While the interconnection regime under the Ordinance provides for any-to-any connectivity and thus alleviates any negative network effects for new entrants on the demand-side, when combined with economies of scale on the supply side, network effects can create significant barriers to entry.
- 4.47 Reputational barriers established by brand loyalty to incumbents may add to the sunk costs faced by a new entrant in the form of advertising and promotion costs. The ongoing investment in advertising and promotion that is required to maintain a differentiated product will accentuate sunk costs. The nature and extent of the barriers created by brand loyalty and product differentiation can be conceptualised as an investment in sunk costs that is required to shift demand to an unknown brand and create a new differentiated market niche.
- 4.48 In some cases, entry to a market might require the use of an essential facility, an asset or infrastructure where: (1) access to it is indispensable in order to compete on the market; and (2) duplication of the facility is impossible or extremely difficult owing to physical, economic or legal constraints, or is highly undesirable for reasons of public policy.
- 4.49 Denial of access to essential facilities is thus capable of constituting a significant barrier to entry, particularly in telecommunications where access to customers in certain situations has to go through a “bottleneck” or “essential facility”. However, the potential for essential facilities to act as a barrier to entry is alleviated by the interconnection and sharing of “bottleneck” facilities regimes under the Telecommunications Ordinance.

- 4.50 Regulatory barriers can create absolute barriers to entry (for example, a moratorium on new licences). Nevertheless, in Hong Kong, from January 2003, all sectors of the telecommunications market have been fully liberalized and there is no pre-set limit on the number of licences unless physical constraints (such as spectrum availability) exist to limit the number of operators.
- 4.51 However, there will continue to be restrictions on certain types of new entrants. For example, the TA will not consider granting any fixed carrier licences to those applicants who intend to primarily rely on interconnection to and reselling of other operators' infrastructure to roll out their network or provide their services. Furthermore, the TA will take into account the financial capability of licence applicants to fulfil the capital expenditure requirement. Such capital requirements may add to the sunk costs of entry. Another example is that the availability of usable spectrum will continue to constitute physical barriers to entry into the market of certain types of mobile networks (e.g. cellular networks).
- 4.52 Market structure comprises those factors that influence the level of competition in a market. The structure-conduct-performance paradigm (as it has become known) has been traditionally relied upon to analyse the effects on competition of mergers (and other market conduct). In short, "structure" determines "conduct" (the level of competition) which yields "performance" (outcomes, usually measured in terms of efficiency gains or losses).

Barriers to entry – Strategic behaviour

- 4.53 The most important non-structural factor, when assessing barriers to entry, is what is generally referred to as strategic behaviour. Strategic advantages can arise from being in the market first (also known as first-mover advantage). First-mover advantage can allow a firm to shape the way the market develops, for example, by reducing or eliminating entrants to the market.
- 4.54 Strategic behaviour is broadly defined as any actions by a firm to alter the market structure, and so alter the conditions and levels of competition (for example, by raising barriers to entry). As such, it goes beyond the normal competitive rivalry between firms.
- 4.55 An example of strategic behaviour is where an incumbent firm or first mover in the market decides to build excess capacity so as to send credible signals to potential entrants that it could profitably (with economies of scale and low marginal costs) push prices down to levels such that new entrants would not earn sufficient revenue to cover their sunk costs.
- 4.56 It can be seen from the example that being the incumbent or first mover can create advantages that can be used strategically to create barriers to entry which can be as effective as any traditional structural barriers to entry described in the

previous section. They are sometimes described as strategically erected barriers to entry.

- 4.57 Strategic behaviour may also be directed at competitors currently in the market. For example, rather than raising barriers to entry, it may be used to raise rivals' costs. As discussed in the next section, this may be a direct consequence of a vertical merger. However, as for raising barriers to entry, the strategic behaviour may already exist in the market and a merger can heighten any adverse effect on market structure of strategic behaviour.
- 4.58 In assessing the likely effects on competition of a merger, the TA will take into account dynamic factors as well as structural factors in assessing the likely effects on competition of a merger.

Vertical integration and vertical mergers

- 4.59 The issues raised by vertical mergers are very much those raised by vertical integration as a vertical merger is essentially vertical integration through common ownership (the other form of vertical integration being achieved through long-term contractual arrangements).
- 4.60 Vertical integration (or a vertical merger) is the integration of two functional levels in the supply chain. Vertical integration can often be pro-competitive as it allows firms to generate efficiencies, particularly through savings on transaction costs and the achievement of economies of scale.
- 4.61 In industries with high sunk costs such as telecommunications, vertical integration can also help reduce the risk of investment. For example, a provider of telecommunications services carried over someone else's network may wish to integrate upstream into network operation in order to reduce the risk of being held captive to the network owner.
- 4.62 More fundamentally, a vertical merger is less likely to be anti-competitive than a horizontal merger because in a vertical merger, the two merging firms will generally supply complementary products whereas in a horizontal merger in the same market the parties will supply substitute products.
- 4.63 However, particularly in telecommunications, competitors at a downstream functional level (e.g. telecommunications service providers retailing to the public) may have to rely on the supply of an input at an upstream level (e.g. reliance on a vertically integrated network provider to carry their services) while at the same time compete with that upstream supplier's downstream arm.
- 4.64 Where there is market power at one functional level, there are obvious incentives where there is vertical integration (or a vertical merger) to leverage

that market power into the vertically-related market for anti-competitive purposes.

- 4.65 The leverage, for example, may take the form of refusing access to an essential facility that the merged firm has recently acquired control of through the merger to foreclose competition in a “downstream” market where it faces competition. Alternatively, access may be supplied only on discriminatory or competitively disadvantageous terms, thus raising its downstream rivals’ costs. However, as mentioned in the section on barriers to entry, the potential for essential facilities to act as a barrier to entry is alleviated by the interconnection and sharing of “bottleneck” facilities regimes under the Telecommunications Ordinance.
- 4.66 To profitably engage in a foreclosure strategy, one must have market power from which to leverage the strategy. Otherwise downstream competitors relying on the upstream facilities firms would simply bypass the facilities and seek better terms elsewhere in the upstream market (unless the market power is exercised through co-ordinated action).
- 4.67 Accordingly, in assessing a vertical merger for its likely anti-competitive effects, the TA will particularly inquire as to whether:
- there is market power at one or more of the functional levels involved in the merger;
 - there are incentives to leverage that market power into a downstream market with the purpose of lessening or foreclosing competition in that market (for example, where the merged firm operates in a competitive downstream market);
 - the market power was likely to be leveraged (for example, where raising rivals costs in downstream markets through discriminatory access pricing would be profitable and would lessen competition); and
 - the effect was likely to substantially lessen competition in that market.
- 4.68 Co-ordinated action at the upstream level may be used for anti-competitive effect in two main ways:
- to raise the costs of non-vertically integrated downstream competitors by co-ordinating the prices of alternative sources of supply; and
 - to collude on retail prices.
- 4.69 Similarly the TA will consider the potential for a vertical merger to lead to a vertically integrated firm controlling important facilities at the downstream level (e.g. means of distribution in the downstream market) and denying access to

such facilities to competitors or granting access to competitors on discriminatory terms, thereby affecting competition in the downstream market.

Price decreases

Industry comments:

- The TA should take into account not just potential post-merger price increases but also price decreases and other competitive actions that may lead to a substantial lessening of competition.

TA response:

- The ability to raise prices is almost universally used as the primary means of assessing the likely competitive effects of mergers and acquisitions. In any event, it is unlikely that the ability to anti-competitively decrease prices would exist without the company concerned also having the power to raise prices in a manner that would raise concerns under section 7P.

Prices and profit margins

- 4.70 The TA will consider the likelihood of a merger resulting in the merged firm being able to significantly and sustainably increase prices or profit margins.
- 4.71 Sustained price increases above competitive levels are the most visible sign that the merged firm has increased its market power and there is a substantial lessening of competition in the market. The price increase may be used to protect inefficient operations rather than to accumulate excess profits. Another possibility is that a merger, instead of increasing prices, may prevent prices from falling to the competitive level by forestalling entry such that profit margins are preserved or even increased.
- 4.72 Cost reductions which are claimed to result from the merger may not result in lower prices to consumers because the savings are allowed to accrue as increased profits. This would mask any signals to the market and may adversely affect competition.

Buying power or countervailing power

- 4.73 So far, the Guidelines have focused on the exercise of market power on the supply-side. However, market power can be exercised on the demand-side by monopsonists or groups of buyers acting together to depress prices below their

competitive levels. The effects are comparable to those associated with the exercise of market power on the supply-side.

- 4.74 Generally, the market power (sometimes referred to as buying or bargaining power) must be supported by a credible threat to bypass the supplier if no acceptable deal can be bargained. This may not always be the case in telecommunications when the existence of alternative suppliers may be constrained by the presence of “bottleneck” or essential facilities, particularly the local loop or the network to which the originating or terminating customers are directly connected. While it may not be common in telecommunications, should it occur the TA will assess the effects of any demand-side market power in an analogous fashion to assessing supply-side market power.

Efficiencies

Industry comment:

- There should be no limit on the efficiencies the TA will take into account, the parties should not have the onus proving efficiencies and the required proof should not be higher than for other factors.
- The requirement for evidence of efficiency claims should be only that “the efficiencies must be clear and very likely to arise”, therefore avoiding the need for verification.
- The TA should bear the burden of proving that claimed efficiency gains are not relevant or not sufficient to overcome a finding of a substantial lessening of competition once the merger proponents have presented a *prima facie* case.

TA response:

- The Guidelines have been amended to describe in greater detail the TA’s approach in this area and how it is consistent with the approach adopted in other jurisdictions.
- The TA does not limit the kinds of efficiencies that can be claimed by merger proponents. He does expect, however, that the parties will present their strongest case not only because it is in their interests to do so but also because they are likely to be better placed than the TA or anyone else to identify and describe these efficiencies.
- Further discussion on the onus and burden of proof relevant to the assessment of efficiencies and other issues is provided further above.

Efficiencies

- 4.75 As mentioned, a fundamental objective of competition policy is to increase economic efficiency. Economic efficiency has three components:
- productive efficiency, which is achieved where a firm produces the goods and services that it offers to consumers at least cost;
 - allocative efficiency, which is achieved where resources in the economy are allocated to their highest valued uses (ie, those that provide the greatest benefit relative to costs); and
 - dynamic efficiency, which is an on-going process of introducing new technologies and products in response to changes in consumer preferences and production techniques.
- 4.76 In relation to productive and dynamic efficiencies, competition seeks to achieve these efficiencies organically or internally within the firm. However, mergers also have a potential to generate significant efficiencies by permitting a better utilization of existing assets and the realization of economies of scale and scope which would not have been available to either firm without the merger.
- 4.77 Efficiencies generated through a merger can enhance the merged firm's ability and incentive to compete. For example, merger-generated efficiencies may enhance competition by permitting two ineffective high-cost competitors to become one effective low-cost competitor. If the efficiency gains are translated into a more vigorous competitor, competition in the market as a whole would be increased rather than lessened by the merger.
- 4.78 Furthermore, in markets with conditions conducive to co-ordinated conduct, an efficiency-enhancing merger can undermine those conditions by increasing the incentive for a "maverick" to break from the pack or, indeed, by creating a new "maverick" firm.
- 4.79 To the extent that an efficiency-enhancing merger increases competition by creating a more vigorous competitor, the TA may consider the efficiency gains to be a relevant matter to take into account in forming an opinion whether the merger substantially lessens competition. However, the TA would need to be satisfied on the following points:
- the efficiency gains must occur as a direct result of the merger ("merger-specific efficiencies");
 - the efficiencies must be clearly identified and verified ("recognizable efficiencies"); and

- the efficiency gains must translate into more a effective level of competition from the merged entity than the level that was offered by the merging parties separately (“translated efficiencies”).

4.80 It must be demonstrated that the efficiencies will be achieved by the merger and would be unlikely to have been achieved without the merger (for example, internal re-organisation) or by another means having comparable or less significant anti-competitive effects (for example, a joint venture arrangement).

4.81 Efficiencies are often difficult to verify and quantify, in part because much of the information relating to efficiencies is uniquely in the possession of the merging firms. Moreover, efficiencies projected reasonably and in good faith by the merging firms may not be realized. Nonetheless, efficiency claims must be substantiated by the merging parties so that the TA can verify by reasonable means:

- the likelihood and magnitude of each claimed efficiency;
- how and when each efficiency would be achieved;
- how each efficiency would enhance the merged firm’s ability and incentive to compete; and
- why each efficiency would be merger-specific.

4.82 Certain types of efficiencies are more likely to be identifiable and more substantial than others. For example, efficiencies resulting from the shifting of telecommunications traffic from formerly separately owned networks onto the one network may result in a reduction in marginal costs which are merger-specific, identifiable and quantifiably substantial. Other efficiencies, such as those relating to research and development, are potentially substantial but are generally less verifiable. Others, such as those relating to procurement, management, or capital cost, are less likely to be merger-specific or substantial, or may not be as identifiable.

4.83 The standard of proof for demonstrating the likelihood and likely magnitude of merger-related efficiencies varies across jurisdictions. In the EC, claimed efficiencies must be “reasonably certain”¹¹ and “substantial, timely and verifiable.”¹² In the UK, they must be “clear and incontrovertible.”¹³ In Australia, the ACCC requires “strong and credible” evidence of efficiencies during its assessment of the competitive impact of a particular merger.¹⁴ The TA will need to be reasonably satisfied that the efficiencies are real and comply with the

¹¹ European Community Merger Regulation.

¹² EU Draft Merger Guidelines.

¹³ Enterprise Act 2002.

¹⁴ Trade Practices Act, Merger Guidelines.

requirements specified above (in paragraphs 4.73 – 4.75).

- 4.84 An increase in competition manifests itself in lower prices, improved quality and service, new products and more choice. However, an increase in efficiency through merger may not be passed on to consumers in the form of increased competitive activity and lower prices, etc. The TA needs to be satisfied that this will not be the case.
- 4.85 A merger effectively reduces the number of competitors in a market by one and there is a presumption that it will lessen competition (though not necessarily “substantially” lessen competition). For this reason, efficiencies are only likely to make a difference in merger analysis when the likely adverse effects on competition, absent the translated efficiencies, are not great. Efficiencies alone would almost never justify a merger where it would result in an oligopoly or monopoly.

Failing firm defence

Industry comments:

- The TA should adopt a more lenient approach towards the failing firm defence, given the pro-efficiency effects of mergers and acquisitions of failing firms, eg avoiding disruption to service, loss or employment and user inconvenience etc.
- There should be no negative presumption about the acquisition of a failing firm when its assets do not exit the market.
- The burden of proving the acquisition of a failing firm would substantially lessen competition should rest with the TA.

TA response:

- The failing firm defence is a way of avoiding a competition analysis of a particular merger or acquisition, and as such needs to be rigorously tested. The TA will adopt an approach which is consistent with that adopted in other leading competition law jurisdictions, including Australia, New Zealand, the US, the UK, the EU and Singapore.
- The TA does not presume that the acquisition of a “failing firm” whose assets do not exit the market will substantially lessen competition. However, like other regulators he intends to assess this situation as he would assess any other acquisition using the assessment process described in the Guidelines.
- The burden of proving any acquisition is anti-competitive rests with the TA, as is acknowledged in the Guidelines. In the present context, it requires the TA to

undertake the usual competition assessment as described in the Guidelines.

Failing firms

- 4.86 At first glance, one would expect that the acquisition of a failing or failed firm would not substantially lessen competition. In some instances this may be the case. However, there may be circumstances where the acquisition of a failing firm may substantially lessen competition. As the issue is essentially whether the acquisition of a failing firm will affect competition, it is a relevant matter for the TA to take into account when forming an opinion whether the merger substantially lessens competition.
- 4.87 Accordingly, in analysing the issue, the TA will need to be satisfied that:
- the firm is likely to experience commercial failure, if the firm has not already failed;
 - without the acquisition, the assets of the firm will exit the market; and
 - the firm has made unsuccessful, good-faith efforts to elicit reasonable alternative offers to acquire its assets that would keep those assets in the market and would pose less severe danger to competition.
- 4.88 If all three conditions are satisfied, then subject to the considerations in the following paragraph, the competitive effects of the firm being acquired by the acquirer are likely to be no worse than if the assets were allowed to exit the market. A competitive influence that would otherwise have been removed by failure is to be removed by acquisition. Thus, in the absence of other considerations, the acquisition would be unlikely to cause concerns from a competition perspective.
- 4.89 One issue that may arise in this scenario, however, is the distribution of the failing firms' customer base if this base is of significant proportions in terms of market share. If the assets exited the market, the distribution of the failing firm's customer base among the remaining market participants would be determined by market forces, whereas an acquisition would tend to deliver those customers to the acquiring firm thus increasing its market share.

Extent to which substitutes are available

- 4.90 In considering the extent which substitutes are available in the market, both existing and potential substitutes from the supply side and the demand side will have to be included. This identification of demand and supply side substitution underpins the market definition process (as explained in section 3). In

considering the extent to which substitutes are available, the TA may also consider the price elasticity of supply of the firms in the market post merger. Unless the producers of the substitutes are able to increase the supply to meet the demand of customers of the merged firm switching suppliers in response to a material price increase of the merged firm, the existence of the substitutes in the market would not be an effective restraint to the exercise of market power by the merged firm. It may therefore be necessary to consider the relative supply capacity of the firms in the market after the merger, as well as the costs of capacity expansion. If the merged firm ends up controlling a majority of the capacity in the market, the other firms in the market may not be able to provide much competitive restraint.

Import competition

- 4.91 Import competition can be viewed as either a form of new entry or supply-side substitution, depending on the circumstances. In an open trading economy such as Hong Kong, import competition can play an important role in restraining the exercise of market power. An example of import competition in the telecommunications industry is the provision of international telephone services to Hong Kong users by service providers not operating in Hong Kong. In considering the effectiveness of import competition as a restraint to the exercise of market power, the capacity of supply of overseas suppliers and speed of entry into the domestic market have to be considered.
- 4.92 In most segments of the telecommunications industry where physical presence in Hong Kong is necessary for the supply of services, the threat of import competition would not be relevant.

Other factors – dynamics and technological change

- 4.93 The factors mentioned above are not exclusive. The TA will take other factors into account when relevant to assess the likely anti-competitive effects of a merger.
- 4.94 Telecommunications is characterised by dynamic and rapid technological changes. In such an industry, market boundaries are not likely to remain constant. Digitalisation and convergence in particular are changing the structure of telecommunications markets and the nature of competition within those markets. For example, networks based on the Internet Protocol (IP) are conveying a range of services such as high speed Internet access, voice and video telephony and television programme services.
- 4.95 As technology develops certain sectors of the market will grow significantly while other sectors will decline as a result of substitution. While mobile services

are now viable substitutes for paging services for most applications, voice over IP services are increasingly viable substitutes for traditional circuit-switched telephony services.

4.96 In a such a dynamic industry where market boundaries can rapidly change through changing conditions of competition and substitution possibilities, the traditional indicators of anti-competitive concern in more stable markets (such as high market shares) may not be as prescient.

4.97 However, digitalisation has released divergent competitive forces which have yet to be fully played out:

- on the one hand, it has facilitated the development of alternative conveyance networks (for example, the broadband fixed wireless access and 3G mobile networks), thus reducing any market power in incumbent networks; and
- furthermore, economies of scale from the ability to deliver a range of services over one network may facilitate greater alternative network roll-out; but
- the economies of scale and scope usually associated with digital networks may lead to market power in wholesale conveyance networks and service platforms which may in turn be vertically leveraged into retail markets (for example, control over the local loops being leveraged into Internet service provision); and
- market power in a particular service (for example, fixed line telephony) transmitted over a particular network may be horizontally leveraged into other retail markets (for example, into Internet service provision).

4.98 It is not the purpose of these Guidelines to predict how telecommunications markets will evolve in the face of digitalisation, convergence and other changes. However, the TA will fully take into account the dynamic changes occurring in the industry when assessing the effects on competition of mergers and acquisitions involving any licensed telecommunications carriers.

5 BENEFIT TO THE PUBLIC

Public benefits

Industry comments:

- The TA's public benefit analysis should be confined to factors external to competition, eg other than efficiency claims which should be assessed during the TA's competition analysis prior to assessing public benefits.
- It is not clear why public benefits will only be considered if they are real, will be realised within a reasonable time and are sustainable.
- The TA should provide guidance on what public benefits he would consider.
- There should be no requirement for public benefit 'performance bonds' to be given by merger proponents.

TA response:

- The TA does not wish to limit the public benefits that might be claimed by merger proponents. However, any benefits which relate directly to competition (such as claimed efficiencies) will be considered during the prior competition analysis.
- The TA considers he has a responsibility to ensure that claimed benefits are real, rather than merely illusory, and therefore adopts the usual tests accepted as normal practice in other countries.
- The TA has added examples of the kinds of public benefits he would consider for any given merger, however he does not want this list to be read as exhaustive or in some way limiting the kinds of public benefit claims that merger proponents may wish to make.
- The requirement for 'performance bonds' has been deleted from the Guidelines.

- 5.1 In investigating a completed merger or acquisition under section 7P(1) or considering an application for consent for a proposed merger or acquisition under section 7P(6), if the TA forms an opinion that the merger or acquisition has, or is likely to have, the effect of substantially lessening competition in a telecommunications market, he will proceed to consider whether the merger or acquisition has, or is likely to have, a benefit to the public and that the benefit outweighs any detriment to the public that is, or is likely to be, constituted by the anti-competitive effect.

- 5.2 The party claiming that the merger or acquisition has, or is likely to have, a benefit to the public that outweighs any detriment to the public arising from the substantially lessening competition caused by the merger or acquisition should state in the information provided to the TA in an investigation under section 7P(1) or application submitted under section 7P(6) what the claimed public benefit is, the likely magnitude and timing of the benefit and provide detailed and verifiable evidence of such benefit. General and unverifiable claims of public benefit are unlikely to be given much weight in the TA's consideration.
- 5.3 The TA will need to be satisfied that the public benefit is real, likely to be realized within a reasonable period after the merger or acquisition, likely to be sustainable and would not be achieved if the merger or acquisition did not go ahead. The TA will also need to be satisfied that the public benefit outweighs the detriment to the public constituted by the anti-competitive effect of the merger or acquisition.
- 5.4 Since "benefit to the public" is not defined in the Ordinance, the TA is able, in principle, to consider any benefit which he believes may be relevant. While the parties are free to put forward any benefits which they consider may outweigh the anti-competitive detriments of the merger, the TA is more likely to be persuaded by economic reasoning since a merger or acquisition is essentially an economic transaction.
- 5.5 The Guidelines can only provide examples of the type of public benefits that the TA will consider. Consumer benefits that the merger or acquisition is likely to generate, despite the substantial lessening of competition in the market, may be relevant. Such consumer benefits may include more innovation, perhaps as a result of engagement in research and development activities. They could also include wider choice, higher capacity or better quality of services as a result of investment in network infrastructure. Continuity of service that cannot be achieved without the merger or acquisition might be another example. Enhancing the international competitiveness of Hong Kong industry might also be considered a benefit to the public.
- 5.6 Any claim of public benefit arising from the merger or acquisition must be justified by the parties, so that the TA can verify by reasonable means, that the benefit is one which should be taken into consideration. The parties will need to show the following:
- that the public benefit will occur as a direct result of the merger;
 - the likelihood and magnitude of the claimed benefit;
 - how and when the benefit would be achieved; and
 - how the benefit would be passed on to consumers, in whole or in part.

6 PROCEDURES

- 6.1 Since there is no requirement to notify mergers or to obtain approval, the TA will keep himself informed about merger activity by monitoring the media and relying on third parties, such as competitors, to bring transactions to his attention. However, the TA anticipates that parties to a merger will wish to contact the Office of the Telecommunications Authority (OFTA) at an early stage to establish whether the TA has any concerns about a proposed transaction. Informing the TA in advance may enable the parties to identify any potential competition concerns and to address the issues in good time, as well as minimizing the risk that a completed transaction will be ordered to be undone or modified following a detailed investigation. Parties are therefore encouraged to contact OFTA at the earliest opportunity to discuss the application of the merger provisions of the Ordinance.
- 6.2 There are a number of ways in which a merger can be considered by the TA, as follows:
- informal advice
 - application for prior consent
 - *ex post* investigation.

Pre-merger consultation

Industry comments:

- Far more guidance is required on the pre-merger consultation process.

TA response:

- The TA has previously emphasised the importance he places on pre-merger consultation with interested parties. Because these discussions will be informal, he considers it appropriate not to set out rigid procedures which may not be suitable in a particular case. The aim is ensure that the discussions will proceed in a way that best suits the needs of the parties to the merger. This approach is common in most other competition law jurisdictions that do not have a mandatory pre-merger notification requirement.

Informal advice

- 6.3 To assist licensees and their advisers when planning mergers, the TA is willing to

provide informal advice on a confidential basis. The TA would be prepared to advise on a proposed transaction which is not yet in the public domain. Since the advice would be given without the benefit of any third party views being made known to the TA, the advice would not be binding on the TA in any way. It would simply be a preliminary view to assist the parties. The advice, however, would be confidential to the party requesting it and the TA requires the party concerned (and its advisers) to agree not to publish the advice or to disclose it in any other way without the TA's prior consent, even after the merger has been made public.

- 6.4 Parties seeking informal advice should provide the TA with concise details of the transaction, using as a guide the check list of information for an application for prior consent, which is to be found in the **Annex** to these Guidelines. The quality of the information provided will determine the extent to which the TA can provide useful advice. Information provided in writing at least several days before a meeting is likely to be the usual format.
- 6.5 There is no timetable for providing informal advice, but the TA will try to deal with requests within the parties' requested time frame, where that is possible.

Applications for prior consent

- 6.6 Under section 7P(6) a party to a proposed merger can apply in writing to the TA for consent to a transaction. The TA can consent to the application, give consent subject to conditions or refuse to give consent. Before forming an opinion on how to determine the application, the TA is obliged to give the parties to the transaction and all carrier licensees, a reasonable opportunity to make representations. The TA is obliged to consider the representations, if any, before taking any action. The TA's determination of the application is final in so far as it prevents the TA from reconsidering the same merger transaction if or when it takes place.
- 6.7 To facilitate the efficient and speedy processing of applications for prior consent, the TA has produced a check list (see the **Annex**) which sets out the general information requirements. Parties are strongly encouraged to contact OFTA before submitting an application, to discuss the types of information which the TA would need in a particular case. These early meetings might also identify additional useful information that might accelerate the TA's consideration of a proposed merger. Parties are then requested to submit the relevant information as part of their application.
- 6.8 The proposed transaction should be in the public domain when the application is submitted. If the transaction is not in the public domain, the TA will ask the applicant to give consent for the TA to consult the public as a pre-condition for accepting the application. This ensures that the TA is able to solicit views from

third parties, which are a vital element of any assessment, and enables the TA to consult all carrier licensees, which he is obliged to do. The TA will publish a notice on the OFTA web site stating that the application has been received, giving brief details of the proposed transaction and inviting representations.

- 6.9 In cases which do not raise serious competition issues, the TA will give consent to the application within one month of receipt of the application. When a detailed investigation is necessary, the TA will give a final decision within 3 months of receipt of the application. The TA will evaluate the application in the same way that he would evaluate an *ex post* investigation. The TA's decision will be published (see paragraphs 6.19 - 6.21 below).

***Ex post* investigation**

- 6.10 The TA is empowered by section 7P(1) to examine a change, as defined in the Ordinance, in relation to a carrier licensee. The relevant change is defined in section 7P(16) with reference to 3 thresholds, as explained in paragraphs 1.9 – 1.12 above. Within 2 weeks after the completion of the transaction has been publicly announced or made known to the TA, the parties will be notified if the TA wishes to carry out a detailed investigation.
- 6.11 As soon as it appears to the TA that a detailed investigation is justified, a notice will be published on the OFTA web site stating that an investigation has been started, giving brief details of the transaction and inviting representations. At the same time the parties to the merger will be asked to provide the TA with the information which is required to assess whether the TA should intervene in the transaction. The TA will request the relevant information set out in the check list for an application for prior consent (see the **Annex**). The information will usually be sought under section 7I of the Ordinance or the relevant licence condition. This should avoid any undue delay in the investigation process, but where the parties do not comply with an information request, the time frame for considering the case may need to be extended. The detailed investigation will be completed within 3 months unless the parties fail to meet the deadlines specified in information requests.
- 6.12 The TA is statutorily bound by section 7P(3) to consult all carrier licensees in the market, but under section 6A(3)(a), the TA is required to have regard to relevant considerations in forming an opinion or making a direction or decision. The TA may therefore wish to make market inquiries which could include consulting with competitors, suppliers, customers, industry associations and consumer groups including the Consumer Council and consider their views in so far as they are relevant. The TA may also carry out some independent research, for example to help assess the degree of competition in the relevant market.
- 6.13 The TA will carefully consider all the information and submissions received

from the parties to the merger and from third parties. Once the TA has evaluated all the available information, a decision will be drafted setting out the TA's preliminary conclusions. This draft decision will be sent to the parties to the merger and they will be invited to comment within a specified time limit.

- 6.14 The TA will then reconsider the draft decision in the light of the representations made by the parties to the merger. A final decision will be prepared. The decision will be sent to the parties to the merger at the same time as, or immediately prior to a public announcement (see paragraphs 6.19 – 6.21 below).

Remedies

Industry comments:

- The TA should provide more explanation as to the kinds of remedies he would consider to overcome a concern about a merger being likely to substantially lessen competition.
- The TA should not give preference to structural remedies over conduct or behavioural remedies as conditions for approving a merger.

TA response:

- The TA has described the kinds of remedies he is likely to consider, but he does not consider it appropriate to attempt to identify specific remedies he may be likely to apply in particular scenarios.
- The TA's preference for structural remedies is consistent with the approach adopted in other leading competition law jurisdictions. It reflects the view that a structural solution to a section 7P concern is entirely consistent with the objectives of this regulation and avoids the TA having to devote his resources to ensuring ongoing compliance with behavioural requirements.

Remedies

- 6.15 When the TA forms an opinion that a merger has, or is likely to have, the effect of substantially lessening competition, he can by notice direct the licensee to take such action as he considers necessary. However, the notice may not be issued if the TA is satisfied, in the case of a completed transaction, that the merger has or is likely to have, a benefit to the public which outweighs any detriment to the public which will, or is likely to, result from a substantial lessening of competition. Similarly, when considering a proposed merger, the TA may decide to give consent without issuing a direction to the parties, if he is

satisfied about an overall benefit to the public.

- 6.16 In circumstances where the TA takes the view that it would be appropriate to require the parties to modify a merger, he will consider both structural and behavioural remedies. In general, structural remedies will be preferred. These could include divestment of part of the merged business through the disposal of assets or shares. Typically this might involve an overlapping business. The TA would require the disposal to be made within a specified time limit.
- 6.17 Behavioural remedies may be appropriate where the TA wishes to ensure that the merged company does not behave in an anti-competitive way after the merger. For example, the parties may be required not to undertake a particular course of conduct made possible by the merger. The TA may wish to consult third parties on any proposed remedies.
- 6.18 The parties to the merger can always take the initiative and propose suitable remedies to meet the concerns of the TA, either in the initial representations or at a later stage. However, the late submission of proposals may delay the conclusion of the investigation process.

Announcement of investigations and publication of decisions

- 6.19 As noted above, the TA will publish a notice on the OFTA web site to announce the commencement of an investigation. This will occur when the TA receives an application for prior consent, and also when the TA decides, on his own initiative, to carry out a detailed investigation of a completed transaction. A public announcement will also be made if the TA decides to open a detailed investigation after a preliminary consideration of an application for prior consent. The publication will always take place after 4.00pm when the Hong Kong Exchanges and Clearing Limited (“Hong Kong Exchange”) is closed. Notification will be sent at the same time to the Hong Kong Exchange. This does not in any way amend or vary the parties’ obligations under the Listing Rules. The parties should make their own arrangements with the Hong Kong Exchange for any announcements under the Listing Rules relating to the publication of the TA’s announcements.
- 6.20 The TA’s final decisions will be published. Section 7P(14) requires the TA to publish, in such manner as he considers appropriate, any opinion, decision or direction made in relation to a proposed or completed merger. The decisions will be published after the Hong Kong Exchange closes, as explained in the previous paragraph. Publication will generally take place in two stages. Firstly, publication of the actual opinion, decision or direction will take place at the same time as, or very soon after, it is communicated to the parties to the transaction. The decision will be notified to the Hong Kong Exchange at the same time. Then the full text setting out the TA’s reasons will be published as

soon as the parties have had an opportunity to comment on confidential material, if any, contained in the text. This will allow the parties to request the TA to delete any information in the decision which they consider to be commercially confidential. The TA anticipates that he will be able to publish the full text within a week or so of announcing the outcome.

- 6.21 In every case where the TA receives an application for prior consent, or opens a detailed investigation of a completed merger on his own initiative, a final decision will be published. However, in circumstances where the TA decides not to investigate a completed merger, no decision will be published.

Confidentiality

- 6.22 The TA will observe strict confidentiality in all aspects of the investigation of mergers. The parties to a merger will also have the opportunity to request the deletion of material in the TA's decision which they consider to be commercially confidential, when they see a final copy prior to publication.

- 6.23 The TA will not normally publish submissions received in a merger investigation because much of the material is likely to be of a commercially confidential nature. However, there may be occasions when the TA will consider it appropriate to publish a submission or part of a submission, in order to elicit comments from third parties. The TA may ask the parties to provide a non-confidential version of the submission. This is most likely to arise in relation to submissions made by the parties to a merger concerning claimed benefits to the public.

Fees

- 6.24 The costs or expenses incurred by the TA in processing an application for prior consent and making a decision on the application, are recoverable as a debt due to the TA from the applicant. The TA will charge the actual costs and expenses incurred and will maintain a time recording system to compute the cost of staff time involved, which is likely to be the largest single item of expense. The amount recoverable by the TA is subject to a cap which is currently set at \$200,000. The TA will not recover any costs or expenses when investigating a completed merger or giving informal advice.

Annex

**Application for prior consent to a merger under
section 7P(6) of the Telecommunications Ordinance**

Check list of information required

Information disclosure

Industry comments:

- The TA should address concerns over the extent of the information to be required from the parties to an M&A transaction, and in particular explain the relevance of particular information to his assessment.
- Information should not be required where the information is subject to legal professional privilege, or if to provide the information would be a breach of the law or if compliance would be overly burdensome.
- The Guidelines should state that for simple cases, on a case-by-case basis, the TA will be willing to agree to the provision of less information than is described in the Annex to the Guidelines.
- Information requirements as listed in the Annex to the Guidelines are excessively burdensome, involve extremely commercially sensitive or privileged information, or are purely speculative or irrelevant.
- The TA should also request any future business plans for the proposed merged entity.

TA response:

- The Guidelines have been amended so that the information required from the merger proponents can be divided into two lists. The first list (List A) indicates the information that will be required in all cases. Some or all of the information in the second list (List B) will be required depending on the transaction in question.
- In accordance with international best practice, the TA also reserves the right to request further information where necessary. It will therefore be advisable for merging parties to consult early with the TA as to the kinds of information required, and the kinds of information not required, in a particular case.
- In addition to the creation of a new “List A and List B” approach, the TA reiterates

his interest in early discussions with merger proponents to identify relevant and irrelevant information for the purposes of his section 7P analysis. This case-by-case approach is something the TA seeks to encourage.

- As to limitations on the information the TA can request, the merger parties are free to explain their reluctance to supply particular documents or other material, but they should also work co-operatively with the TA to ensure that the review process is undertaken as efficiently as possible.
- The TA's list of information required for him to assess a merger is not excessive by international standards, nor is it unusual.
- Concerns over the disclosure of commercially sensitive information should be allayed by the TA's normal confidentiality safeguards and in any event cannot in themselves be a reason for not providing information for the purposes of a section 7P assessment.
- Business plans are commonly required by regulators in merger review assessments largely because they indicate the expected effect of a merger on competitive dynamics, the commercial justifications for a particular transaction and the significance of any efficiency and public benefit claims.

Applicants are requested to discuss with OFTA the information requirements of a particular case, before submitting an application. The exact requirements will depend on the circumstances of the case. The TA will require all of the information in list A below in all cases, and some or all of the information in list B. The TA may also require other additional information. Please provide the information using the paragraph numbers of this form, and supply a copy of all documents requested.

List A

General information

1. State the name and address (registered office) of the carrier licensee or "interested person" on whose behalf this application is submitted.
2. If a representative has been appointed to act on behalf of the applicant, please state the name and address of the representative. An applicant can appoint a representative to submit the application on its behalf and to act for it in further correspondence with OFTA. To authorise a representative, please complete and sign the declaration attached to this form. The authorisation may be changed or withdrawn at any time but the change will only be effective when written notice is received by OFTA.
3. Provide the following details of the person to whom OFTA should send all

correspondence relating to this application:

Name
Hong Kong address
Telephone number
Fax number
E-mail address

4. State the name and address (registered office) of the acquiring company and the target company.
5. State the type of transaction (for example, whether it is an agreed bid, a full takeover or the acquisition of a minority shareholding or a joint venture).

Description of the proposed merger

6. Give details of the ownership and control of the acquiring company, and the target:
 - (a) before the merger; and
 - (b) following the merger.
7. Provide full and complete details of the proposed change in the carrier licensee. This will include share acquisitions, changes of directorships etc and any factors upon which the completion of the merger is conditional.
8. State the expected time scale for (i) exchange of contracts; and (ii) completion of the merger.
9. Provide a brief description of each product or service of the acquiring company and the target in the telecommunications sector and identify any areas of overlap.
10. State the commercial rationale for the merger.
11. In the event that the applicant wishes to propose any conditions to address possible competition concerns arising from the merger, please attach a separate statement describing the proposed conditions and the way in which they will address these competitive concerns.
12. Provide a description of any efficiencies that you believe the merger will bring (attach any appropriate supporting documentation).
13. Provide details of any benefit to the public which you believe will result from the merger, including but not limited to what the claimed public benefit is, the likely magnitude and timing of the benefit and detailed and verifiable evidence of such benefit. Please explain whether, and if so, how any such benefit might outweigh

any detriment to the public which would result from any substantial lessening of competition.

Declaration

14. The applicant should sign and enclose the declaration attached to this form when submitting an application.

List B

15. Explain how the transaction qualifies as a change in relation to a carrier licensee as defined in subsection 7P(16) of the Telecommunications Ordinance.
16. Provide details of the group structure of the acquiring company and the target (including the ultimate holding company and all subsidiaries in the telecommunications sector). This could be illustrated by the use of organisation charts or diagrams.
17. List all the other companies in the telecommunications sector in which either the acquiring company or the target hold more than 5% of the voting rights, issued share capital or other securities, and state the percentage held.
18. List any members of the board of the acquiring company or the target who are also members of the boards of any other companies in the telecommunications sector, and identify the other companies, and the position held.
19. List all the telecommunications licences held by the acquiring company, the target and their affiliated companies.
20. State whether the transaction has been notified for approval in any other countries.
21. Briefly describe the steps taken to publicise the proposal and enclose a copy of any press release or report (including those in specialist or trade journals) and details of any notifications to listing authorities.
22. Provide two copies of the most recent annual report of the acquiring company and the target. If annual reports are not available, please provide the audited financial accounts (including a profit and loss account; and pro forma balance sheet showing total turnover and profit before tax).
23. Provide the business plans for the acquiring company and the target for the current and previous year and any business plan prepared for the post-merger entity.

24. Supply a copy of the final or most recent version of the contract(s) giving effect to the merger, or a copy of the offer document in a public bid.
25. Provide a definition of the relevant product and geographic markets for the purposes of this application (that is, the market or markets in which the carrier licensee(s) will operate).
26. For products or services identified in question 9 above, please provide:
 - (a) a brief description, in terms of characteristics/price differences, of any product(s) or service(s) that might be considered close substitutes, on the demand or supply side;
 - (b) the market share (in terms of monetary value, volume/capacity and subscriber base) of the acquiring company, the target and all affiliated companies in the telecommunications sector;
 - (c) the contact details (to include contact addresses, e-mail addresses, fax and telephone numbers) and market shares of the acquiring company's and the target's top five competitors (including overseas companies/importers) for each product or service; and

the contact details (to include contact addresses, e-mail addresses, fax and telephone numbers) and estimated share of the business of both the acquiring company's and the target's top five customers (including overseas customers where appropriate) for each product or service.
27. For the product and geographic market(s) identified in question 25 above, please provide:
 - (a) an assessment of the level of competition in the market and a description of how competition works in the market;
 - (b) an estimate of the capital expenditure required to enter the market on a scale necessary to gain a 5 per cent market share, both as a new entrant, and as a company which already has the necessary technology and expertise. Please estimate the extent to which this cost is recoverable should the firm decide to exit the market;
 - (c) an estimate of the ratio of annual expenditure on advertising/promotion relative to sales required to achieve a market share of 5 per cent;
 - (d) details of any other factors affecting entry, e.g. licensing requirements, technology or R&D requirements, length of contract etc including, where possible, an estimate of the time and resources necessary to overcome these factors, citing any relevant examples; and

- (e) an assessment of the ease of exit from the market citing any relevant examples.
28. Provide details of any shareholding agreement or joint ventures with other operators in the telecommunications sector.
 29. Provide a brief assessment of any other features of the market that the TA should take into account in considering the effect of the merger.
 30. Provide copies of analyses, reports, studies and surveys submitted to or prepared for any member(s) of the board of directors or the shareholders' meeting, for the purpose of assessing or analysing the proposed transaction with respect to competitive conditions, competitors (actual and potential), and market conditions. Please indicate the date of preparation of these documents.

DECLARATION

This declaration is to be signed by the applicant.

1. I acknowledge that the TA may bring the existence of the proposed change in the carrier licensee described in this application, and the fact that this application has been submitted, to the attention of interested parties.
2. I declare that to the best of my knowledge and belief, the information given in the application is true, correct and complete, that the copies of documents supplied are complete and that all estimates are identified as such and are the best estimates of the underlying facts.
3. I confirm that the person named as the applicant's representative (if any) is authorised to act on behalf of the applicant for the purposes of this application.

Signed:

Name: (block letters)

Position: (block letters)

Date: