

For discussion on 28 May 2001

**Legislative Council Panel on
Information Technology and Broadcasting**

**Regulation of Acquisitions and Mergers
in the Telecommunications Market**

Introduction

On 17 April 2001, the Office of the Telecommunications Authority (OFTA) issued a consultation paper entitled “Regulation of Mergers and Acquisitions in the Telecommunications Market”. A copy of this consultation paper (English only) is in the Appendix to this paper. OFTA invited comments from the telecommunications industry and the public on the proposal put forward in the paper on or before 12 June 2001.

Background

2. It is the existing policy of the Government in the telecommunications sector to promote fair and effective competition in the market. All sectors of the telecommunications market in Hong Kong are liberalised and subject to competition rules. Through competition, consumers benefit from lower prices, better quality of service and wider choices.

3. In line with our pro-competition regime, acquisitions and mergers in the telecommunications market should not adversely affect the level of competition in the market. Up to now, the regulation of acquisitions and mergers is mainly done through licence conditions, where there is a transfer of licence, or under some licences, transfer of the shares of the licensee. However, in many cases, acquisitions and mergers do not involve transfer of licences or transfer of shares in the licensee as such activities may take place at the holding company level. In view of the significance of acquisitions and mergers to the development in the telecommunications sector, the Telecommunications

Authority (TA) proposes to rectify the present deficiency as soon as possible by way of legislation.

The Proposal

4. The policy objectives of the regulation proposed to be introduced in the telecommunications sector are :

- (a) to promote fair and effective competition and protect consumers' interests;
- (b) to have a transparent and efficient regulatory regime governing mergers and acquisitions activities; and
- (c) to assist the industry in making informed decisions concerning such transactions which are of regulatory concern, as well as to speed up the processes for regulatory approval, without compromise on the objectives of having such regulatory controls.

Scope

5. In the consultation paper, the TA has proposed that the regulation should target "carrier licensees" (meaning fixed and mobile network operators) only. This is because TA is not, for the time being, aware of any current market factors, such as high barriers against entry, which may cause concern in other sectors in the telecommunications market. An alternative also put forward in the consultation paper is to apply the regulation across the board to all classes of licensees whilst empowering the TA to exempt from the regulation certain classes of licensees involving which acquisition and merger activities do not raise regulatory concerns.

Proposed Regulations

6. The existing provisions (sections 37(1)(ga) and (gb)) in the Telecommunications Ordinance provides that the Chief Executive in Council may by regulations provide for the control to be exercised over

or the beneficial ownership or control of any of the voting shares in a licensee. The TA has proposed to make use of this empowering provision to make regulations that require a licensee to seek the prior approval of the TA for transactions which will result in a person acquiring -

- (a) a beneficial ownership or control of more than 15%, 35% and 50% of the voting shares in a carrier licensee or beneficial ownership of interest in a carrier licensee which entitles the person direct or indirect influence of the licensee to the extent equivalent to ownership or control of more than 15%, 35% and 50% of the voting shares in the licensee; or
- (b) control over the carrier licensee where the person does not already have control over the carrier licensee concerned.

7. The rationale for the choice of the thresholds of 15%, 35% and 50% is as follows:

- (a) The 15% threshold is chosen as the starting point to trigger regulatory concerns by reference to European precedents as the right level representing a significant minority interest at which one can assume a level of influence.
- (b) 35% is recognized by takeovers code in Hong Kong as representing a significant change in control which triggers the mandatory general offer requirements for listed companies. (If amendment to this threshold is made to the takeovers code in the future, the TA intends to make corresponding changes in the proposed regulation.)
- (c) Control in excess of 50% will in the ordinary sense represent a majority control.

In addition to the above three thresholds, the TA has in the consultation paper sought the views of the industry on the desirability of including the additional threshold of 25% (associated with veto powers for certain important corporate decisions) for prior consent by the TA, and 10%

(which is the present threshold for disclosure of interest under Securities (Disclosure of Interests) Ordinance) for notification to the TA so that the TA can monitor development in the market.

8. The sanction against the licensee for failure to comply with the regulations will be the normal sanctions available under the Telecommunications Ordinance (such as a direction to the licensee, financial penalty, suspension or cancellation of licence). Prior to making any decision on whether to grant the approval for a transaction, the TA shall provide a reasonable opportunity for any interested parties to make representations.

9. The TA also includes in the consultation paper a set of draft guidelines on how the TA will consider proposals for acquisitions and mergers of telecommunications operators to give guidance to the industry on the manner in which the TA intends to exercise his powers under the proposed regulations. The TA recognises that the majority of acquisitions and mergers do not raise competition concerns. Such activities can perform an important role in the efficient performance of markets and the Hong Kong economy as a whole. The TA would not unnecessarily interfere with acquisitions and mergers which are normal market consolidation and expansion activities. Only in circumstances where TA has regulatory concerns will he step in. The main considerations of the TA in deciding whether a transaction should be approved is whether the transaction would prevent or substantially restrict competition, or create or enhance a dominant position in the telecommunications market.

10. At present, TA's decisions in relation to competition safeguards under sections 7K to 7N of the Telecommunications Ordinance are subject to review by the Telecommunications (Competitions Provisions) Appeal Board (Appeal Board). Similar to decisions involving the competition provisions, TA's decisions on the regulation of acquisitions and mergers will also involve wider economic issues, such as market structure and conditions. To provide a balanced and open regulatory regime that encourages fair competition, the TA has proposed in the consultation paper to subject his decisions on acquisitions and mergers to the review of the Appeal Board. This may entail amendments to section 32N of the Telecommunications Ordinance to extend the functions of the Appeal Board.

Way Forward

11. The TA intends to finalize the proposals after considering the comments received from the public and industry during the consultation. We will introduce the necessary legislative changes to the Legislative Council as soon as practicable.

Information Technology and Broadcasting Bureau

23 May 2001

**REGULATION OF MERGERS AND ACQUISITIONS
IN THE TELECOMMUNICATIONS MARKET -**

**A Consultation Paper Issued by
the Office of the Telecommunications Authority**

17 April 2001

INTRODUCTION

Over the past few years, there has been a number of mergers and acquisitions affecting the telecommunications industry. Some more are expected in the pipeline. This is not just a Hong Kong phenomenon but one that is encountered around the world. Mergers and acquisitions, whether for expansion, consolidation or diversification, can be very crucial to the future of the industry. They could also have significant implications on the long-term benefits of the consumers in Hong Kong. As a result, the Telecommunications Authority (TA) is currently considering whether the existing regulatory regime to regulate mergers and acquisitions in the telecommunications sector is adequate and whether additional regulations need to be introduced. This paper gives the TA's proposal and consults the views of the industry and the public on the issue.

**EXISTING REGULATORY REGIME FOR MERGERS AND
ACQUISITIONS IN THE TELECOMMUNICATIONS SECTOR**

2. It is the existing policy of the Government in the telecommunications sector to promote fair and effective competition in the market. The Government believes that competition is the best vehicle to protect and enhance consumer interests in the telecommunications sector. While mergers and acquisitions are normal commercial activities, the Government would not wish to see the level of competition to be significantly diminished by mergers and acquisitions.

3. At present, under sections 37(1)(ga) and (gb) of the Telecommunications Ordinance (Cap. 106), the Chief Executive in Council may make regulations on the control to be exercised over, or the beneficial ownership or control of the voting shares in, a licensee under that Ordinance. This is intended to allow the Government to make regulations, where considered necessary, to prevent over-concentration of market power in a few

firms and undesirable cross-ownership so as to safeguard the level of competition in the market. Up to the present, however, no such regulation has been made under the Telecommunications Ordinance.

4. Under the licences for public telecommunications services, there is a general condition which requires the licensee to obtain the consent of the TA prior to transfer of the licence, or any permission, right or benefit arising from the licence. When the TA gives such consent, he may impose conditions. The TA could invoke this provision to exercise a degree of control over the acquisition or merger only if the transaction involved the transfer of the licence from one legal entity to another.

5. Some licences for public radiocommunications services contain a condition providing that the licensee shall not register the transfer of shares in the licensee or any interest therein without the prior consent of the TA. This will enable the TA to regulate the direct ownership of the shares in the licensees.

6. As regards indirect ownership or control, some licences contain the condition that the licensee shall *notify* the TA, to the best of the licensee's knowledge and belief, all disposals of shares in the licensee or in its holding company, or of any interest, direct or indirect, beneficial or legal, in the shares of, or interest in, the licensee, except for transactions of shares of companies listed on a recognized stock exchange.

7. Some licences for public telecommunications services contain a condition requiring the licensee to seek the TA's consent for deviation from the representations made in the application for the licence. As the shareholding structure of the licensee may be one of the representations made in the application, the licensee is required to seek the TA's consent for changes to the shareholding structure of the licensee. However, this form of regulation over the ownership of the licensee is considered to be vague and inadequate.

8. Thus under the existing regime, until a regulation under section 37 of the Telecommunications Ordinance is enacted, there is no comprehensive requirement for the TA's consent to be obtained for changes to the ownership or control of a licensee unless transfer of the licence, or under some licences, transfer of the shares of the licensee, is involved.

9. However, where two licensees under common ownership or control are regarded as functioning as one single economic entity in the market, the TA may consider whether the licensees, as a whole, are dominant in the market under section 7L of the Telecommunications Ordinance and whether the dominant operator provisions under section 7G, 7L and 7N of the Telecommunications Ordinance should be applied to them. In relation to non-dominant licensees, the TA may consider whether the anti-competitive practices provisions under section 7K of the Telecommunications Ordinance

should be applied to them.

10. The current regulatory regime also enables the TA to have the option of issuing additional licences if he considers that further opening of the market is warranted after an acquisition or merger in order to safeguard the level of competition. The TA has the option of withdrawing the assignment of radio spectrum after the acquisition or merger if he considers that the spectrum under the control of the merged or affiliated operation would be inefficiently utilized or in any other manner prejudicing fair competition in the market. Ultimately, the Chief Executive in Council has the power under section 34 of revoking a licence if public interest so requires.

11. Because of the above measures which may be used to deal with mergers and acquisitions, it has been the practice of licensees to seek the consent of the TA prior to any significant change of ownership or control, whether or not involving an acquisition or merger.

POLICY OBJECTIVES OF PROPOSED REGULATION

12. The policy objectives of the regulation proposed to be introduced in the telecommunications sector are:-

- (a) to promote fair and effective competition and protect consumer interests;
- (b) to have a transparent and efficient regulatory regime governing merger and acquisition activities; and
- (c) to assist the industry in making informed decisions concerning such transactions which are of regulatory concern, as well as to speed up the processes for regulatory approval, without compromising on the objectives of having such regulatory controls.

PROPOSED REGULATION

13. The TA proposes a regulation be made by the Chief Executive in Council under section 37(1)(ga) and (gb) of the Telecommunications Ordinance and that the regulation should initially apply to carrier licensees (network operators). The TA may consider extension of the regulation to non-carrier licensees (mainly service providers) if there is concern about possible over-concentration of market power in the provision of public telecommunications services as a result of merger and acquisition activities in markets involving non-carrier licensees. For the time being, the TA is not

aware of any current market factors such as high barriers to entry which may cause him concern in such markets. An alternative proposal would be for the regulation to be applied across the board to all classes of licensees, and for the TA to exempt from the application of the regulation those classes of licensees which are not on a list given in a TA order. Under this arrangement, the TA will need to be empowered to exempt classes of licensees from the application of the regulation.

14. The TA proposes that a carrier licensee should notify the TA and obtain his prior approval of any proposal of a transaction or a series of transactions, if, as a result of such transaction or series of transactions, any person would have

- (a) beneficial ownership or control, directly or indirectly, of more than 15% of the voting shares in a carrier licensee, or beneficial interest in the carrier licensee which entitles the person direct or indirect influence of the carrier licensee to the extent equivalent to ownership or control of more than 15% of the voting shares in the carrier licensee (where that person does not already have the beneficial ownership or control of more than 15% of the voting shares in the carrier licensee concerned, or influence to the extent equivalent to ownership or control of more than 15% of the voting shares in the carrier licensee concerned); or
- (b) beneficial ownership or control, directly or indirectly, of more than 35% of the voting shares in a carrier licensee, or beneficial interest in the carrier licensee which entitles the person direct or indirect influence of the carrier licensee to the extent equivalent to ownership or control of more than 35% of the voting shares in the carrier licensee (where that person does not already have the beneficial ownership or control of more than 35% of the voting shares in the carrier licensee concerned, or influence to the extent equivalent to ownership or control of more than 35% of the voting shares in the carrier licensee concerned); or
- (c) beneficial ownership or control, directly or indirectly, of more than 50% of the voting shares in a carrier licensee, or beneficial interest in the carrier licensee which entitles the person direct or indirect influence of the carrier licensee to the extent equivalent to ownership or control of more than 50% of the voting shares in the carrier licensee (where that person does not already have the beneficial ownership or control of more than 50% of the voting shares in the carrier licensee concerned, or influence to the extent equivalent to ownership or control of more than 50% of the voting shares in the carrier licensee concerned); or

- (d) control to be exercised over a carrier licensee (where that person does not already have control over the carrier licensee concerned).
15. For the purpose of this consultation paper,
- (a) "transaction" or "transactions" may, where the context requires, include event(s) or occurrence of any event(s);
 - (b) control over the voting shares includes the ability to control, directly or indirectly, by the exercise of a right or entitlement (absolute or conditional, for example, by way of an option) to exercise such a right to vote, whether through or by means of a nominee, a trust, agreement or arrangement, understanding or practice, with or without legal or equitable force;
 - (c) the exercise of control over a licensee includes any forms of control and influence by whatever means and whether directly or indirectly (for instance, by virtue of any powers to exercise control in a carrier licensee conferred by the memorandum or articles of association, composition of the board of directors or other instrument (for instance, management agreement or shareholder agreement)) regulating the carrier licensee or any other body corporate whereby affairs of the carrier licensee are conducted in accordance with the wishes of that person.

The legal drafting of the significant definitions (such as "transactions", "control", "voting shares" etc.) will be subject to professional advice but views and comments are invited on the broad concepts as introduced by this consultation paper.

16. The 15% threshold is chosen as the starting point to trigger regulatory concerns by reference to European precedents as the right level representing a significant minority interest at which one can assume a level of influence. 35%¹ is recognized by the Codes on Takeovers and Mergers and Share Repurchases in Hong Kong as representing a significant change in control which triggers the mandatory offer requirements for listed companies. Control in excess of 50% will in the ordinary sense represent a majority control. Under corporate law, 25% is also considered as a significant control as important decisions of a company (for example, removal of directors under section 157B

¹ The Securities and Futures Commission has recently issued a Consultation Paper on a Review of the Codes on Takeovers and Mergers and Share Repurchases (the Takeovers Codes), in which it is proposed that the level of control of a company that triggers a mandatory offer should be lowered from 35% to 30% to bring Hong Kong more in line with the Mainland and other international markets. As the proposed 35% threshold of this consultation paper is based on the recognized level of control that triggers mandatory offer under the Takeovers Codes, in the event that the trigger under the Takeovers Codes has been lowered at the time when the proposed Regulation is enacted, the threshold proposed in this consultation paper should also be adjusted accordingly.

of the Companies Ordinance, Cap. 32 are to be determined by special resolutions in general meetings pursuant to section 116 of the Companies Ordinance (Cap. 32), which require a minimum of 75% of the votes cast). The holding of 25% voting shares will therefore enjoy a veto power on important corporate decisions and therefore views and comments are welcome as to whether 25% should be included as an additional threshold subject to the TA's approval.

17. Bearing in mind that the triggering point will start at 15%, the TA also proposes that the carrier licensee shall notify the TA of any change in (a) a beneficial ownership or control, directly or indirectly, of the voting shares in a carrier licensee or beneficial interest in the carrier licensee which entitles the person direct or indirect influence of the carrier licensee to the extent equivalent to ownership or control of the voting shares in the carrier licensee, in each case, equal to or in excess of 10%; or (b) control to be exercised over a carrier licensee so that the TA can monitor any development that may trigger the regulatory approval.

18. The proposed regulation should not apply to situations where:

- (a) credit institutions or other financial institutions or insurance companies, which hold on a temporary basis securities which they have acquired in a body corporate with a view to reselling them under certain circumstances (provided that they do not exercise voting rights in the meanwhile);
- (b) liquidators and receivers who acquire control of the voting shares by virtue of their offices; and
- (c) financial holding companies whose sole object is to acquire holdings in bodies corporate, and to manage such holdings and turn them into profit, without involving themselves directly or indirectly in the management of those bodies corporate.

19. Prior to making any decision on whether to grant the approval, the TA shall provide a reasonable opportunity for the interested parties to make representations and shall give consideration to all representations made.

20. At present, TA's decisions in relation to competition safeguards under section 7K to 7N of the Telecommunications Ordinance are subject to appeal to the Telecommunications (Competition Provisions) Appeal Board. We propose to apply the same appeal mechanism to TA's decisions on regulating merger and acquisition activities. This takes into account that TA's decisions will involve wider economic issues, such as his assessment of market structure and conditions (including market share, barriers to entry and vertical integration). Subjecting his decisions to appeal on merits by an independent

appeal board will be appropriate in providing a balanced and open regulatory regime that encourages fair competition. To implement this appeal mechanism for the decisions of the TA under the proposed regulations on mergers and acquisitions, it will be necessary to amend section 32N of the Telecommunications Ordinance to extend the functions of the Telecommunications (Competition Provisions) Appeal Board.

GUIDELINES

21. The TA plans to issue Guidelines to give guidance on the manner in which the TA intends to exercise his power under the proposed Regulation.
22. The main consideration of the TA in deciding whether a transaction should be approved is whether the transaction will prevent or substantially restrict competition, or create or enhance a dominant position in a telecommunications market.
23. A draft of the Guidelines is in the Annex.

Invitation of Comments

24. Views and comments on this consultation paper should reach the Office of the Telecommunications Authority **on or before 12 June 2001**. The TA reserves the right to publish all views and comments and to disclose the identity of the source. The submissions should be made on the basis that the TA may publish all or any part of the submissions in such manner as the TA deems fit. Any part of the submission, which is considered commercially confidential, should be marked. The TA would take such markings into account in making his decision as to whether to disclose such information or not. Submissions should be addressed to:

Office of the Telecommunications Authority
29/F Wu Chung House
213 Queen's Road Central
Wanchai
Hong Kong
[Attention: Miss Catherine CY Fung]
Fax: 2803 5110
E-mail: ccyfung@ofta.gov.hk

An electronic copy of the submission in Word 7.0 format should be provided by e-mail to the address indicated above.

Office of the Telecommunications Authority

17 April 2001

**Draft Guidelines on the Basis
Upon Which
the Telecommunications Authority Considers
Proposals for Mergers and Acquisitions
in the Telecommunications Market**

1. Introduction

1.1 These guidelines outline the factors the Telecommunications Authority (the TA) will take into account in an analysis of the effects on competition of a particular merger or acquisition in the telecommunications industry.

1.2 At the outset, it should be stressed that the TA starts from a presumption of minimal regulatory intervention in what are essentially market-driven commercial transactions.

1.3 The TA recognises that mergers and acquisitions can perform an important role in the efficient performance of markets and the Hong Kong economy as a whole. The most obvious efficiency gains arise from economies of scale. Indeed, the achievement of an efficient scale of operations through merger activity can greatly facilitate industry rationalisation.

1.4 Scale is particularly important in the telecommunications industry, which is characterised by significant economies of scale in the production and distribution of many telecommunications services. Greater scale through mergers also spreads the costs and risks of investment in an industry characterised by high sunk costs.

1.5 With a wide range of services on offer, economies of scope in production and distribution are also a feature of telecommunications. Mergers can facilitate the achievement of an efficient scope of operations.

1.6 In some cases however, mergers may adversely affect the efficient performance of markets by reducing competition and increasing the market power of the new merged entity. Reduced competition and increased market power can lead to excessive prices and inefficient markets.

1.7 The potentially adverse effects on competition and the efficient performance of markets are the prime concern of the TA in relation to telecommunications mergers and acquisitions. It would only be in those cases

where these concerns are raised that the TA would be likely to intervene and possibly withhold consent.

1.8 The majority of mergers do not raise competition concerns. In such cases where those concerns are not raised, the consent of the TA would be given.

1.9 Before discussing the legal and analytical frameworks, the TA wishes to emphasise that the purpose of these guidelines is to set out the broad approach that will be taken in the analysis of any mergers or acquisitions that raise competition concerns. They provide guidance only. Particular mergers will require an analysis of the particular circumstances and market structures surrounding the mergers before a specific response can be given by the TA.

2. Legal framework

2.1 In cases where a particular merger raises competition concerns, the TA will assess it in the terms of the *Telecommunications Ordinance*, regulations made pursuant to it, and any relevant telecommunications licences issued by the TA.

2.2 In particular, section 7K of the *Telecommunications Ordinance* prohibits a licensee from engaging in conduct that, in the opinion of the TA, has the purpose or effect of preventing or substantially restricting competition in a telecommunications market.

2.3 In addition, section 7L of the *Telecommunications Ordinance* prohibits a licensee from abusing a dominant position in a telecommunications market. A licensee in a dominant position is deemed to have abused its position if, in the opinion of the TA, it engages in conduct that has the purpose or effect of preventing or substantially restricting competition in a telecommunications market.

3. Analytical framework

3.1 As competition law has developed globally, well-accepted principles have been established to assist in the analysis of the likely effects on competition of certain types of market conduct such as mergers and acquisitions.

(i) Market definition

3.2 The starting point for any competition analysis is the concept of a market. Competition does not occur in a vacuum. It occurs in markets where

suppliers of substitutable products seek to attract consumer demand by competing on the basis of price or quality.

3.3 A market is thus essentially that field of competition where suppliers of substitutable products compete. The determination of what are close substitutes, and hence the boundaries of the market, starts with a description of the products supplied by the merging companies.

3.4 The product in question is described in terms of the purpose for which it is supplied (e.g., to carry telecommunications services), the geographic area in which it is supplied (e.g., Hong Kong) and the functional level in the supply chain at which it is supplied (e.g., at the wholesale level to resellers).

3.5 This description establishes the initial market boundary. The initial market boundary is then expanded to include all other products that are close substitutes. The resulting boundary establishes the field of competition in which one can then analyse the likely effects on competition of a merger.

3.6 The question of substitutability is generally assessed in terms of price responsiveness: what would be the response of consumers (the demand-side response) and other suppliers (the supply-side response) to a relatively small increase in the price of the merged entity's product?

3.7 Should other products be close substitutes, one would expect substitution to occur in response to the price increase. On the demand-side, consumers would switch their demand to the close substitutes and, on the supply-side, companies would switch their production lines to supply the customers with close substitutes.²

(ii) Competition analysis

3.8 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, import competition, vertical integration and countervailing power.

3.9 Competition can be stifled when the market structure gives rise to significant market power or dominance. Market power is the ability of a company to profitably divert prices, quality, variety, service or innovation from their competitive levels for a significant period of time, unconstrained by competitive forces.

² In the United States and Canada, a 'SSNIP' test is used. Under this test, the process of market definition is viewed as establishing the smallest area of product, functional and geographic space within which a hypothetical profit maximising monopolist would impose a small but significant and non-transitory increase in price (SSNIP) above the level that would prevail absent the merger. This would only be possible if all sources and potential sources of close substitutes for the merged entity's products have been included in the market definition.

Market share and concentration

3.10 Market share refers to the proportion of sales a particular company has in a market. Market concentration refers to the degree to which the market is dominated by a small number of large firms.

3.11 High market shares and concentration levels as a result of a merger are necessary but not sufficient conditions for the exercise of market power. On the other hand, a merged entity with only small market share in a relatively unconcentrated market would not normally be able to exercise market power.

3.12 As information on market shares and concentration levels is often more readily available than other information on market structures, thresholds on market shares and concentration levels are a relatively low-cost means of screening out mergers that are not likely to reduce competition through an increase in market power or an increase in the scope to co-ordinate market conduct among remaining competitors.

3.13 In line with overseas practice, the TA will generally only start to assess mergers if the merged entity would supply:

- 40 per cent or more of the market; or
- at least 15 per cent of the market and the concentration ratio of the four (or fewer) largest companies ('CR4') in the market is 75 per cent or more.

Barriers to entry

3.14 The most important structural factor is generally recognised to be 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 entity has a high market share.

3.15 Barriers to entry are any market features that place a prospective entrant at a significant competitive disadvantage to incumbents. In telecommunications, high barriers can be created by high sunk costs and economies of scale and scope. Absolute barriers can be created by licensing schemes.

Import competition

3.16 Hong Kong is an open economy. It is therefore important to consider the role of actual levels of import competition and potential levels in assessing the likely effect of a merger on competition.

Vertical integration

3.17 Vertical integration can be achieved through common ownership or long-term contractual arrangements. Vertical integration can often have efficiency-enhancing effects through the achievement of economies of scope and the minimisation of transaction costs.

3.18 In industries with high sunk costs such as telecommunications, vertical integration can help reduce the investment risk. For example, a reseller may wish to integrate upstream into distribution to reduce the risk of being held captive to the owner of necessary distribution infrastructure.

3.19 On the other hand, where there is market power at one of the input levels in the supply chain, vertical integration may be used to hinder or foreclose downstream market entry by denying access to essential inputs such as distribution. Alternatively, access may be given only on discriminatory and competitively disadvantageous terms.

Countervailing power

3.20 Countervailing power exists where the bargaining power of a company is balanced by the power of another or others with whom the company trades or deals. Generally, the bargaining power must be supported by a credible threat to bypass the company if no acceptable deal can be bargained.

Efficiencies

3.21 As noted in the introduction, mergers and acquisitions can perform an important role in the efficient performance of markets and the Hong Kong economy as a whole. As part of this process, they can also enhance the efficiency of the merged entity through, for example, the achievement of economies of scale or the combination of research and development facilities.

3.22 These efficiencies within a company are called 'production efficiencies'. To the extent that these production efficiencies as a result of the merger create a new competitive constraint on the conduct of other companies in the relevant market, the merger is likely to increase competition.

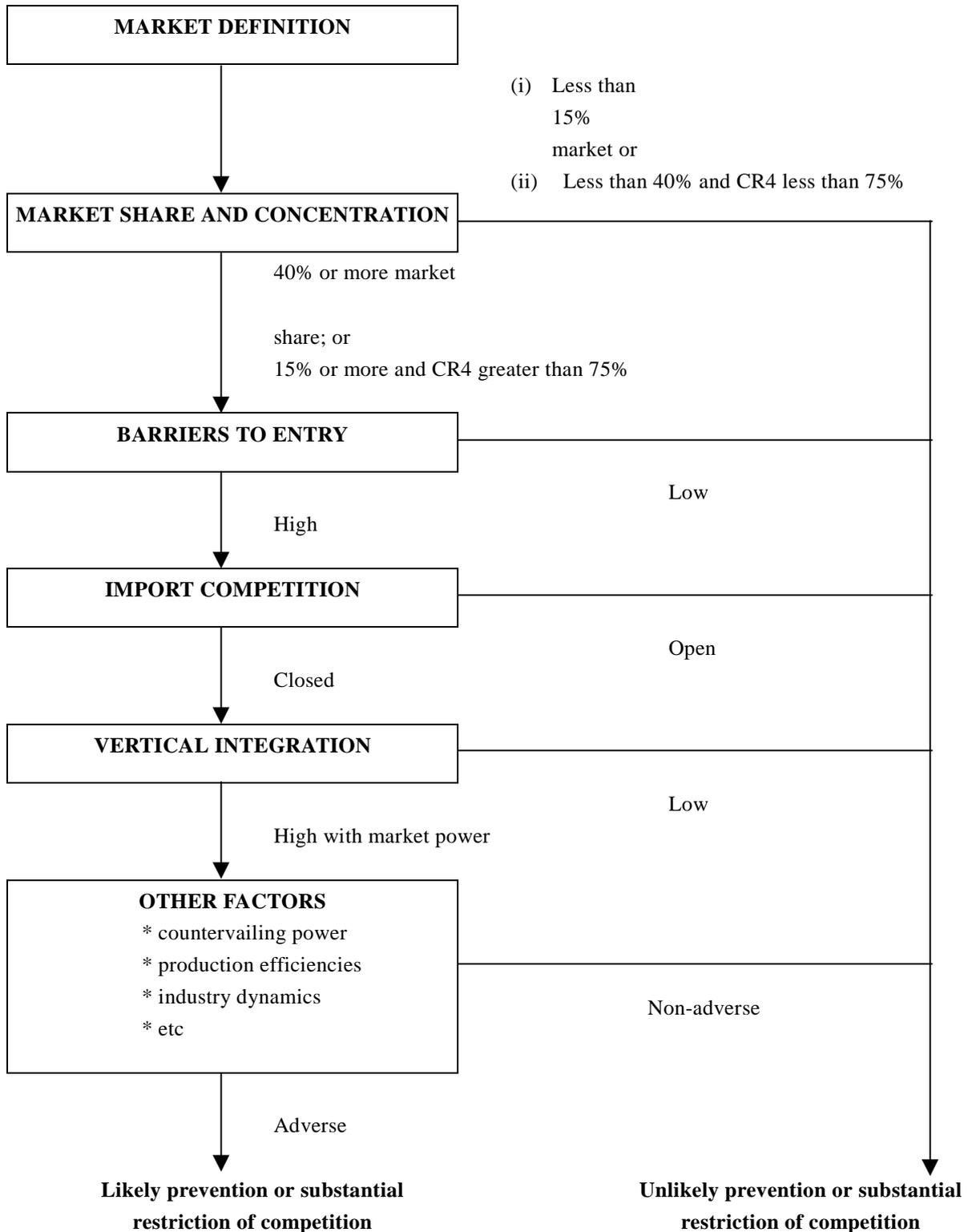
3.23 On the other hand, the merger may create market power that may be abused to the detriment of competition and any potential efficiency gains.

Other factors

3.24 The factors mentioned above are not exclusive. Other factors may bear on the likely competitive effect of a merger.

3.25 Importantly in a dynamic industry such as telecommunications, technological change and innovation can change market boundaries and levels of competition. For example, technical convergence has increased demand for new services and content by network operators, resulting in a plethora of new service providers entering telecommunications. On the other hand, first mover advantage and brand loyalty can quell such changes.

**SYSTEMATIC PROCESS FOR ASSESSING
PREVENTION OR SUBSTANTIAL RESTRICTION OF COMPETITION**



Note: This flow-chart provides a guide to the steps taken by the TA in its analysis of a merger. At each step, the presence or absence of a particular merger factor will indicate whether the merger is likely or unlikely to be anti-competitive in terms of the Telecommunications Ordinance. However, the presence or absence of a particular merger factor will not be conclusive in itself. The TA will consider the interaction of all relevant factors before coming to a conclusion.