Antitrust, Competition and Economic Regulation Alert - China

MOFCOM Issues Conditional Clearance of Russian Potash Merger and Circulates Two Draft Regulations for Public Comment

On June 2, 2011, the Ministry of Commerce ("**MOFCOM**"), China's merger control authority, approved the proposed merger between two Russian potash producers, Uralkali and Silvinit, subject to conditions. The decision [1] is MOFCOM's first conditional clearance in 2011 and only the seventh since the Anti-Monopoly Law ("**AML**") came into force on August 1, 2008.

Background

Announced in December 2010, the Uralkali/Silvinit transaction is to be implemented in two stages (Uralkali first acquires 20% of Silvinit's shares, followed by a full-blown merger), with Uralkali being the surviving post-transaction entity.

Uralkali and Silvinit are both producers of potash, which mainly serves as a fertilizer for agricultural use but is also used, to a much lesser extent, in industrial and other "special" applications. More specifically, the MOFCOM decision defined potassium chloride – the most common potash-based product – as the relevant product market.

Competition concerns identified by MOFCOM

Having defined potassium chloride as the relevant product market, MOFCOM was less specific about the geographic market definition, simply noting that it had "considered" both the worldwide market and the Chinese market. The decision went further in highlighting the importance of imports into China and made a distinction between imports into China through "seaborne trade" and "cross-border trade."

The MOFCOM decision was short, too, on detail as to the competition law theories underlying the negative impact of the merger. It seems that MOFCOM found both anti-competitive 'unilateral effects' – *i.e.*, the elimination or reduction of competition between the merging parties– and 'coordinated effects' – *i.e.*, the reduction of competition between the merged entity and third parties.

As to unilateral effects, the merging parties had a combined share of 33% of the worldwide market, and a 25% market share in China. However, if the market were defined in a narrower way, focusing on potassium chloride imports into China or, even narrower still, cross-border trade imports into China, then the parties' combined market share would increase to over 50% and 100%, respectively. At the same time, MOFCOM found the transaction to be anti-competitive because it would increase the likelihood that potassium chloride suppliers coordinate production and sales. The decision states that the aggregate market share of the two leading suppliers worldwide (Canada's Potash Corp and the merged entity) would be around 70%. Finally, MOFCOM pointed out that new entrants into the potash market faced high entry barriers in that they needed to make a substantial investment in money and time, hence contributing to its finding that the merger would have anti-competitive effects.

The remedies imposed

After several rounds of negotiations, MOFCOM accepted the remedies proposed by the merging

[1] http://fldj.mofcom.gov.cn/aarticle/ztxx/201106/20110607583288.html

parties. The remedies are basically a standstill commitment by the merging parties. Indeed, the parties promise to maintain the existing "sales practices and procedures," to continue imports into China by railway and sea, and to continue offering various types of potassium chloride products in sufficient quantities to supply the Chinese market. In addition, the merged entity commits to preserve "customary negotiation procedures" and, in price negotiations, to take into account the historic and current relationship with Chinese customers, as well as the particularities of the Chinese market. The decision points out that "customary negotiation includes price negotiations based on spot sales (per transaction or per month) or contract sales (annual or bi-annual)."

In order to ensure compliance with the commitments, the merging parties agree to appoint a monitoring trustee that reports to MOFCOM.

The decision's implications

It is not immediately apparent what lessons can be drawn from the *Uralkali/Silvinit* decision because MOFCOM relied on a variety of arguments to conclude that the transaction was anti-competitive.

If one looks at the unilateral effects theory in isolation (*e.g.*, without taking into the account MOFCOM's explanations on the importance of imports into China), then the decision appears to be quite far-reaching. In *Uralkali/Silvinit*, the merging parties had a relatively low combined share in the potassium chloride market: 33% worldwide and 25% in China. These figures are considerably below the level of the previous lowest market share objected to by MOFCOM when imposing conditions (46.3% in *Panasonic/Sanyo*). The merger would, according to MOFCOM, only create the world's No 2 potash supplier.

A careful reading of the decision, however, suggests that coordinated effects may have played a role as well: indeed, the two major potash suppliers (including the merged entity) would control 70% of the worldwide market post-transaction. This is MOFCOM's second public decision where it has taken issue with the coordinated effects of a transaction. However, unlike in *Novartis/Alcon*[2] where MOFCOM found that the exclusive distribution agreement between the merged entity and a third party would lead to coordination of their conduct, the *Uralkali/Silvinit* decision does not explain how Potash Corp and the merged entity would coordinate their behavior. In that regard, it is surprising that MOFCOM neither provided additional details on the concentrated nature of the potash market, nor mentioned the export cooperation mechanisms that exist between the various potash suppliers in Canada and Belarus.

MOFCOM's explanations about China's high level of dependence on potash imports and the distinction between seaborne and cross-border trade suggest that a further interpretation is possible, namely that the decision was (at least in part) motivated by industrial policy concerns. This would reportedly not be the first time that such concerns have come up in a MOFCOM merger control ruling, and would not be particularly surprising in this specific context. Indeed, some would argue that industrial policy issues will inevitably surface when dealing with the potash industry. As the MOFCOM decision points out, over 80% of global potash reserves are located in three countries (Canada, Belarus and Russia), and the supply side is, to a certain extent, influenced by industrial policy. For example, the Canadian government is reported to have blocked BHP Billiton's attempted takeover of Potash Corp and to have encouraged export cooperation among Canadian potash suppliers. However, the

[2] http://www.hoganlovells.com/antitrust-competiton-and-economic-regulation-alert---august-2010-08-17-2010/

reference to China having to buy from a single entity instead of two companies post-transaction (which would "likely have the effect of eliminating or restricting competition") for cross-border imports into China suggests that the emphasis here is really on the impact on China trade, which points to a policy-based interpretation.

This background may help to better understand MOFCOM's concerns about the Russian potash merger. A question mark remains, however, behind the specific remedies imposed by MOFCOM to address these concerns. Given the various concerns identified, the remedies appear to be rather tame and unintrusive with respect to the business activities of the merged entity. With the *Novartis/Alcon* decision as a 'precedent,' for instance, one could have expected MOFCOM to have challenged the agreements underlying the coordinated effects theory which, in this case, arguably, would mean the export cooperation agreements between foreign potash suppliers. Similarly, no asset divestitures or supply obligations were included in the package of remedies.

Perhaps MOFCOM may have achieved its primary purpose by obtaining the commitment from the merged entity to respect "customary negotiation procedures" including price negotiations. At present, it appears that potash imports into China are mainly made by state-owned companies, which jointly negotiate with foreign potash suppliers under MOFCOM's guidance. Overall the importers' interest is likely to be to enter into long-term contracts (bi-annually or annually) which lock-in supply at a fixed price, rather than following the vagaries of spot prices. To that extent, although drafted in vague terms, the commitments in the *Uralkali/Silvinit* decision may provide a useful tool for MOFCOM and/or Chinese importers to improve their bargaining position in future negotiations with the merged entity.

Draft regulations circulated for comment

In a separate but related development, on June 3 and 13, MOFCOM issued two draft regulations on the substantive assessment process in merger control cases and on the procedures that apply if a company fails to notify a reportable transaction, respectively.

The language in the draft regulation on the substantive assessment process [3] is disappointingly vague; in some respects, the draft seems to be a step backwards as compared to a similar draft that was circulated informally in 2009. Although the current draft regulation makes reference to many factors commonly used in merger control procedures around the globe – including in relation to some of the issues that arose in the *Uralkali/Silvinit* transaction, such as entry barriers or, more vaguely, coordinated effects – it consistently lacks detail. For example, although the draft mentions that MOFCOM will use the Herfindahl-Hirschman Index ("**HHI**") for measuring market concentration, it does not specify which HHI levels or increments are problematic. Similarly, the draft makes a vague reference to the 'failing firm' doctrine used in other jurisdictions, by pointing out that an examination of whether a merging party "is about to go bankrupt" should be conducted, but does not contain any operational criteria to put the doctrine into practice. In sum, it is not clear to what extent the draft regulation on the substantive assessment process, if enacted, would actually provide additional guidance to merging parties in future cases.

The second draft regulation[4] circulated for public comment on June 13 provides a few details on the procedures applicable to cases where the parties, in violation of the law, fail to file a notifiable transaction. According to the draft

[3] http://fldj.mofcom.gov.cn/aarticle/zcfb/201106/20110607585023.html

[4] http://tfs.mofcom.gov.cn/aarticle/as/201106/20110607595564.html

regulation, MOFCOM will initiate an investigation to confirm whether a violation of the law has occurred, based upon complaints filed by "any unit (单位) or individual" or, presumably, launched upon its own initiative. If the violation is confirmed, the merging parties are essentially under an obligation to file a standard notification, and the standard merger control procedure applies. A key question that the draft regulation leaves open is whether the most stringent sanction foreseen under the AML – *i.e.*, the unwinding of the transaction – is possible only if the transaction has anti-competitive effects, or whether the ultimate sanction can also be imposed in the absence of such effects but where other elements – for example willful action – are present. The draft is also unclear about the consequences if the merging parties refuse to cooperate in the MOFCOM investigation, which would make it very difficult, if not impossible for MOFCOM to conduct a proper substantive merger assessment. Although the draft provides for specific sanctions against the parties and/or individuals in that scenario, it is not clear how the review process would end, if at all.

What seems more clear, in contrast, is that the enactment of the regulation on failure to file may well mark the beginning of a new phase in MOFCOM's enforcement history. Many observers on the ground view the current lack of procedural rules as the main reason why MOFCOM has so far refrained from taking action with respect to transactions that were not notified in violation of the law, and hence would expect investigations to start shortly after enactment of the regulation. The fact that the scope for whistle-blowing in the draft regulation is broad further enhances this impression; MOFCOM may even be going so far as to encourage reporting by individuals *within* the company breaching the law. In addition, the draft regulation gives MOFCOM's antitrust officials in Beijing the possibility of working with their provincial-level offices throughout the country. If this arsenal of enforcement measures and personnel were fully deployed, it would mean considerably more manpower and resources being devoted to detecting notifiable transactions that have not been filed. Companies doing business in China, particularly those who might otherwise be having second thoughts about filing, should take note.

Contacts

Beijing

Jun Wei
jun.wei@hoganlovells.com
+86 10 6582 9501

Adrian Emch
adrian.emch@hoganlovells.com
+86 10 6582 9510

Hong Kong

Henry Wheare
henry.wheare@hoganlovells.com
+852 2840 5087

Shanghai

Andrew McGinty
andrew.mcginty@hoganlovells.com
+86 21 6122 3866

Ulaanbaatar

Michael Aldrich
Michael.Aldrich@hoganlovells.com
+976 7012 1020