

# Horizontal mergers in the China context: The Uralkali/Silvinit potash merger and continuity of supply obligations

## Introduction

The Ministry of Commerce of the People's Republic of China (MOFCOM) granted conditional approval of the US \$1.4 billion transaction between Uralkali and Silvinit, two Russian producers of potash.<sup>1</sup> The decision is MOFCOM's seventh conditional clearance decision since China's Anti-monopoly Law (AML) came into effect in August 2008. The conditions imposed offer insight into MOFCOM's evolving approach to the assessment of mergers, as well as behavioural or non-structural remedies. MOFCOM has reviewed more than 240 cases so far and cleared the vast majority without prohibition or conditions.

## Background

The transaction triggered merger control filings in several countries, including China. The transaction was notified to MOFCOM on 14 March 2011. MOFCOM initiated a Phase II investigation on 12 April and, about one month into Phase II, raised substantive concerns with Uralkali on 11 May. This triggered a series of negotiations on the conditions that might be imposed to secure approval. MOFCOM published its conditional clearance decision on 2 June, well within the 90-day Phase II review period.<sup>2</sup>

## Market definition

MOFCOM defined the relevant product market as the supply of potassium chloride. In defining the relevant market, the decision considered a market for imports or seaborne trading in potassium chloride to China. MOFCOM also appears to have considered the different purity grades and applications of potassium chloride but did not segment the market further. However, the relevant geographic market on which MOFCOM relied is less clear. The decision emphasizes the global dimension of the market but the competition analysis focused on the competitive impact of the transaction in China. Consistent with its practice, MOFCOM ultimately considered the merging parties' market position in China and globally.

<sup>1</sup> Announcement of the Anti-Monopoly Review Decision on the Approval of the Acquisition of OAO Silvinit by OAO Uralkali with Conditions, 2 June 2011.

<sup>2</sup> There is a three-stage statutory review process: Phase I is 30 calendar days, Phase II is 90 calendar days, which can be extended by a further 60 calendar days in limited circumstances.

## Key Issues

Introduction	1
Background	1
Market definition	1
Competition analysis	2
Remedies imposed	2
Assessment of mergers in China	2
Security of supply obligations in China	3
Implications for future transactions	4

If you would like to know more about the subjects covered in this publication, please contact:

**Beijing**  
[Ninette Dodoo](#) +86 10 6535 2256

[Bai Yong](#) +86 10 6535 2286

If you would like to know more about our China publications, please contact:

[Chlorophyll Yip](#) +852 2826 3426

Clifford Chance, 28th Floor, Jardine House,  
One Connaught Place, Hong Kong SAR  
[www.cliffordchance.com](http://www.cliffordchance.com)

### Competition analysis

MOFCOM found that the merger would create the second-largest potassium chloride supplier in the world with a market share exceeding one third of the global market. In particular, it found that the merger would increase the merging parties' market power by creating a large leading supplier of potassium chloride. Furthermore, following the merger, the merged company and the market leader would account for 70% of the global market raising the prospect of coordination between major potassium chloride suppliers with effects in China. Both unilateral and coordinated effects theories of harm underlie the decision.

MOFCOM also found that the market for potassium chloride was highly concentrated with potassium resources concentrated in a few geographies and global supply limited to a few companies. It determined that there were significant barriers to entry, with the development of new mines or expansion of existing facilities requiring significant capital outlay.

In the China context, MOFCOM found that: "*China relied heavily on the international market of potassium chloride*", that about 50% of China's demand for potassium chloride were met through imports, that Silvinit and Uralkali represented 50% of China's imports of potassium chloride and that potassium chloride was an important raw material used in fertilizers in China. MOFCOM's analysis focused on the impact of the merger on China as a significant importer of potassium chloride. It concluded that "*due to China's dependence on imported potassium chloride and the existing market structure of potassium chloride, the proposed concentration will have a certain level of adverse effects on China's relevant sectors including agriculture,*" and imposed remedies to address its substantive concerns.

### Remedies imposed

The remedies are designed to maintain the pre-merger market dynamics. In particular, the remedies are aimed at assuring continuity of supply of potassium chloride on reasonable terms for all applications in China. The remedies can be summarized as follows:

- the merged company must continue to maintain current sales practices and procedures in connection with the sale of potassium chloride to China, including by direct trading and using best efforts to maintain a reliable and stable supply of potassium chloride to China by rail or by sea;
- the merged company must continue to supply a full range of potassium chloride products to China and in sufficient quantities, including specific purity grades, to satisfy demand for different applications (including agricultural, industrial and specialized applications);
- the merged company must continue to maintain existing negotiation practices taking into account the historical context and current trading relationships with Chinese customers as well as the particularity of the Chinese market. In particular, the decision requires the merged entity to maintain customary procedures in relation to price negotiations, including for spot sales (on a monthly or transaction basis) and contract sales (on a half-yearly or annual basis); and
- the merged company must report to MOFCOM every six months, or when required to do so, on its compliance with the above remedies. The decision does not specify for how long and leaves open the question as to whether the remedies are indefinite. The parties must also appoint a trustee to monitor the parties' compliance with the remedies. The decision allows MOFCOM to impose penalties if the parties breach these conditions.

### Assessment of mergers in China

The decision highlights MOFCOM's evolving approach to the assessment of mergers in China. In particular, it shows increased sophistication in the analysis of competition effects compared with earlier published decisions where substantive analyses were sometimes conclusory in nature or not fully reasoned on the face of the decision. It also contrasts with previous decisions in terms of the degree of insight it offers into MOFCOM's assessment of competition and non-competition factors under the AML.

The decision is based on the internationally accepted theories of unilateral effects and coordinated effects.<sup>3</sup> It offers some insight on approach in the China context:

- unilateral effects: the analysis seems to focus on market shares, market concentration levels and the resulting market position of the merged entity. As the decision suggests, MOFCOM will also consider other market dynamics such as the competitive position of competitors, barriers to entry and the impact of the transaction on domestic customers and suppliers.
- coordinated effects: the decision suggests that the mere likelihood (or risk) of coordination in an oligopolistic market may be enough to raise coordinated effects concerns. It also suggests that a market with few suppliers with very high market shares without more may be enough to trigger concerns. Indeed, the decision does not fully explain how the collusive mechanism would operate, nor does it specify why collusion is significantly more likely post-merger. Similarly, the decision does not explain why the merger would make collusion more effective or sustainable post-merger, or why the combined Uralkali/Silvinit and the market leader were more likely to reach a common understanding on a particular collusive mechanism, or how deviation from the common understanding might be monitored to punish such deviation.

The decision also highlights the non-competition factors that underlie MOFCOM's analysis. Potassium chloride is a sensitive product in China given its primary application in the agricultural sector. The level of scrutiny in this case and the remedies imposed are, therefore, not altogether surprising given China's dependence on imported potassium chloride and the reliance of the agricultural sector on such imports.

MOFCOM's approach to unilateral and coordinated effects is reflected in its draft *Interim Provisions on the Effects of Concentrations of Undertakings on Competition* (Interim Provisions), which it published for public comment.<sup>4</sup> The Interim Provisions also set forth the competition and non-competition factors that MOFCOM may consider in merger reviews.<sup>5</sup>

### Security of supply obligations in China

The decision requires the parties to maintain existing terms and conditions of sale prior to the merger, including negotiation procedures as far as possible. The decision does not explain what is meant by the particularity of the Chinese market or transaction histories and the circumstances of Chinese customers leaving scope for interpretation. The decision also does not set specific parameters or benchmarks for future pricing, or precise terms and conditions for future contracts. However, it can reasonably be supposed that extraordinary or dramatic increases in the price of imported potassium chloride by the parties, or significant divergences from current trading terms and conditions, will be carefully scrutinized.

Paradoxically, the remedies imposed restrict the ability of the world's second largest supplier of potassium chloride to freely determine the terms and conditions of sale of the product to Chinese customers, including how future negotiations are conducted, but leave the market leader free to conduct business ostensibly on its own terms. MOFCOM could not of course impose conditions on the market leader as it was not party to the transaction. The potential question still arises as to the effectiveness of the remedies in maintaining the pre-merger market situation if the commercial policy of only one major supplier (and not both major suppliers) is carefully circumscribed.

The remedies imposed highlight MOFCOM's willingness to accept non-structural or behavioural remedies. The remedies are broadly defined and contrast with the continuity of supply and price-related obligations in *GM/Delphi*.<sup>6</sup> In that case, the merging parties undertook to maintain existing quality and service levels and to maintain a reliable supply of products

<sup>3</sup> Broadly, whether the combined firm will have the ability to increase prices unilaterally (unilateral effects) or whether the remaining suppliers in the market post-merger are significantly more likely to coordinate their competitive behaviour, including as to prices (coordinated effects).

<sup>4</sup> Notice on Soliciting Comments on the Interim Provisions on the Assessment of the effects of Concentrations of Undertakings on Competition, 3 June 2011.

<sup>5</sup> These include market shares, the market position of the merging parties and their competitors, market concentration levels, barriers to entry, impact on technology and third parties (including competitors, consumers and suppliers) and national economic development.

<sup>6</sup> The merging parties accepted behavioural remedies to secure General Motors' acquisition of parts of Delphi Corporation's car accessories business. To read more, see the Clifford Chance client briefing: "[Chinese Authority imposes conditions on Pfizer/Wyeth and GM/Delphi](#)".

to domestic companies at contract prices or the prevailing market price. The parties also undertook not to discriminate against independent suppliers and not to disclose sensitive commercial information regarding domestic companies.

### Implications for future transactions

MOFCOM has reviewed more than 240 transactions and has prohibited one and imposed conditions in seven. Intervention has focused on foreign-to-foreign transactions, and this trend may continue as foreign investors eye China for growth opportunities and more companies notify qualifying transactions to MOFCOM for review.

Timely clearance of transactions remains a challenge for many companies. In *Uralkali/Silvinit*, MOFCOM moved swiftly and cleared the transaction well within the 90-day second-phase review period – signaling a resolve to move quickly even in cases that raise substantive competition concerns. Companies would be well advised to consider possible remedies and to discuss them early in the merger review process, where appropriate, in an effort to secure the timely clearance of a transaction.

In terms of possible remedies in cases that raise substantive competition concerns, MOFCOM seems willing to accept non-structural or behavioural remedies in lieu of structural remedies. Structural remedies are generally more intrusive than non-structural or behavioural remedies. In the China context, behavioural remedies are by no means a soft option and should be considered carefully. As the GM/Delphi and Uralkali/Silvinit decisions show behavioural remedies can be far-reaching, may restrict a company's future commercial policy and may set long-term compliance burdens for merging parties. It also remains unclear in what circumstances MOFCOM would determine that non-structural or behavioural remedies are sufficient and adequate to address identified competition concerns. Any envisaged non-structural or behavioural remedies would need to be credible, substantive and have sufficient bite to withstand antitrust scrutiny.

The past year has drawn the world's attention to fertilizers as a sensitive strategic issue for policy-makers. In September 2010, the Canadian Government blocked BHP Billiton's proposed acquisition of the Potash Corporation of Saskatchewan. This latest merger involving two of the world's leading potash producers in Russia highlights some of the substantive issues and non-competition factors that may arise as the sector undergoes further consolidation. Earlier this year, China's State Council published a Circular that identifies key sectors in China that will be subject to national security review in addition to merger control review. The relevant sectors include the agricultural sector – one of China's strategic industries – and separate national security review is required when a foreign investor acquires actual control of a Chinese entity or assets active in the sector.<sup>7</sup> MOFCOM will effectively become gatekeeper under the national security review system, with the power to determine whether transactions should be subject to parallel scrutiny by a joint ministerial panel comprising MOFCOM, the National Development and Reform Commission as well as relevant government agencies with responsibility for the sector concerned.

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<sup>7</sup> Circular of the General Office of the State Council on the Establishment of a Security Review System - Guobanfa (2011) No.6.

To read more, see the Clifford Chance client briefings on national security:

[China Launches National Security Review System for Foreign M&A](#)

[Interim Provisions released for China's New National Security Review for Foreign M&A](#)

[China and CFIUS : a double-edged sword](#)

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