BEFORE THE
COMPETITION COMMISSION OF PAKISTAN

IN THE MATTER OF

ACQUISITION OF 79% SHARES OF M/S. AGRITECH LIMITED BY M/S. FAUJI FERTILIZER COMPANY LTD

(FILE NO. 324/MERGER/CCP/2010)

Dates of hearing:	October 27, 2010, January 10, 2011
Present:	Ms. Rahat Kaunain Hassan **Chairperson**
	Ms. Vadiyya S. Khalil **Member**
On behalf of: Fauji Fertilizer Company Ltd:	 Mr. Zahir Riaz, Orr Dignam & Co. Mr. Khalid Rohail Ansari, Syed Iqtidar Saeed Mr. Zia ud Din Brig. Fiaz Ahmed Satti (Rtd) Brig. Tariq Izaz (Rtd) Mr. Ather Javed Mr. Omer Shahid Mr. Aman Mir Mr. Mohsin Kadir
Azgard Nine Ltd & Agritech Ltd	Mr. Ahmad Humayun Shaikh Syed Akbar Ali Bilgrami, Advisor Mr. Waqqas Ahmad Mir Mr. Maliha Sardar Azam Mr. Wali Muhammad Mr. Irfan Ahmad Khan
Raja Mohammad Akram & Co:	Mr. Salman Akram Raja, ASC Mr. Waqqas Ahmad Mir, Advocate
NIB Bank:	Mr. Burhan Nasir
Standard Chartered Bank:	Mr. Shauzab Ali

O R D E R

Fauji Fertilizer Company Limited (hereinafter referred as to '**FFC**') submitted its pre-merger application on 2nd August, 2010 for the acquisition of 75% to 79.87% shares of Ms. Agritech Limited (formerly Pak American Fertilizers Limited hereinafter referred to as '**Agritech**'). The Commission intimated FFC *vide* its letter dated 12th August, 2010 that the Commission has decided to move the case to Phase 2 Review, with the view to determine whether the merger situation is likely to substantially prevent or lessen competition in the market and to ascertain the probability that the merged entity in the post-merger market will behave competitively or cooperatively. The Commission under the Competition Act, 2010 (the '**Act**') is obliged to complete the Phase 2 Review within 90 days.

It is important to note that the 90 working days commences: a) upon the party being notified that Commission has proceeded to the Phase 2 Review and b) upon receipt of all information required from the Applicant by the Commission. It is pertinent to mention that Commission received requests for extension of time for filing of relevant documents reply and adjournment of hearings by FFC or its allied representatives. Particularly, the revised reply in which FFC asserted a substantially revised position vis-à-vis the market shares in all three relevant fertilizer products was only filed on 14th December, 2010 and subsequently submission of the documents (including the case law) was made on 11th January, 2011. Therefore, the Commission has completed Phase 2 Review much within the prescribed timeframe.

1. *Impact of Merger on Competition:*

The fertilizer industry in Pakistan is (admittedly) a duopolistic market dominated by FFC and Engro, together having more than 80% of market share. The FFC has pre-merger market share of more than 50% in the relevant product market of Urea and DAP before the proposed merger. The market shares of FFC in the relevant product markets, in per-merger and post-merger scenario as provided by FFC in its application is as follows:

Table 1: Market Position of FFC alongwith FFBL				
Product	**Original-2009**		**Revised-2010**	
	Pre-Acquisition	Post-Acquisition	Pre-Acquisition	Post-Acquisition
Urea	From 47.6% (37.90% FFC + 9.70% FFBL)	To 53.6% (37.90% FFC + 9.70% FFBL +6% Agri)	From 48.1% (39.8% FFC + 8.3% FFBL)	To 51.5% (37.7% FFC + 8.6% FFBL+5.2 Agri)
DAP	From 42.0% (2.2% FFC+39.7% FFBL)	To 49.3% (2.2% FFC+39.7% FFBL+7.4% Agri)	From 53.9% (5% FFC+48.9% FFBL)	To 47.1% (0% FFC+47.1% FFBL+0% Agri)
SSP	From 0%	To 59.0%	From 0%	To 21%

In the post-merger scenario market share of FFC in Urea and DAP will be enhanced but the increase is not be substantial with respect to already established dominance of FFC. A substantial increase is shown in the case of Single Super Phosphate (**SSP**), which as per FFC claim constitutes about 1% of fertilizer market. In addition, the imports constitute almost 22% of the industry in terms of market share and the imported fertilizer is available at a competitive price, in fact, slightly less than local brands. In our order on the alleged tie-in by fertilizer industry issued on 23rd July, 2010, it was observed that '*on average about four percent (4%) of the* *demand for Urea in Pakistan for the past 5 years has been met through imports. In the year 2008-09 about ten per cent (10%) of the total demand of Urea had to be met through imports despite the fact that the local producers of fertilizer were operating at more than hundred percent (100%) production capacity (for the years 2008-09). '* For the year 2009-10 it has gone upto 22% as provided in the report by the National Fertilizer Development Centre. It means that the imported fertilizer can provide an effective substitute. However, considering that imports are not as such free and are dictated by the government, it is difficult to assess the actual level of 'import competition'. However, under the given facts and taking a holistic view, it is concluded that the merger alone is unlikely to *substantially* lessen competition in the fertilizer industry.

2. *Problems in FFC/Azgard-9 Analysis:*

All the arguments and submissions made by the FFC and Azgard-9 have been carefully analyzed, and we do not agree with the methodological assumptions, assertions and general findings. For instance:

a. *Revised estimates:* It is not clear how FFC has revised its estimates for urea from 45.9 % to 39.8%. Similarly, FFC's estimate of Agritech's SSP production has been revised downwards from 59% to 21% by changing the production from actual sales percentage to declared production capacity of competitors. It is noteworthy that FFC uses actual production to demonstrate efficiency gains, but installed capacity to calculate market share, which makes their submission of estimates skewed. In this regard, we have obtained data from the National Fertilizer Development Centre which is reflected in the table below providing the share in the market of SSP on production basis and clearly showing Hazara to enjoy dominant position by holding 44% of the market share. The market of SSP, therefore constitutes 2% of the aggregate fertilizer market and not 1% as maintained by FFC:

Year: 2009-10. (SSP)

Company	Production (Tons)	Market Share
Suraj	32,000	13.73
Asghar	924	00.40
Agritech	***103,000***	***44.18***
Al Hamad	47,000	20.16
Salaar Fertilizer	25,000	10.73
Riches Fertilizer	25,172	10.80
	233,096	***100.00%***

***Source: National Fertilizser Development Centre, Islamabad**

As for DAP, the parties claimed that the import of DAP is dictated by the government, hence revising the market share on the basis that there is no likelihood of import is not tenable.

b. *Flawed Assumptions:* Throughout their casework, FFC has made some unjustified assumptions and then heavily drawn upon them to make sweeping conclusions. For instance, FFC has emphasized the synergy from merger specific efficiencies without explaining or providing evidence of how those benefits are exclusively merger specific, and how that benefit will transfer to consumers.

c. *Failing firm argument*: FFC has persistently maintained the failing firm argument and has gone at great lengths to warn of the lurking disaster in case the acquisition is not allowed, when Agritech is simply not a failing firm and thus the argument does not even apply. The Commission does not agree with the assumptions made in terms of input cost and incremental projections in administrative and brand expenses as well as apparent accounting inconsistencies. Agritech is not a failing firm; rather it is a going concern which is validated by the lenders outlook to re-profile the entire debt repayable over eight years, including two years grace. The Applicant’s reliance on the *International Shoe Company v. Federal Trade Commission* in this regard is of little help. With regard to the financial condition of the McElwain Company the Courts observed that there was a marked falling off in prices in sales of shoes and because of indebtedness for large sums of borrowed money its offices concluded that the Company was faced with financial ruin and that the only alternatives presented were liquidation through a receiver or an outright sale. New orders were not coming in, there were huge losses, surplus had turned into deficit within a year, the factories were producing far below their capacity limits and examination of its balance sheets and statements and testimonies of its officers clearly demonstrated that the Company could no longer pay its debts as they became due.

On the contrary, Agritech apart from making profits till the last year, the plant capacity utilization is beyond 100% and it is not understood how Argitech, which has been generating consistent cash flows from operations be viewed as "bound to fail". In addition to some unwarranted assumptions, FFC has made some unsubstantiated claims. For example, FFC claims that Agritech and its subsidiary Hazara have been operating beyond their capacity and that has led to lower quality of the end product, and only FFC can improve both efficiency and quality, it remains unknown as to how. The fundamental assumptions, including gas feed price used for BMR associated production, variations in figures reported in audited accounts for 2009 and 2010 and those used in financial projections and certain other inconsistencies raises doubts that the diagnostic study conducted on the future viability gives correct analysis. As for the request **"Azgard Group as failing firm"** if acceded to by the Commission, the group definition would perhaps extend to the JS Group, which would distort the present merger analysis.

d. *Unsubstantiated Claims:* In addition, FFC claims that Agritech does not have the long term commitment in terms of investment and deployment of experienced manpower resources. It remains to be seen that how FFC can make claims with such certainty on the prospects, sustainability, and commitment of a third party.

3. Countervailing powers:

The expression ‘countervailing power’ generally refers to the ability of a given number of buyers to be able to influence the market. In terms of the fertilizer market in Pakistan, sales of the product of all domestic fertilizer producers takes place through dealers who in turn sale such product to end users. Seemingly, there is no countervailing power in the sense of few large buyers.

Notwithstanding the fact that fertilizer industry demonstrates captive market, it still appears to be a growing industry as the demand for different kind of fertilizers has continued to grow and although the industry does not lend itself to be characterized as competitive, its duopolistic nature, together with potential for imports, creates latent inter-firm rivalry necessary for competition or to prevent the likely abuse by one dominant undertaking. However, the Commission strongly recommends the government to lift any regulatory barriers and other tariff and non-tariff barriers that may inhibit imports of the fertilizers that help as countervailing power in the industry.

4. Conclusion:

Notwithstanding the analytical problems apparent in the application and subsequent arguments by FFC, we are of the considered view that the proposed acquisition/merger, if allowed, will not substantially lessen competition. Although, the pre-merger HHI for urea alone reflects a highly concentrated market (much greater than 2000 – a yardstick for measuring the high concentration level in the market) and any further consolidation will further raise the concentration in the market, which may give rise to serious competition concerns but we are taking into account the fact that Engro has launched a major expansion plan which as purported by the Applicant indicates '*the dynamic characteristics of the market including growth, innovation and product differentiation*' the dominance it is maintained by the Applicant '*would be off set by its competitors*'.

On behalf of FFC it was urged that in the U.S the Court of Appeals had allowed a merger where the merger led to a duopoly. Reference *Western Coal Traffic League v. Surface Transportation Board & others* decided on March 23, 1999. We appreciate that the Court of Appeals in the said case upheld the decision of the Transportation Board. However, the Board noted that: "*the outcome where just two companies offer the only significant competitive alternatives in a market may range all the way from intense rivalry to collusion, depending on the circumstances of the industry*." What was presented before the Board as empirical evidence of competitiveness in the nation's rail systems was that the competitive pressures had been sufficient to enhance productivity by adopting efficient operating and management systems, and their costs had gone down each year because of increased productivity gains. The gains had been passed along to shippers in the form of lower rates and more responsive service. In addition there was no evidence that railroads had colluded overtly or tacitly to maintain "*inefficient operations, unresponsive service or above market rate levels".* Although there is no evidence of collusion in the fertilizer industry so far, but no empirical evidence is provided as to how mere expansion on part of Engro or Fatima is likely to result in rivalry. Nonetheless, the Commission takes the claims made by FFC with respect to the positive impacts of this merger for the industry and the national economy on their face value and considers them as clearly stipulated conditions of the merger. Furthermore, the monitoring conditions we are imposing will deter possible collusion and enable the Commission to take any necessary corrective action to alleviate anti-competitive concerns. Therefore, the Commission hereby issues its no objection to the bidding by FFC for the proposed merger subject to the following conditions:

(1) FFC shall maintain “tara” and “sona” brands separately for two years and there shall be a price cap on the price increase of “tara” product by FFC for a period of one year (although with efficiencies claimed we expect that the price for ‘tara’ shall go down). The maintenance of the two brands shall be subject to review after a period of one year or any time later but prior to two years; provided the market share of Urea acquired by FFC i.e., 6% drops from the existing market share through distribution or redistribution amongst existing and upcoming players in the fertilizer sector. (It may be noted that the 6% is taken from the Applicant’s estimate of the share in the market, prior to the revised percentage i.e. 5.2%).

(2) FFC shall maintain transparency for any change in price in all its fertilizer products and shall for the period of three years intimate to the Commission any price escalation along with reasons for such price increase (if any) within seven days of such increase.

(3) Subject to review of this decision as stipulated below, the Commission if deemed necessary may require FFC to divest a portion of shareholding in Hazara.

(4) In terms of sub-section 11(b) of Section 11 this approval is subject to review within one year under sub-section 13 of the said section. For the purpose of review, the following shall be considered as a yardstick which may include but shall not be limited to the monitoring of:

a) unexplained escalation in price levels;

b) tendency of price parallelism;

c) changes in market share and levels of concentration;

d) new investments made in Balancing Modernization Replacement of the target firm by the acquirer leading to enhancement of production capacity; and

e) commitment to nondiscriminatory behavior.

(5) FFC shall file its commitment within four weeks from the date of issuance of this decision to comply with all the conditions stipulated herein above, in letter and in spirit and the clearance/approval given here under shall only be deemed effective upon the filing of the commitments.

While, competition generally drives undertakings to achieve efficiencies internally, the primary benefit of the mergers to the economy is their potential to produce substantial efficiencies by enhancing its ability and incentive to compete. Efficiency claim, however, should not be vague or speculative and should be verifiable by reasonable means. Be it incremental cost reduction which may control the incentive to increase prices or leading to new and improved products or the ability of merged firms to conduct research or development which may encourage innovation. The eventual benefit, from the consumer's perspective, is to see whether these efficiencies would result in lower prices, improved quality, enhanced services or new products. The Commission hopes that this decision will help achieving economies of scale in the fertilizer industry leading to decrease in consumer prices without substantially lessening competition. The Commission is also of the view that free trade ensures competition, keeps competitive pressure on the local industry and protects consumers from possible exploitation.

(RAHAT KAUNAIN HASSAN)
CHAIRPERSON

(VADIYYA S. KHALIL)
MEMBER

<u>Islamabad the January 26th, 2011</u>