For Official Use **DAF/COMP/WD(2007)33**

Organisation de Coopération et de Développement Economiques
Organisation for Economic Co-operation and Development **02-Feb-2007**

English text only

DIRECTORATE FOR FINANCIAL AND ENTERPRISE AFFAIRS
COMPETITION COMMITTEE

DAF/COMP/WD(2007)33
For Official Use

ROUNDTABLE ON VERTICAL MERGERS

-- Note by Poland --

This note is submitted by the Polish Delegation to the Competition Committee FOR DISCUSSION at its forthcoming meeting to be held on 21-22 February 2007.

JT03221128

English text only

CONTROL OF VERTICAL MERGERS IN POLAND

1. There are two different approaches to vertical relations on the market. The first is connected with a classical competition theory[1]. It concentrates on the defects caused by horizontal mergers and horizontal market structure. According to the classical approach, vertical integration can be dangerous only due to the fact that it can affect the horizontal structures. In line with the second approach[2], vertical agreements of companies may improve the effectiveness and rationalise the costs. They do not always disturb horizontal market structures. The dangers of vertical relations and restraints can be minimised by relevant legal regulations. These two aspects[3] of vertical mergers should be taken into account in the control procedures.

1. Legal regulations of mergers of entrepreneurs in the Polish law

2. The article 20 of the Polish Constitution states that the basis of the Polish economic system shall be "a social market economy, based on the freedom of economic activity, private ownership, and solidarity, dialogue and cooperation between social partners". It defines freedom of market activities as a fundamental rule of economic life. However, according to article 22 "limitations upon the freedom of economic activity may be imposed only by means of statute and only for important public reasons". Controlling mergers of companies should be considered as a form of such limitation.

3. The Polish law acknowledges the necessity of state control over mergers of entrepreneurs. The main controlling body in this sphere is the Office of Competition and Consumer Protection ("Office", "OCCP"). Its work is based on the Act of 15 December 2000 on Competition and Consumer Protection ("Act of 2000", "Act") and the Regulation 139/2004/EC of the Council of 20 January 2004 on the control of concentrations between undertakings.

4. The Act does not provide a specific definition of the term "concentration". Nevertheless, it specifies a list of situations, when a transaction should be reported to the President of the OCCP. First of all, under the current law, a concentration is to be notified to the OCCP only when the total turnover of the entrepreneurs who participate in the process exceeds the equivalent of 50 million EUR in the preceding year. However, in the opinion of the OCCP, only the largest concentrations should be controlled, as only those seriously affect the market. Therefore, an amendment to the Act, which is currently discussed in the Polish Parliament provides an increase of the turnover thresholds in the cases of concentration of entrepreneurs. Upon the amendment the obligation will apply only to the transactions carried out by the entrepreneurs who have achieved the total turnover that exceeds 1 billion EUR in the world or EUR 50 million PLN in Poland.

---

1 According to Anna Zielińska-Głębocka, an example of such classical theory is the Georg Stigler's model; Anna Zielińska-Głębocka, *Podstawowe założenia teorii konkurencji*, [in:] Zdzisław Brodecki (ed.) *Konkurencja*, Lexis Nexis 2004.

2 The Chicago School approach, for example Harold Demsetz, *Industry structure, market rivalry and public policy*, "Journal of Law and Economics", 1973.

3 Anna Zielińska-Głębocka, *Podstawowe założenia teorii konkurencji*…

5. Moreover, according to the Polish law, "concentrations" should be reported to the President of the OCCP in case they take form of one of the situations exposed in the article 12 of the Act, i.e.: a merger of two or more independent entrepreneurs, consisting in taking direct or indirect control over another entrepreneur or a number of them, e.g. through the shares (acquisition) as well as in creating a new company by the companies that already exist (joint venture). Additionally, the intention of a concentration should be reported when one person takes charge of the managing or controlling bodies of two or more competing entrepreneurs. Also, in the case of taking over or acquisition of stocks or shares of another entrepreneur resulting in achieving at least 25% of votes at a general assembly or assembly of partners and initiating to exercise the rights arising from stocks or shares taken over or acquired without prior notification.

6. The Polish model of concentration enforcement is a model of ex-ante notification (in opposition to the ex-post approach). It is consistent with the approach of the European Commission, which has competence in the ex-ante concentration control of companies with a turnover over 5 000 000 000 Euro (or 2 500 000 000 Euro, depending on other conditions). The ex-ante approach helps to avoid situations when a decision made by an antimonopoly organ is actually a reaction to an existing harm (as in case of post-ante notifications).

7. The Act of 2000 describes (art. 13) five situations when the obligation of the notification of concentration is excluded:

a) There is no need of reporting the concentration when the turnover of the entrepreneurs in Poland from last two years has not exceeded the equivalent of 10 million euro. However, even in this case, when the concentration can create or strengthen the dominant position on the market, the intention of it should be notified;

b) When the financial institution, the normal activities of which include investing in stocks and shares of other entrepreneurs, takes over the shares on a temporary basis without the intention of executing the shareholder rights (except from the right to dividend);

c) When the entrepreneur acquires on a temporary basis stocks and shares with a view to securing debts, provided that such entrepreneur does not exercise the rights arising from these shares/stocks (except from the right to sell). In the moment when executing of shareholder rights begins, the obligation of notifying the concentration appears;

d) When it is an effect of insolvency proceedings (except from a situation when shares are taken over by a competitor or member of competitor's capital group);

e) In case of concentration of entrepreneurs from the same capital group.

8. After the administrative proceeding the President of the Office issues a decision. The consent is given when the concentration is not regarded to be a restriction for the competition on the market. There is a possibility of issuing a conditional consent. In this case, the President of the Office can burden the entrepreneur with specific obligations. In particular, he can oblige the company to sell part of its property or to dispose of control over another company (for example through selling the shares). The company may be also obliged to grant certain licenses (e.g. for selling products) to the competitor. The obligations described in the Act are not exhaustive; it means that the actual obligations can be different from those mentioned in the Act. In the decision, the President of the OCCP imposes upon the company the obligation of reporting about the realisation of the specified conditions.

9. The President of the OCCP prohibits the concentration if it causes significant restriction for the competition on the market (art. 17). However, even in this case consent can be given if the concentration

could *"contribute to economic development or technical progress"* and if it had a *"positive effect on the national economy"*.

10. The decisions of the President of the OCCP expire if the concentration has not been made two years from the decision. Nevertheless, the date can be prolonged (to three years) on application of the participant of the concentration under the condition that the entrepreneur proves that there have been no significant changes of situation and the concentration still does not cause danger of restricting competition on the market.

11. The President can reverse his decision if it has been based on unreliable information, for which the entrepreneurs are responsible. The decision can also be reversed if the entrepreneurs do not realise the obligations stated in the conditional agreement. If the decision had been realised already, the President of the Office can order the division of the company, selling out the shares or dismissal of the member of the managing body. An appeal against all types of decisions can be submitted to the Court of Competition and Consumer Protection (District Court in Warsaw).

12. The controlling procedure may involve the so-called *"interested subject"* (art. 95), which may submit a motion to participate in the control. It is a subject, which is not a participant of the merger, nevertheless has a legal interest connected with the case. It may be, i.e. an entrepreneur active on the market, where the concentration is going to occur. The OCCP in one of the cases admitted as an *"interested subject"* a group of franchisers who signed contracts with the company, which was to be acquired. The "*interested subject"* has an insight into the files of the case within the scope it is necessary to protect his rights (providing that this will not infringe the enterprise's business secret, or any other secrets being liable to protection). It may also submit documents and explanations about the circumstances of the case.

13. The Act of 2000 does not make a distinction between "vertical" and "horizontal" mergers. Terms of "vertical merger" and "horizontal merger" can be referred to the terms appearing in the Regulation of the President of the Council of Ministers of 3 April 2002 on Notifying of the Intention of Concentration of Undertakings. It defines the relevant market, which is influenced by the concentration in vertical or horizontal configuration. According to this Regulation, the relevant market, which is influenced by the concentration in horizontal configuration is *"every product market, where at least two entrepreneurs-concentration participants are engaged and where the concentration leads to common market share higher than 20%"*. On the other hand, the relevant market, which is influenced by the concentration in vertical configuration, is every product market if at the same time: (1) at least one entrepreneur-concentration participant is active on this market, (2) it is at the same moment the market of purchase/sale for at least one of the others entrepreneurs-concentration participants, (3) individual or common market share of the entrepreneurs-concentration participants is higher than 30% (no matter if they are currently bound as deliverer and recipient on this market).

2. The effects of vertical mergers in comparison to horizontal and conglomerate mergers

14. Although in the Polish law there is no direct distinction between restrictions connected with vertical and horizontal or conglomerate mergers, the consequences can vary depending on type of the transaction. Horizontal mergers involve companies at a single level of the supply chain. This kind of concentration unifies manufacturers of substitutive products, thus creating a direct competitive restraint. Conglomerate mergers take place between companies, which operate on different markets. Non-horizontal mergers (both vertical and conglomerate) unify the deliverers of complementary (or unrelated) products, therefore they do not foreclose the competition in a direct way. The direct consequence of a non-horizontal merger is in many cases pro-competitive.

15. Non-horizontal mergers allow preventing profit losses. In a process of a vertical concentration externalities are internalized, which leads to potential efficiency gains. In case, where various products are produced in scope of a single company, the costs can be lower than in a situation, when they are produced by different companies. Internalisation of pricing externalities is profitable for customers. Besides, vertical integration results in a more efficient use of inputs and productive assets, because of improved managerial and financial efficiency[4]. It eases the coordination of design, production and distribution of goods. It excludes the need for negotiation and execution of contracts and minimises the risk and uncertainty (according to the transaction cost theory). In conclusion, it may be said that vertical mergers have many assets, which are not achievable by horizontal or conglomerate mergers. These arguments were raised i.e. in the controlling proceedings which will be described later.

16. Additionally, competitors of the integrated company may be stimulated to a counter-merger, achieving the access to the upstream distribution or downstream production at minimal cost[5]. The first merger might cause a series of vertical mergers, which would maximise the profits of companies.

17. However, vertical integration and foreclosure also reduce the potential new entrants' profits in such way that they are deterred from entering on a certain market. Negative aspects of vertical integration include price squeeze (minimising the difference between the price at which it sells the products to the external competitors and the price at which the end-products are sold by the "internal" company in one's capital group) and supply squeeze (putting competitors from the purchasing company in disadvantage by refusing to sell them products). Vertical mergers can also lead to restraints to the potential customers, when either the products are only delivered to a particular group of recipients or certain groups are excluded from delivery.

18. Vertical mergers give rise to anticompetitive effect thus increasing likelihood of predation, which is banned in article 8 of the Act of 2000 ("abusing the dominant position"). Predation occurs at both levels of market concentration: when the merged companies aim to harm the rivals and after the rivals' exit from the market. One of the most common forms of it is direct or indirect imposing of unfair prices, including too high or flagrantly low prices (predatory prices), extended deadlines of payment or other conditions of sale/purchase of products. The second abuse of a dominant position, mentioned in the Act, is foreclosure of production, distribution or technical development to the detriment of contractors or consumers. Other forms of abuse include: using diversified or harmful conditions in similar contracts with contractors or consumers, creating dependence between the contract's closure and fulfilling other irrelevant performance, acting against development of competition on the market, imposing unfair conditions of the contracts by a dominant entrepreneur, dividing the market by territorial, assortment or subject criteria, creating harmful conditions for consumers' vindication of rights. In all abovementioned cases, the President of the OCCP has competence to issue a prohibition of a particular activity. The list in the article 8 is not exhaustive; "abuse of the dominant position" can also include other activities, which cause harm to competitors or customers.

19. However, the analysts of competition policies and predation practices notice that it is essential to distinguish between (a) harmful reduction of prices as an element of predation policy and (b) reduction of prices which is profitable and results just from high effectiveness of production[6]. In the first case, after eliminating the competitors an increase of prices occurs. In the second case, reduction of prices is

---

4 Kimon Bishop, Andrea Lofaro, Francisco Rosati, Juliet Young, *The Efficiency-Enhancing of Non-Horizontal Mergers, Office for Official Publications of the European Communities, 2005.*

5 Jeffrey Church, *The impact of Vertical and Conglomerate Mergers on Competition*, Department of Economics, University of Calgary 2004.

6 Ibidem.

permanent as it is a consequence of higher productivity. In this case, eliminating the competitors is a natural result of fair competition in the market.

20. As it will be pointed out in the analysis of the Carey Agri case, the negative changes can be prevented by means of imposing special conditions on the merged companies. The practical solutions to these problems will be discussed in the analysis of particular cases in Poland.

3. Vertical mergers control – case studies

21. This part of the presentation will be devoted to examples of decisions made by the President of the OCCP concerning vertical mergers in Poland: the first case was finalised with an approval for a performance of a vertical merger, the second was terminated with a conditional approval. In the third case the merger was prohibited.

(1) In October 2006 the President of the OCCP issued a decision consenting a vertical merger in the sector of municipal services. The concentration was planned in a form of acquisition. **Remondis Aqua** GmbH & Co. located in Luenen notified the intention of acquiring 49,9% shares in the Polish company **Municipal Services Company** (Zakłady Gospodarki Komunalnej i Mieszkaniowej, further: ZGKiM) located in Drobin. The concentration would lead to obtaining 49,9% votes on the associates' assembly.

Remondis is active on such markets as community waste reception and disposal, cleaning streets and roads, cultivation of plants, construction works and burial services, cleaning, maintenance and repair of road signs. ZGKiM works in similar scope of sanitary services and municipal property management.

The OCCP stated that the concentration would have influence on the market in both horizontal and vertical configuration (the limits of 20% and 30% of shares defined in the Regulation were exceeded). The market of waste storage, on which ZGKiM operates, is a market of sales for Remondis, Department in Płock. Therefore, the companies are connected in a relation "deliverer-producer".

However, the Office also stated that the concentration would not be a significant restriction to the competition on the market. It would have a marginal influence on the relevant markets. The President of the OCCP took into account the fact that the concentration would enable investments and will create new places of work, therefore diminishing unemployment. The acquisition would improve the infrastructure of ZGKiM, ensuring finances for the necessary improvement of the water supply system and sewage system. It would be profitable for both economic and technical development.

(2) A different example of a vertical merger – in alcoholic drinks sector – was finalised with a conditional consent for concentration in September 2005. The concentration was planned in a form of acquisition of Polmos company from Białystok by Carey Agri International Poland. The passive participant of this merger – **Polmos Białystok** – works in the scope of production and sales of alcoholic drinks. The activity of both companies on various levels of the market turnover results in a vertical character of this merger. The companies fulfilled legal prerequisites for both merger in a horizontal configuration (vodka sales and delivery) and merger in a vertical configuration (vodka production, sales and delivery). However, the concentration thresholds (20% for horizontal mergers, 30% for vertical mergers) were not exceeded, so the concentration was in harmony with legal regulations.

In administrative proceedings the President of the OCCP took into account the foreseen vertical direction of the consolidation in the branch of alcoholic drinks. It could lead to a

situation when the market position of the producer would be determined by its position in the scope of distribution. It could cause a supply squeeze as well as a price squeeze. The antimonopoly body evaluated that the period of these changes would be the next 3-4 years – in consequence, it was justified to impose the obligations on Carey Agri in the years 2005-2008. The President of the OCCP issued the consent for concentration under two conditions. Carey Agri had to resign the exclusiveness in distribution of vodkas offered by Bols and Polmos Białystok for the benefit of the entrepreneurs outside Carey Agri capital group. Furthermore, the company was obliged to sell 35% of its products in the period of 2005-2008 by hands of independent distributors. The final decision aimed at maintaining the rule that distributing companies should compete by means of differentiating the offered products.

(3) After the acquisition of Polmos Białystok, Carey Agri had a strong position on the market of alcoholic drinks. Nevertheless, it submitted a notification concerning the acquisition of another significant producer, **Jabłonna Lublin**. In this case, the OCCP prohibited the acquisition (in the decision issued in May 2006) due to the significant shares of the entrepreneur in the markets of production of pure vodka and brand vodka. The new concentration would lead to acquiring over 20% of shares in the relevant markets. The combined share of the entrepreneurs in the market of vodka sales (pure vodka as well as brand vodka) would exceed 30%. This meant that the concentration would influence the market in both horizontal and vertical configuration. The consent could not be issued.

The analysis of current concentration on the market and potential future concentration (after the merger) are calculated with help of Herfindahl-Hirshman indicator[7]. The indicators after the merger showed a high level of concentration on the market.

In both cases of mergers in the market of alcoholic drinks the intention of Carey Agri was to acquire the brands, which are well known by Polish consumers. It would minimise the necessary costs of promotion and advertising. After the acquisition of their producers and after creating a net of internal distributors, Carey Agri would be able to limit the activities of non-merged distributors on the market, for example by refusing to sell them the most popular brands. This thesis was confirmed in the opinion poll, ordered by the OCCP. According to the consumers as well as the competitors of Carey Agri, the brands offered by acquired companies Polmos Białystok and Jabłonna Lublin were the most recognisable alcoholic drinks in the market of pure and brand vodka. Therefore in case of Polmos Białystok the condition for the consent was the obligation sell the most famous products of Polmos ("Absolwent", "Żubrówka") through independent distributors. However, the crucial factor in both cases was the level of concentration on the relevant market. In case of Polmos Białystok, the thresholds defined by law (20% for horizontal merger, 30% for a vertical one) were not exceeded, so the consent was issued. In case of Jabłonna Lublin and the prohibition, the threshold was exceeded. The case of Carey Agri has also proved the importance of opinion polls as an auxiliary element during administrative proceedings. The competitors who filled in the questionnaires paid attention to the harmful effects of restrictions in the distribution of popular brands.

[7] In the branch where only one entrepreneur is active, HHI indicator comes to 10 000. In the situation of huge competition in the market, the indicator approaches 1. The concentration spectrum in this model is divided into three scopes: (1) non-concentrated market (HHI lower than 1000), (2) medium concentrated market (HHI 1000-1800), (3) highly concentrated market (HHI over 1800).

4. Summary

22. The effects of vertical mergers differ from those which arise from horizontal mergers. They include certain positive aspects, which are not always implied by non-vertical integration. However, with all vertical concentrations it is essential to consider the probable competitive consequences of the merger in both markets of the delivering company and the market of the purchasing company.

23. It is not necessary to take complete control over an entrepreneur from another level of production in order to restrict the competition on the market. Often it is enough to be in possession of a minor share in order to create stable vertical boundaries and change the situation on the market. In consequence, the results of vertical concentration are often similar to the results of vertical agreements[8].

24. It is worth distinguishing between short-term positive consequences of the mergers (beneficial for customers due to the fact that are conducted with intention to harm the rival companies) and long-term effects, connected with competitors' exit from the market or deterrence. Long-term effects may involve restricting equal access to customers (by reducing the ability of competing companies to gain such market shares that are necessary to achieve a satisfactory level of production) and well as restricting equal access to suppliers (using supply squeeze strategy and imposing difficult burden of entries for new companies).

25. On the other hand, mergers in a vertical configuration (as in the case of the Polish municipal services sector) can create financial stability necessary to conduct huge investment. Therefore they facilitate technical and economic development.

[8] *Piotr Mueck, Doświadczenia Polski w kontroli koncentracji*, Office of Competition and Consumer Protection, 2004.