Assessing excessive pricing – the case of flat steel in South Africa

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1. Introduction

At first sight the arguments ranged against taking excessive pricing provisions seriously are weighty and well-founded. They are led by the point that proscribing firms’ pricing decisions risks penalizing innovation and the making of risky investments. In the terms used by Judge Learned Hand in the Alcoa judgment, it may be akin to asking firms to compete and then turning on the winner. It likely discourages effort to succeed over competitors whether in developing better products, more attractive brands, or better service. High prices on the part of incumbents are also what attracts entrants, and thus, in time, increased competition. The limited ability of competition or anti-trust authorities and courts to judge in such cases has also been widely highlighted in arguments that emphasise the risk of Type I errors, that is, errors from over-enforcement (Hordijk, 2002; Kovacic, 2006; Evans and Padilla, 2005a). Excessive pricing is effectively not an offence under US law while in the EU excessive pricing cases in competition law have been relatively few and far between. The USA and EU are, however, huge markets, where it is difficult to think of single firm behavior unconstrained by actual or potential competitors, in the absence of an advantage derived from innovation or a peculiar geographic market or regulatory limitation.

Excessive pricing is effectively not an offence under US law while in the EU excessive pricing cases in competition law have been relatively few and far between. The USA and EU are, however, huge markets, where it is difficult to think of single firm behavior unconstrained by actual or potential competitors, in the absence of an advantage derived from innovation or a peculiar geographic market or regulatory limitation.

In favour of taking excessive pricing seriously, however, it is notable that even the self-described ‘neo-Chicagoans’, Evans and Padilla (2005a and b), do identify that excessive pricing may be applicable where monopoly or entrenched dominance is due to current or past special rights or state support including current or past legal protection (see also Vickers, 2006; Motta and de Streel, 2006; Lowe, 2006). With reference to the possible dangers of over-enforcement, Fingleton (2006), then Chairman of the Irish Competition Authority noted that ‘[t]he big [competition] problems in Ireland, and probably in many other European countries, still stem from lack of effective sanction against monopolization, and not from any fear of excessive enforcement against firms that have obtained high market shares by virtue of vigorous competition and efficiency’. Fingleton also notes ‘It matters greatly whether monopolies have resulted from decades of state protection or from successful competition on the merits’. Evans and Padilla (2005a) also recommend vigilance

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1 This paper is written in my personal capacity and does not necessarily reflect the views of the Competition Commission. It draws on research undertaken together with Ryan Hawthorne and Reena Das Nair for the case brought by Harmony against Mittal Steel South Africa, in which I was an expert witness for Harmony.

2 See also the 2004 Trinko decision of the US Supreme Court.


4 The best known include European cases of bananas, funeral services, pharmaceuticals, ports and horse racing data.
where the actions of dominant firms negatively impede the development of related industries and markets.

In South Africa, the practice of import parity pricing in steel has been widely noted as a problem for economic development, albeit with little action being taken. The President has highlighted it in opening addresses to Parliament, the Minister of Trade and Industry has raised it in several speeches and National Treasury has listed it as one of six constraints to growth. Separately, the problems of high levels of concentration and anti-competitive behavior as evidenced by high mark-ups have been noted (Aghion et al., 2006). High concentration and mark-ups in the South African economy were found to be associated with low levels of productivity and employment growth.

One of the motivations for the new Competition Act was the need to address anti-competitive practices, to achieve a more efficient economy as part of government’s programme of microeconomic reforms. The South African Competition Act (Act 89 of 1998 as amended) addresses abuse of dominance under section 8, which states that ‘it is prohibited for a dominant firm to: (a) charge an excessive price to the detriment of consumers’. An excessive price is defined under the Competition Act as a price which bears no reasonable relation to the economic value of the good or service, and is higher than such value (Section 1.(1) (ix) Definitions and interpretation).

The first ruling on excessive pricing has recently been made by the Competition Tribunal in the case brought by Harmony Gold against Mittal Steel South Africa, with regard to the pricing of flat steel in the South African market. The case focused to a large extent on the base product of hot-rolled coil (HRC), and related mainly to the conditions at the largest plant in which is produced, at the Vanderbijlpark. This paper discusses the appropriate tests for excessive pricing under the Competition Act in the context of this case.

2. What is it, and how to test for it?

The definition of excessive pricing under the South African Act leaves what is meant by ‘economic value’ to the competition authorities to determine. It might be observed that the value to consumers is what they are willing to pay for a product. However, the most obvious determination of excessive pricing and economic value is the charging of (non-discriminatory) monopoly prices with a loss of consumer surplus and a deadweight loss. This means an efficiency loss to the economy and harm to consumers, both of which are at

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5 The five per cent import duty on basic iron & steel products was eliminated in 2006.
6 Address of the President at the opening of Parliament, 11 February 2005. The Treasury DG, Lesetja Kganyago, identified six impediments standing in the way of achieving SA’s six per cent per annum growth target, namely currency volatility, infrastructure backlogs, the regulatory environment, delivery, skills shortage and import-parity pricing (‘Government to tackle economic constraints’, Business Day, 28 November 2005).
8 The South Africa formulation appears directly taken from the EC’s United Brands ruling, where the Court held that:

249. It is advisable therefore to ascertain whether the dominant undertaking has made use of the opportunities arising out of its dominant position in such a way to reap trading benefits which it would not have reaped if there had been normal and sufficiently effective competition.

250. In this case charging a price which is excessive because it is not reasonable in relation to the economic value of the product would be an abuse.
the core of competition law and policy objectives. In these terms, the economic value is the marginal cost, with excessive pricing being about the mark-up over this (the Lerner Index).

This would suggest an exercise to do with assessing prices against costs and/or profit levels to see whether they are excessive against some pre-determined standard. This was the approach followed by the economist for Mittal, who sought to draw a distinction between the price levels and the price system, with the appropriate test for excessive pricing being related to the former. It is also the approach generally followed by regulators, whether in employing a price cap or rate-of-return.

I argue that drawing such a distinction between price levels and the pricing system or practice is inappropriate, and that excessive pricing is essentially about the exertion of market power in the absence of effective competitive constraints (in the long, as well as short, run). It is this which is meant by the reference to ‘normal and sufficiently effective competition’ in the United Brands ruling. It goes to the heart of the purpose of competition policy and law, including merger evaluation, which relates to the static and dynamic benefits of competitive rivalry. However, this is not to assume that one must identify the outcomes against a theoretical ‘textbook’ model of a perfectly competitive market. Rather, we are concerned with the pricing that would be expected from competitive behaviour, that is, effective rivalry between firms, rather than the unilateral exercise of market power.9

Whether pricing is reflective of rivalry or the unilateral exertion of market power goes to the pricing systems and practices in place. The pricing observed is an outcome or effect of the market conditions. Undertaking an evaluation of the market conditions in order to assess the nature of the pricing will also naturally lead to ways in which the pricing can be addressed. In practice, excessive pricing is unlikely to occur in the absence of other exclusionary concerns, whether by regulation or enforced by the strategic behaviour of the firm in question, or both.

To assess the observed pricing against the standard of what would be expected under conditions of effective competition a process of benchmarking can be employed (Motta and De Streel, 2006). The pricing in the market in question is compared against markets where there is evidently competitive discipline. Drawing from Motta and De Streel, there is a range of comparators that can be used in this exercise, including:

- Pricing in relation to costs for different products and markets, where the pricing of different products where the costs can be compared provides a basis to assess margins, and where the lower margins can be deemed to yield a ‘reasonable’ profit.10 This approach is complicated by the difficulties in obtaining and computing costs and in determining what a ‘reasonable’ profit margin would be.11 We must be careful to assess whether costs are inflated because of productive

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9 The need to encourage real rivalry underlies the concept of ‘fair competition’ in the competition laws of East Asian countries (Fox, 2003). The concern with very large firms with entrenched dominance also underpins the provisions for monitoring and reporting by designated firms (mainly the chaebols) in South Korea and also for extensive provisions addressing the position of small and medium enterprises and subcontractors vis-à-vis dominant firms (Wise, 2000).

10 This approach has been followed in European cases, including United Brands, CICCE, SACEM II, Ahmed Saeed (see Motta and de Streel, 2006).

11 For instance, there was no reliable accounting cost information to make a detailed average cost analysis for the European Commission to rely on in the Deutsche Post II decision and so the Commission had to use an alternative cost estimate (see Motta & de Streel, 2006).
inefficiency (X-inefficiency) arising from a dominant position and poor monitoring of managers by shareholders.12

- Comparing different prices charged to different customers in the same geographic market by the dominant firm in question but where there are similar or even identical costs. If the lower price is profitable, then the higher may be judged to be excessive.13

- Comparing different prices for the same product charged to customers in different geographic markets (after correcting for transport and related costs). To show excessive prices, it is important to demonstrate that the lower prices are profitable, and that the prices are different without justification (such as in terms of costs of production and supply).14

- Prices of similar products in a market which can be identified as relatively competitive, compared to the monopolised market in question. This is benchmarking, similar to ‘yardstick competition’ used in regulation of some utilities markets.15

- A detailed assessment of the market dynamics and the anti-competitive rationale underpinning the difference in prices from the comparators.

In effect, some of these measures are based on discrimination by the firm in question, while others are more clearly comparators. In both cases, the value of the measure depends on being able to assess the extent of the differences, and to what extent these derive from differences in competitive rivalry as opposed to other factors (such as differences in the cost of supply).

While there have been relatively few cases ruled on in Europe, Motta and de Streel (2006) observe that the European Commission investigated many more cases which were then closed on changes (decreases) in the prices occurring. For example, there were several cases opened in member states in 1998 against excessive pricing for international calls, which were subsequently closed following price reductions of 26 to 28 per cent.16

In addition, caution ought to be exercised in addressing excessive pricing as this may relate to the reward for investment in innovations and/or risk-taking investment decisions. It is not that such factors should necessarily allow the unconstrained exertion of monopoly power, but where the dominance results from other factors such as historical state-ownership and support, or other legal barriers, the imperative of addressing excessive pricing and abuse of dominance is less debatable. The possibility of increased rivalry through entry in response

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12 The ECJ ruled that excessive costs incurred by a dominant firm should be ignored in Ministere Public v Tournier (Whish, 2003: p. 692). The court also ruled that the costs of an efficient firm should be considered when considering whether a price is excessive, in SACEM II (Motta & de Streel, 2003: 5).
13 This approach has been applied in General Motors, and British Leyland (Motta & de Streel, 2006).
14 This is the approach in United Brands, although the Court found that the Commission had not showed the lower prices in Ireland were profitable, indeed this analysis had not been undertaken. It was confirmed in Deutsche Grammophon case where different prices for original product in France and Germany could constitute an abuse if it was unjustified by any objective criteria and is particularly marked. Prices for similar products in different geographic markets were used as benchmarks in the Sirena, SACEM I and SACEM II decisions, which related to exploitative excessive pricing cases. (Motta and de Streel, 2006.)
15 This approach was adopted by the ECJ in Corinne Bodson v Pompes Funebres, and Lucazeau v SACEM (Whish, 2003: 691).
16 Hordijk (2002) also notes several such cases, although this is to support his point that the price reductions are not consistent with the extent to which prices were viewed to be excessive.
to abuse should also be taken into account.\textsuperscript{17} It is thus where dominance is entrenched that we should be most concerned.

3. The case of the import parity pricing of flat steel in South Africa

The flat steel industry in South Africa has been dominated by Iscor, now Mittal Steel South Africa, for over 70 years.\textsuperscript{18} It produces around 80 per cent of the flat steel consumed in South Africa at the Vanderbijlpark plant, with the remainder being supplied by Highveld Steel and Vanadium, and a small amount of imported product (mainly of grades not made locally). Mittal and Highveld are large net exporters, with exports around 40 per cent of output until the demand boom in the past year or so. The main inputs into flat steel are iron ore and coal (including coking coal), the great majority of which is sourced locally at export prices or cheaper.\textsuperscript{19} Mittal expresses this as the benefits of backward integration and domestic supply integration. Reflecting these cost advantages, the Mittal plant has been in the lowest quartile of all steel plants in the world for many years.

Iscor was established and run by the South African state until its privatisation and listing on the Johannesburg Securities Exchange in 1989. It remained highly protected in the first half of the 1990s, until in 1996 tariffs were reduced from 30 per cent to five per cent. In the early 1990s it adopted import parity as the basis for its pricing in the local market which it has identified as being ‘naturally protected’.\textsuperscript{20}

Mittal has been clear in its vision statement as to its market position and its objectives in respect of maintaining and exerting its market power:

‘\textit{Iscor strives to be one of the highest operating margin steel producers globally, while controlling the steel market in sub-Saharan Africa.}’

[Iscor Annual Report 2003, p.1]

I define import parity pricing in the context of the flat steel market examined here and the pricing practices of Mittal. As such, it is the practice whereby local firms charge prices equivalent to those charged for a similar, imported product even although there is a trade surplus and imports are not required. This means that the price includes the notional costs of transporting the imported product to South Africa, the duties and related costs incurred, and even the costs of transport from the coast to Gauteng.\textsuperscript{21} Mittal calculates the import-parity price (or international parity price as Mittal now terms it) by taking the cheapest import source, such as steel from the Black Sea region (the free-on-board price), and adding on the sea freight, wharfage and other port and administration charges, agents commission of 2.5 per cent, import duty of five per cent (until 2006), the costs of forward exchange cover that would be incurred by an importer, the ‘hassle factor’ of importing (set at a further five per cent), and the overland transport from Durban to inland customers. This price has been around thirty to forty per cent or more above the free-on-board price at the base of the calculation. Having done this calculation of the import parity price, Mittal uses price ‘discounts’ to adjust the list price for month-by-month fluctuations in international

\textsuperscript{17} This is in line with the consideration of supply side substitutability, and entry barriers in merger evaluation.
\textsuperscript{18} Hereafter simply referred to as Mittal, except where it is necessary to distinguish it from the Mittal Group.
\textsuperscript{19} The exception being coking coal for which South Africa is a net importer.
\textsuperscript{20} Iscor presentation of Audited Results for the six months ended 31 December 2003.
\textsuperscript{21} Holden (2005) however defines the import parity price as the import price at the border (that is, the CIF price) in local currency, and includes freight costs, insurance, tariffs and quantitative restrictions. In these terms Mittal prices above import parity due to the inclusion by it of a ‘hassle factor’ to importing, the costs of foreign exchange forward cover, as well as overland transport costs to Gauteng.
prices and the exchange rate to equate it, for very large local buyers, to the import parity price that has been computed. For all but very large buyers (generally the major steel traders), prices are above the import parity price.

This compares with the price received by Mittal for its exported steel on which actual transport and related costs must be incurred. When the import parity and export prices are compared, the net price for steel sold to local customers at the import parity level is very substantially above that received for steel sold to export customers.\(^{22}\) Competing rivals in such a situation would attempt to win the much more lucrative customers in the local market, by offering the hitherto exported product, bidding prices down to net export levels. With more than one producer there is an incentive for each to under-cut their rivals to win a greater share of the local market, so undermining the basis for import parity pricing. This appears to be explicitly accepted by Iscor:

‘Iscor’s steel pricing policy in the domestic market is based on import-parity principles as its main competition in most of its product ranges is represented by imports. The exceptions to this principle are:
- in the case of products where local competition exists and where over-capacity results in prices that are lower than import parity, as it is in the case with certain lower quality long products…’

[Iscor’s revised listing particulars of 29 October 2001, as cited in the Competition Tribunal report on the large merger of Iscor and Saldanha Steel, 4 April, 2002, p. 11]

The net export position reflects the fact that South Africa is one of the lowest cost manufacturers of steel in the world, further reinforced by the state’s investments in the industry. The South African trade surplus has persisted over many years, with exports in the order of 40 per cent of domestic production, and insignificant imports.

Although some have analysed import parity pricing with reference to clothing and motor vehicles (such as Parr, 2005),\(^{23}\) it appears to make little sense to use the terminology to describe pricing by firms in industries in which South Africa has a comparative disadvantage, with net imports. Such pricing is presumably at landed import price levels, given the substantial imports actually occurring, not a computed import parity level. The prices may be inflated by import duties, depending on government’s trade policy decisions which protect internationally uncompetitive local producers.

**Arbitrage possibilities, and the MacSteel International arrangement**

The differential between export and import parity prices means there is an incentive for a buyer of exported steel to re-sell back into the local market. The arrangement with MacSteel International for the export of steel effectively regulates the market to ensure that this arbitrage is not possible. Under this arrangement overseas export customers must purchase the steel from MacSteel International, a joint venture between Iscor and MacSteel in 1995. The joint venture ensures that the steel cannot be re-sold locally, but rather it must exit the country.

\(^{22}\) Estimates of some sixty per cent and above.

\(^{23}\) Fedderke and Schoer also make reference to import parity pricing in clothing and motor vehicles in ‘Puzzle of import parity pricing’, *Business Day*, 3 October 2006.
During the Tribunal hearing on the complaint Mittal’s witness testified that the reason for the MacSteel International arrangement was to ensure that the exported product could not leak into the domestic market.\textsuperscript{24} If MacSteel International were able to trade into the local market the steel intended for export then Mittal testified that prices would tend to the export price (at which MacSteel International acquires the product, that is, net of all overseas shipping and delivery costs).

**Differential pricing to local customers**

There is an incentive for any monopolist to increase its profits by seeking to discriminate and, indeed, this would raise welfare relative to a non-discriminating monopolist. The ability to do this depends on two key factors. These are: first, the ability to assess the willingness to pay of different consumers (and the same consumers for different units purchased); and second, the ability to prevent arbitrage by those consumers purchasing at a lower price. Price discrimination may also be undertaken by firms in a competitive market, however, with the outcome of differential pricing being a result of the competitive dynamics in the presence of significant fixed costs. Possible examples of this include different prices at cinemas for shows during the day than in the evening, different prices charged for flights at different times of the day, or purchased under different conditions, and different prices charged by tourist lodges with discounting for those who purchase empty rooms at the last minute.

Mittal has evolved a complex system of regulations and rules explicitly designed to increase local sales at prices below import parity, but above the export price that would otherwise be earned on the product.\textsuperscript{25} Are these practices consistent with a price discriminating monopolist, or a market characterized by competitive rivalry? And, what are the implications for the assessment of excessive pricing? I briefly describe the main features of Mittal’s differential pricing before assessing the implications.

**Secondary export rebates**

This type of rebate is given to firms that purchase steel, add value to it and then export this value-added product.\textsuperscript{26} The rebate is only given under strict conditions of proof (through relevant export documentation) that Mittal’s product was used and at least twenty per cent value was added to the steel. While Mittal claimed that the prices after rebates equate to the net export prices, it is evident that rebates were until recently of much smaller amounts, and that there are different export rebate schemes for different groups of customers. Specifically the tube & pipe industry had historically received larger export rebates than other groups of customers.

**Rebates in the face of threat of substitute products**

Where a steel product directly competes with a product made from another material rebates have been designed on a specific customer or industry basis. For example, a rebate exists

\textsuperscript{24} Tribunal ruling footnote 109 and paras 167&168, 195-197. Mittal’s witness in this regard was Mr Dednam, Mittal’s Manager: Market Strategy and New Business Development.

\textsuperscript{25} Although note that Mittal claims to discount in some cases to prices equal to the lowest export price (Tribunal ruling, para 179).

\textsuperscript{26} There are in fact two rebates. The Council for Secondary Manufacture (CSM) rebate is run by SAISI and Iscor awards separate export rebates. However, the effective governance of incentives by the steel producers is emphasised by a condition that reduces the Iscor rebate if the CSM increases.
for manufacturers of steel roofing tiles that compete with cement tiles. In this case, the rebate is not designed to equate the price of the steel tile with that of a cement tile, but to equate the price of constructing a roof of one covering compared with the other. Cement tiles are heavier and require more robust timber beams and joists, while steel tiles allow savings in this area. A roofing firm testified that to motivate for a rebate an exercise in actual construction of roofs from each covering had to be undertaken and presented to Mittal.

Other cases exist where steel products compete with those made of aluminium or of plastic. In each case there are strict conditions attached to the rebate such that it is awarded only for that product which competes with the substitute. In the case of the roofing manufacturer, the rebate did not apply to galvanized painted metal that was not cut into tiles and was supplied for factory roofs and such like.

Special industry deals

Another rebate class offered to certain customers is in the form of special industry deals. The basis for these may be linked to rivalry from substitute products, but it may also be due to other types of leverage or buyer power. Two major industry deals (or strategic rebates) apply to the packaging and auto industries.

One large firm in the packaging industry receives a special deal for the tin-plate that they procure from Mittal. The deal has combined international benchmarking with a cost-plus type formula for price adjustments, by taking into account a weighted basket of the world price of tin and the price of other input materials (gas, iron ore, local and imported coking coal, salaries, electricity and other costs). This pricing regime, in contrast to the IPP set price, is more representative of the costs of manufacturing tinplated steel. The price mechanism is adjusted periodically (three to five years) by benchmarking against prices in other international markets, most notably the EU.

The automotive industry agreed a specific pricing deal following negotiation with Mittal. This was based on recognition by Mittal that firms would not invest in capacity to manufacture steel components in South Africa if input costs were significantly above those in other locations. It was therefore agreed to price at a comparable level with the EU on an ex-works to ex-works basis (that is, prices measured on an ex-factory rather than on a delivered basis). The price for flat steel was based on a benchmarking exercise with the EU (which entailed a significant reduction in the prevailing price), with six monthly price adjustments based on a weighted basket of the PPI and the exchange rate, over a period of three years. The agreed price for the auto industry was attained through the implementation of a ‘Sales to the Auto Industry Discount’. Mittal however unilaterally altered the pricing arrangement during the three year period when international prices spiked, as the agreed adjustment mechanism had not catered for this.

The significance of comparators in assessing excessive pricing

The comparators are indicative of what prices would be expected in an effectively competitive market, even though some of them reflect only very limited rivalry. In many cases, the conditions governing the prices charged are also indicative of the exertion of market power in the form of a discriminating monopolist segmenting the local market and

27 Tribunal hearing, Lang evidence in chief, transcript pp229-230.
preventing arbitrage by customers. Evaluating the comparators in terms of both of these features requires demonstrating why the comparator better approximates prices under conditions of competitive rivalry, while the price under question (the import parity based local price) is reflective of the full exertion of market power by a dominant firm.

Two areas of enquiry necessarily follow from this. First, it is necessary to assess whether the pricing practiced flows from a lack of local rivalry, over time, including whether the position is derived from innovative effort or risk-taking investments through which rivals were out-competed. Second, for the effectively competitive prices to be just that, they must be prices that are sustainable for an efficient firm. This can be addressed indirectly as well as directly.

All of the comparators outlined here are based on maintaining market segmentation. What the Tribunal has termed ‘ancillary conduct’, that is, the conditions enforced on customers, including those in the export market through the employment of the MacSteel International joint venture, are to prevent arbitrage by customers. Moreover, the comparators reflect limited competitive rivalry – where customers have competing alternatives steel prices are lower to meet this competitive threat. In some cases there is direct competitive rivalry, in others the rivalry is indirect. But, the impact of the rivalry is not to lower prices overall because Mittal is able to enforce conditions on the customers receiving different classes of rebates. And, the conditions (the ‘ancillary conduct’) are central to the analysis of the comparators. The whole range of differential pricing is thus clearly the behavior of a dominant firm and not the outcome of pricing by two or more vigorous rivals.

That the differential prices, and the conditions under which they are charged, reflected the exertion of market power and not the outcome of normal competitive rivalry, also emerged from the testimony of Mittal’s witnesses. In addition, it is necessary to bear in mind that Mittal accepted, indeed strongly argued for different reasons, that it was one of the lowest cost producers in the world. It also accepted that its prices were above those in many other countries, as was reflected in the pricing adjustments built into the arrangements for the auto and packaging sectors. In international comparisons presented by Mittal’s economic expert witness, Dr Walker, a picture was presented of their prices being only slightly above the average of prices in different countries, a picture that was contested.

The nature and origins of Mittal SA’s market position

Relatively high prices and profit margins at any given point in time may merely be the necessary reward for the innovation and R&D effort necessary to attain that position. It may also reflect the willingness to take risk and, as such, reflect a bias in only reflecting successes and not the costs of many failed ventures. A related consideration is whether the high prices and profits are just the signal required to attract entrants and are thus just a temporary and necessary phenomenon bound up with the processes of dynamic rivalry.

It thus matters greatly whether the position of the dominant firm is one protected by high barriers to entry, and why and how the position was attained in the first place. The Tribunal characterized the position as being uncontested and incontestable. This accords with the concerns cited above with a monopoly or entrenched dominance due to current or past special rights or state support including current or past legal protection (Evans and Padilla, 2005a; Vickers, 2006; Motta and de Streel, 2006; Lowe, 2006).
With reference to flat steel, the small size of the domestic market coupled with economies of scale and the previous state-ownership and high levels of previous state support all point to an entrenched position, not due to innovation or previous risk-taking. This was not contested in the hearing.

The Tribunal ruling drew a further characterization deemed relevant to excessive pricing, of ‘super-dominance’ or ‘quasi-monopoly’. In terms of the Competition Act, this raises an important hurdle in excessive pricing as the provision in the Act applies to dominant firms, where a presumption of dominance exists for firms with a market share of 45 per cent or more. That a super-dominant firm may bear a greater burden in not abusing its position is something raised by Whish (2003: 189-190), as well as in the UK Napp Pharmaceuticals case.

I argue that the focus should be more on the extent of market power than market share. For example, a firm may have a market share far from 100 per cent, but if the other firms are all capacity constrained and it has flexibility in supply then it is effectively a unilateral price setter for the market and has quasi-monopoly power. In this case, Mittal’s share of the local market was around 80 per cent, however, of equal importance was the fact that the other producer Highveld did not provide competitive discipline, indeed Mittal’s witness even suggested that Highveld essentially operated at Mittal’s pleasure such was its weak position.\(^{28}\)

The two key features are the extent of unilateral market power and the entrenched nature of the market position. These effectively collapse together if one considers that the entrenched nature of the market position must take into account the ability of existing firms to expand, as well of new firms to enter. However, raising entrenched dominance to be the over-arching criterion also suggests extending the scope further than current or prior state ownership, support or special rights. I return to this below. It is also important to note that the pricing will generally be accompanied by other practices that are manifestations of, and designed to enhance, the firm’s market power.

**Are export prices reflective of those under effective competition?**

For pricing to be that which would be expected under effective competition it matters that it is sustainable. Under conditions of large net exports with uninhibited trading by customers the price in the local market would tend to the net export price (that is, the export price received on an ex-factory or ex-works basis). If this were not so then there would be an incentive for a purported export customer to re-sell into the South African market. The restraints on customers are designed by Mittal precisely to prevent this from happening. In this regard, data presented by Mittal’s witnesses revealed that local prices for Hot Rolled Coil were only marginally above fob export prices in Japan and CIS/Russia, by an average margin of 6.4 per cent and 2.7 per cent respectively over the period 1999 to 2005. A similar picture is revealed by data for local German prices compared with EU fob export prices, with an average difference of 8.2 per cent in the same period.\(^{29}\)

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\(^{28}\) See Tribunal ruling paras 109-111.

\(^{29}\) Note, there are issues of comparability of product and volumes sold locally and into export markets. If the exported product is large volume standardized product while local sales include product made to the different specifications of local customers then local prices would be expected to on average be above export prices even under competitive conditions. Competition would be expected to encourage improvements in quality and service for which firms could charge. This service might be expected to be targeted more at local customers.
But, it is justified and, indeed, may be quite normal, for firms to sell some product at below average total cost where the sales of this product cover variable costs and make some contribution to fixed costs. As noted above, such differential pricing can be the outcome of competition rather than a signal of the absence of competitive pressures. I have already addressed the nature of Mittal’s position and the absence of competitive rivalry. It still matters greatly whether the export prices to which prices would fall in the absence of restrictive conditions are sustainable competitive prices.

For Mittal’s net export prices not to be sustainable prices, the transport cost disadvantage to be able to sell product into international markets must be less than the cost advantages from local production. This does appear to be the case with Mittal, given the extent of its cost advantages (see Figure 2 below). In addition, while international prices fluctuate in a cyclical way, there is reason to believe that these fluctuations will be less in future and, in particular, future price slumps will not be of the same order as in the past.  

The Mittal supply decision is based on prices obtained in export markets and the marginal costs of production (Figure 1). Prices and supply decisions in the local market are based on pricing power given the local demand curve (and the corresponding derivation of marginal revenue, not shown in the Figure), subject to the cap represented by the import parity price. There are thus two decisions – how much to produce overall, and how much to supply locally and at what price. One decision is made with reference to competitive markets into which product is exported, and takes into account the revenue earned from the marginal unit relative to the cost of producing it (the marginal cost), the other decision is over pricing in the local market, essentially a monopoly pricing decision. With regard to the latter, economic theory tells us that the supply decision would be made with reference to marginal cost and marginal revenue, with the price being set on the demand curve. In practice, however, the price has been set at import parity on the apparent assumption that the monopoly price would have been even higher than this ceiling.

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30 As noted by the two international steel experts who testified in the hearings, the consolidation in the steel industry globally makes production adjustments more likely to occur in response to demand fluctuations, as major firms recognize the impact that reducing production in some of their higher cost locations will have on market prices. In addition, according to the Financial Times (3 March 2006) in reporting on Lakshmi Mittal’s view of the industry: ‘The next few years will be relatively stable for the steel business, he [Mittal] predicts. “There’s more interest in the industry in creating value [for shareholders]. The industry will continue to be cyclical. But the volatility will be reduced.”’

31 There was a period of some nine months in 2003/2004 when the local price was above the import parity price due to the effect of Rand strengthening in reducing the import parity price, while Mittal did not lower the local price it charged. It should also be noted that the marginal cost of an additional unit supplied to the local market is in fact the net export price, not the actual costs of producing that unit, as the overall production has already been determined and there is no sense in increasing supply to the local market if the marginal impact on revenue earned from the local market is less than the export price that could be earned.
Figure 1. Mittal’s HRC pricing and costs, factory gate, based on assessment over cycle

Note: Prices and costs (given in US$) are based on costs for 2004/05 (if common input costs such as iron ore increase then prices and costs would both be higher for producers around the world, albeit that Mittal is insulated from such a development). The export low is estimated as the cash cost of the 80th percentile producer (of approximately $435/t), less transport and all related costs of approximately $100, based on Mittal’s actual costs to get product to market. This compares with Mittal’s cash cost of approximately $300, plus depreciation, head office costs to bring it to $322. Import parity at $613 reflected the price levels prevailing in 2005/06. Note also that costs are average for all HRC, while local prices would include add-ons etc. meaning that local prices for other than large volume bulk sales would not be at the export low, but this would be the base price. (See Tribunal Hearing transcript p.1221-1223.)

The investment in incremental additions to output also has the effect of reducing average costs (reflected in Figure 1 as AC1). Partly this reflects ongoing scale economies that can be reaped together with the ability to update technologies when old capital equipment is replaced with newer generation machinery, leading to process efficiencies. Mittal is currently undergoing an investment programme replacing and upgrading its capital stock which is projected to increase production by close to 30 per cent, and lead to a substantial reduction in average costs (of more than $50/town overall measured in 2004/05 terms). This will ensure that Mittal’s exports will be amongst the lowest cost product, landed in Europe (that is with the transport costs included), given the already low production costs (Figure 2).
Costs and Profits?

The analysis of costs in this approach is far from that undertaken by a regulator. A regulator is seeking to set a price cap, or possibly to establish a price that would yield a reasonable rate of return for an efficient firm, hence the tightening of price caps in telecoms markets based on expected improvements in productive efficiency. Here we are concerned with confirming whether the pricing we have identified as that which would be realised under effectively competitive conditions is in fact such, and thus whether the restrictive conditions to ensure prices substantially above this are part of a system of excessive pricing.

In relative terms, it is clear that Mittal Steel SA is highly profitable. A comparison with the performance of the parent company indicates margins on turnover/revenue that are around two to three times higher than for the group as a whole. These returns take into account the very high export proportions of Mittal Steel SA. As noted on the Mittal group website:

*The Rest of the World operations are among the lowest cost, highest margin steel producers in the world, with a highly diversified product and customer mix, and enjoy substantial access to captive raw materials.*

[Mittal Steel SA falls within the ‘Rest of the World’]

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32 Although this has not yet been observed in South Africa, it is commonplace internationally.
This is borne out by a comparison of margins contained in the Mittal group’s presentation of the fourth quarter results for 2005, which we reproduce here (Figure 3). These margins for Africa & Asia are similar to those reported for Mittal Steel SA, which reported an operating margin of 29 per cent in 2004 and 2005, and is the single largest of Mittal’s operations in the Asia and Africa region accounting for close to half of the volumes. Mittal Steel SA had liquid steel production of just over 7mn tpa, the other plants, in Kazakhstan and Algeria, have a combined production of liquid steel of 7.5mn tpa.

Figure 3. Operating margins for Mittal’s operations, by region

![Operating margins for Mittal’s operations, by region](image)

Source: Mittal 2005 Fourth Quarter results presentation, 15 February 2006, slide 20

The results for the full 2004 year reveal a similar picture (Table 1). Mittal SA was fully consolidated for this year, with the earnings due to minorities only subtracted after Operating income, to calculate Net profit. Mittal SA’s Operating Income (Profit) for 2004, before the subtraction of the BAA payment was R7.4bn, or approximately US$1.15bn, close to 20 per cent of the operating income of the whole Mittal group.

Table 1. Comparison of Operating Income of Mittal Group, by region, 2004

<table>
<thead>
<tr>
<th></th>
<th>Americas</th>
<th>Europe</th>
<th>Rest of World</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shipments (tons)</td>
<td>12.1</td>
<td>18.0</td>
<td>11.9</td>
</tr>
<tr>
<td>Revenue (US$bn)</td>
<td>6.6</td>
<td>9.9</td>
<td>7.6</td>
</tr>
<tr>
<td>Operating income (US$bn)</td>
<td>1.6</td>
<td>2.0</td>
<td>2.4</td>
</tr>
</tbody>
</table>

Source: Mittal 2004 Full Year and Fourth Quarter 2004 Results presentation, 10 February 2005, slide 7

As noted above, Mittal Steel SA has consistently been one of the lowest cost producers in the world on an operating or ‘cash cost’ basis (that is on materials and services inputs). Furthermore, incremental investments were judged profitable, based on the additional production being sold at export prices. The internal rate of return for the expansion of

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33 Slide 27 of presentation, ‘Mittal Steel SA Ltd Annual Financial Result for the 12 months ended December 2005’
output planned in 2004 had been estimated by Mittal at 29 per cent on pessimistic export margins, and 89 per cent on optimistic export margins.\textsuperscript{35}

Mittal’s expert witnesses claimed that it was not profitable over the steel price cycle, and thus could not be charging excessive prices. In this analysis any lower prices than actually attained would have greatly increased the chances of Mittal going out of business, in the medium if not the short-term. This certainly appears somewhat strange given its very low production costs and relatively high prices in the local market.

The use of the profitability test also crucially rested on the assumption of efficiency.

\textit{Production efficiency and its measurement}

While Mittal is low cost, we are to believe it is unprofitable. Does this point to productive inefficiency? To address this it is important to assess whether the low cost position is due to cheap inputs, or efficient conversion. Productive efficiency clearly relates to the latter – the efficiency with which factors of production are employed to transform inputs. Once input costs of materials and services are subtracted we are able to estimate conversion costs (more closely approximating the contribution of factors to value added). Mittal is no longer low cost and on some calculations is high cost.\textsuperscript{36} This is especially true when the comparison of conversion costs is not done at an exchange rate prevailing in the year 2001/02 (the undervalued rate of R10.19 to US$1).

The second important indicator of inefficiency is the actual efficiency improvements implemented since the involvement of Mittal, and whether these improvements were due to particular technical or managerial capabilities of Mittal, or whether they effectively amounted to just implementing sensible steps to improve production practices and processes, which could have been undertaken at a much earlier stage had shareholder or competitive pressure on management been exerted.

Employees at Vanderbijlpark were reduced by some 37 per cent from 2000 to 2004 (with a reduction of 19 per cent in 2002 alone). Over the period 2000 to 2005 efficiency savings to total cash costs (including employment efficiencies as well as procurement savings and process improvements) of hot rolled coil produced at Vanderbijlpark were achieved of a similar order to the employment reductions. More aggressive owners certainly could have made many of these improvements earlier. In addition, the incremental investments planned over 2006 and 2007, and projected to realize a further 20 per cent reduction in cash costs, could also have been made at an earlier date.\textsuperscript{37}

\textit{Harm to consumers?}

The South African Act prohibits the charging of an excessive price to the detriment of consumers. The effect of the pricing of steel was dealt with at some length by the many customers who testified as well as in analysis of the impact of steel pricing on different downstream industries. In general, higher steel prices are passed on to end consumers of products from corrugated roofing to steel tubing, unless they are not internationally competitive and are constrained by import competition in which case higher steel prices

\textsuperscript{35} Tribunal hearing, transcript p.1216.
\textsuperscript{36} See Tribunal Hearing transcript, evidence and cross examination of Mr Tomlinson.
\textsuperscript{37} See Tribunal Hearing transcript, evidence and cross examination of Mr Schoeman.
impact mean higher levels of imports and less activity in these often more labour-intensive industries. The impact of pricing on local demand for steel and the ability of downstream industries to expand and compete in export markets and locally against imports are explicitly recognized by Mittal in its differential pricing regime. However, as described above, the ability to get rebates is strongest where there are organized downstream firms able to motivate to Mittal and/or where there is some indirect rivalry to steel from substitute products.

In addition, recent work on the effects of trade liberalisation by Edwards and Lawrence (2006) finds that it has been responsible for the growth of diversified non-commodity exports, and has particularly highlighted the positive impact of the reduction of protection on the intermediate inputs of these sectors. Export taxes, that is, tariffs on inputs, are particularly important for the costs, profitability and export performance of non-commodity manufactures. Their analysis leads them to ‘place particular emphasis on policies that can assist exporters by reducing their costs, not only through further tariff reductions but also through other policies that focus on key input prices’ (Edwards and Lawrence, 2006:7). As tariff protection on steel has now been reduced to zero and we are left with the ‘natural protection’ of the domestic market, more competitive pricing of steel is an obvious way to achieve this.

4. Implications and conclusions

Effective competition and rivalry (the competitive process, market conditions, and the outcomes) are at the heart of the Competition Act and the appropriate tests to be employed. In the specific matter discussed here the tests are close to a structural approach but, as can be seen in merger evaluation, we have moved beyond the structure-conduct-performance paradigm to a more nuanced understanding of competitive conditions. This is consistent with arguments being made by economists for a shift to an effects rather than form based approach in examining abuse of dominance with reference to exclusionary practices (see, for example, Gual et al., 2005; Vickers, 2005).

Excessive pricing is about the exertion of market power by an entrenched dominant firm. It matters how the firm acquired this position, and that this position is sustained through the lack of effective challenge from new entrants or other smaller firms, rather than through the firms own ongoing product development or innovative effort. It is this entrenched position, and the unilateral market power resulting from it, which is more important than simply the size of the firm’s market share. In the case of Mittal’s local pricing of flat steel, based on import parity pricing, these generally include the conditions placed on export customers to prevent arbitrage and segment markets in order to ensure that the significant exports do not undermine the local prices.

Ultimately the prices in question, as they are set by the dominant firm and not by competitive discipline, are the result of a set of pricing practices or pricing system. A monopolist cannot behave completely independently of others (whether customers or other firms) – indeed the monopolist’s pricing decision is based precisely on taking these things into account – and the pricing will often be part of conditions or restrictions which serve to reinforce the firm’s position. In the case of import parity pricing, these generally include the conditions placed on export customers to prevent arbitrage and segment markets in order to ensure that the significant exports do not undermine the local prices.

38 As noted by Holden (2005), and the Tribunal ruling with reference to liquid fuels and sugar, this can also be achieved in oligopolistic markets through collusion and/or regulation.
The prior state ownership of Mittal, and substantial state support, matters in terms of the reason for the entrenched dominant position being attained. It also accords with the exceptional conditions identified by economists such as Evans and Padilla (2005) for pursuing a case of excessive pricing. It is, however, not clear that the application should be as limited as these neo-Chicago economists argue for. The developments in industrial organization over the past two decades have highlighted how, under conditions including imperfect information and sunk costs, it can be possible for dominant firms to entrench their positions through their strategic behavior and not through their superior innovation or product development. As Geroski and Jacquemin (1984: 22) cautioned ‘when, however, small asymmetries can be solidified into dominant positions that persist, the inequities they create become institutionalized, creating long-term problems in the performance of the economic system which cry out for policy attention’. Note, however, that it is still very likely that excessive pricing occurs along with other restrictive arrangements. In and of themselves such arrangements may not obviously constitute an infringement of the Act but, as reinforcing mechanisms to achieve the pricing outcomes, their anticompetitive nature is likely to be clearer. The Act distinguishes different acts and arrangements for the purposes of setting legal standards, however, it is ultimately because of their outcomes and effects that we are interested in them.

Lastly, where does South Africa stand in terms of the relative weight given to Type I and Type II errors? In light of our economic history, industrial structure, size and position, applying the same standards as other jurisdictions but taking these specific conditions into account is likely to support conclusions that accord more with the reflections of Fingleton on the situation in Ireland than with those of scholars more oriented to large and sophisticated markets such as the USA.

References


39 See Vickers (2006b) for brief review of what he terms the 'post-Chicago synthesis'.


Vickers, J. (2006a) ‘How does the prohibition of abuse of dominance fit with the rest of competition policy?’ in Ehlermann and Atanasiu (eds)

