Locals subsidise exporters:

The Competition Tribunal's case against Sasol

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On 5 June 2014, the Competition Tribunal found Sasol Chemical Industries guilty of excessive pricing of propylene and polypropylene to the detriment of consumers. These include mainly plastic product manufacturers (e.g. of plastic furniture, household goods, components for motor vehicles, building materials such as plastic pipes, and packaging), for whom polypropylene is a very important input. While there has been criticism of the beneficiation agenda on the grounds that it means subsidising local buyers by enforcing prices below export prices, this case is actually concerned with the local customers "subsidising" the export customers.

In October 2007, the department of trade and industry (DTI) requested that the Competition Commission investigate the pricing of polymer chemicals. This reflected the DTI's concern with the pricing of important material inputs and their effect on the cost-competitiveness of downstream industry. The Competition Commission initiated an investigation, and, in August 2010, referred a case of excessive pricing of propylene and polypropylene by Sasol Chemical Industries (SCI).

Almost four years later, after lengthy hearings and consideration of factual and economic evidence, the Competition Tribunal made its finding, imposed a financial penalty of R534 million, and ordered SCI to price its products such that the location of the buyer would not influence the price.[1] When enforced, this means that SCI can no longer charge local customers much higher prices than export customers when the prices are compared at SCI's factory gate.

The South African economy is skewed towards upstream heavy industry, despite the obvious need to increase labour-intensive downstream activity. At the same time, heavy industries like steel and chemicals produce the inputs needed by downstream manufacturing, making a clear link between the behaviour of upstream firms and the costs of downstream firms. Government has viewed the competition authorities as a means to address the conduct of firms such as Sasol.

What does the Competition Tribunal decision tell us about how pricing is assessed under competition law? And what does this case suggest for the effectiveness of competition enforcement in changing economic outcomes?

WHY WAS THE CASE BROUGHT?

The case brought by the Competition Commission focused on polypropylene: it was commonly agreed that SCI had very low costs of production, produced large volumes for both the export and local markets, and yet charged local customers as if the customers had to import the product. The case thus related to SCI's practice of import parity pricing (IPP). It is important to recognise that it deals with IPP in this context, and not with IPP in general terms.

In effect, the low costs of SCI – the basis for its production and export of polypropylene – were not reflected in the prices that it charged to local customers. And, given the size of transport and related costs, this meant that prices charged by SCI to local buyers were substantially higher than those charged to export customers.

SCI's low production costs and the way it priced to local customers are not in dispute. SCI is one of the lowest-cost producers in the world: its main input cost is 25 to 30 percent lower than typical producers in other regions, such as Europe. At the same time, the prices it charged local customers at IPP were higher than prices in Europe, by 41 to 47 percent.[2] The core of the dispute was that SCI argued its cost advantage was "special", and it should be allowed to keep the advantage in the form of the high profit margin, rather than pass it on to customers.

The low costs derive from the abundance of feedstock propylene, which is produced as a by-product of the Sasol Synfuels coal-to-fuel process. Some of the product can be combined back into fuel, but this involves some further processing and there are constraints. Taking into account the processing costs, but not the constraints, Sasol calculated a "fuel alternative value" for the feedstock as the price for the input to SCI.

The low costs of the feedstock and its abundance have underpinned the expansion of polypropylene production, including increased exports. According to an independent study for the Liquid Fuels Industry Task Force in the mid-1990s, polypropylene was supplied to local buyers at that time in line with export prices.[3] Import prices were then around 36 percent higher than the domestic price.

Interestingly, the purpose of the task force study was partly to assess whether the benefits from fuel regulation were being passed on, where appropriate, to downstream industries. In effect, the history of state support for Sasol was having wider benefits for production and employment in the economy. However, around the end of the 1990s and early 2000s, the pricing of polypropylene changed, increasing to charge local customers at IPP rather than on the same basis as export customers. It is this high pricing, relative to costs and relative to export prices, that the competition case seeks to address. It appears as if nothing had committed Sasol and its SCI business to continue pricing on the same basis to local and export customers. In effect, the competition case can be understood as addressing a loophole in regulation and industrial policy. For its part, SCI argued that the historical advantages provided to Sasol are immaterial and nothing stops it from maximising the prices it charges local customers.

The issue matters greatly to the country. When polypropylene was priced competitively to local customers, the plastics industry grew strongly, at an average of 6 percent per annum from 1994 to 2002. From 2002 to 2013, the plastics industry contracted by 1 percent on average. Thirteen thousand direct jobs were lost over this period.

APPROPRIATE STANDARDS APPLIED

The competition enquiry had to assess whether the prices charged by SCI at IPP levels were excessive and thus anti-competitive. Under the South African Competition Act, a price charged by a dominant firm is excessive if it bears no reasonable relation to the economic value of the good or service and is higher than this value to the detriment of consumers. However, the Act does not define economic value. As excessive pricing is a unilateral abuse by a firm unconstrained by effective competitive rivalry, the price can be assessed relative to prices that would prevail under conditions of normal and effective competition. Central to the enquiry was whether SCI's cost advantage was "special" or whether we should consider the benchmark in terms of competition between established firms each with similar costs to SCI. In an earlier decision, the Competition Appeal Court had referred to prices under a notional "long run competitive equilibrium"; however, the parameters that should be specified in determining equilibrium still needs to be decided. As SCI's expert economist argued, monopoly is also a possible equilibrium if the hypothetical market is small relative to scale economies.

After reviewing how SCI came to achieve its cost advantage, the Competition Tribunal found that it is not "special" and should be passed on to customers. Thus the counterfactual for the analysis was the outcomes that would be expected if there had been competition between firms with similar costs. The tribunal based its conclusion on evidence that showed that SCI had not achieved its advantaged position through risk-taking and innovation, but, in fact, the propylene and polypropylene businesses reduced risk in the upstream fuel business. This is important to highlight because there has been speculation that the decision will chill investments in South Africa by dissuading firms from risky investments that are incentivised by the possible high profits to be made. However, we must recall that the position of Sasol and its SCI business is also quite

unusual, even in the South African context, in terms of the state support it received and its relationship with the apartheid government.

Excessive pricing enforcement depends on the structure of the market. The markets where competition authorities concern themselves with excessive pricing are those where there are high barriers to entry and where monopolists have gained dominance through state support, instead of through risk, investment and innovation. Though excessive pricing cases are not often pursued in other jurisdictions, in South Africa it is necessary as the economy is relatively small and highly concentrated. In bigger economies, when a firm charges unfairly high prices it is expected that this will signal other firms to enter that particular market and competition will result in lower prices. In markets where there are high and non-transitory barriers to entry, there will be no constraint on the incumbent firm's conduct and the competition authorities must intervene to rectify.

The standards that are applied to prove an excessive pricing case in South Africa are no different to those applied internationally and the same economic tests are used. The economic value of the good or service has to be determined. This can be done by using different methods, considered together. Commonly used tests include benchmarking against prices of the same product in other markets, the price of similar products in the same market and against the economic costs of production. Once economic value has been determined, it is compared to the price alleged to be excessive and a decision is taken about the reasonableness of the difference. Having considered the historical context and facts of the case, the tribunal found that the differences, ranging between 32 and 42 percent for propylene and 18 and 47 percent for polypropylene, were not reasonable.[4]

To conclude that the prices were indeed excessive, the Competition Tribunal also has to be satisfied that the prices were to the detriment of consumers: in this case, plastic convertors. Evidence shows that the domestic plastic industry has been uncompetitive. Import penetration has increased and firms are even less competitive on exports. Though SCI argued that this was not a result of the input prices, this is difficult to believe when polypropylene represents 40 to 60 percent of total costs, as several plastics companies testified.[5]

Polypropylene is the biggest cost for plastics convertors, and convertors are price-sensitive. The impact of the input costs is so high that one plastics convertor sent certain moulds to China, where products are toll-manufactured on its behalf and then imported back into South Africa. The purchasing director testified that if the polypropylene prices were to be reduced then those moulds would be brought back. The tribunal's finding was that the excessive prices, maintained through the exercise of market power by SCI, further resulted in missed opportunities for innovation and development for the domestic manufacture of downstream plastic goods. This suggests that South Africa should be concerned with the risk of under-enforcement of the excessive pricing provision, as the conduct could discourage investments in downstream, often labour-absorbing, industries if firms cannot recoup investments.

The Tribunal is usually averse to setting price remedies, but in an excessive pricing case this may not be avoided if the conduct is to be rectified. In addition, a financial penalty is important to deter such contraventions.

IMPLICATIONS FOR THE WIDER ECONOMY

Beneficiation has been high on the government's agenda for some years now and high input prices have been a constraint on the success of this strategy. The DTI has spoken out against import parity pricing, particularly by large firms such as ArcelorMittal and Sasol. In this case, the import parity price for polypropylene included notional shipping and related costs, inland transport costs and the import duty that was applicable until 2010. This case demonstrates how an excessive import parity price can have detrimental effects to the downstream industry. This is not to say that every instance of import parity pricing is equivalent to excessive pricing. It is dependent on the market structure and the nature of competition expected in that particular market. In this case, there is excess capacity and thus an expectation that, if there were effective competitive rivalry, prices would be driven towards export levels, which is the next best alternative for producers.

The challenge for industrialising economies is to reach the threshold of competitiveness and to continually upgrade the ability to compete by bringing together a set of production capabilities, along with ensuring that the basic conditions are in place, such as competitively priced inputs, access to finance and the ability to source appropriate technology. When there are price pressures on an intermediary input product, smaller margins mean that firms are unable to reinvest in up-to-date equipment and research and design. These firms may find themselves in a vicious circle of competitiveness, with low investment and little development of capabilities. Instead, low-cost inputs should be generating a virtuous circle of investment, increased efficiency, and economies associated with throughput and scale reducing average fixed costs.

It is critical to create a conducive environment for manufacturing sectors such as the plastics sector to flourish if we are to achieve inclusive economic growth. History has shown that countries that have experienced rapid growth have achieved this through growing manufacturing. Growth in manufacturing

has multiplier effects and remains critical to growth in South Africa.

The IPP prices charged for polypropylene have undermined industrial policy efforts to build productive capabilities in the plastics sector. Post-1994 industrial policy clearly identified an objective to retain and increase the natural resource advantage that South Africa has, and to encourage the transfer of that natural resource advantage through to the growth of downstream, higher value-added and labour-intensive industries.[6] The consequences of the high input prices have been lost opportunities, not only for the domestic plastic conversion industry but the wider economy. With plastics convertors choosing to manufacture elsewhere, local jobs have been lost. The high prices have also constrained the ability of domestic firms to expand and develop production capabilities.

The plastics sector is a labour-absorbing industry, which grows at rapid rates in industrialising countries. However, South Africa has underperformed its peers and continues to run a very large trade deficit, notwithstanding having cost production of the basic input required, in the form of feedstock propylene, amongst the lowest. While undoubtedly not the only factor, the cost of polypropylene has by far the largest cost and impact on price competitiveness. Sasol's polypropylene prices to these local businesses are, by its own admission, higher than they are to plastics firms in regions such as coastal China – which manufacture products for sale into South Africa. Developing employment-absorbing sectors such as plastics in middle-income countries is imperative to achieve sustainable and more inclusive growth. Exploitative conduct that undermines the process of developing these sectors is thus particularly harmful.

Action to ensure competitive input prices that would induce a production and investment response from firms may assist plastics convertors and the economy. It is thus imperative for such action to be taken. The remedies imposed by the tribunal on SCI going forward are expected to give relief to the downstream industry. For polypropylene, SCI is required to price on an ex-works basis without discriminating in price between any of its customers, no matter where they are located. This remedy is consistent with the principles of a notional competitive market. The remedy will allow convertors to enhance local production, thereby enabling them to compete more effectively with imported final plastic products, to manufacture locally rather than overseas, and to introduce new products to South African consumers, adding to their choice of product through greater innovation. For purified propylene, SCI and the commission are required to propose a pricing remedy that is in line with specified principles.

SCI has, however, appealed the tribunal's decision and the matter may well be tied up in litigation for several more years. Coming on top of the seven years that have already passed since the DTI made its request to the Competition Commission, the long duration of the matter raises the question as to whether there are other avenues by which such matters can be resolved. The competition authorities can be seen as the regulator of last resort; however, in this industry there is already extensive regulation of liquid fuels and the base product here (propylene) is in fact a by-product of fuel. Extending the regulatory framework to cover important by-products could thus be an option. The Arthur Andersen review of 1995 certainly considered liquid fuels together with their related products.[7]

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There could also be scope for measures under the mining rights regime, as the standard mining licence specifies non-discriminatory and competitive pricing of the mineral and products made from it. While there has been criticism of the beneficiation agenda on the grounds that it means subsidising local buyers by enforcing prices below export prices, this case is actually concerned with the local customers "subsidising" the export customers. The remedy merely seeks to put export and local customers on the same footing.

NOTES

1. The Tribunal case number 48/CR/Aug10; see www.comptrib.co.za/cases/complaint/retrieve_case/1722
2. Competition Tribunal Decision, Competition Commission v Sasol Chemical Industries, case number 48/CR/Aug10, para 18–19.
3. Arthur Andersen. 1995. *Sasol Synfuel Protection Study: A Report to the Liquid Fuels Industry Task Force.*
4. Competition Tribunal decision, para 17–19.
5. Competition Tribunal decision, para 437.
6. Rustomjee, Z. 2012. Witness Statement in Competition Commission v Sasol Chemical Industries, case number 48/CR/Aug10 (non-confidential)
7. Arthur Andersen. 1995. *Sasol Synfuel Protection Study: A Report to the Liquid Fuels Industry Task Force.*