Stirring up the pot of gold:

Import parity pricing in South Africa

By **Zunaid Moolla**

The author is an economist specialising in modelling and economic literacy

Plastic buckets manufactured in China.

South Africa's economic performance has been disappointing on many fronts, save for the export of its raw minerals. The share of ores and metals exports as a percentage of total merchandise exports grew from around 5 percent in 1994 to 32 percent in 2012, after peaking in 2011 at 34 percent. For a resource-rich country, this should be a cause for concern. The jobless growth of the past several years has proved inadequate for the levels of unemployment, poverty and inequality from which South Africa continues to suffer. While there are many possible explanations for this poor performance, and its attendant negative consequences for growth and employment, one area that merits investigation is the lack of beneficiation of its mineral resources.

South Africa's rich mineral endowment makes possible a chain of production stretching from mining of raw ore to a range of manufactured products. Economists and analysts have captured the benefits of such a chain of production voluminously since 1994. These include:

- inward investment that leads to greater fixed capital formation
- job creation
- skills development
- innovation from forward and backward linkages
- import substitution, leading to a reduction in deficits on the trade account
- possible growth of exports of finished goods
- accumulation of foreign reserves
- more competitive markets for consumer goods.

Unlike many other "developing" economies that suffer from the well-known "resource curse", South Africa is (and has been) well placed to undertake beneficiation: industrialisation of the country dates back to the 1870s and its infrastructure matches that of any of the highly industrialised countries. So what can explain the long neglect of the minerals sector from developing its full potential?

Part of the answer may lie in the way in which the South African economy was articulated during the period of British rule, followed by the political accommodation of Afrikaner interests after 1910, and the subsequent imposition of apartheid in the decades that followed.

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The country adopted the role of a supplier of primary commodities – principally gold and diamonds and other minerals – to the world (but mainly British and European) market. The interests of foreign capital, it seems, held sway over any domestic market concerns. While the manufacturing sector grew over time, the system of apartheid did little to broaden the economic base, as production of consumer goods was restricted to a small section of the population. The result is an economy that lacks diversification, with downstream industries barely rising above their infant stages. Fast-forward to 2014 and the shift to broaden the base of the minerals sector still faces daunting challenges.

Although issues of diversification have been raised in successive industrial policy announcements, with emphasis on the creation and development of downstream industries, progress has been elusive. A review of industrial policy and strategy shows that ministers and department officials as far back as 2005 placed diversification high on a list of policy priorities. Concerning the natural resource-based sectors, the department of trade and industry (DTI) observed that the abundance of mineral and plant resources, coupled with cheap electricity and substantial state support, gave rise to distinct comparative advantages in a range of resource-processing sectors.

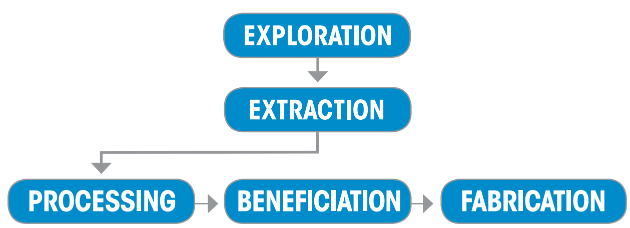
While state support may no longer be necessary for these sectors, the 2007 National Industrial Policy Framework notes selected areas in which government needs to play a role. The first of these was the significant pricing problems between these sectors and more labour-intensive downstream sectors, as reflected in the practice of import parity pricing (IPP). The second area was government facilitation of new value-adding opportunities in the oil and gas, pulp and paper, and platinum sectors, and the third concerned the management of finite mineral resources and the provision of infrastructure.

The New Growth Path Framework (2011) also raises the issue of beneficiation and pricing. One of its core strategies is to:

> [refocus] the beneficiation strategy to support fabrication... (rather than only smelting and refining, which are both capital and energy intensive), including stronger measures to address uncompetitive pricing of intermediate inputs, such as, where appropriate, export taxes on selected mineral products linked to clear industrial strategies.

Industrial policy sees diversification of the economy as a means to increase the number of commodities produced and to stem the volatility and decline in the terms of trade. The manufacturing of exportable commodities is also one way of expanding the formal economy to take advantage of rising incomes that flow from integration into the world economy. The newly industrialised countries (NICs) are often cited as examples of successful industrial-policy implementation lifting large sections of their populations out of poverty and raising their living standards.

Beneficiation, which is an important component of industrial policy, is comprised of two pillars: *upstream* (machinery, equipment, intermediate inputs) and *downstream* (a range of manufactured products including end use). The sequence of the value chain in mining can be illustrated as follows (Turok 2014):



Stages 1 and 2 are associated with the production of capital goods (upstream), while 4 and 5 involve consumer goods (downstream). However, in the beneficiation and fabrication stages, capital (or intermediate) goods are just as important. This discussion paper approaches beneficiation from both ends of the value chain – upstream and downstream.

While exploration and extraction are extremely well developed, the stages of beneficiation have not achieved their economic potential. This is acknowledged in government policies. In the Industrial Policy Action Plan 2013/14 – 15/16 (IPAP 5), we find the following:

> Mineral beneficiation is an area of work that presents much untapped opportunity, but has lagged in terms of policy development and implementation. Much greater attention will

have to be devoted to downstream beneficiation opportunities and the enormous potential that exists to deepen and extend the upstream value chain, with a sharp eye towards meeting the explosion of future demand associated with the sub-Saharan commodity boom.

Given South Africa's comparative advantage in minerals production and the imperatives of beneficiation, we ask why IPP is practiced by some of the large suppliers of mineral products in their pricing formula. How helpful or harmful is it to the country's industrial strategy in general, and to beneficiation in particular? We focus on the effect of IPP in select mining and minerals industries because of their potential for manufactured exports, import substitution and employment creation.

IMPORT PARITY PRICING: THE BASICS

According to Parr (2005),

> Import parity pricing is a pricing policy adopted by suppliers of a good for their sales to domestic customers, according to which price is set at the opportunity cost of a unit of an imported substitute good. As such, price is set equal to the world price converted into rands, plus any transport, tariff and other costs the customer would bear if importing.

Economists disagree on the reasons for IPP. In one view, it is an instrument of competition between domestic and international suppliers. A domestic supplier that is a less efficient producer than other international suppliers may add the raft of transport and tariff charges to remain competitive. The economic profit thus earned would be deemed reasonable, even if customers were unhappy about the inefficient production.

The second view is that IPP is a source of market power. Here, the pricing behaviour is explained by the structure of an industry. In an industry characterised by oligopoly or duopoly, there could be price collusion if the supplier/s decide to set prices at IPP level. Under such market conditions, suppliers use their dominant market positions to effectively discourage or prevent other suppliers from challenging their market power. In an industry characterised by a monopoly, IPP would be used to match the monopoly price (the point at which marginal cost is equal to marginal revenue and the quantity demanded that corresponds to this point), except when IPP is higher than the equilibrium price of the monopolist.

The question of whether IPP is a legitimate cost hinges on how the regulatory authorities determine whether the level of profits earned as a result is substantially higher than would be the case if IPP were not used. There are also issues of economic value and abuse of dominant market position. Each of these criteria is examined with regard to its detriment to consumers. When the Competition Commission investigates cases of market abuse, it primarily focuses on pricing: does the price of a product (or service) reflect its cost of production plus a reasonable profit? Prices can be said to be too high or too low. Prices that are too high result in excessive profits, while those that are too low limit competition. In either case, improper pricing works to the detriment of consumers.

The Competition Act, Section 4(1)(b)(1), which concerns price fixing, states: "An agreement between, or concerted practice by, firms, or a decision by an association of firms, is prohibited if it is between parties in a horizontal relationship and if it involves any of the following restrictive horizontal practices: (i) directly or indirectly fixing a purchase or selling price or any other trading condition...".

"Any other trading condition" could well be interpreted to cover the behaviour of firms that inhibit or restrain the supply of inputs to downstream producers.

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The conventional deterrent to market abuse by dominant firms (monopolies, duopolies or oligopolies) is a monetary penalty, if successfully prosecuted. This, however, has not opened opportunities for creating new downstream industries. The structure of the economy, and the entrenched power that some firms enjoy in this structure, remains unchallenged and market abuse takes new forms to get around competition legislation. A wider policy net seems to be necessary, one that covers pricing decisions as well as conditionalities pertaining to licensing agreements for the extraction and processing of the country's mineral resources. It should also include forms of state intervention to promote and protect downstream manufacturers.

IPP IN SOUTH AFRICA: SASOL AND MITTAL STEEL

While other factors may explain the failure to establish the many downstream industries in a country with such a well-endowed natural resource base (e.g. return on capital, skills shortages, energy costs and availability, environmental risks), there is good reason to isolate IPP as a major impediment. Sasol and Mittal Steel provide good examples.

Ann Crotty (2014) recently sketched how a factory in China that manufactures plastic buckets from polypropylene purchased from Sasol has an advantage over one in South Africa. Pointing out that South Africa has one of the largest and cheapest sources of polypropylene in the world, she writes, "You have to suspect that something has gone badly wrong with South Africa's industrial policy when Qian Sijiang in Wuhan, China, is employed by a South African-owned company to convert polypropylene, imported from this country, into a plastic bucket that is exported back to South Africa."

Although the fines imposed on both Sasol and Mittal are heavy and can be expected to change the pricing behaviour of both companies, there is need for a remedy that would not only prevent such pricing formulae to begin with, but would establish relationships of mutual support and benefit.

While the Chinese may be favoured by scale efficiencies, government subsidies on a range of inputs including electricity and finance, and attractive tax incentives, what swings bucket production towards China is that the South African company in China can get supplies of polypropylene cheaper than a factory in South Africa. Excessive pricing (read IPP) may be the most plausible explanation for this lopsided trading practice.

Mittal Steel South Africa Ltd (Mittal SA) is the dominant producer of flat steel products in South Africa. Macsteel International BV (Macsteel), a joint venture between Mittal SA and Macsteel Holdings, is a large South African-owned trader of steel in the domestic and international market. Two gold mining companies – Harmony and Durban Roodepoort Deep – brought a case against Mittal SA to the Competition Tribunal, alleging that Mittal SA imposed an excessive price on its sales of flat steel products in the domestic market:

> Mittal SA is the primary producer of both long and flat steel products in South Africa with four production facilities, two producing flat steel products and two producing long steel products. It is noteworthy that the most modern of Mittal SA's four plants, the coastal Saldanha plant producing flat steel products, was initially controlled by a Joint Venture [JV] in which Mittal SA (or Iscor, as it was then known) held a 50 percent share, with the remainder held by the Industrial Development Corporation (IDC), a state-owned development finance institution which provides loan and equity capital in support of industrial development. The IDC's 50 percent share of the Saldanha plant was purchased by Mittal SA in 2002 as part of the restructuring programme… During the period in which Saldanha was controlled by the JV, an agreement between Iscor and the JV provided that all Saldanha output was to be exported. In other words, a market sharing agreement provided that Saldanha output would not compete with Iscor in the domestic market for flat steel products.
> (Lewis 2009)

Between 1984 and 1992, Iscor's prices followed the domestic inflation rate, which resulted in flat steel products entering the country. Mittal SA applied the IPP after 1992, when it was no longer subject to price controls which were determined on a "cost-plus" basis.

Lewis (2009) explains how the IPP was calculated:

> In brief, the import parity price was calculated by establishing a free on board (FOB) price based upon one or other European price (the prevailing Black Sea price was often referred to) and then adding on the relevant logistical costs of transporting the product to South Africa, such as the shipping, the stevedoring, the handling, and the port costs, a commission of 2.5 percent, an import duty (recently scrapped) of 5 percent, the South African logistical cost for port and railage delivered into the inland Gauteng region and, finally, a 5 percent 'hassle factor' reflecting the additional costs or 'hassle' entailed in importing over the advantage of utilising a domestic supplier. This is then converted from a dollar price to a rand price based on the prevailing exchange rate. This, the import parity price (IPP), is determined monthly by Mittal SA and is conveyed to customers as a discount off or surcharge on a list price that is published every three months.

The Competition Tribunal fined Sasol R534 million and Mittal SA R691.8 million, but the latter was settled privately between Harmony and Mittal.

What emerges from the two cases here is that prices are not set according to production costs plus a reasonable profit, but on what is established in a foreign country. Add to that a declining exchange rate and a tariff that is based on the rand value of the order, and the cost to buyers in South Africa becomes prohibitive. Although the fines imposed on both Sasol and Mittal are heavy and can be expected to change the pricing behaviour of both companies, there is need for a remedy that would not only prevent such pricing formulae to begin with, but would establish relationships of mutual support and benefit between dominant firms and downstream manufacturers. The aim of such a remedy should be to transcend the interests of a few large companies in favour of a national economic strategy. This is one of several factors that account for the achievements of the South Korean economy during its early period of industrialisation.

It should be pointed out that the beneficiation of minerals does not face any legislative barriers. On the contrary, amendments proposed in Section 21 of the Mineral and Petroleum Resources Development Bill (B–15 2013) give the minister a specific directive to promote beneficiation:

- "The Minister [may] must initiate or promote the beneficiation of minerals and petroleum resources in the Republic."
- "If the Minister, [acting on advice of the Board and] after [consultation with the] consulting a Minister of [Trade and Industry,] the relevant State department finds that a particular mineral, mineral product or form of petroleum can be beneficiated [economically] in the Republic, the Minister may promote such beneficiation subject to such terms and conditions as the Minister may determine."
- "The Minister shall from time to time by notice in the Gazette determine such percentage per mineral commodity or form of petroleum and the developmental pricing conditions in respect of such percentage of raw minerals, form of petroleum or mineral products as may be required for local beneficiation, after taking into consideration the national interest."
- "Every producer shall offer to local beneficiators a certain percentage of its raw mineral or mineral products as prescribed by the Minister."
- "Any person who intends to [beneficiate] export any designated [mineral] minerals mined or form of petroleum extracted in the Republic [outside the Republic] may only do so [after written notice and in consultation with] with the [Minister] Minister's written consent subject to such conditions as the Minister may determine."

(Words in square brackers indicate omissions from existing enactments.)

Two points can be drawn from these sections: beneficiation is deemed to be of economic importance, and its promotion forms part of the minister's responsibility. By extension, they also advocate for the accommodation of interests of the downstream manufacturers.

Secondly, the minister's powers to "determine developmental pricing conditions" and to "prescribe a certain percentage" of raw products to be offered to local beneficiators would appear to prohibit the use of IPP if, as has already been found by the Competition Commission, it constitutes excessive pricing.

CONCLUSION

The projected economic growth rates for South Africa in the remainder of this year are a shade darker than gloom. The National Development Plan has done little to brighten the prospects. The removal of IPP is not a panacea, but it could provide a boost to industries that have been languishing in the doldrums for far too long. Even a slight reduction in the importation of certain goods can have a significant impact on the economy.

A rise in imports can also have significant impacts by raising the deficit on the trade account of the balance of payments (with negative consequences for a country's reserves) and inhibiting domestic investment in productive resources. It does not lead to significant job creation.

In IPAP 5, the DTI estimates that, once fully implemented, polypropylene beneficiation will result in the fabrication of about 40 000 tonnes per annum of new plastic products, made from feedstock that is currently exported. The project will add approximately R600 million in revenue per annum, replacing existing imports as well as adding new exports of approximately R300 million.

With an expected R1 billion investment, up to 22 754 new manufacturing jobs will be created through the utilisation of technologies, such as blow and injection moulding, that require low capital expenditure and have high employment potential.

Doing away with IPP opens up opportunities to advance labour intensive manufacturing. Add to this the spin-offs from the innovation that flows from research and development, and the backward and forward linkages formed over the short to medium term, and we have the makings of a minerals-manufacturing complex that might just become the pot of gold for the Rainbow Nation.

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