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COMPETITION AND COMMODITY PRICE VOLATILITY

Contribution from Japan

-- Session I --

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-- Japan --

1. Introduction

1. In this written contribution, we would like to present a case in which the JFTC reviewed a plan to establish a joint venture in the production of iron ore as a commodity, while taking the global iron ore market into account¹.

2. BHP Billiton Plc and BHP Billiton Limited (hereinafter, referred to as “BHP Billiton”) and Rio Tinto Plc and Rio Tinto Limited (hereinafter, referred to as “Rio Tinto”), each engaged in the business of mining and sales of iron ore, etc., planned to establish a joint venture to produce iron ore in Western Australia (hereinafter referred to as the “JV”). In response to prior consultation on the establishment of a JV from both parties concerned, the JFTC commenced its review. The provision applied to this case is Article 10 of the AMA. After finishing the primary review and in the process of the secondary review, the JFTC pointed out its concerns to both parties on 27 September 2010. Thereafter, the JFTC closed the review concerning prior consultation because both parties publicly announced the withdrawal of their plan to establish a JV on 18 October 2010.

3. The following is the view expressed by the JFTC at the time when the concerns were pointed out to the parties. Therefore, the following view is not the final judgment by the JFTC in response to the submission of their counter opinion.

2. The scheme of the JV

4. In this JV, BHP Billiton and Rio Tinto planned to commission the control and management of the iron ore production business in Western Australia to a management company established with the capital investment by both parties concerned. The iron ore produced by the JV is generally allocated to each of the parties concerned in the following manners 1 through 4.

1. The management company gives both parties an estimate of the maximum production capability for each term (6 months) with respect to each brand of iron ore.
2. Each party notifies the management company of the rates relative to the maximum production capability with respect to each brand of iron ore. (The term “rate” in this context refers to what each party wishes to receive during a specific term).
3. The management company allocates iron ore, according to the given rule(s), with respect to each brand of iron ore (e.g., when both parties wish to receive iron ore exceeding 50% of its maximum production capability, each party receives the iron ore corresponding to 50% of the maximum production capability, etc.).
4. Regardless of the allocation rate, each party bears 50% of the necessary production costs.

¹ In this written contribution, only the summarized results of the review are presented because of the allocated numbers of pages. If you would like more detail of the review results, see Case 1 of “Major Business Combinations in FY 2010”, (published on 21 June 2011 and available at <http://www.jftc.go.jp/pressrelease/11.june/110621zirei.pdf> (Japanese only). They will also be downloaded from the English website of the JFTC at http://www.jftc.go.jp/en/policy_enforcement/mergers/index.html).

3. Particular Field of Trade

3.1 Product Range

5. Like iron ore used in producing steel products by blast furnace methods, the products traded between suppliers and users are typically classified into three types:

- Lump ore (lump iron ore which is directly loaded into blast furnaces)
- Powdered ore (powdered iron ore which is loaded into blast furnaces after forming lumps called “iron ore sinters” by coagulation and annealing with limestone, etc.), and
- Pellets (products obtained by mixing fine-powder iron ore with limestone to form ball-shape iron ore and annealing)

6. Since there is no substitute for either supply or demand among these three types of iron ore (“lump ore”, “powdered ore”, and “pellets”), the product ranges are defined for each type of iron ore².

3.2 Geographic Range

7. Since iron ore is not mined in Japan, all the iron ore traded in Japan is supplied through sea borne trade. Therefore, it is advantageous for suppliers to sell iron ore to users near their mines in consideration of their marine transportation costs. On the other hand, it is disadvantageous for suppliers to sell iron ore to users far from their mines. Nevertheless, iron ore suppliers all over the world, practicing through seaborne trade, basically supply users in any region.

8. Moreover, while users procure quite a lot of iron ore from the suppliers near their blast furnaces because of the costs related to seaborne trade, iron ore users can select from a plurality of procurement sources all over the world. In reality, the steel companies which operate their businesses in East Asia and West Europe and who depend on seaborne trade have procured iron ore from a plurality of suppliers all over the world.

9. For these reasons, the geographic range is defined as a “global seaborne trade market.”

4. Characteristics of the Demand Curve and Supply Curve in the Iron Ore Market

10. Production of pig iron by means of the blast furnace method requires continuous operation of blast furnaces in order to maintain the production efficiency constant, and there is no product that can be substituted for iron ore as a raw material. On the other hand, steel companies, as iron ore users, generally do not change one type of iron ore for another type of ore in order to keep the production of their blast furnaces constant even in cases where the price of a certain type of iron ore relatively increases. For these reasons, the price elasticity of demand with respect to lump ore is very small and therefore, its demand curve is considered almost vertical.

11. Like lump ore suppliers, there are enterprises, including both parties concerned (hereinafter referred to as “low-cost/large-scale suppliers”) capable of supplying large amount of products at low cost. On the other hand, there are enterprises operating small-scale mines at a high marginal cost. Generally, the

² “Pellets” were not subject to this review because the share held by both parties was low and the expected impact due to a JV on competition seemed to be negligible. In addition, the result of the review concerning powder ore is omitted in this contribution because of the limited number of pages.

marginal costs of iron ore suppliers are substantially constant up to their maximum production capability, and low-cost/large-scale suppliers are located on the left side of the supply curve. Inversely, the enterprises operating their small mines at a high marginal cost are located on the right side of the supply curve.

12. The prices of lump ore are determined at the point of the intersection between the demand curve and the supply curve and at the level equal to the marginal costs of suppliers producing products at the point of the intersection (note that such suppliers are called “marginal suppliers.”). Therefore, in determining the price level of lump ore, the important thing is the level of quantity of production by the suppliers (low-cost/large-scale suppliers) located on the left side of the supply curve, such as both parties concerned.

5. Impact of the Establishment of a JV on Competition

5.1 Impact of the Establishment of a JV on Competitive Behavior between Both Parties Concerned

13. The establishment of a JV anticipates an expansion of production capabilities through negotiations between both parties, as opposed to a self-motivated decision by one party.

14. In addition, after the establishment of a JV, since both parties concerned share supply characteristics in terms of brands of lump ore, supply quantity, costs, etc., they can easily agree on their preferred supply quantity. At the same time, under a JV, neither party can change the amount of iron ore it receives flexibly during a term, which would reduce the uncertainty about each other’s activity. This would facilitate both parties to coordinate the alignment of the supply amount.

15. Moreover, each party so far adopts a different sales strategy for competition, but it is supposed that establishing a JV would significantly decrease their incentive to take on a competitive business behavior in terms of the sales process because (i) of their inability to flexibly control the quantity of production, (ii) they deal with the same brands and (iii) they share production costs under this JV scheme.

16. In light of the above-described circumstances, it is concluded that the establishment of a JV between both parties decreases incentives to take on a competitive business behavior, and as a result, a coordinated relationship between the parties might be formed.

5.2 Market Share and Competition Status of the Global Seaborne Trade of Lump Ore

17. The market share held by Rio Tinto in 2008 was approximately 30 to 35% and is ranked in 1st place, and on the other hand, the market share held by BHP Billiton was approximately 25 to 30% and is ranked in 2nd place. The combined market share held by both parties is approximately 55 to 60% and is ranked in 1st place. After the establishment of a JV, the HHI would be approximately 3,750 to 3,850 and the increment of the HHI would be approximately 1,750 to 1,850.

18. The mines owned by both parties are located in Western Australia and are close to East Asia which holds most of the demand for the global seaborne trade market. Therefore, both parties are in an advantageous position in comparison with competitors in terms of marine transportation costs. And since both parties are peers in terms of products’ quality and marine transportation costs, and at the same time they are the substitutable suppliers to each other for steel manufacturers, both parties are the most important competitors to one another.

19. The market share held by other competing supplier is only 10 to 15% and much smaller compared to both parties. In addition, lump ore suppliers, except for both parties, do not have their own mines to produce large amounts of lump ore at low costs. For this reason, no supplier can compete against both parties effectively.

5.3 *New Entry/New Expansion by Small-Scale Suppliers*

20. There are a variety of plans for new entry into the iron ore market by small-scale suppliers as well as new expansion by existing small-scale competitors. However, it will take several years before becoming profitable. Furthermore, not only is there a need to expend vast costs to establish infrastructures, such as, railways, shipping ports, etc., but also to secure a considerable amount of working force. These facts reveal that there are practical obstacles for newcomers. Moreover, there exist institutional obstacles to entry such as, acquisition of approvals/licenses from government authorities. For this reason, it is difficult for newcomers to enter the iron ore market pursuant to their plans and also for existing competitors to realize their business expansion. Moreover, since small-scale suppliers do not have their own mines and thus abundant high-quality iron ore, not only might the scale for new entry and new business expansion be small but also they need to bear high mining costs. For the above reasons, if both parties concerned with the JV limit their amount of iron ore supply, it will be difficult for small-scale suppliers to offer supplies with sufficient low costs to cover the reduction of supplies by both parties.

5.4 *Competitive Pressure from Users*

21. As described in the discussion on the shape of the demand curve in the above 4, since iron ore is indispensable to steel manufacturing using blast furnaces, it is impossible for steel manufacturers to use alternative materials in place of iron ore.

22. Moreover, not only a recent shortfall of supply due to a rapid increase in demand for iron ore in East Asia but also a supply-side oligopoly allows iron ore suppliers to take initiative in the negotiation of the pricing system and prices. Therefore, it is supposed that competitive pressure from users does not function well.

5.5 *Efficiency*

23. Both parties concerned alleged that the purpose of establishing a JV was to integrate the production business of iron ore in Western Australia and thus allow them to achieve efficiency amounting to over 10 billion U.S. dollars. However, it seems that a JV would create a situation similar to a monopoly on the lump ore market. As a result, it is supposed that achieving the efficiency alleged by both parties will not bring about competitive behavior and for this reason, does not justify the JV.

24. Furthermore, the JFTC scrutinized the efficiency alleged by both parties from the following three viewpoints:

- “Whether or not the improvement of efficiency is specific to the JV (merger-specificity)”,
- ”Whether or not the improvement of the efficiency is feasible (feasibility)”, and
- “Whether or not the improvement of efficiency contribute to the interests of users (possibility of increasing the users’ welfare)”

25. The results of scrutiny revealed that a merger-specificity, feasibility, and possibility of increasing the users’ welfare could not be found.

5.6 *Assessment from the Viewpoint of the AMA*

5.6.1 *Substantial Restraint of Competition through Unilateral Conduct*

26. Establishing a JV brings about a coordinated relationship between both parties, each having their own infrastructures and a lot of mines with abundant deposits in the future. The combined market share of lump ore held by both parties in the global seaborne trade market is approximately 55 to 60% and is ranked

in 1st place. After the JV, the HHI is very high, able to reach approximately 3,750 to 3,850. The increment of the HHI is large enough to reach approximately 1,750 to 1,850. The market share held by the competing suppliers other than both parties remains approximately at 10 to 15%, and the difference in the market shares between both parties and other supplier is large.

27. The demand in the East Asia region is expected to continuously lead the world's demand. The mines owned by both parties are located in Western Australia which is close to East Asia occupying most of the iron ore demand. Therefore, both parties are in an advantageous position for marine transportation costs in comparison with competitors. Also, both parties are not only peers in terms of iron ore quality and their marine transportation costs but also substitutable suppliers to each other for steel manufacturing. For these reasons, it is important to maintain competition between both parties. Both parties have been competing with one another by adopting different sales strategies so far. Under such circumstances, forming a coordinated relationship by establishing a JV has a significant impact on the competition of lump ore in the global seaborne trade market.

28. As discussed in the above (a), the combined market share held by both parties by establishing a JV is high enough to account for approximately 55 to 60% in the global seaborne trade market of lump ore. The difference between both parties and other suppliers in regard to the market shares is large. Moreover, the period required for expanding production capability of iron ore takes long. For these reasons, it is supposed that if both parties make specific strategies to restrain competition, such as to reduce the amount of their production, in the phase of determining the amount of production in respective terms or to determine sales strategies, other suppliers cannot compete against them effectively. Furthermore, the suppliers in question are located far from East Asia where most of the demand exists, and therefore they are in a disadvantageous position for marine transportation costs in comparison with both parties. In addition, it is supposed that the suppliers in question do not have an excess supply capacity. Moreover, there is not only a recent shortfall of supply due to a rapid increase in demand for iron ore but also a supply-side oligopoly results in a situation where competitive pressures from users do not function. For these reasons, it is considered that competition of lump ore in the global seaborne trade market will be substantially restrained.

29. The period required for expanding production capability of iron ore is generally long. In light of this consideration, it should be discussed whether there are suppliers capable of playing a role of "effective deterrence" against both parties in the long term. First, only the mines belonging to both parties produce a lot of lump ore at low costs in terms of deposits and costs while other suppliers do not own such mines. Other suppliers are in a disadvantageous position for marine transportation costs as well. In addition, it is difficult for small-scale enterprises to newly enter into this field of business or to expand their production capabilities because there are many practical obstacles to entry as well as institutional obstacles to entry for small-scale enterprises. Therefore, it is quite unlikely that the suppliers other than both parties implement enough expansion of their production capability if both parties postpone or suspend expansion of their production capability. For these reasons, there is no supplier who can be an "effective deterrence" against them in the long term.

5.6.2 Substantial Restraint of Competition through Coordinated Conduct

30. Since there is no supplier who can be an effective deterrence against both parties in the global seaborne trade market of lump ore, it is not necessary to discuss the substantial restraint of competition through coordinated conduct between both parties and other suppliers.

6. Conclusion

31. In light of the above circumstances, the JFTC pointed out the problem that may arise in the establishment of a JV and how it could substantially restrain competition in a particular field of trade, and in response thereto, both parties concerned announced revocation of the plan in question.