IN THE COMPETITION TRIBUNAL
REPUBLIC OF SOUTH AFRICA

Case No: 83/LM/Jul00

In the large merger between:

The Tongaat-Hulett Group Limited

and

Transvaal Suiker Beperk, Middenen Ontwikkeling (Pty) Ltd, Senteeko (Edms) Bpk, New Komati Sugar Miller's Partnership, TSB Bestuursdienste

Reasons for the Competition Tribunal's Decision

APPROVAL/PROHIBITION

1. We prohibit the transaction between the Tongaat-Hulett Group Limited and Transvaal Suiker Beperk. The reasons for our decision are set out below.

BACKGROUND

2. In this section we first describe the transaction. Secondly, we provide a brief overview of the major players in the South African sugar industry. Thirdly, we identify key features of the regulatory regimes that characterize the sugar industry both in South Africa and abroad.

The Transaction

3. The proposed transaction involves the acquisition of the Transvaal Suiker Beperk (TSB) group of companies by the Tongaat-Hulett Group Limited (THG).

4. The TSB group of companies include:
    - Transvaal Suiker Bpk,
    - Middenen Ontwikkeling (Pty) Ltd,
    - Senteeko (Edms) Bpk,
    - New Komati Sugar Millers Partnership and
    - TSB Bestuurdienste (Pty) Ltd.

5. THG will acquire the sugar, molasses and animal feed business of TSB as a going concern. Tongaat will also acquire the issued share capital of TSB Bestuurdienste (Pty) Ltd.

6. THG is controlled by Anglo South Africa (Pty) Ltd, which, in turn, is controlled by the Anglo American Corporation of South Africa Ltd and, ultimately, by Anglo American PLC. Tongaat Hullett Sugar (THS) is the South African sugar division of THG and is involved in a wide range of activities in the sugar industry. Apart from its mills in South Africa it also owns 100% of Triangle Sugar Ltd in Zimbabwe and its parent, Anglo American PLC, owns 51% of Hippo Valley Estates Ltd in Zimbabwe. The group has recently invested in packaging operations in Namibia and has also acquired interests in two sugar mills in Mozambique.

7. The Rembrandt Group Ltd, through Hunt Leuchars & Hepburn Holdings Ltd (HL&H), ultimately controls the TSB group of companies. TSB primarily conducts business within the sugar industry and, to a lesser extent the citrus industry. It is not selling its citrus business. TSB does not have sugar producing assets in any other country.

8. Rembrandt informed the Tribunal that it was selling TSB because it has not achieved satisfactory returns on investment due to, *inter alia*, its inability to achieve economies of scale, the deregulation of the sugar industry since 1994 and a drop in the world sugar price. It has therefore decided to disinvest from sugar because it believes that TSB is too small to obtain the critical mass necessary to achieve acceptable returns. The Tribunal was informed that HL&H had, over the past decade, unsuccessfully attempted to merge TSB with other sugar companies.

9. THS, for its part, informed the Tribunal that the reason for the transaction was that for a number of years it has been implementing a strategy to expand and rationalize its production base to achieve lower costs of production. In line with this strategy it has, via its land sale program and long-term cane supply agreements, reduced its exposure to cane growing in South Africa by 30% since 1996. However, the major milling assets remain within the same geographic area (Kwa-Zulu Natal North Coast) and cane supply is largely rain fed. The acquisition of TSB therefore gives rise to further opportunities for THS to shift its production base to lower cost areas, whilst at the same time realizing value for redundant

assets to part-fund the acquisition and reducing the risks of dry-land farming.

Key players in the South African Sugar Industry

The primary sugar industry – the sugar cane growers

10. In South Africa sugar is produced almost exclusively from sugarcane. The high bulk/low value of sugar cane and the fact that the cane must be milled immediately after cutting creates a regional relationship between cane growers and millers. Growers, the parties assert, are bound to a single regional miller thus eradicating competition at the level of cane procurement.[1]

11. In South Africa primary cane production is undertaken by more than 53 000 registered cane growers comprising approximately 2000 large-scale farmers, farming on freehold land, and approximately 51 000 small scale growers. South Africa has 15 mills with a total milling capacity of more than 2.5 million tons. The small-scale growers are responsible for 18% of the total average cane production of 22,2 million metric tons.

12. Milling companies currently own about 16% of the land under cane. It appears that most of this land was purchased defensively to avoid it being lost to timber production. Two of the milling companies have already introduced schemes to dispose of portions of their land to create new opportunities for the development of medium-scale black farmers.[2]

13. The South African sugar industry alone employs about 130 000 people directly and a further 110 000 indirectly.

The secondary sugar industry – the millers

14. Illovo is the largest of the South African sugar producers and produces 1,2 million tons of raw sugar per annum. The geographical spread of Illovo's mills in South

1 The relationship between the growers and the millers is highly regulated with the Equitable Proceeds arrangement (see below) responsible for distributing the proceeds of the sale of milled and refined sugar between the millers and growers. While the relationship of the growers to the millers has not been a central feature of this investigation we are not prepared to accept the assertion that the regional relationship between cane growers and millers *necessarily* implies that there always be a *single* regional mill. We return to this issue below.

2 See Board on Tariffs and Trade – 'Revision of the Tariff Dispensation and Maximum Price Dispensation for Sugar' Report No. 4039, June 2000

Africa range from Pongola in the north of Kwazulu-Natal to Umzimkulu on the lower south coast. Illovo operates seven sugar mills, four of which have refining facilities. Approximately 15% of Illovo's cane is irrigated and 85% is rain-fed. Illovo has significant access to preferential markets in the EU and USA, by reason of its investments in Swaziland, Malawi, Mauritius and Tanzania.

15. THG's sugar division, THS, is the second largest in South Africa and produces approximately 900 000 tons of raw sugar per annum in five mills all located on the Kwa-Zulu Natal north coast between Durban and Richards Bay. It has a central refinery based in Durban with a capacity of 650 000 tons of refined sugar per annum. Like Illovo its cane supply is largely rain-fed with some 13% of its supply being irrigated. THS is internationally cost competitive due to the scale of its refinery and its predominantly larger sized mills. However it faces a higher exposure to world market prices than Illovo. Less than 1% of THS's production receives preferential market prices compared with Illovo's 21%. Less than 1% of TSB's output receives preferential market prices. THS has recently acquired interests in two mills in Mozambique and it owns 100% of Triangle Sugar Ltd in Zimbabwe. It is also invested in packing operations in Botswana and Namibia.

    - TSB is the third largest sugar producer in South Africa and has two sugar Mills in Mpumalanga, Malelane and Komati, together producing 440 000 tons of sugar per annum i.e. 17% of South African production. Its entire cane supply is irrigated and after the Maguga dam is completed in 2002 it will have two years water security from dams on all the major rivers in the area. The Malelane mill has an annexed refinery with a capacity of 320 000 tons including off-crop refining. It also farms 8000 ha of cane land, producing 850 000 tons of cane.

The Regulatory Framework

16. Across the world, the production and consumption of sugar is subject to massive regulatory intervention. In evaluating this merger considerable attention has been given to the interplay between regulation and competition, between regulation in the rest of the world and regulation in South Africa, and between competition in the rest of the world and competition in South Africa.

General Characteristics

17. The sugar industry, internationally, is influenced by the following:

    - 75% of sugar produced worldwide is consumed in the countries in which it is produced with only the balance, or surplus, entering world trade. As such, the

world sugar market is considered to be a residual market, that is, a market into which only sugar surplus to domestic needs is sold, and from which sugar is bought only if domestic production falls short of domestic requirements. The residual nature of the market combined with the vagaries of agricultural production makes sugar the most volatile of all commodity markets;

- The domestic markets of net-exporter sugar producers are regulated and protected from the volatility of residual world market prices by tariff and/or non-tariff barriers. World prices are below average production costs in the majority of sugar producing countries;

- Domestic market prices in net-export sugar producing countries are higher than the world market price;

- Preferential trade agreements distort the market. The EU and the US operate the largest preferential access arrangements. South Africa does not benefit at all from the European agreement and it has a token preferential allocation into the US market;

- Farmer support, such as the Common Agricultural Policy (CAP) in the EU, the Farm Bill in the USA and the fuel alcohol program in Brazil, together with high domestic prices, enable high cost producers to sustain export production – one of the largest exporters (the EU) is also one of the highest cost producers;

- Government sanctioned export quotas exist in one form or another in all net-exporting sugar producing countries. Many achieve this via single-channel export regulations.

General Features of the South African Regulatory Regime

18. The South African industry is a world class, cost competitive producer of high quality raw and white sugar. It is a diverse industry combining the agricultural activities of sugar cane cultivation with the production of sugar, syrups, specialty sugars, and a range of by-products. It has sophisticated research and training facilities that are available to other SADC sugar producers.

19. Sugar cane is grown in fifteen cane producing areas extending from Northern Pondoland in the Eastern Cape Province through the coastal belt and Midlands of Kwa-Zulu Natal to the Mpumalanga Lowveld. Of the 424 444 hectares currently under sugar cane production, about 68% is grown within 30 km of the coast, 17% in the Midlands of Kwa-Zulu Natal and 15 % is grown in the northern irrigated areas that comprise Pongola and the Mpumalanga Lowveld.

20. There are 16 mills, 8 are owned by Illovo Sugar Ltd, 5 by Tongaat-Hulett Sugar Ltd, two by Transvaal Suiker Beperk and 1 by a co-operative. Four of the Illovo mills and one TSB mill have refineries attached to them. Tongaat-Hulett Sugar owns a stand-alone refinery in Durban.

21. According to 1998 International Sugar Organization figures, South Africa is the eleventh biggest producer of sugar, the eighteenth biggest consumer of sugar and the ninth lowest cost exporter in the world, with sugar mills currently attaining the highest capacity utilization by international comparison. Two of its neighboring industries, Zimbabwe and Swaziland, are respectively ranked second and third lowest-cost exporters in the world.

22. The South African Sugar Industry is protected against sugar imports from:

    - Swaziland, by an inter-governmental accord on access by Swazi producers to the South African market as members of the Southern African Customs Union (SACU).

    - Zimbabwe, by an import tariff on direct imports of sugar, and via value addition criteria in respect of sugar imported from that country into Namibia and Botswana (both members of SACU) under bilateral trade agreements with those two countries.

    - The rest of the world, by an import tariff. South African sugar producers are not protected from imports by non-tariff barriers as is the case with many other producer nations. Consequently, for as long as domestic sugar is priced at or below the cost of imported sugar – being the sum of the world price, the tariff and various other transport and transaction costs, in other word, the *import parity price* - it will not be economically viable for any person to import sugar into South Africa. However this is the ceiling price, that is, should the domestic sugar price exceed import parity, South African producers will be acutely vulnerable to international competition.

23. Swaziland is in a unique position in the context of the South African Sugar Industry. Swaziland forms a part of SACU and as such Swaziland's sugar exports to South Africa are not subject to duties or other importation restraints. The South African and Swaziland sugar industries have reached an accord in terms of which Swaziland sugar enjoys access to the South African market, achieving a share of 18,2% of the SACU market in 2000/01 sugar season, equal to some 243 000 tons sugar sales into South Africa.

24. The South African Sugar Association (SASA) is an autonomous organization and operates in terms of the Sugar Act and Sugar Industry Agreement. It administers the interface between the Cane Growers' Association and the Sugar Millers'

Association, each of whom have 11 members on the council of SASA. It provides specialist services to the industry and determines the notional price, used in calculating the equitable sharing of proceeds, as well as the quantities of sugar required for the local market and the export market.

25. The Sugar Act, 1978, provides for the establishment of a Sugar Industry Agreement that constitutes subordinate legislation and enables the industry to regulate itself and to take decisions on key marketing questions such as the volume of sugar to be exported in terms of the single channel export market. The Minister of Trade and Industry has approved a review of the Sugar Act, the aim of which is to ensure that the Sugar Act only provides for or enables government approved intervention in the sugar industry.

26. The Sugar Industry Agreement 2000, which was published in May 2000, addressed some deregulation and restructuring issues such as:

- The replacement of the maximum industrial pricing system with a notional pricing system,

- The replacement of a cane payment system based on sucrose content with a system based on the recoverable value of cane,
- The selling of sugar on an ex-mill basis instead of a free-on-rail Durban basis, which allows for competition based on geographical location and mill efficiencies; and

- The limitation of sugar exports undertaken by the Sugar Association in terms of the single-channel export provision to indirect consumption raw sugar, with refined sugar being directly exported by refineries themselves.

27. The provisions of the Sugar Act are supported by three regulatory 'pillars'. These are, firstly, the tariff that protects the domestic market against low world sugar prices. Secondly, the equitable proceeds arrangement that provides for the equitable sharing of industry proceeds, or, expressed differently, equitable exposure to the world market, as between cane growers and millers and between the various millers. Thirdly there is the single channel export arrangement. A maximum price arrangement was maintained until the end of September in order to prevent the industry from exploiting the market through inflated prices caused by artificially created shortages in domestic supply. It was, however, abandoned after the implementation of a new duty structure at the end of September 2000.

The Tariff

28. Before September 2000 the formula for determining the tariff was designed to

achieve import parity at Durban free-on-rail for refined sugar. The world price indicator used was the London Futures Market No. 5 contract for refined white sugar. Added to this was an amount of $33 for freight and insurance. Any adjustment to the tariff level was triggered when the 20-day moving world price was changed by 10% - as world market prices declined, the duty would compensate by rising, and vice-versa. It was also triggered when the domestic price was changed by more than 4%.

29. The only limit to the level of the duty is South Africa's agreed WTO commitments, set out in schedule XVIII of the Agreement. South Africa bound itself to a maximum *ad valorem* duty of 105% of the 20-day moving world price average.

30. The new tariff is a dollar-based reference price system to protect the industry against imports. The new system no longer caters for domestic price increases. The domestic sugar price is derived from the long-term average world price of sugar. The tariff is calculated in relation to a reference price of $330. The $330 is based on a long-term world price average of $300, adjusted upwards by $60 to compensate for perceived "distortions" in the world market, and adjusted downward by $30 for transportation costs. A trigger mechanism is employed, i.e. an adjustment occurs if the difference between the 20-day moving average of the London No. 5 world price for refined sugar and the 20-day moving average of the same price on which the previous trigger was based amounts to more than $20 for 20 consecutive trading days. The tariff is then the difference between $330 and the 20-day moving average price on which the duty was triggered, in ZAR, converted at the prevailing exchange rate on the day of the trigger.

The Equitable Proceeds Arrangement

31. The equitable proceeds arrangement refers to a formula through which revenue that accrues to the sugar industry is allocated to the millers and growers. The Division of Proceeds calculation is a notional calculation, and, whilst representing industry income, does not reflect actual revenues. Proceed-sharing is practised horizontally, between the millers based on their production, and vertically, between the millers and growers based on the 'recoverable value for cane' pricing system.

32. Export quotas are calculated by the industry and allocated to producers on the basis of their respective production capacities. Price competition in the domestic market is expressly dis-incentivised insofar as the equitable proceeds arrangement provides that increases above the allocated domestic market share are penalized through calculations based on the difference between the notional price, which is calculated by the industry, and the world price for sugar. Sugar producers selling more than their allocated quota on the domestic market have to pay the 'under

performing' producers the difference between their 'over performance' and the world price. South Africa exports roughly 50 % of its national sugar production.

The Single Channel Export Arrangement

33. Surplus production is removed from the domestic market via a single-channel export arrangement for raw sugar. This is effectively a component of the equitable proceeds arrangement. SASA is the single channel exporter of raw sugar, with sugar refiners being responsible for export of refined sugar. This is presently under review. It appears that government intends to assume responsibility for the export marketing of South Africa's raw sugar surplus.

THE COMPETITION ANALYSIS

The relevant market

34. The identification of the relevant market always occupies a central place in anti-trust analysis. In this case the decision with respect to the relevant market, in particular the relevant geographic market, powerfully influences the outcome of the enquiry. As we shall outline, the relevant market enquiry is, in this matter, focused not on the impact of subtle segmentations within a broader market, not on nuanced enquiries regarding the substitutability of one similar product for another. It centers on the interplay between domestic producers and consumers of sugar, on the one hand, and, on the other hand, the production and consumption of sugar in the rest of the world. In short, we are required to decide whether South African sugar production and consumption takes place within an international market or whether it is contained within the boundaries of a domestic market effectively isolated from the vagaries of production and consumption elsewhere, from, in other words, the vagaries of international trade. Are South African producers properly viewed as proverbial big fish in a small pond, or tiny minnows in a veritable ocean?

The product market

35. The following sugar products have been identified: raw sugar, brown sugar, white sugar, specialty sugars, molasses, bagasse and animal feeds. However, since white sugar accounts for 90% of sugar produced and sold in South Africa, we accept the Commission's view that it (white sugar) will act as an adequate barometer of the transaction's impact on competition. We treat the white sugar supplied by the South African sugar millers/refiners as absolutely homogenous.[3]

3 It does appear that there are quality differentials in white sugar. It appears that South African sugar is of

36. In the domestic market, white sugar is distributed to two customer groups, namely, industrial customers (notably carbonated soft drink and confectionary manufacturers) who only buy in bulk, and direct customers such as wholesalers and retailers who sell pre-packed sugar to ultimate consumers.

37. Retail customers trade in packages of 25 kg or smaller. In addition to the refiners' brands – Huletts, Illovo and TSB's Selati - sugar is retailed under a number of distributors' and retailers' brands such as Econo, Spar, Right Value, Woolworths, DB, Clarks, Cake Prides, Blue Crystal, Marathon and Makalani. These retail house brands are packed by one or other of the refiners.

38. Customers in the industrial sector trade in bulk (30-32 ton shipments) or in 1ton packages. Industrial users do not purchase 25kg packages of sugar even though the price per ton of 25kg packages is slightly lower than the price of a 1ton package because the handling costs of 25kg packages are too expensive. Similarly, wholesalers and retailers do not want bulk or 1ton packages of sugar because they would have to repackage it themselves.

39. The millers appear to view industrial and direct sales as separate product markets and SASA grants rebates to the bottlers and confectionary industry, the largest customers in the industrial market. It has never given rebates to the direct market.

40. High Fructose Corn Syrup, commonly referred to as HFCS, a sweetener product manufactured from maize is, according to the Objectors, a suitable substitute for sugar in its industrial usage. However, the cost of establishing a HFCS plant in South Africa is prohibitively high (capital expenditure in the order of R1.5 billion was suggested). Moreover, an HFCS plant would have to be built close to an adequate source of maize, which would be inconvenient for the supply of HFCS to many parts of South Africa. The barriers to entry by HFCS are accordingly viewed as prohibitive.

41. The Tribunal, therefore, defines the product market as the market for white sugar, which can be divided into two sub-markets, the industrial market for white sugar and the retail or direct market for white sugar. We note the Commission's recommendation that the two sub-markets be viewed as separate relevant markets and the case law cited in support of this view.[4] For the purposes of this analysis, we do not consider it necessary to decide this issue. We note however that the merger will deepen a clear separation in the sugar market characterized by Illovo's focus on the industrial market and THS's focus on the direct or retail

a particularly high quality and is able to command something of a premium on world markets. It also appears that South African sugar is of a higher quality than Swazi sugar. For the purposes of the present analysis we have ignored these quality differentials.

4 British Sugar/Tate & Lyle/Napier Brown/James Budget – Case IV/F-3/33 708

market. The conspicuous extent of this separation suggests either that there are, indeed, two, well segmented relevant markets or, if not, then an agreement between the parties to divide a single relevant market.

The relevant product market is that for refined white sugar.

Geographic market

42. The delineation of the relevant geographic market involves the identification of the area over which merged firms and its rivals currently supply, or could supply, the relevant product and to which consumers can practically turn. Identifying the geographic market has proved to be the most complex and, arguably, the most critical step in this evaluation. It inevitably involves another brief excursion – not for the last time – into the regulatory regimes governing sugar.

43. From one perspective, the sugar market appears to be a clear example of a perfectly competitive international market – there are a great many producers located across the globe none of whom are large enough to influence world supply; the product is absolutely homogenous and is already highly traded; international institutional arrangements for trading sugar are well developed; there is a quoted international price; there is a highly developed international transport infrastructure. Looked at from this perspective we would have to conclude that the relevant geographic market for refined sugar is the world and that, in this context, South African producers, like their counterparts elsewhere, are not possessed of market power. 50% of South Africa's sugar output is exported and on this market South African producers are price takers.

44. However, this depiction omits a crucial reality. As already elaborated, sugar is produced and traded in a highly regulated market, regulated not by an international public governance structure or even by an international cartel but rather via the uncoordinated interventions of national states or regional economic blocs, which structure the international market for sugar and all its key outcomes.

45. The bare bones of the various regulatory regimes have already been outlined. Suffice for present purposes to note that the most important outcome of the regulatory regime is an international sugar price depressed below the price that would have prevailed in the counterfactual, that is, in an unregulated, perfectly competitive, international market.

46. This invites a regulatory response from the economies of *efficient* sugar producers anxious to protect their producers from the consequences of the artificially depressed world price. Hence, South Africa, in international terms a relatively low cost producer, has responded by imposing a tariff on imported sugar.

47. The Commission argues that ubiquitous trade barriers have transformed the single international market into a series of isolated national markets, of which the South African market is one. For the Commission then the relevant geographic market is South Africa.

48. The parties have proffered several alternative relevant market definitions. Their most explicit statement with respect to the relevant market asserts that 'the relevant market context in which the merger should be contemplated is SACU'. Argument presented in the hearings suggest that they accept the view that an international market has effectively been fragmented or segmented by regulatory interventions into a discrete number of national or, as in the case of the various common market and customs union areas, multinational markets.[5] The crucial rider that the parties append to this argument holds that, in order to effect the transformation from relevant *inter*national market to relevant national market, the authorities have been compelled to put in place a regime that eliminates all competition in the domestic market.

49. However, the parties also argue that there are discrete regional (that is *sub*-national) markets segmented by transport costs.

50. We cannot accept the argument that there are relevant sub-national or regional markets. In support of this claim, the merger parties cite evidence showing that one or other of the millers dominate key regions or provinces of South Africa. This is attributed to transport costs that, it is argued, effectively segment the country into a number of regional markets. In opposing this argument, the Commission observes that there are regions in which each producer trades and that Swazi Sugar has a presence throughout the country. In our view, the dominance of important regions of the country by single companies, or, conversely the striking absence of, for example, THS from Gauteng, suggests, as with the divide between the retail and industrial markets, the influence of inter-firm co-ordination rather than transport costs.[6]

51. We must then decide whether the geographic market is the world or South Africa.

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5 The parties continue to insist very strongly that the international price disciplines the domestic price although they appear to stop short of arguing for a single international market. It appears that international rivals would, in the parties' analysis, be characterized as extremely likely entrants in the event that local producers priced uncompetitively. For present purposes the treatment of imports, whether viewed as part of the relevant market or as very likely new entrants, is identical and we have decided to deal with the issue in this section.

6 Producers generally accept that, because, in part, of the existence of transport costs, their returns from trading in their domestic markets will be higher than those from trading in geographically distant markets, whether markets in other countries or in regions of their home country far away from the production location. But, only in exceptional cases, does this prevent trade from taking place. We repeat: it is difficult to accept that the geographical division of the South African market is rooted in a series of independent decisions driven by transport cost considerations.

52. We deal with two conflicting positions here. The first view notes that there are no sugar imports into South Africa and, while it is conceded that there is an identical product available on the international market, it holds that the tariff ensures that consumers cannot practically turn to this source of supply. The second argument concedes that there are no imports into South Africa. However it holds that this is explained by competitive pricing on the part of South African producers *vis a vis* the international price. Were South African pricing not competitive then domestic producers would lose their local market to their international rivals.

53. It is difficult, in this instance, to separate the relevant market enquiry from the market power enquiry. Suffice to say that while the fact that sugar is priced in the domestic market at import parity gives the appearance that the international price (lurking immediately above the present domestic price and preventing any increase) acts as an effective discipline in the domestic market, in reality the ability of domestic producers to price up to import parity thereby taking full advantage of the tariff is symptomatic of their *monopoly power in a domestic market* rather than their *lack of power in an international market*. Moreover, by adjusting the tariff to the reference price of $330, and given the maximum bound rate of 105% it would take a catastrophic drop in the world price, even from the current trough, before it became commercially viable to import sugar, or, expressed otherwise, before the international price actually weighed down upon the domestic price.[7]

54. This was amply demonstrated by Coca Cola's rather theatrical importation of a token volume of sugar. Thanks to the tariff, sugar available on the international market was commercially non-viable, and, as such, beyond their practical reach.

55. In summary then, despite an active international market in sugar, the presence of the tariff places it beyond the practical reach of South African consumers. ***We conclude then that the relevant geographic market is South Africa.***

56. Note that the merger parties argue for the inclusion of Zimbabwe (via bilateral trade agreements with Southern African Customs Union members, Botswana and Namibia) and Swaziland's share of South African consumption thus extending the relevant market to SACU. While clearly some allowance has to be made for Swaziland and Zimbabwe's shares of the SACU market, since both are subject to quota arrangements they cannot be uncritically incorporated into the market share figures. Moreover it appears that, South Africa, in common with other sugar

7 As outlined above, the duty adjusts upwards and downwards depending on the difference between the reference price and the actual world price. A document submitted by the Objectors – the Coca Cola bottlers – calculates that it is only at $161 (at an exchange rate of R7.23/$) that the 105% *ad valorem* bound tariff becomes effective. Such a world price would be below the fourteen-year lows recently reached. The objectors further calculate that by adjusting the tariff to the reference price of $330 the world price would have to fall to $107,67 (versus the long term average price of $305) to transport, land and clear imported sugar to match the current SASA rebated price of R2522 per ton.

producers, is obliged to import a small quantity of sugar duty free each year. Imports from Swaziland are utilized to meet this obligation. In any event, we are not of the view that incorporating these into the market share figures materially affects the outcome of this evaluation.

The Impact of the Transaction on Competition

57. The Commission has provided detailed measures of the extent of concentration in the South African sugar market. The parties have a somewhat different basis for their HHI calculations and arrive at somewhat lower scores. The HHI and CR3 are extremely high. They are tabulated below. The Commission's calculations show that the merger will increase THS's share of total sugar sales from 36% to 54% followed by Illovo at 31% and Swazi Sugar at 15%. THS's share of direct sales will be at 64% with Illovo at 19% and Swazi Sugar at 17%. Illovo will retain the largest share – 53% - of industrial sales, followed by THS at 36% and Swazi Sugar at 11%. As a result of the merger the HHI in respect of total sales will increase by 945 – from 2629 to 3574, while in the direct sales segment the HHI increases by an astronomical 1806, from 2940 to 4746. Note that the Commission's HHI calculations incorporate Swazi Sugar's market share. At the risk of stating the obvious, the concentration measures and the changes in these measures as a result of the merger all exceed the thresholds accepted in other major jurisdictions.

HHI AND CR3 CONCENTRATION MEASURES – THE COMMISSION'S CALCULATION

Product Market	**CR3**		**HHI**		**Change in HHI**
	Pre-merger	**Post-merger**	**Pre-merger**	**Post-merger**	
Total sales	85	100	2629	3574	945
Direct sales	83	100	2940	4746	1806
Industrial sales	89	100	3578	4179	601

58. The merger parties incorporate Swaziland and Zimbabwe shares of Southern African Customs Union into a SACU based market share. As noted above we have not taken a final view on the parties' argument that the relevant market be defined as SACU rather than South Africa. As already intimated, although the market share and concentration measures are obviously reduced in consequence of expanding the market to incorporate SACU, they still exceed thresholds generally employed in merger evaluation. The merger parties also include artificial sweeteners in their concentration calculations. We are of the view that these are not part of the relevant market – there are a wide variety of uses in which sweeteners are not a substitute for sugar. However, even with the inclusion of artificial sweeteners the HHI scores are *prima facie* grounds for concern.

HHI MEASURES – THE MERGER PARTIES' CALCULATIONS

COMPANY	**MARKET SHARE PRE-MERGER**	**HHI**	**MARKET SHARE POST MERGER**	**HHI**	**CHANGE IN HHI**
Illovo	30.4%	924.16	30.4%	924.16	
THS	27.1%	734.41	40.8%	1664.64	
TSB	13.7%	187.69	-	-	
Swaziland Sugar Association	16%	256	16%	256	
Zimbabwe Sugar Sales	4.3%	18.49	4.3%	18.49	
Artificial					

Sweeteners	7.2%	51.84	7.2%	51.84	
TOTAL	**100%**	**2172.59**	**100%**	**2915.13**	**742.54**

59. The parties have also submitted HHIs for other national sugar markets. These latter calculations seek to demonstrate that concentration levels in the South African sugar market are not unusual. These measures approximate to the concentration levels reflected in the Commission's calculation.

60. The parties do not, in any event, construct their defence of the transaction on the basis of a denial of high levels of concentration. Their principal rejoinder to the Commission's findings derives rather from the impact of the regulatory system. The parties argue that, in consequence of regulation, competition in the market, that is in the relevant domestic market, has been eliminated. In the premises, then, the transaction cannot be held responsible for a 'substantial lessening of competition' there being no competition to 'lessen'.

61. While the Commission – as well as the objectors and the DTI – agree that competition in the domestic sugar market has been severely compromised by regulatory intervention, they find evidence of non-price competition that, they fear, will be eliminated by the removal of TSB from the market. Secondly, they argue that the regulatory system is in flux, that progressive deregulation will permit the introduction of competition, and, hence, that while the transaction may have, in the current regulatory environment, a limited impact on competition, it will, by permitting of higher levels of concentration, serve to pre-empt efforts to intensify competition through progressive deregulation. In a word, they are concerned that the structure of the market post-merger will permit private regulation to replace public regulation thus frustrating the positive impact that deregulation will have on the level of competition in the sugar market.

62. For their part, the merging parties insist that there is little prospect of fundamental change in the domestic regulatory system and hence little prospect of intensified competition without prior deregulation of the European and US markets. Were deregulation to follow the removal of European and US subsidies and trade barriers then the possibility of a perfectly competitive international market will have been realized and the question of dominance in the South African, or any other, domestic market would not arise.

63. In order to evaluate the proposed transaction's impact upon competition, we are required to examine, once more, the regulatory regime.

64. The tariff represents one of the regulatory pillars. It is common cause that South

African producers cannot increase their price above the tariff adjusted world price, that is, above the import parity price. This ceiling is absolutely effective regardless of the structure of the South African market. Hence if the ability to *increase* price in the wake of the merger were indicative of the extent of the market power, then we would have to conclude that the merger does not give rise to such power. However, as intimated earlier, the fact that domestic producers are able to price at import parity may indicate that market power has already been exercised. Accordingly, while a lessening of competition may not be reflected in a price rise, the introduction of competition may result in a price decrease. This is, indeed, our conclusion. The basis for the monopolistic conduct that underpins, *inter alia*, import parity pricing is found in regulation. Moreover, there is considerable evidence of co-ordination that goes beyond the regulatory framework, most significantly, the geographical division of the South African market and the division, between Illovo and THS, of retail and industrial sales.

65. The regulatory instrument that effectively constitutes the ceiling price, the import parity price, as a floor price, is the equitable proceeds arrangement. This arrangement is described above: in summary it ensures that all producers have an equivalent exposure between the international and domestic markets. An 'over-performer' on the domestic market (that is, an 'under-performer' on the international market) will compensate an 'under-performer' on the domestic market.

66. While it appears that the equitable proceeds agreement would effectively dis-incentivise any effort on the part of any of the producers to gain domestic market share there nevertheless is evidence of non-price competition. Coca Cola has provided evidence of the successful attempts by TSB to increase its share of the soft drink producer's considerable purchases. Coca Cola has characterized TSB as a maverick competitor, as the producer most likely to deviate from industry 'standards' with respect to, for example, credit terms. Correspondence in which Coca Cola requests a meeting with THS in order to consider the apparently superior terms and conditions offered by Illovo is further evidence of some semblance of competition between domestic producers. Moreover, there are, as mentioned above, a large number of active retail brands. Each of the three producers retails under a separate brand name with TSB's Selati's brand said to be a strong brand. Several of the large national grocery chains and manufacturers of bakery products retail sugar under their own brand names. While we have not been provided with evidence of inter brand competition and while this is undoubtedly dampened by the regionally-based producer monopolies in the retail market, it is clear that certain of the retail chains stock several brands of sugar and that there are price differences between the various brands.

67. In general though we must recognize that the equitable proceeds agreement does severely limit incentives to compete for domestic market share. Accordingly, the

parties were specifically asked to explain this evidence of non-price competition. THS conceded that the organization of production at particular mills necessitated a certain mix of industrial and retail sales and that, at times, this constituted the basis of competition between the various producers.

68. However, as already mentioned, even within the limits of the equitable proceeds agreement, the extent to which competition has been comprehensively eliminated remains striking. In particular we are struck by the extent to which each of the producers has specialized in particular regions of the country. As striking is the division between THS and Illovo of the retail and industrial markets. The proposed merger strengthens each of these sub-market specializations. The parties have offered several unconvincing explanations for this – a long history in a particular market giving rise to efficient distribution systems is one explanation offered, transport costs are another. No evidence has been presented in support of the claim that the absence of distributions facilities accounts for market segmentation. Nor are we persuaded that transport costs are prohibitive.[8] This division of the geographic and product markets does not appear to be an inevitable consequence of the equitable proceeds arrangement. Nor is it accounted for the alternative explanations offered by the parties. Rather it smacks of the exercise of private market power facilitated by the unusual freedom that the industry has been given to regulate itself.

69. But, we repeat, the regulatory regime has undoubtedly undermined the extent of competition. In essence the tariff holds international competition at bay while the equitable proceeds arrangement eliminates the incentive to compete for domestic market share. That there is evidence of non-price competition should not serve to understate the extent of the limitation imposed upon competition by the regulatory regime. In the face of this reality the parties argue that the merger will not ' substantially lessen or prevent competition', the principal test imposed by the Act in evaluating a merger.

70. The Commission, on the other hand, argues that the conduct of trade policy and the imposition of related regulations should not determine the outcome of a competition evaluation. The Commission insists that the task of those responsible for upholding the Competition Act is, in this instance, to ensure that the possibility of introducing competition is not undermined by the underlying structure of the market. The Commission is supported by the Department of Trade and Industry, which, in asking for the transaction to be prohibited, states its intention to review imminently the regulations governing the sugar industry principally with a view to introducing greater competition.

8 As noted above, it is one thing to argue that trading in export markets or in distant parts of the domestic market may, in consequence of transport and other transactions costs, generate somewhat lower returns than trading in one's own backyard. It is quite another thing to argue that the presence of transport costs prevents trade from taking place.

71. For their part, the parties to the merger insist that the industry cannot be deregulated without preceding deregulation by the industrialized countries whose interventions, the merging parties argue, are principally responsible for the depressed international sugar price. Deregulation along these lines will, they argue, effectively constitute the introduction of the perfectly competitive international market referred to earlier. In the context of this market structure South African sugar producers, as with their counterparts elsewhere in the world, are price takers – the relevant market will be international and the question of domination of national markets by national firms will not arise. In the documents submitted by the parties to this enquiry they advance the view that progress in the WTO will result in sugar deregulation in the foreseeable future, although in the hearings they appear to have conceded that this assessment is unduly optimistic.

72. The parties argue that piecemeal amendment of the South African regulatory regime is not feasible. In particular they argue that the artificially depressed sugar price will ensure the maintenance of tariff protection. The Commission and the DTI share this latter view. However the Commission holds that it is conceivable that the equitable proceeds agreement be reviewed and amended so as to permit competition between domestic producers for the domestic market. Were the parties free to compete for domestic market share then this would serve to reduce the price below import parity. In short, the Commission argues, the equitable proceeds arrangement is the regulatory instrument that allows for monopolistic pricing, for import parity pricing. The boost that competition will receive in the absence of this arrangement will be compromised by an industrial structure capable of underpinning post-deregulation monopolization. Accordingly the Commission recommends that the proposed merger be prohibited.

73. The parties insist that the equitable proceeds arrangement will remain in force. They argue that if South African producers were to compete for domestic market share, this process would immediately force the domestic market price down to the world price – in other words the import parity price would be forced down to the export parity price. This flies in the face of the objective of tariff protection itself, which, all agree, will be a feature of the sugar market for as long as the world price remains artificially depressed. The tariff is intended to raise the domestic price above the world price – why, ask the parties, maintain a tariff if the mechanism necessary for holding price above the world price, namely the equitable proceeds agreement, is eliminated. Moreover the parties point out that although the DTI is committed to reviewing the regulation of the sugar industry it has clearly stated that the equitable proceeds arrangement will remain.

74. The DTI's arguments are confusing and half-baked. It has insisted that tariff protection will be retained and, under close questioning from the parties, it has

conceded that it does not intend eliminating the equitable proceeds arrangement.[9] It nevertheless continues to insist that it is beginning the process of reviewing the various regulations governing the industry with the express intention of strengthening competition. It, in part, rescues its argument by suggesting that, while the equitable proceeds arrangement will not be terminated *in toto,* competition will be introduced by changing the mode of implementation and management of the various regulatory instruments, specifically including the equitable proceeds arrangement. It has, however, not been able to elaborate its intentions leaving the distinct impression that the DTI's thinking on this matter has not moved much beyond a general desire to strengthen competition. **The DTI must grasp the following nettle: introducing international competition means lowering the tariff to a level that gives South African consumers practical access to sugar imports; while introducing domestic competition of any significant degree, presupposes a very hard look at the equitable proceeds arrangement.**

75. We are left then with the task of interpreting the DTI's stance – on the one hand it wants to strengthen competition and, for that reason, has taken the serious step of opposing the transaction; on the other hand it disavows any intention to remove either of the regulatory pillars that compromise competition, although it insists that it intends to explore the introduction of competition-friendly mechanisms of managing the key regulatory pillars.[10]

76. We are satisfied that the DTI's input does demonstrate a clear commitment to maintaining the tariff, to protecting domestic producers from *international* competition. Given, the lack of clarity that pervades the rest of the DTI approach to regulation and competition, it appears that the best approach is to ask whether the equitable proceeds arrangement is necessary in order to protect South Africa sugar producers from the world market price? After all tariff protection is not, as a matter of course, accompanied by the imposition of monopolistic pricing structures and practices in the domestic market.[11] In other words, we are aware

9 In the evidence presented to us, DTI endorsement of the equitable proceeds arrangement is most forcefully articulated in its strategy document, 'A Strategy for the Optimal Development of the South African Sugar Industry within SACU and SADC Context' (DTI, March 1999). Note however, that in this context the DTI's overriding concern is that a SADC Free Trade Agreement , particularly in the context of the review of major preferential trade agreements such as Lome, may suddenly boost the supply of sugar on the South African market thus depressing prices on the national market. Because in an FTA the tariff is no longer available as a mechanism for protecting national producer interests, alternative mechanisms which offer a certain degree of protection of sensitive *national* interests within the common market (in the case of the equitable proceeds arrangement, in the form of a negotiated share of the market within the free trade area) come to the fore. Hence the perceived requirement for a separate sugar protocol, one that effectively reserves the lion's share of national markets to national producers, within the tariff-free trading area.

10 The change in the mode of determining the tariff, in particular the elimination of an allowance for a domestic price increase to determine the tariff does bear out the DTI's undertaking to manage or implement that regulatory pillar in a more competition-friendly manner.

11 Quite the contrary. For obvious reasons, in the context of tariff protection that blunts or, as in this case,

that the co-incidence of tariff protection and a domestic monopoly leads to import parity pricing; but, in this instance, the monopoly is imposed by regulation, by the equitable proceeds arrangement. We understand the role of the equitable proceeds arrangement in supporting import parity or monopoly pricing. But is the equitable proceeds arrangement needed in order to protect the domestic market from international competition; is it needed, in other words, to protect the domestic market from the world price?

77. There are several factors present in the sugar and other commodity markets that, despite the presence of a tariff, may, in the absence of a market allocating mechanism, lead to a severe drop in domestic prices. These are, the homogeneity of the product (in other words, price is the sole basis for competition), the explicit two-tier price structure, and surplus production in the domestic market. The latter feature – production surplus to domestic requirements despite an unattractive international market – is, in part, a consequence of certain technical characteristics of sugar cane that make it difficult for cane growers to respond to short term changes in demand. In brief, cane has a growing cycle of several years with a single planting harvested over several seasons. However, the ability to respond to this undeniable problem by constant *excess* production, excess, that is, in relation to domestic demand, is a function of the ability to cross-subsidise periodic low earnings in the international market from protected earnings available in the domestic market. In other words, given the present operation of the equitable proceeds arrangement there is absolutely no incentive to reduce excess supply.[12] [13]

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that eliminates international competition, industrial policy specialists would generally insist on intensified vigilance in maintaining robust competition between domestic producers.

12 This should be clearly appreciated. We repeat: the manner in which the equitable proceeds arrangement is operated provides no incentive for producers to reduce excess supply. They will always be able to sell their excess production on the international market at a more or less attractive price; and they will, because of the operation of the equitable proceeds arrangement (including single channel marketing), always be able to maintain the domestic market price at import parity. Hence even when prices are low internationally they will have the cushion of the domestic market and when prices increase internationally they will earn a windfall. Hence there is no incentive to reduce excess supply – on the contrary there is every incentive to expand supply *ad infinitum* while continuing to deny domestic consumers any advantage from this expansion in output. Whenever domestic regulators question the equitable proceeds arrangement they will be met with the same refrain: 'if we divert our excess supply to the local market it will cause a catastrophic drop in price' - the likelihood is that this excess supply will continue to expand thus rendering this argument increasingly powerful. But it is a self-fulfilling prophecy. However should the responsibility for allocating the share of output between the domestic market and the international market be taken out of the hands of the producers, this may blunt the current incentive to simply continue expanding output. If government or another responsible regulatory agency made it clear that persistent increases in excess supply would be penalized by placing additional supply on the domestic market this would offer some prospect of disciplining the producers. This was hinted at by both the Commission and the DTI as a possible amendment to the application of the equitable proceeds arrangement.

13 Note also that 'South Africa's marginal milling costs are 0,7 US c/lb, making it profitable at the margin even at the current low world market prices to mill cane within existing capacity'. (Submission by Merger Parties to the Competition Commission, Annexure E – 'Report Assessing the Transaction with Respect to Competitive Conditions' p11) Our understanding is that South Africa's competitive position will have

78. In the wake of the elimination of the equitable proceeds arrangement there would be an immediate incentive for each producer to divert product from the international market to the relatively lucrative domestic market. This would have no impact on the international price, that is, it would not result in an increase in the international price, but it would immediately depress the domestic price. The refiners, faced with a drop in the domestic price and freed from the strictures of the equitable proceeds arrangement, would offer a lower price to the growers. The fall in price would be arrested by the inevitable reduction in capacity caused by the exit from the market of the least efficient growers and millers.[14]

79. There can be no doubt then that eliminating the equitable proceeds arrangement would alter the face of the sugar industry. Even, changing the mode of implementation of the agreement along the lines suggested above would have a considerable impact. But these are nevertheless conceivable options and are consistent with the objective of reserving the South African market for domestic producers, with, in other words, the purpose of the tariff. Faced with the realistic prospect of European and EU induced distortions extending into the foreseeable future, it is conceivable that government elects to use a tariff in order to reserve the domestic sugar market for local producers while discontinuing the arrangement whereby production for the international market is effectively subsidized by South African consumers. This may, depending on the trajectory of the world price, be a somewhat smaller industry; the process of restructuring the industry in this way will likely lead to the exit of certain producers and, conceivably, to a further process of concentration. However, the merits of consolidation under that scenario will be evaluated under conditions different to those prevailing now.

80. The merging parties have not considered this prospect. Their argument essentially holds that only the two ends of the regulatory spectrum are feasible: no regulation and a perfectly competitive international market; or the current system in a domestic market from which competition is all but eradicated. In their refusal to countenance any alternative to these polarities they are supported by government's stated commitment to the equitable proceeds arrangement but are, nevertheless, undermined by government's simultaneous commitment to

improved significantly since the compilation of this as a result of further Rand depreciation. While the international price is undoubtedly depressed below its competitive equilibrium in the deregulated counterfactual, South Africa's exceptionally low refining costs ensure that, even in the current price trough, the international market remains commercially viable.

14 Note that, while (as already suggested) the homogeneity of the product may exacerbate price competition (there being few other bases for competition), homogeneity may also serve to arrest a price decline insofar as it lends itself to forms of co-operation generally referred to as 'price leadership' or 'conscious parallelism' that will fall short of full-blown cartelisation and, in any event, may be difficult to detect but that will nevertheless be effective in holding the actual price above the competitive price. The merger would certainly facilitate this type of price formation, although we have little doubt that even the present structure of the market would lend itself to this conduct.

introduce greater level of competition into the industry. Implicitly they assume that government would not contemplate a step that would result in the restructuring of an industry as important as the sugar industry. But stranger things have happened as trade policies and technologies have changed. In the context of further rapid globalization and the introduction of new technologies, including agro-based technologies, we cannot dismiss a future in which the domestic and international sugar industry develops along lines distinct from those that prevail currently. It is not for competition authorities to second-guess future trade and industrial policy by permitting the development of an industrial structure that would render attempts at greater liberalization a nullity in an important domestic market, the more so when trade and industrial policies are, in general, increasingly directed at strengthening competition in the domestic market. Bear in mind that the consequences for the industrial structure of permitting this merger are well nigh irreversible.

81. The Commission has urged a similar view upon us. It has argued that the responsibility of the competition authorities is simply to defend a more competitive industrial structure against a merger that provides for a possible exercise of market power in the industry. The Commission's view is essentially that the introduction of regulation that diminishes competition is the prerogative of the executive and legislature. While this regulation may, in particular circumstances, be laudable, and, in any event, is beyond the reach of the competition authorities, the latter should still remain alert to the power, actual or potential, of *private* regulation of markets. While regulation in the sugar industry is far-reaching, government has stopped short of actually licensing participation in the industry.[15] Entry and exit is not subject to the decision of a licensing authority, so that even within the current framework the possibility of a number of competing participants is clearly countenanced. This has undoubtedly been compromised by the imposition of regulations that diminish the prospect of competitive outcomes. However these regulations do not preclude the possibility of maintaining a competitive structure. The Commission effectively urges us to secure the latter, albeit that the competition authorities have, given the regulations in force, limited power to secure more competitive outcomes.

82. The merging parties, on the other hand, insist that should not adopt a formalistic, blinkered approach to our task, one that is narrowly focused on competition to the exclusion of the environment within which competition plays itself out. We are, they argue, adjudicating competition in the real world and, where that real world is characterized by a regulatory framework that impacts on the level of competition, then our decisions must reflect that reality.

15 Our understanding is that, until relatively recently, the planting of cane and the establishment of new mills was subject to certain licensing requirements. However in order to permit greater freedom of entry these provisions were scrapped by Sugar Industry Agreement of 1994. (see Board on Tariffs and Trade – 'Revision of the Tariff Dispensation and Maximum Price Dispensation for Sugar' Report No. 4039, June 2000).

83. While we broadly concur with the approach taken by the parties, it leads us to a conclusion diametrically opposed to that suggested by them. If we are to evaluate the future of *competition* in a real world that includes regulation, then so too are we obliged to take a view on the future of *regulation* in that real world. As already indicated the parties' conclusions are implicitly rooted in the view that there are certain given, immutable parameters in the regulatory framework. Experience shows otherwise. The interplay of new technologies, trade and investment liberalization and regulatory reform has seen entire industries re-invent themselves or relocate or, even, disappear. The agricultural sector is certainly not immune from the pressure emanating from new technologies and trade reform. Time-honoured modes of regulation are, in consequence, being called into question. Under these fluid circumstances it would be a brave or, more likely, foolish competition regulator that predicated its decisions on the claimed permanence of a given regulatory structure. There are credible scenarios for the sugar industry in which regulatory reform may promote competition in domestic markets despite the gross distortions in the surrounding global market. Moreover, this scenario seems to reflect most accurately the reality of South Africa's commitment to introducing greater competition in the domestic economy, and the continued commitment of the EU and the US to closed agricultural markets and farmer support programs. In this scenario the industrial structure will matter and this potential is an important consideration in our decision to prohibit this transaction.

84. Our Act obliges us to consider whether or not a merger 'is likely to substantially prevent or lessen competition'. In prohibiting this transaction are we meeting that standard? As indicated there is evidence of non-price competition. In a competitive market it would not be regarded as significant, however, in this market it is all the competition that exists and this must influence the application of our standard. Furthermore, there is a strong suggestion of co-operation – as, for example, in the allocation of the domestic market by product and region – that extends beyond that necessarily implied by the regulatory arrangements in force. The merger will consolidate the concentrations created by these allocations and this too has been considered in the decision to prohibit. Above all, though, is the *potential* for competition. We have explained our stance in respect of potential competition and we are satisfied that it complies with the standards established by the Act – competition analysis, and particularly merger analysis is always concerned with the construction of plausible counterfactuals. In the counterfactual developed here, a counterfactual that accords with the overall trajectory of deregulation, while it may be difficult, given the low baseline, to assert with confidence that competition will be '*substantially* lessened', we are satisfied that *potential* competition will be 'prevented' by this merger. Accordingly it falls to be prohibited.

85. The Act requires that we consider a number of factors that may ameliorate the exercise of market power post-merger. The Commission and the merger parties have considered the range of evaluation criteria listed in Section 16(2) of the Act. We refer to two that, on the face of it, may have influenced the outcome of this evaluation:

86. First, with respect to *'the ease of entry into the market'*, the Commission points out that there has been no new entrant for the past 20 years – indeed consolidation rather than new entry has been the norm. It believes that there will be no new entry in the foreseeable future.[16] The parties concur and point out that access to cane is a substantial impediment to new entry.[17] We, too, do not believe that the dim, even absent, prospect of new entry will constrain the exercise of market power. It appears that the SADC protocol will allow new entry from our neighbouring countries but this will, as in the Swaziland case, be regulated by quota arrangements.

87. The only prospect of a new *entrant* – and given that this will be entry via an acquisition it does not constitute new capacity or new 'entry' as such – is if TSB is purchased by any firm other than THS or Illovo, the two incumbents. TSB avers that it had, some years back, discussed a possible sale to Tate and Lyle, the British sugar multinational, but this came to nothing. A local empowerment initiative, Tswelopele Sugar Distributors, has expressed some interest in purchasing TSB but this too has come to nought. We note, however, that HL&H's Chairman, in response to Tswelopele's expressed interest in the sale of TSB, had specifically refused to countenance alternative offers while talks with THS were in progress. Hence the possibility of another buyer may now be canvassed afresh.

88. A senior representative of Rembrandt, TSB's ultimate controlling shareholder, informed the Tribunal that, in the event that we prohibited the transaction, Rembrandt would, in preference to seeking a new buyer, consider 'harvesting' its asset, reaping what returns it could from its existing investment but making no new investment. This is, of course, the prerogative of TSB's shareholder to whom this may represent the most commercially attractive alternative. However, although we accept, that sugar is a volatile market, and that the international price has plumbed new depths, we cannot accept that there are not potential buyers for a firm whose product is protected from international competition, has a guaranteed share of the domestic market, and can sell everything else produced in the international market. We should note, moreover, that it is common cause that

16 Note, again although the parties at times appear to treat the import question under the relevant market analysis and at other times under new entry, conceptually the treatment is, for purposes of this enquiry, identical and we have elected to deal with it under the relevant market analysis

17 Note that the Tribunal was told that there is significant potential for planting new cane in (irrigation-fed) Mpumulanga. There appears to be no sound reason why THS, given its desire for irrigation-fed cane, should not make the investment necessary to enter that area of the country. We return to this below.

this is a technologically sophisticated, well managed firm with access to particularly attractive, irrigation fed, cane fields. Our reading of this transaction is that Rembrandt, a company increasingly identified with high-end luxury good markets, is exiting a market for which it, by its own admission, has no further appetite. It is going through a major restructuring and TSB has no place in that new structure. Moreover, Rembrandt, in common with other leading multinationals, is not the sort of company that remains forever in national markets in which it is destined to occupy, at best, third place. For these reasons, and, we note with interest, because, of 'deregulation', Rembrandt is exiting. We can, given the market power that will accrue as a result of the transaction, understand that THS will be willing to offer a premium over other potential purchasers. But we cannot believe that there are no other potential buyers on the horizon.

89. The merger parties have asked us to consider the existence of '*countervailing power*' in the market, in particular to consider the size and power of their customers and their inability to exercise market power against these purchasers of their product. On the face of it this is a credible argument by the parties.

90. A relatively small number of retail and wholesale groups and industrial companies account for a very large share of the parties' sales. According to the parties very little sugar, if any at all, is sold directly by the miller or refiner to the end consumer. 60% of the domestic demand for sugar is sold to the wholesale and retail trade, 30% of domestic demand to industrialists for further processing as an ingredient and 10% of domestic demand for repacking in neighbouring states.

91. Furthermore, approximately 60% of the wholesale/retail sector is represented by 6 customers, 70% of the industrial sector by 5 customers and 90% of the repacking business by 3 customers, which means that 14 customers represent the buying power of approximately 70% of demand.

92. However, in spite of this concentrated buying power, industrial customers cannot negotiate with millers for rebates. SASA interposes itself as the negotiating forum between the customer and the millers by determining a fixed rebate per ton of sugar supplied by its member producers or distributors recognized by it. This arrangement favours the millers because they share any rebates granted by SASA with the growers in the same ratio as revenues. SASA has, therefore, effectively neutralized rebates as a potential source of competition between millers.

93. This goes a long way towards explaining why the largest and apparently most powerful of their industrial customers – Coca Cola – participated in this enquiry by lodging an objection to the transaction. While we did not always agree with Coca Cola's argument, the absence of countervailing power, even in the hands of a company that accounts for a significant share of all sugar consumption in this country, is striking. A large proportion of the rebate that Coca Cola enjoys in

common with all other industrial purchasers, is subject to a loyalty requirement. Coca Cola could not persuade the sugar producers to participate in a tender for its business. And, on an occasion, when Coca Cola was obliged, for technical reasons, to shift part of its custom from THS to Illovo, the former displayed a marked lack of urgency in winning back this business.

94. The wholesalers and large retail groups have also informed the Competition Commission that they are unable to negotiate price with sugar suppliers. This is in contrast with other agricultural products such as dairy products, meat and vegetables where quantity discounts are granted. This too suggests the absence of countervailing power.

95. We find, then, that this transaction will result in the merged firm having market power, and that it is likely to substantially prevent or lessen competition in the relevant market, namely the South African market for refined white sugar.

Technological, efficiency or other pro-competitive gain

96. Because we have found that the transaction is likely to 'substantially prevent or lessen competition' we are required, in terms of Section 16(1)(a)(i), to determine whether there are any offsetting technological, efficiency or other pro-competitive gains attributable to the merger and which would not occur were the merger to be prohibited.

97. Note that, in balancing a lessening of competition with pro-competitive gains, the only limit drawn by the Act is that the claimed efficiencies, in addition to offsetting the effects of a lessening of competition, should be attributable to the merger and that, in the absence of the merger, would not have occurred. However, despite the absence of a clear set of criteria in effecting the trade off between a lessening of competition, on the one hand, and pro-competitive gains, on the other, we, nevertheless, hold that an accurate reading of the Act requires us to set a high standard for establishing possible countervailing efficiency gains.[18]

98. What, after all, are these 'effects' arising from a prevention of competition and for which the efficiency gains must compensate? They are precisely the boost that *competition* gives to efficiency. The objectives of the Act require us 'to promote

18 Clause 16(2)(a)(i) of the Competition Act – the efficiency defence in mergers – is effectively identical to Subsection 96(1) of the Canadian Competition Act. The problems of balancing efficiency gains and a substantial lessening of competition is discussed by the Canadian Tribunal in The Matter of the Acquisition by Hillsdown Holdings (Canada) Ltd of 56% of the common shares of Canada Packers Inc (CT-91/1). The Tribunal essentially also argues for a high standard to be set for successful efficiency defences in the case of anti-competitive mergers. In particular the Canadian Tribunal holds that a wide view must be taken of the anti-competitive consequences of the merger, including allocative efficiencies and distributional effects (that is, distribution from producers to consumers) thereby raising the hurdle that must be cleared by any claim to a countervailing efficiency.

and maintain competition in the Republic in order …to promote the efficiency… of the economy'. Competition is, in other words, not deemed neutral with respect to efficiency – on the contrary the Act seeks to promote competition precisely *because* it is efficiency enhancing. Conversely, the Act presumes that a lessening of competition *diminishes* efficiency. The standard in establishing an efficiency gain that outweighs the efficiency loss generally presumed to flow from a 'bad' merger must accordingly be set very high indeed – an efficiency gain has to offset, it must compensate for, the efficiency that is sacrificed by the lessening of competition.[19]

99. Moreover, we concur with the Commission that the onus in demonstrating the efficiency gains rests with the merger parties – it is for the Commission to establish a lessening of competition; it is for the parties to establish that the efficiencies sacrificed by an anti-competitive merger are countervailed by efficiency gains.[20]

100. The skeptical stance adopted by the US Courts towards efficiency defences in merger evaluation is evident in the following extract from the judgment in United States v Philadelphia National Bank[21]:

101. 'We are clear, however, that a merger the effect of which may be substantially to lessen competition is not saved because, on some ultimate reckoning of social or economic debits and credits, it may be deemed beneficial. A value choice of such magnitude is beyond the ordinary limits of judicial competence, and in any event has been made for us already, by Congress when it enacted the amended Section 7. Congress determined to preserve our traditionally competitive economy. It therefore proscribed anti-competitive mergers, the benign and malignant alike, fully aware, we must assume, that some price might have to be paid.'

102. Our Act does not allow us the latitude assumed by the US Courts. The Competition Act clearly contemplates that there may be a price – measured in

19 The Act uses the terms "greater than" and "offset" which imply that the efficiency gains must outweigh the anticompetitive effects likely to result from the merger. According to the Concise Oxford Dictionary the term "greater than" implies that it must be considerably above average and the term "offset" means to counterbalance or to compensate for. Therefore the efficiency gains must be considerably more than the anticompetitive effect to neutralize the diminution of efficiency caused by an anti-competitive merger.

20 The Canadian Tribunal, in The Matter of the Acquisition by Hillsdown Holdings (Canada) Ltd of 56% of the common shares of Canada Packers Inc (CT-91/1) has this to say on the question of burden of proof: 'Counsel for the respondents (the merger parties) seemed to argue that once they had established the claimed efficiency grounds on a *prima facie* basis, that was sufficient to transfer the onus of proving them to the Director (the competition authority). He argued that if on the balance of probabilities there was uncertainty, the doubt should be resolved in the respondents' favour. The Tribunal does not accept that argument. The respondents have the onus of proving the existence of the efficiencies claimed, or the likelihood of their existence when the merger has not been consummated, on the balance of probabilities in the normal way.' (p84)

21 374 U.S. 321, 371 (1963)

foregone efficiency – too great to pay for prohibiting an anti-competitive merger. But that price must be very great indeed. At very least, payment, as it were, must be extracted in the same coin: the economic efficiency sacrificed by permitting an anti-competitive merger must be compensated, or rather 'over-compensated', by pro-efficiency gains expressed in the same terms, in economic welfare terms rather than purely commercial terms. Many of the gains usually identified as 'pro-competitive' or 'efficiency enhancing' generally represent an assessment of the commercial merit of the transaction. This falls beyond the scope of our competence. Our task is not to second-guess the commercial wisdom of the deal.[22] Nor should the efficiency defence be invoked simply to place the acquiring company on a commercial footing preferable to its current situation. An efficiency defence that simply equates to enhancing the commercial prospect of a successful firm is not an efficiency gain as contemplated in the Act, it cannot, in other words, countervail the anti-efficiency consequences presumed to flow from a merger that substantially lessens competition.[23]

103. An efficiency gain contemplated in the Act, one that may compensate for the anti-competitive consequences of a merger that otherwise falls foul of the act, is one that, for example, evidences new products or processes that will flow from the merger of the two companies, or that identifies new markets that will be penetrated in consequence of the merger, markets that neither firm on their own would have been capable of entering, or that significantly enhances the intensity with which productive capacity is utilised. This is, by no means, intended to be an exhaustive listing of possible efficiency gains – it is merely intended to demonstrate that much that is presented as a countervailing efficiency gain falls outside of this ambit and firmly into the ambit of firm level commercial gains.

104. The merging firms start their efficiency defence from a particularly high plateau. THS, in particular, is a world-class, leading edge firm, in its own words, 'a low cost producer in international terms, thus being well positioned if world protection should fall away'. This is evidenced by the fact that it has lowered, in real terms, its production costs per ton of sugar every year since 1992. Indeed, the costs of refining sugar in South Africa are the lowest in the world. Granted this has much to do with the high levels of capacity utilization achieved, in large part, because of the particular nature of the cane harvesting cycle, but clearly it is also attributable to the exceptional competence of South Africa's leading refiners. THS is hard put to establish that it requires the merger in order to boost its efficiency – its record suggests that it already performs to the very highest level of efficiency.

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22 Were we to do this we would, of course, be obliged to take account of the strong evidence that suggests that many mergers are not, in fact, commercially successful.

23 The converse is, by way of analogy, also provided for in the Act. There is a particular provision in merger evaluation criteria designed to deal with commercial failure – the 'failing firm' defence provided for in Section 16(2)(viii). However, it is there not in order to save a firm from its own commercial folly or bad fortune – *it is there because failure, and the consequent elimination of capacity that flows from it, may diminish competition.*

105. Nor is THS's efficiency simply attributable to the quality of South Africa's natural resources. The parties aver that 'THG is recognized as being one of the most technically advanced sugar companies in the world'. THS technology is widely diffused both in this country – one of the TSB mills is a THG design – and abroad. There is no claim that its ability to produce cutting-edge technology is in any manner strengthened by the merger. Although TSB, for its part, is clearly a well-managed firm, with some technical expertise and experience of its own – its experience in irrigation technology and management is cited – it adds little, if anything, to THS's technological armoury. To the extent that TSB wishes to benefit from THS's superior technological expertise, it will find this available on the open market. Nor should it be assumed that an R&D joint venture between the companies would fall foul of the Act – a full merger may not be necessary for supporting technological development. It appears that SASA already plays a role in developing and diffusing efficiency-enhancing technologies across the industry, including amongst SADC producers.

106. For these and other reasons both THS and TSB are cost competitive producers. There will be no integration of plant and little rationalization of plant loads and throughput. Consequently the scale and other production efficiencies frequently claimed in transactions of this nature are absent. The Commission in fact points out that no significant production efficiencies with respect to the core business of milling and refining have been claimed.[24]

107. From THS's perspective it appears that the most important efficiency rationale for the transaction derives from its current reliance upon rain-fed cane resources. By contrast, TSB's cane supply is irrigation-fed. We have no cause to dispute the claim that greater diversification of THS's source of cane supply would lower the relatively greater risk that, the parties aver, attaches to the company's earnings. However, we are compelled to pose an heretical question: if THS so urgently requires diversified cane resources why does it not invest in a new mill suitably proximate to the irrigation-fed cane resources and compete for the supply of that cane? We will no doubt be referred to the equitable proceeds arrangement, to the sanctity of the 'partnership' between the millers and growers which, we will be assured, underpins the stability of the industry and is as much in the interest of the relatively atomized growers as it is of the monopsonistic miller. We are, however, not inclined to accept these arguments at face value. In the Tribunal's short life, it has become apparent that, in diverse corners of the agricultural sector, the processors' claim of mutuality of interest between themselves and the

24 There are highly regarded authorities that would limit an efficiency defence to this category of factors. In the Canadian Tribunal's survey of views on efficiency defences it notes: 'Areeda and Turner would limit the defence to certain certain types of efficiencies (i.e. plant size and plant specialization where there is product complementarity) which they feel are most likely to result in significant cost savings. Former FTC Chairman Miller similarly would recognize an efficiencies defence, but only for efficiencies related to economies of scale.' (see reference in footnote 11)

growers, is frequently not shared by the growers themselves.[25] As noted above, the Sugar Agreement of 1994 scrapped licensing requirements regulating the planting of cane and the establishment of new mills. This can only have been done to attract new investment in growing and milling.[26] This may be the pro-competitive alternative to a merger that simultaneously addresses THS's diversification requirements.

108. Note that the parties also submitted transport cost savings as representing efficiency gains from the transaction. Since the revised Sugar Agreement came into effect in June 2000 sugar is sold on an ex-mill basis instead of free-on-rail Durban, which, according to the DTI, was introduced precisely to allow for competition in transport cost. The efficiencies will be realized by THS transporting its sugar to the Northern parts of the country from the Malelane Mills rather than from their Durban Mills. The efficiency gain, therefore, only relates to transport in the northern parts of the country and not the country as a whole.

109. Balanced against the above efficiencies is the anti-competitive effect of eliminating the second largest player in direct sugar sales that is also the main supplier to the Northern half of the country and a competitor in the Western Cape. Moreover, if we keep in mind that Illovo, the remaining miller, is focused on the industrial market and is not regarded as a competitor in the direct market the net effect of the merger is that there remains one player in each of the two product markets. Furthermore, the competitor that is being eliminated is projected by THS to grow its sugar production by 2% in the year 2001.

110. We, accordingly, find that the technological, efficiency or other pro-competitive gains arising from the merger will not offset the negative impact of the transaction on competition.

Public Interest

111. We have determined that the merger will prevent competition, certainly it will forestall any attempt by the authorities to introduce greater competition in a deregulated or partly deregulated market. We have also found that the technological, efficiency or other pro-competitive gains arising from the transaction will not offset the negative impact of the transaction on competition. We are finally required to examine whether or not the merger can be justified on substantial public interest grounds. Section 16(3) specifies that the public interest evaluation must consider the effect of the transaction on a particular industrial

25 See Jakobus JP Bezuidenhout & Another v Patensie Sitrus Beherend Ltd (66/IR/May00) and South African Raisins (Pty) Ltd and Johannes Petrus Slabber v SAD Holdings Ltd and SAD Vine Fruit (Pty) Ltd (04/IR/Oct99)

26 Note that the parties acknowledge that 'there is substantial opportunity for increasing cane production in Mpumalanga'.

sector or region, on employment, on the ability of small businesses or firms controlled or owned by historically disadvantaged persons to become competitive, and on the ability of national firms to compete in international markets. The parties have entered a public interest defence under each of these categories.

112. The transaction will give rise to approximately 165 redundancies, all at middle to senior management level and mostly employed at head office. The parties aver that the 'merged firm, by virtue of its economies of scale and the opportunities available to it, will be in a position to expand its operations and thereby offer additional employment opportunities with a potential for the creation of over 3000 additional jobs'. This latter appears to derive from the projected sale of the TSB cane plantations to small farmers.

113. The parties claim that the transaction will impact positively on the Mpumalanga region as well on the Southern African region. Mpumulanga, it is averred, will benefit from THS's undertaking to continue procuring imputs for the Mpumalanga operations from local suppliers. It also intends to sell a portion of TSB's 8000 hectares of cane land to small-scale growers from historically disadvantaged communities. However, these benefits are not sufficiently substantial to countervail the negative impact of the merger on competition, nor is it at all clear that they will not occur in the absence of the merger. While the sophisticated South African sugar industry undoubtedly impacts positively on the development of the sector in Southern Africa, the merger will have no impact, one way or another, on the ability of South African firms to play a positive role in the region.

114. Finally, the parties argue that the merger will enhance the ability of the firm to compete on international markets. Again, we stress, the parties are making this argument from a very high plateau. The South African sugar industry is a low cost producer well set up to compete successfully on international markets. Moreover, the argument that the transaction will boost the cost competitiveness of the merged entity is rooted in the notion that South African firms are small by international standards and that the merger will enhance scale economies. These arguments are not borne out by the data. Illovo and THS are sizable enterprises by world standards. TSB is significantly smaller than its two fellow South African millers and, obviously, than the large scale international firms. However, as the Commission points out, TSB is larger than the second largest European miller and refiner and larger than the third largest Australian refiner in terms of refining capacity. It is also noteworthy that TSB, by a significant factor the smallest of the South African companies, is generally recognized as the lowest cost producer in South Africa. Clearly, and not surprisingly, productive efficiencies have little to do with the size of the firm. Cost competitiveness may be considerably influenced by the size of the productive units, however the merger has no direct influence on this there being no consolidation of any

productive capacity.

115. In general we are skeptical of arguments that insist that a precondition for successful international competition is domination of the domestic market. In select instances scale economies and rationalization of production units may support this argument. However, to the extent that broad generalizations assist merger analysis, we incline to the view that the most aggressive and successful international competitors are those who face robust competition at home.

116. The Tribunal finds that the public interest factors cited do not countervail the substantial lessening and prevention of competition caused by the proposed transaction.

D.H. Lewis

Concurring: M. G. Holden and C. Qunta

27 November 2000