

CEMEX UK OPERATIONS LIMITED

COMMENTS ON THE COMPETITION COMMISSION'S PROVISIONAL FINDINGS IN CONNECTION TO THE PROPOSED JOINT VENTURE BETWEEN ANGLO-AMERICAN PLC AND LAFARGE S.A.

1 INTRODUCTION

- 1.1 CEMEX has reviewed the Competition Commission's ("CC's") Provisional Findings report of 23 February 2012 in relation to the proposed Anglo-American/Lafarge JV. It sets out below the reasons why it considers that (i) the CC's findings in relation to pre-existing coordination should be maintained in its final Decision; and (ii) other aspects of the CC's provisional findings should not become final. CEMEX sets out its comments in two parts. First this response document sets out CEMEX's legal and factual observations on the CC's Provisional Findings. Second, CEMEX's economic advisors, Compass Lexecon, have prepared the attached economic paper which responds to the CC's economic analysis in relation to the theory of coordinated effects.
- 1.2 In summary, CEMEX does not believe that the CC has adduced sufficient evidence to support a finding of pre-existing coordinated effects in any UK market for bulk grey cement. It therefore considers that the CC was correct to avoid making such a finding in its Provisional Findings, and urges the CC also not do so in its final Decision. However, CEMEX does not agree that the evidence on market outcomes that the CC has reviewed, indicates that there are shortcomings in the way the market functions. CEMEX strongly disagrees that the evidence the CC has considered is consistent with a degree of pre-existing tacit coordination and sets out the reasons for this in further detail below.

2 THE CC'S PROVISIONAL FINDINGS ON CEMENT MARKETS – NO FINDING OF PRE-EXISTING COORDINATION

- 2.1 CEMEX notes that the CC has not come to a conclusion in its provisional findings as to whether or not there is pre-existing coordination in relation to the supply of bulk cement. It is CEMEX's view that, whilst the CC has been provided with sufficient evidence to be able to make a finding that there is no such coordination, at the very least the CC should not seek to alter its existing conclusion in its Final Report. CEMEX explained the reasons why a finding of existing coordination would be inappropriate in its letter to the CC of 26 January, and for the avoidance of doubt, CEMEX sets out its key reasoning for this again below. In summary, it is not necessary for the CC to make a finding of pre-existing co-ordination; any finding that there is any such coordination would be incorrect as a matter of fact; and moreover, it would significantly prejudice the inquiries that the CC is currently undertaking as part of the Market Investigation in relation to aggregates, cement and RMX.

(i) The CC's test for finding a substantial lessening of competition

- 2.2 Under its merger control powers in Part 4 of the Enterprise Act 2002, the CC is obliged to decide whether a relevant merger situation may be expected to result in a substantial lessening of competition ("SLC") within any market in the UK.¹ As the CC knows, it applies a '*balance of probabilities*' test which the CC interprets as whether it is more likely than not² that an SLC will result. It is not necessary that each individual step in the CC reasoning fulfils this test, but rather it is only necessary that the CC's overall conclusions fulfil this test. Accordingly, it is not necessary

¹ Section 36(1) of the Enterprise Act 2002

² The CC and OFT's Joint Merger Assessment Guidelines note at paragraph 2.12 that the Court of Appeal has endorsed the approach of expressing an expectation as more than 50% chance in *IBA Health Ltd v OFT* [2004] EWCA Civ 142, para 46.

- for the CC to reach a view on the balance of probabilities on each and every aspect of its reasoning.³
- 2.3 The joint CC and OFT Merger Guidelines make clear that a merger may give rise to an SLC on the basis of coordinated effects either where:
- (a) *"there is evidence that the firms in the market were coordinating pre-merger. If so, they will examine whether the merger makes coordination more stable or effective, given the characteristics of the market"; or*
 - (b) *"if there is no evidence of pre-merger coordination, they will examine whether the merger makes it more likely that firms in the market will start to coordinate, given the characteristics of the market".⁴*
- 2.4 It is clear that the CC could base its reasoning on either of these alternative analyses, and indeed the CC makes its Provisional Findings not on the basis that pre-existing coordination exists, but that the conditions for coordination may exist and would be enhanced by the proposed JV. CEMEX understands therefore that the CC considers there to be no practical or legal reason why the CC needs to include a finding of existing coordination in the Tarmac/Lafarge case.
- (ii) A finding of existing coordination would unfairly prejudice CEMEX***
- 2.5 CEMEX is very concerned that any incorrect findings reached by the CC in a process resulting from a commercial decision by two of its competitors, risks causing significant harm to CEMEX by materially prejudicing its position in the CC's Market Investigation into aggregates, cement and RMX and the European Commission's investigation in relation to cement.
- 2.6 Any finding of pre-existing coordination, in particular in the market for cement, as part of the CC's Tarmac/Lafarge case would clearly taint and unfairly prejudice decisions subsequently taken as part of these other investigations. CEMEX notes that the CC itself has indicated that the members of the CC's Market Investigation Group will be entirely separate to those in the Tarmac/Lafarge case Group, which in our view, acknowledges the need to avoid the Tarmac/Lafarge case prejudicing the outcome of the separate Market Investigation in any way.
- 2.7 The recent publication of CC guidance on the need to avoid not only real bias but also *apparent* bias, can only re-emphasise the need for the CC to take every necessary precaution in ensuring that its published Decisions avoid prejudicing the outcome of other investigations.
- (iii) Right to be heard not satisfied***
- 2.8 Any prejudice created as a result of the CC's Decision would be amplified by the lack of a proper forum within a merger inquiry for a third party such as CEMEX to defend itself against any allegation of existing coordination. Prior to the eventual publication of the CC's Provisional Findings, CEMEX was asked to comment on a detailed and extensive theory of harm only partially revealed to CEMEX through the medium of various written 'putback' papers that framed the CC's analysis in an incomplete way, with no express indication of the CC's workings or evidence under consideration. Much of the relevant evidence has been withheld from CEMEX on confidentiality grounds.
- 2.9 CEMEX has cooperated with the CC's merger inquiry in Anglo-American/Lafarge to the fullest extent which it could and yet there is a risk that this enquiry results in findings adverse to CEMEX's

³ The CC and OFT's Joint Merger Assessment Guidelines note at paragraph 2.3 that clarity about the application of the threshold applicable to the CC when answering the SLC question was provided by the Court of Appeal in *BskyB and Virgin Media v Competition Commission and BERR* [2010] EWCA Civ 2

⁴ Para 5.5.4 of the OFT and CC's Joint Merger Assessment Guidelines

interests and which may prejudice the outcome of a Market Investigation, prior to CEMEX being given an opportunity to defend itself against any allegations of existing coordination in the context of that Market Investigation.

- 2.10 As the CC will appreciate, a merger inquiry primarily affords only the merging parties full rights of defence, and in the current context, it is essential that no final Decision is taken which may affect another party without that party being provided with an adequate opportunity to be heard in exercise of its right of defence.⁵

(iv) A Market Investigation is the best forum to make any assessment of existing coordination

- 2.11 CEMEX recognises that the CC will need to set out its reasoning in its Decision on the Tarmac/Lafarge merger.⁶ However, CEMEX would like to reinforce that it is not *necessary* for the CC to reach any firm findings on whether there is any existing coordination, just as it has not done in its Provisional Findings, because this is not a pre-requisite for an SLC finding (see para 2.3 above).

- 2.12 If the CC were to make such a finding, this would be based only on the work it has been able to undertake in a condensed 32-week process, where the CC is simply not able to undertake the same level of in-depth and exhaustive analysis as will be undertaken in the context of the current 2-year Market Investigation. More importantly, the Market Investigation will afford *all* the parties involved the same procedural protections, including a proper opportunity to a full hearing and ability to assess all evidence, on an equal footing. It is therefore essential that the CC continues to avoid making a finding of pre-existing coordination which could taint and prejudice that process.

3 THE CC'S PROVISIONAL FINDINGS ON CEMENT MARKETS - INDICATORS OF COORDINATED BEHAVIOUR

- 3.1 The Annex to this note comprises a paper from Compass Lexecon which updates the submission previously made on 26 January 2012. In this annex, Compass Lexecon reiterates certain key points in relation to the CC's theory of coordinated effects which it believes the CC has failed to take on board, or where in Compass Lexecon's view the CC incorrectly disagreed with CEMEX's submissions (because of misinterpretation or misunderstanding). CEMEX also makes a number of other key legal and factual points below concerning the CC's findings, which broadly follow the chronology of the CC's decision.

(i) Capacity and capacity utilisation

- 3.2 The CC comments in a number of instances in its coordinated effects analysis that there is 'significant' spare capacity across the operations of the 'majors' which provides them with sufficient spare capacity to instigate a 'punishment' mechanism should they observe competitors who 'deviate' from 'coordinated behaviour'. Even if the 'majors' had attempted to instigate such a strategy (which CEMEX disputes) the CC's own evidence does not confirm this.

- 3.3 The CC concedes that Lafarge's maximum capacity is only a theoretical figure, based on a plant running at maximum reliability and performance with zero unplanned outages. Lafarge correctly pointed out to the CC that this capacity is rarely achieved due to unplanned breakdown and outages, leading the CC to accept that Lafarge operated at close to full capacity from 2001 to 2008 with 'excess capacity' (which the CC does not claim to be 'substantial') only since 2009. This does not correlate with a long-term ability to punish deviations. While the evidence for Hanson was

⁵ *R v Secretary of State for the Home Department, ex parte Doody* [1994] 1 AC 531, at page 560

⁶ Section 38(2)(c) of the Enterprise Act 2002.

more mixed, CEMEX notes that Hanson operated at full capacity in 2006 and 2007, and that Tarmac has operated at close to capacity for most of the past ten years, and indeed was obliged to increase its capacity in each of 2004 and 2008.

3.4 The CC notes that CEMEX's spare capacity has generally increased since 2009, which is accepted. The CC also rightly notes that this was due to a significant contraction in demand combined with the opening of CEMEX's new grinding plant at Tilbury. The decision to invest in the new plant was taken years earlier, however, demonstrating the hazards of operating a business requiring long-term investment decisions, against a backdrop of short term volatility. Whilst this misalignment of capacity with demand may have increased theoretical capacity recently, the CC does not appear to have understood the full context of CEMEX's capacity. As explained to the CC [§<]

3.5 [§<]

3.6 Even putting these matters aside, it is important to note that all of the reasons put forward above by Lafarge for a realistic assessment of capacity are equally applicable to CEMEX. [§<]

(ii) Asymmetry in sales portfolios

3.7 Despite noting that the split of sales of bulk of CEM I compared to other bulk cement products varies significantly among the majors, the CC does not accept that this asymmetry would make coordination harder. Based on the CC's general assertions that symmetry leads to greater transparency and alignment of incentives, thus facilitating coordination, CEMEX considers it entirely inconsistent of the CC to state that this asymmetry is not relevant. The CC offers no evidence whatsoever to support a supposition that majors could in fact use this asymmetry to "engage in some sort of customer allocations based on the types of product". This allegation should be substantiated or withdrawn.

(iii) Margin analysis

3.8 The CC says that its analysis has revealed that variable margins for each of the 'majors' increased from 2008 to 2009, despite a significant decrease in demand. Compass Lexecon makes a number of points in relation to the movement of variable margins which the CC has previously failed to take into account. CEMEX would therefore urge the CC to carefully consider again these previously-dismissed points.

3.9 More generally, CEMEX wishes to record that it strongly agrees with the point made by the CC at paragraph 3, Annex L of its provisional findings, that variable profit margins are not in themselves definitive indicators of market power or 'excess' profitability. CEMEX agrees that an appropriate comparator or benchmark is required to determine whether profits are 'excessive' and that a measure such as, for example, ROCE is better suited as an indicator of profitability when weighted against an appropriate cost of capital. In relation to day-to-day pricing decisions, CEMEX entirely agrees with the submission made by Anglo-American that it is misleading for the CC to focus on a measure that excludes significant semi-variable and fixed costs, which a plant will always need to consider in the context of its wider pricing decisions.

(iv) Switching data

3.10 CEMEX notes that the CC has focussed on the fact that CEMEX's volumes won and lost to a particular competitor allegedly exhibit a [§<] in any given year. The CC observes that this would be consistent with periods of "deviation" and "retaliation". CEMEX considers this assertion to be without foundation.

3.11 It is far more likely that, as the CC suggests (but then rejects), [§<]

3.12 [redacted]

(v) Constraints from importers

3.13 CEMEX agrees with Lafarge that Aggregate Industries should be treated as a standard importer and not be subject to any particular carve-out from the CC's import analysis. Whilst CEMEX acknowledges that Aggregate Industries does not sell the volumes that it imports onto the open market, it nevertheless acts as a constraint on the pricing of the cement-producing majors. This is because they know that if a price quoted to a major customer such as Aggregate Industries is not competitive, it has the necessary supply chain operation to simply import further cement from overseas.

3.14 More generally, CEMEX is concerned in relation to the approach that the CC has taken in assessing the competition that UK producers face from importers. CEMEX notes that the CC's PCA results suggested that independent import terminals do not constrain Lafarge's prices, because the cost for cement importers to deliver to the UK is "substantially higher" than UK-based producers. The CC notes that independent importers apparently incur estimated average transport costs of £55-£60 per tonne, compared to "£25" (based on variable costs) per tonne ex-works from UK producers, and that it would cost an importer around £70 per tonne to deliver cement in the UK, compared to "£34" (based on variable costs) per tonne for domestic producers. The CC claims that this would allow UK producers to undercut importers "profitably", as average selling prices in the UK were found to be between £72 and £84 per tonne.

3.15 This analysis is however simply incorrect. CEMEX notes that both it and Lafarge explained that such an analysis does not compare like with like. A true comparison can only be made if all attributable costs per tonne are taken into account. This must include not only variable costs but also carbon costs (around £[redacted] per tonne) plus significant fixed costs which are at least as important as variable costs. The CC considers that Lafarge would be able to serve additional customers profitably at any price exceeding average variable costs (therefore undercutting importers and limiting their competitive constraint). However, Lafarge's fixed cost elements cannot be simply ignored. It cannot be excluded that it would be possible to undertake some short-term discounting, but cement manufacture is an extremely capital-intensive business. It is unrealistic to assume that UK producers would have the ability to discount away their fixed costs over a sustained period of time, such that they only seek to recover average variable costs when bidding against an importer. The fixed cost element of any quoted price is usually at least as valuable as variable cost elements. It is therefore misleading of the CC to choose to quantify one element, but not the other.

3.16 CEMEX also considers that the CC has significantly underestimated the constraint that can be exercised by import terminals. If importers serve a range of 40-100 miles from a terminal, in aggregate the vast majority of UK demand centres for cement will have access to an import terminal. Nowhere in the UK is more than a hundred miles from the sea.

(vi) Constraints from new entrants

3.17 CEMEX notes that the CC considered the possibility of a new competitor entering the UK market via setting up a grinding station or an import terminal. CEMEX reiterates that its Tilbury plant has demonstrated that this is feasible. [redacted]

4 MARKET DEFINITION

4.1 Finally, aside from its views on possible coordination, CEMEX wishes to record that it disagrees with a number of the CC's findings in relation to market definition, as follows.

(i) Aggregates

- 4.2 CEMEX continues to consider that both primary, secondary and recycled aggregates form part of a single product market, and that secondary/recycled aggregates exert more than a mere competitive constraint on primary aggregates. CEMEX competes vigorously with both primary and secondary/recycled aggregates producers and considers that the CC has not given due weight to the fact that around 28% of total aggregate purchase volumes relate to secondary and recycled aggregates, or the many examples given throughout Annex G of the CC's Provisional Findings report, concerning the evidently wide and varied degree of substitution across all aggregate types.

(ii) Cement

- 4.3 CEMEX is disappointed that the CC has provisionally concluded that bagged and bulk cement form part of separate product markets. CEMEX continues to consider that there should be a single market for all grey cement. The technical properties of the product are identical. Furthermore, most sellers of bagged cement in the UK also sell bulk cement, and vice versa. As the CC has noted, it is only necessary to invest in inexpensive packing equipment in order for a bulk cement supplier to begin to supply bagged cement.
- 4.4 Irrespective of whether the market is for bulk cement, bagged cement or both, CEMEX concurs with the CC's finding that all types of grey cement (i.e. CEM I, II and III) form part of the same product market.

(iii) RMX

- 4.5 CEMEX is concerned that the CC has misjudged the impact of volumetric concrete suppliers. These manufacturers are nimble, efficient and high-quality operators, who continue to win market share year-on-year from CEMEX and from other traditional RMX operators. CEMEX does not accept that they do not form part of the same relevant market as its RMX operation.

16 March 2012