AGGREGATES, CEMENT AND READY-MIX CONCRETE MARKET INVESTIGATION

Summary of hearing held with Lafarge on 6 December 2012

Introductory comments and general questions

1. Lafarge wished to address a key point raised in the CC's working papers—how had Lafarge managed to raise prices and sustain margins given the 2008 demand shock and also loss of volumes following Hanson's decision to self-supply cement volumes in 2009. Lafarge said that, in Easter 2008, the recession hit suddenly. In late 2008, Hanson notified Lafarge that it was planning to internalize [✂] kT of cement sales. Lafarge reacted aggressively to recover this volume—it had not acted as part of a coordinated punishment mechanism. In the last ten years, Lafarge had lost [✂] percentage points of market share [✂]. Lafarge had also seen its costs spiralling. It had embarked on a significant programme of cost savings, which the CC's analysis did not acknowledge. Taken together, these steps (reaction to loss of Hanson volume and cost savings) had enabled Lafarge to hold its margins. [✂]

2. Lafarge said that the entry of Mittal Investments (Mittal) also needed to be considered. With Mittal, there was now a committed long-term investor in the cement industry, in contrast to Anglo American. The Hope works had [✂] per cent more capacity than Tarmac's Tunstead works, with the ability to sell more than [✂] tonnes a year to the external market—ie more [✂] as ever was supplied by Tarmac to the external market. [✂].

3. The South-East had remained relatively buoyant compared with the rest of the country but it was slowing down post-Olympics. It was a very different picture outside the South-East—in some areas, it was quite drastic. Lafarge anticipated a difficult 2013 with maybe some recovery emerging in 2014.

4. Each of Lafarge's business lines was run separately [✂].

5. Lafarge said that, although the CC may have overplayed the differences between greenfield sites and site extensions (as planning and environmental policies were applied in the same way to both), it agreed with the CC that the planning regime for aggregates did not have a great impact on competition. The MASS operated to ensure continuity of supply and there was no 'hoarding' of unworked quarries.

6. In relation to barriers to entering the supply of cement in Great Britain, the need for cement producers to purchase carbon allowances from 2020 meant that it was very unlikely that any new cement capacity would be installed within the EU. The EU Emissions Trading Scheme (ETS) also operated as a strong incentive for producers in other EU countries with spare cement capacity (such as Spain and the Republic of Ireland) to export cement to the UK so as to qualify for the ETS.

Aggregates

7. Lafarge considered that secondary and recycled aggregates were substitutes for primary aggregates. It had mothballed quarries due to the constraint from recycled aggregates. Lafarge's last greenfield quarry opening had been in Norfolk in 2010.

8. The vast majority of Lafarge's rail-borne aggregates were from its Leicestershire quarry, Mountsorrel. It had seen a significant decline in the competitiveness of its rail-borne aggregates in the South-East due to the impact from recycling aggregates. This had been the case for crushed rock especially. Local recycling centres had been established (eg near St Pancras railway station) as well as on-site recycling centres where buildings were in the process of being demolished and recycled aggregates were being produced from the demolition waste.

9. Lafarge noted that the CC's analysis showed that in 98 to 99 per cent of local markets in which Lafarge was present, customers had a choice of five or more suppliers. Lafarge interpreted the CC's analysis as showing that the presence of additional suppliers in a market did not affect pricing because markets were already very competitive. It did not distinguish between the impact of a local independent supplier or a major in a local market—it was the fact that there were lots of suppliers to any particular customer site which was the constraint. Lafarge's own win/loss data demonstrated that it lost as many jobs to independents as it did to other majors. Its own win/loss analysis showed (based on 2011 figures) that of the jobs it pitched for and lost, [✂] per cent were lost to independent aggregates producers (in 2007, [✂] per cent of jobs it had pitched for and lost were lost to independent producers). Whilst Lafarge might have more aggregates sites than independents, the size of its sites was the same—it was this which was important when competing for jobs.

10. Lafarge said that the CC's analysis may underplay the constraint from recycled aggregates, especially on-site recyclers (see paragraph 8), whose activity may not be fully captured in the data.

11. In relation to the so-called 'Torcoed Agreement' in South Wales, [✂].

12. The volume of Lafarge's sales to the other majors was de minimis ([✂]). There was no element of reciprocity in these sales.

13. Lafarge explained that its budget cycle begun in October when the business assessed expected input cost increases for the forthcoming year. Price increases were necessary to recover future and, sometimes, past cost increases. The driver of Lafarge's annual price increase letters was cost recovery. Increases had been higher for single-size aggregates compared with lower-grade aggregates where it was competing with recycled aggregates. Competitors' price increase letters did not influence Lafarge's own pricing approach.

Profitability

14. The CC's analysis suggested that Lafarge's margins for internal aggregates sales were significantly higher than its margins for external aggregates sales. This was not the case. Lafarge thought that the evidence relied on by the CC may not have taken into account the fact that aggregates supplied internally tended to be higher-value aggregates, whereas aggregates supplied externally were a mix of lower- and higher-value aggregates. The evidence may also have miscategorized transfers of aggregates to Lafarge's rail depots (for subsequent external sale) as internal sales. Lafarge's margin on like-for-like products to like-for-like customers, be it internally or externally, was the same.

15. Lafarge's main financial performance indicator was its post-tax ROCE—for 2011, for its cement business this was [✂] per cent. It said that the CC should consider profitability on a modern equivalent asset (MEA) basis. Globally, Lafarge was targeting a ROCE of [✂] per cent. On a historical cost basis, large returns indicated under-investment in the cement business in the UK.

16. Lafarge had maintained cement margins through cost savings (one-off plant closures as well as a programme of efficiency improvements) and through pushing value-added products (VAPs) very hard. Whilst average prices had increased, Lafarge's individual prices to its (625) cement customers varied widely—some prices had remained the same, some had gone up and some had gone down.

17. [✂]

18. On a month-by-month basis, both Lafarge's cement and aggregates businesses looked at 'current operating income' (COI) against budget as a key financial performance indicator. For cement sales, Lafarge looked at: volume versus budget by customer, price versus budget by customer, value-added product penetration product by product by customer, and 'Extra Mile', a target for new product launches.

19. Lafarge's margins [✂].

20. Lafarge said that the other UK cement producers faced common input costs, which might explain some similarity in pricing. It was possible for any person to be able to estimate its competitors' cost structures using publicly-available data (eg common energy costs and emissions data) and its own knowledge of the efficiency of different cement kilns (Lafarge was able to benchmark performance against 140 cement kilns worldwide). Using this information, it could construct a very general cost structure for a cement producer which would be within approximately [✂] per cent of a producer's actual cost structure. Its [✂] Lafarge kiln in the UK. ([✂]) It was more efficient to run a kiln at nearly full utilization and then cease production for part of the year than run a kiln continuously but at a lower level of utilization.

21. Lafarge said that the RMX market had fallen by about 40 per cent since 2007. Variable costs accounted for [✂] per cent of total costs. In the period 2009 to 2011 Lafarge's RMX business had [✂]. Lafarge had a 'legacy' of 90 RMX plants spread all over the country and it would not choose to be configured in this way in the current economic climate. Independent RMX producers had smaller plant networks in very restricted geographical areas. They also tended to use more volumetric trucks. Lafarge had shut about [✂] per cent of its RMX plants and was organized around 21 local sectors with each RMX manager running his plants on an independent basis.

Cement

22. Lafarge viewed the cement market as a cementitious market. GGBS and pulverized fuel ash were important additions to cement and, if they did not exist, Lafarge would probably sell 40 per cent more cement to the RMX sector.

23. Lafarge estimated that greenfield entry in the form of a new 1,000 kT cement plant would cost £300–£400 million. Lafarge had had planning permission for a new cement works on the Medway since 2002 but had not commenced building because demand had not been strong enough. In addition, the threat of cement imports from places like Spain and the Republic of Ireland deterred entry. Uncertainty around the availability of carbon allowances for the cement industry after 2014 deterred the investment case further. After 2020 the cement industry was expected to have to pay for carbon allowances. Given this, and at least a six-year planning permission time frame, Lafarge did not currently expect any new planning applications for cement plants in the UK. It expected existing cement capacities to remain the same (it did not have any plans to close any cement plants in the UK). The EU ETS operated to incentivize producers outside the EU to export to the EU and also to incentivize EU producers to maintain production at (at least) 50 per cent to qualify for the EU ETS.

24. [✂]

25. [✂]

26. [✂]

27. Lafarge said that the fact that it had lost [✂] points of market share in the last ten years suggested that it had not been able to manage the market to preserve its market share.

28. Lafarge described the process for the annual price increase letters for cement. In the summer in the year preceding the price increase, Lafarge would begin considering its costs position as well as its ROCE target for the coming year. Based on this analysis, it would decide on an appropriate price increase for its customers. As many customers required three months' notice of a price increase, they would be notified in October. Lafarge had seven cement salespeople and approximately [✂] bulk cement accounts.

29. Lafarge said that [✂]. Each of its prices was individually negotiated with customers. It did not know why other cement companies had issued price increase letters after Lafarge. Whilst the announced price increases were aspirational, actual prices bore no relation to the announced increase. The letters were for the benefit of Lafarge's customers. The letters announced that Lafarge wanted to talk to its customers about the necessity of increasing prices.

30. In relation to the mid-2008 price increase for cement, Lafarge explained that, whilst in the short term prices might have increased for some customers, Lafarge's cement prices to non-majors showed a decline through 2009. Lafarge said that its prices for CEM I to non-majors showed a very wide dispersion ([✂]).

31. Lafarge commented on the CC's price correlation analysis. First, Lafarge questioned whether average price increases was the correct focus. The wide dispersion of prices suggested that coordination in relation to prices would be very difficult. Secondly, Lafarge noted that the CC's analysis contained only 16 to 20 observations, which was insufficient for a reliable correlation analysis to be performed.

32. Lafarge said that price increase letters created transparency in that they signalled that a producer was looking to increase its prices. The vertical integration of the industry meant that cement producers were aware of others' price increase letters, and also customers would tell Lafarge about other producers' price increases (some of the information from customers might not be correct). The letters had limited value, however, given the similarity of the cost pressures faced by cement producers and the variation in actual [✂].

33. Lafarge's price increases aimed to recover cost inflation. One of its KPIs [✂]. Cement prices took into account any previous under-recovery of cost increases as well as anticipated future cost increases. Therefore a simple correlation analysis (even with lagging) would not capture fully the relationship between changes in costs and changes in prices. A 'co-integration' analysis would need to be performed, but this would require a long span of data.

34. [✂]

35. Lafarge said that, when Hanson announced it intended to internalize, it should not have been that surprised, given the acquisition of Castle Cement, but that Lafarge was very surprised because of the very large volume involved. Lafarge said that its

reaction had been uncalculated. [✂] Lafarge accepted that it had initially targeted Hanson customers as part of the 'emotional' reaction. [✂]

36. Lafarge did not have a specific strategy in relation to importers. It did not target any particular supplier group. Importers now had about 13 per cent of the market. It was more exposed to importers than the other Majors because it supplied more independent cement customers. The threat from importers was growing. In the period 2007 to 2010, Lafarge had [✂] cement sales to importers. Importers were not homogenous. They included vertically-integrated businesses with cement production overseas and RMX assets in the UK (eg CPV), smaller importers (eg Thomas Armstrong) and 'opportunistic' importers (eg Quinn Cement (Quinn)).

37. [✂] Lafarge's Republic of Ireland cement business was very small, so very unlikely to be able to be used as a lever to prevent CRH/Quinn etc importing cement into the UK. The growing imports of cement from the Republic of Ireland into Great Britain indicated that any such Lafarge strategy, were it in place (which Lafarge said was not the case), had been unsuccessful.

38. Lafarge did not believe there was any tacit coordination in the cement market. It said that there was a degree of transparency in the market.

39. The GGBS that Lafarge purchased from Spain already had limestone in it, so it could not receive 'CE' marking and therefore Lafarge could not sell it in the UK (although the landed price of this GBBS compared favourably to the cost of Hanson GGBS). However, Lafarge could sell the blended cement made from this GGBS in the UK as the RMX would have the 'CE' mark. It would not be cost-effective for Lafarge's Spanish GGBS supplier to make GGBS without limestone in it specifically for Lafarge.

Impact of the entry of Mittal

40. Lafarge said that Mittal would be able to supply more [✂] cement than Tarmac supplied to the external market. It might, potentially, also have access to a supply of GGBS. [✂]