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## Competition Act 1998

Decision of the Director General of Fair Trading pursuant to section 14(2)(b)  
(CA98/17/02)<sup>1</sup>

and a Statement of the Director relevant to not withdrawing an exclusion

Notification by Lucite International UK Limited (formerly Ineos Acrylics UK Limited) and BASF plc of an agreement concerning the production and sale of hydrogen cyanide

29 November 2002  
(Case CP/1288-02)

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### SUMMARY

On 5 April 2002, Lucite International UK Limited (Lucite), formerly Ineos Acrylics UK Limited,<sup>2</sup> and BASF plc (BASF) notified an agreement made between them to the Director General of Fair Trading for a decision under section 14 of the Competition Act 1998. The agreement, dated 29 September 2000, provides for the sale of hydrogen cyanide by BASF to Lucite for a given period. The agreement also provides for the construction of a plant by Lucite, on BASF's site, to be run by BASF for the purpose of converting hydrogen cyanide to acetone cyanohydrin.

The Director has decided under section 14(2)(b) of the Act that the agreement constitutes a vertical agreement within the terms of the Verticals Exclusion Order.<sup>3</sup> The Chapter I prohibition is therefore not applicable to the agreement.

This document also contains a statement explaining, for the purposes of transparency, why the Director is not proposing to exercise his discretion to withdraw the exclusion so that the Chapter I prohibition can apply to the agreement.

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<sup>1</sup> Certain information has been excluded from this decision in order to comply with the provisions of section 56 of the Competition Act 1998 (confidentiality and disclosure of information). Excisions are denoted by [...].

<sup>2</sup> Ineos Acrylics UK Ltd was renamed in May 2002. For the purposes of this decision the new name, Lucite International UK Limited, is used.

<sup>3</sup> The Competition Act 1998 (Land and Vertical Agreements Exclusion) Order 2000, SI 2000/310.

# I THE FACTS

## A Background

- 1 On 5 April 2002, Lucite International UK Limited (Lucite), formerly Ineos Acrylics UK Limited, and BASF plc (BASF), notified an agreement made between them on 29 September 2000 (the agreement) to the Director General of Fair Trading (the Director) for a decision under section 14 of the Competition Act 1998 (the Act). The agreement concerned the sale of hydrogen cyanide (HCN) by BASF to Lucite and for the construction of a plant to convert HCN to acetone cyanohydrin (ACH). Lucite and BASF (the parties) considered that the agreement might infringe the Chapter I prohibition of the Act, and requested that the Director grant the agreement an individual exemption under section 4 of the Act.
- 2 A summary of the notification was placed on the public register of the Office of Fair Trading (the Office) and published in the Office's Weekly Gazette.<sup>4</sup>
- 3 This decision is made under the Act in accordance with Rule 15 of The Competition Act 1998 (Director's Rules) Order 2000.<sup>5</sup> It states the facts on which the Director relies and his reasons for making this decision.

## B The products and the parties

- 4 HCN is a raw material used in a small number of industrial processes resulting in final consumer products. The main use covered by the agreement is as a source of ACH, which in turn is used to make methyl methacrylate ('MMA'). MMA is the basic chemical component used to make acrylic products such as: paints and fibres; cast sheet acrylic for baths, spas and retail lighting; extruded acrylic sheet for lighting and glazing; composites for sinks and tubs; and acrylic polymer chip and resins. HCN is also used to make sodium cyanide liquor, which is used to make dyes and in electroplating and gold extraction.
- 5 Only three undertakings in the UK supply or use HCN:

a) Lucite, one of the parties to the agreement, is primarily a producer of methacrylate monomers including MMA. It also manufactures sodium cyanide liquor. Lucite produces HCN solely for use in the manufacture of its downstream products. It does not sell HCN on to other users.

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<sup>4</sup> Issue 13-19 April 2002.

<sup>5</sup> SI 2000/293, Rule 15(1), Director's Rules.

b) BASF, the other party to the agreement, is a transnational chemical company with a wide product range that includes plastics and fibres, colorants and pigments, automotive and industrial coatings, agricultural products and fine chemicals. BASF also produces fibre intermediates including acrylonitrile, from which HCN is derived as a by-product. BASF has no use for the HCN by-product, and must either sell it or incinerate it as waste.

c) Dow Chemical Company Limited (Dow) is the only other UK user of HCN. It uses it to make sodium cyanide liquor and the products derived from it.

- 6 HCN is highly toxic and transporting it is difficult due to stringent safety restrictions. All the undertakings that use it are located near to BASF's plant in Teesside. The restrictions on transport are confined to HCN itself and do not apply to products derived from it.
- 7 In the last three years, BASF has produced from [...] metric tonnes ('mt') of HCN per year. It is the only producer in the UK with surplus production and hence the only seller. Lucite also produces HCN (about [...] mt per year), but not in a sufficient quantity to meet its own industrial needs. Therefore, it has had a contractual arrangement with BASF for the supply of HCN since 1970. In the last three years Lucite has purchased about [...] mt of BASF's annual output, which has accounted for about [...] per cent in any given year. A further [...] mt ([...] per cent) has been sold to Dow, and the remainder has been incinerated as waste.
- 8 The majority of the downstream products referred to in paragraph 4 may be produced through alternative industrial processes that do not use HCN as an input. However, in contrast, Lucite's plant is committed to using the HCN process and cannot be switched cost-effectively to use one of these other processes.

### **C The notified agreement**

- 9 The notified agreement develops the arrangement between BASF and Lucite. It provides that BASF will sell [...] mt (estimated to comprise at least [...] per cent of BASF's future production capacity) of HCN a year to Lucite for a [...] year period. It also provides that the HCN, which is currently transported by rail to Lucite's premises, will now be converted to ACH at BASF's premises using facilities to be constructed by Lucite and operated by BASF on behalf of Lucite. The ACH will then be transported by pipeline by Lucite to its premises for storage and ultimate use in its downstream processes.

## **II THE DECISION**

### **A Introduction**

- 10 On an application to the Director under section 14 of the Act the Director may make a decision under section 14(2)(b) that the Chapter I prohibition has not been infringed, whether that is because of the effect of an exclusion or because the agreement is exempt from the prohibition.

### **B The Verticals Exclusion Order**

- 11 By virtue of section 50 of the Act and the Verticals Exclusion Order the Chapter I prohibition does not apply to an agreement to the extent that it is a vertical agreement.

- 12 The parties consider that as both undertakings produce HCN and will jointly be producing ACH in the new plant, they can be considered to be operating at the same level in the production or supply chain. The parties, therefore, consider that the agreement is caught by the Chapter I prohibition.

- 13 Under article 2 of the Verticals Exclusion Order a vertical agreement is defined as meaning:

'an agreement between undertakings, each of which operates, for the purpose of the agreement, at a different level of the production or distribution chain, and relating to the conditions under which the parties may purchase, sell or resell certain goods or services ...'

- 14 The Director considers that the agreement meets the terms of the definition as being an agreement between undertakings, each of which operates, for the purposes of the agreement, at a different level of the production or distribution chain, and relates to the conditions for the sale and purchase of HCN. Therefore, the Director considers that the agreement is a vertical agreement and is thus excluded from the Chapter I prohibition.

### **C Conclusion on section 14(2)(b) of the Act**

- 15 On the basis of the facts and for the reasons set out above, the Director has decided, pursuant to section 14(2)(b) of the Act, that the notified agreement has not infringed the Chapter I prohibition because of the effect of the exclusion for vertical agreements provided by the Verticals Exclusion Order.

### III STATEMENT BY THE DIRECTOR

#### A Introduction

- 16 For the purposes of transparency the Director sets out his reasons below (paragraphs 18 to 51) explaining why he does not propose to exercise his discretion to give a direction withdrawing the applicability of the Verticals Exclusion Order from the notified agreement.

#### B Criteria for withdrawing the exclusion

- 17 By virtue of Schedule 1, paragraph 4(5) of the Act, and article 7 of the Verticals Exclusion Order, the Director has discretion to withdraw the Verticals Exclusion Order if he considers:

- a) that the agreement will, if not excluded, infringe the Chapter I prohibition; and
- b) that he is not likely to grant it an unconditional individual exemption.

#### C Assessment of whether the agreement, if not excluded, would infringe the Chapter I prohibition

- 18 Section 2(1) of the Act prohibits agreements between undertakings, decisions by associations of undertakings or concerted practices which may affect trade within the UK, and have as their object or effect the prevention, restriction or distortion of competition within the UK.
- 19 In assessing this matter the Director must consider whether the agreement contravenes the prohibition in section 2(1) of the Act. This involves determining the relevant product and geographic markets, the effect on trade in the UK, the object or effect of the agreement on competition and whether the effect on competition is appreciable.

#### THE PRODUCT MARKET

- 20 The Commission's Notice on the definition of the relevant market for the purposes of Community competition law<sup>6</sup> and case law of the European Courts has established that a relevant product market comprises: 'all those products which are regarded as reasonably interchangeable by reason of the products' characteristics, their prices or their intended use'.

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<sup>6</sup> [1997] OJ C 372/5 3.12.1997/ See also OFT Guideline 403, 'Market Definition' (March 1999).

- 21 The agreement concerns the supply and conversion of HCN. Although, as noted above, the majority of products that are derived from HCN can be produced using alternative industrial processes, there is no substitute for HCN itself in the plant and processes covered by the agreement. It would not be practical or economic for Lucite to switch to an alternative process. Lucite estimates that it would cost £ [...] million to set up a plant using alternative products, and that it could not modify its current plant cost-effectively. Dow has stated that it could substitute sodium cyanide for [...] per cent of the HCN it uses, but the other [...] per cent would still have to be HCN. However, Dow currently purchases sodium cyanide from Lucite, which manufactures it from HCN, so sodium cyanide is not a full substitute for HCN. On the supply side, it would also be very difficult for manufacturers of other chemicals to switch production to making HCN, even if there were greater demand for the product. The Director concludes, therefore, that the supply of HCN is a separate product market.
- 22 Although Lucite produces HCN, it supplies only to itself. In assessing whether a product which an undertaking supplies only to itself should be included in the measurement of market shares for the product, the Director will generally consider: 'the ease with which production can or could be switched from internal to external sales. If an undertaking could not easily produce for external customers (if all its capacity were committed to internal requirements for the foreseeable future, for example), internal consumption would not normally be included within the market.'<sup>7</sup> For this reason, the Director considers the relevant UK market to be the 'by-product' HCN produced by BASF. The product market is characterised, therefore, by a single supplier (BASF) and two purchasers (Lucite and Dow).

#### GEOGRAPHIC MARKET

- 23 The relevant geographic market comprises the area in which the undertakings concerned are involved in the supply and demand of products or services in which the conditions of competition are sufficiently homogenous and which can be distinguished from neighbouring areas because the conditions of competition are appreciably different in those areas.<sup>8</sup>

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<sup>7</sup> See OFT Guideline 415, 'The Competition Act 1998 - Assessment of Market Power' (September 1999), paragraph 4.6.

<sup>8</sup> Case 27/76 *United Brands Co v Commission* [1978] ECR 207 [1978] 1 CMLR 429. Under section 60, in the application of the Chapter I prohibition, the Director is required to ensure that there is no inconsistency with either the principles laid down by the EC Treaty and the European Court or any relevant decision of the European Court. The Director must also have regard to any relevant decision or statement of the European Commission.

- 24 As noted above, HCN's high toxicity means that all UK suppliers and purchasers/users are located near to each other, in Teesside. HCN is not imported to or exported from the UK, although it is produced in many countries in the European Union and in countries outside the EU. The relevant geographical market for HCN is, therefore, likely to be restricted to the Teesside area.

#### EFFECT ON TRADE WITHIN THE UK

- 25 The agreement applies to the supply, purchase and conversion of HCN solely within the UK, and covers the majority of the UK market, ie at least [...] per cent of HCN available for purchase in the UK. It may therefore affect trade within the UK within the meaning of section 2 of the Act.

#### THE OBJECT OR EFFECT OF PREVENTING, RESTRICTING OR DISTORTING COMPETITION WITHIN THE UK

- 26 The Director has considered whether any of the provisions of the agreement, either alone or taken together, would have as their object or effect the prevention, restriction or distortion of competition within the UK or any part thereof.
- 27 BASF's previous contractual arrangements with Lucite did not specify volume obligations and have in theory left HCN available to other purchasers. Despite this, and in practice, there have only ever been two customers for the HCN from BASF. The notified agreement, however, marks a significant hardening of the previous arrangements due to the capital investment made by Lucite and the significant benefit to BASF. Specifically:

i) clause [...], which guarantees that BASF will sell, and Lucite purchase, a minimum of [...] mt of HCN per year (about [...] per cent of BASF's current production capacity, and a higher proportion of its output in some years);

ii) clause [...], which provides the penalties for failing to meet those obligations (principally financial compensation); and

iii) clause [...], which sets a minimum term for the arrangement of [...] years (with an option to extend this period), and provides that the agreement can only be terminated with three years' notice, but not before the [...] year after the start up of the new plant.

- 28 Having considered the precise purpose of the agreement in the economic context in which it is to be applied, the Director does not consider the agreement to have the object of restricting competition.<sup>9</sup>
- 29 In considering the effects of the agreement, the Director has had regard to the *BP Kemi-DDSF* decision<sup>10</sup> where a purchasing agreement which provided for DDSF to buy its total requirements of synthetic ethanol from BP Kemi during a certain period was found to be a restriction of competition within the meaning of Article 81(1) (ex 85(1)). The European Commission ('EC') found that in a market where competition was already weak, a long term contract between one of the most important suppliers and one of the most important purchasers, whereby the latter would purchase the majority of its requirements from the former, would have an appreciable disadvantage for the supplier's competitors and for purchasers. It concluded that this was a restriction on competition.
- 30 As noted in detail in paragraphs 33 to 37 below, the notified agreement is likely to have a similar effect as it will also take effect in a market where competition is already limited, and where the major purchaser of HCN will, by virtue of the agreement, be contracted to purchase the majority of the available product from the only major seller of HCN for a lengthy period.
- 31 In the light of the above, the Director considers that the agreement would have the effect of preventing, restricting or distorting competition in the market for HCN by restricting its availability to users other than Lucite for at least [...] years.
- 32 The Director does not consider that the agreement affects competition in the markets for products which use HCN in their manufacture. He is satisfied, from information obtained from independent sources, that these products can be obtained by alternative industrial processes or from sources outside the UK.

#### APPRECIABILITY

- 33 Whether a restriction in an agreement has an appreciable effect on competition in a market is usually determined by the market power of the parties and the extent of the market that is affected by its restrictions. One measure of this is the combined market share of the parties to the agreement. The Director takes the view that: 'an agreement will generally have no appreciable effect on competition if the parties' combined market share of the relevant market does not exceed 25 per cent, although there will be circumstances when this is not

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<sup>9</sup> See Case 56/65 *Societe Technique Miniere v Maschinenbau Ulm GmbH* [1966] ECR 235.

<sup>10</sup> EC Commission Decision of September 5 1979 OJ L 286/32, paragraph 68.

the case.<sup>11</sup> In this case, BASF produces [...] per cent of the available HCN and, by virtue of the agreement, will supply at least [...] per cent of its current production capacity to Lucite. This situation will last for at least [...] years.

34 Entry into the market as a producer of HCN is not easy. The parties have estimated that an entrant would have to spend £ [...] million on a new plant and it would take three years to achieve full production. In addition, HCN is not a product that an undertaking would be likely to produce by itself. It would need either to have its own downstream markets to use the product or to make it as a by-product and sell to a user.

35 In addition, as a result of the agreement, market entry as a purchaser would be unattractive as Lucite is guaranteed most of the current available supply for at least [...] years.

36 The agreement represents a very high share of the HCN market, having regard to the market shares held by BASF and Lucite, the volume of HCN involved in relation to the total HCN available in the market and the very long duration of the agreement.

37 The Director therefore considers that the effect of the agreement on competition is appreciable, and that, but for the exclusion, the agreement would be caught by the Chapter I prohibition.

#### **D Assessment of whether the Director would be likely to grant the agreement an unconditional individual exemption**

38 Section 9 of the Act allows for exemption to be granted to agreements caught by the Chapter I prohibition if they meet the criteria specified in section 9. Taking the section 9 criteria in turn:

*Section 9(a)(i) and (ii)- the agreement contributes to improving production or distribution, or promoting technical or economic progress*

39 The parties cite the main benefits of the agreement to be improvements to safety and to the local environment. There are several examples in EC case law where such benefits have been considered favourably under the heading above, in assessments under Article 81(3). For example, the Commission Decision in *CECED*<sup>12</sup>, which granted an individual exemption to an agreement between manufacturers of domestic appliances which would, inter alia, lessen the

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<sup>11</sup> OFT 415 'Assessment of Market Power' (September 1999), paragraph 2.3.

<sup>12</sup> Commission Decision of January 24 1999, OJ [2002] L187/47, at paragraph 51.

pollution of the environment from noxious gases and so was likely to deliver both individual and collective benefits for users and consumers.

40 The switch from rail transport to pipeline will reduce the risk to the environment from a highly toxic material. Similarly, the incineration of waste HCN involves a large amount of carbon dioxide and various nitrous oxide emissions. These are greenhouse gases and constituents of acid rain. The reduction of waste HCN provided for by the agreement will reduce the amount incinerated and hence the environmentally harmful emissions.

41 In addition, the parties' main reason for undertaking the investment is to provide Lucite with an additional source of ACH. There is therefore a benefit from the investment in a new facility, which makes it economic to use most of the HCN that BASF now has to incinerate.

*Section 9(a)(i) and (ii) - allowing consumers a fair share of the resulting benefit*

42 Consumers in the Teesside area are likely to benefit from the increased safety and improvement to the environment arising from the factors referred to in paragraphs 39 and 40 above.

43 It is also reasonable to suppose that increased output of ACH from BASF's HCN should increase the availability on the UK market and lower prices to some extent. This effect can be expected to feed through to downstream products derived from it. The UK consumer can be expected to gain from those lower prices.

*Section 9(b)(i) - the agreement must not impose on the undertakings concerned restrictions which are not indispensable to the attainment of those objectives*

44 The benefits referred to above would not be realised without the agreement. In turn, it is highly probable that the agreement itself would not be effected without the restrictions relating to the guaranteed sale and purchase of a high volume of HCN. The Director considers this agreement to be an instance of, or similar to, a type of agreement that is a commercial solution to the 'hold-up problem'.<sup>13</sup>

45 The 'hold-up problem' can arise if parties to relationship-specific sunk cost investments do not contract in advance as to how they will trade with one another ex post C after the investment costs have been sunk. In the absence of an ex ante contract, one or both parties might seek opportunistically to exercise bargaining power against the other ex post C ie to hold up the other C with the

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<sup>13</sup> See the Commission Notice on Vertical Restraints (2000/C 291/01), paragraph 116.

result that the other party is deprived of some of the return on its investment. This could deter efficient investment in the first place. It is therefore recognised that without sufficient safeguards against such ex post opportunism, including a reasonable duration in which to recoup the investment, one or both parties might be unwilling to commit to the deal. In these circumstances, the EC has sometimes accepted that the restrictions were 'indispensable' to the attainment of the deal's objectives and necessary to ensure that the deal went ahead.

- 46 In this case, there seems to be inadequate incentive for Lucite to commit to financing the new plant unless the exclusive supply condition is in place. In the absence of this condition, Lucite would be vulnerable to future opportunistic behaviour by BASF, which could seek to renegotiate terms to its advantage.
- 47 The question of the duration of the agreement is less clear in relation to the exemption criteria of indispensability. The parties argue that the [...] year duration is necessary in order to recoup fully the investment made in the new plant. They consider such a period to be relatively normal in a transaction of this type in this industry. There is some indication from third parties that this might be so. The parties have provided some corroborative evidence to support their claim, but the Director considers that this was insufficiently detailed for him to conclude with certainty that the duration is indispensable.
- 48 His view is that the parties' assessment may be well-founded, but that it is also arguable that tying up a market for so long may harm potential competition unduly. If the circumstances of the market were to change in the intervening period, the tie up of BASF's supply may make it difficult to adapt to that change. The Director has, therefore, not reached a conclusion on whether it is indispensable to have an agreement with a duration as long as [...] years, but he is satisfied that otherwise there are no restrictions that are not indispensable.

*Section 9(b)(ii) - the agreement must not afford the undertakings concerned the possibility of eliminating competition in respect of a substantial part of the products in question*

- 49 The Director acknowledges that the agreement may make it more difficult for Dow or a new entrant to purchase HCN, as Lucite will control the great majority of the supply. Lucite has a use for the HCN, unlike BASF, and has entered the agreement in order to secure a steady supply for as long as it can. It obviously places a high value on obtaining the optimum amount of HCN, to the extent that it is willing to pay for a new plant to convert it to ACH. Arguably, Lucite will not wish to reduce ACH production and sell a portion of its HCN to others unless they can offer an attractive price.

50 Nevertheless, the Director considers that competition has not been eliminated in a substantial part of the product in question. There was little competition to eliminate in the market before the agreement, as there were just one seller and two purchasers. Entrants wishing to purchase HCN still have access to the product if they can pay for it. For the most part, Dow does not compete directly with Lucite in the products in which HCN is an input, so Lucite has little motive for refusing to sell some of its HCN in the event that BASF produces insufficient HCN over and above the amount it is contracted to supply to Lucite. Finally, it is open to potential users of HCN, not currently in the Teesside area, to obtain supplies from other parts of the world.

## **E Conclusion**

51 The Director concludes that the agreement might, if the exclusion were withdrawn, have received either an unconditional exemption or a conditional exemption restricting the agreement to less than [...] years. The Director has therefore not reached a conclusion on the issue of whether he would be likely to grant the agreement an unconditional individual exemption. In any event, when considering whether to make a direction to withdraw the exclusion, the Director took note of the statement in his guidelines on vertical agreements, that he would 'exercise these powers only rarely'.<sup>14</sup> Taking into account all the circumstances of this case, the Director does not propose to exercise his discretion to withdraw the exclusion.

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<sup>14</sup>See OFT 419 ' Vertical Agreements and Restraints' (March 2000), paragraph 5.2.