Countervailing power, bargaining power and market definition: a reflection on two mergers

Working Paper- Not for citation

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When assessing whether a merger is likely to substantially prevent or lessen competition, the Act specifies that the Commission should assess the strength of competition by taking into account the degree of countervailing power in a market. We highlight the importance of understanding this in terms of the factors underlying bargaining power, such as the alternative sources of supply available to buyers, the alternative sources of demand to sellers, cost structures, and information asymmetries. To do this we critically compare the approach adopted by the Competition Tribunal in evaluating two mergers: Chlor-Alkali Holdings – Botash and Sasol – Engen. We find that in both cases an analysis of bargaining power should have played an important part in market definition and the analysis of the effects on competition. However, in Sasol – Engen, the Tribunal determined that the merger was not horizontal in nature due to insufficient attention paid to the role of bargaining power. By comparison, the significance of bargaining power in the CAH – Botash merger underpinned the Tribunal’s evaluation and conditions for approval.

1 Employees of the Competition Commission. This paper is written in the authors’ personal capacities and does not reflect the views of the Competition Commission.
1. Introduction

Market definition is sometime seen as about drawing boundaries, however, it should be properly understood as part of understanding the nature of competitive rivalry. It is a “tool for aiding the competitive assessment by identifying those substitute products or services which provide an effective constraint on the competitive behavior of the products or services being offered in the market by the parties under investigation” (Bishop and Walker, 1999: 47). It should not be undertaken in a vacuum, ‘unmoored from the theory of harm to competition’ (Baker and Bresnahan, 2008).

In this paper we explore where effective competitive constraints overlap with the need to take into account bargaining power on the part of buyers. This can also be framed as countervailing power. However, following Inderst (2007), it makes sense to distinguish between buyer power – the ability of buyers to obtain advantageous terms of trade from their suppliers – and countervailing power - the presence of strong buyers mitigating or even fully averting adverse consequences for consumer surplus or total welfare that would otherwise arise from a horizontal merger of suppliers.

In the two merger cases we examine here, it is the existing bargaining power which underlies the identification of competitive constraints. The mergers were judged to have anti-competitive consequences because they lessened the bargaining power on the part of buyers, rather than their effects being mitigated by countervailing power. The cases are also interesting as they illustrate the different outcomes in the presence of both concentrated sellers and buyers and the types of factors which change these outcomes. In this sense, there is a link with abuse of dominance cases where firms may need to engage in potentially exclusionary conduct to exercise their market power (Rey and Tirole, 2006: 12; Gual et al., 2005: 26-28).

At the heart of understanding the bargaining power of buyers is their alternative options, the credibility of their threat to resort to these options, and the costs they impose on the seller as a result. These options are described as ‘outside options’ as they are alternatives that would not normally be viewed as good substitutes.

The two mergers reviewed here included the merging party acquiring a supplier of the same product located some distance away. In the Botash/ChlorAlakali Holdings(CAH) merger the Tribunal included the supplier being purchased in the market, and considered the countervailing power argument as a “key aspect” of the analysis.2 This meant that the merger took on a distinctly horizontal aspect and conditions were attached relating to post merger price and supply. In Sasol/Engen merger (uHambo), the Tribunal viewed the Engen refinery as not being in the same market as the Sasol refineries due to transport constraints and hence viewed the merger as primarily vertical in nature, although the effect on the supplier versus buyer power was still critical to the Tribunal prohibiting the merger albeit largely due to the effect it had on the credible threat of Sasol to foreclose its customers as downstream rivals in the marketing of fuel.

The structure of the paper is as follows. Section 2 begins with an overview of the current literature on the defining of markets in merger analysis and buyer or countervailing power. Section 3 provides a critical analysis of the Tribunal’s treatment of the Sasol/Engen merger while section 4 describes the assessment of the Botash/CAH merger. In section 5 we contrast the approaches in both cases and conclude.

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2 Competition Tribunals reasons for decision, 14 May 2010. Case number 34/LM/Apr09
2. Market definition and Buyer/Bargaining power

The ICN guidelines (2006) explain that merger analysis is founded on a sound understanding of the comparative effects that a merger may have, should it be approved or rejected, on the state of competition in that market. As “competition can be seen as a process of rivalry”, the competitive constraints acting on the merging firms pre- and post-merger would define the market in which competition occurs. The purpose of defining the market is to identify the scope of competition and whether the merged entity possesses, or will post-merger, possess market power. The assessment of market power in that market indicates the ability of the merged entity to engage in unilateral or coordinated anticompetitive conduct post-merger.

Where the exercise of defining markets emphasises identifying demand-side attributes of the industry concerned, the measurement of market power emphasises the identification of supply-side attributes (Baker and Bresnahan, 2008). In South Africa the authorities often take both the supply and demand side characteristics of the market into account for both sets of analyses.

In defining the relevant market an authority would consider whether products in certain regions can technically serve the same purpose in such a way that customers consider them realistic economic alternatives. Firms in the same defined market would offer the most direct competition to each other. The ICN guidelines state that “in this sense, market definition sets the stage on which competition takes place ... the relevant market is in practice no more than an appropriate frame of reference for analysis of the competitive effects.” These products therefore need not be perfect substitutes for customers to consider them viable alternatives to each other.

The ICN guidelines state that only after defining the relevant product and geographic market is it possible to consider how the merger would change the state of the market. Considerations regarding the impact of the merger on the state of the market include a buyers’ competitive pressure on a supplier. Analysis should take into account “the closeness of competition between rivals and the ability of customers to switch between them.” It is important to reflect here that the closeness of competition between rivals and the buyer’s ability to switch (a manifestation of buyer power) should also be considered at the market definition stage of the analysis. The competitive constraint applied by rivals and by customers would define the realm in which competition or the “process of rivalry” should be assessed.

In the South African Act (s12A(2)) countervailing power is identified as one of the specific factors relevant to the likelihood of a substantial lessening or prevention of competition in the relevant market (rather than the definition of that market).

Market power and bargaining power

The OFT (2007) defines market power as the ability of a seller profitably to sustain prices above competitive levels (or to sustain quality or innovation below competitive levels). Buyer power, on the other hand, relates primarily (although not always) to the strength of a buyer in negotiations with sellers - a powerful buyer group/individual can act strategically to improve its bargaining strength. In negotiated deals the terms of supply will depend on the bargaining strength of each side. The balance of negotiating power between a buyer and seller is premised on the outside options available to each party. Competitive discipline on upstream market power arises through the buyers having options to purchase from alternative sources. Buyer power is further enhanced if the seller does not have alternative sources of demand.
The Organisation for Economic Cooperation and Development (OECD, 2000) explains the relative economic dependency of buyers and sellers in that: “... a retailer is defined to have buyer power if in relation to at least one supplier it can credibly threaten to impose a long-term opportunity cost (harm or withheld benefit) which, were the threat carried out, would be significantly disproportionate to any resulting long-term opportunity cost to itself”. This power is related to the buyer’s dependency on the seller and thus its ability and incentive to buy less or switch suppliers to influence the terms of supply it receives. This is supported by the dependency of the supplier on the customer in terms of how large the consequence of this reduction in sales is likely to be.

According to the ICN Merger Guidelines (2006), the following are the factors to consider when assessing buyer power:

i. Whether or not the customer can credibly threaten to resort, within a reasonable timeframe, to alternative sources of supply; and

ii. Whether or not the buyer is able to refuse to buy products produced by the supplier or delay the purchases.

Countervailing power of the customer is affected by several factors including the buyer’s size and commercial significance to the seller. Although size or importance to the market is a consideration in evaluating buyer power even large buyers may not have countervailing buyer power. The Australian Consumer and Competition Commission’s (ACCC) guidelines, for example, explicitly state that it “does not consider that countervailing power is synonymous with a small number of buyers”. Even large purchasers might be in a very weak negotiating position with their suppliers because of their inability to switch (ICN, 2006). We encounter this in the post-merger Botash/CAH scenario.

This countervailing power of the buyer would only be present when the buyer has the ability and incentive to:

- reduce, or credibly threaten to reduce, purchases from the merged entity through switching to rival suppliers; A horizontal merger between suppliers might reduce the scope for such switching and therefore diminish countervailing power (Röller, 2004). See also Motta (2004), p.237 where it is noted that '[s]trong buyers can constrain upstream market power by threatening to withdraw orders from one seller to give them to another or by threatening to start upstream production itself.'

- change procurement processes including developing alternative sources of supply or multi-sourcing to reduce dependence on a single supplier;

- threaten to enter the market themselves or sponsor entry;

- otherwise impose costs on the supplier even if switching is not possible, such as refusing to buy other products from the supplier, delaying purchases if the customer does not require constant supply (International Comparative Legal Guide, 2008)

These actions are dependent on the alternative a customer has, the barriers to entry upstream and the dispensability of the input. The above points are critical to the countervailing power a buyer can exert on its supplier. Additionally, the importance of the customer to the supplier and its alternatives for the input supplied are crucial to this balance of power, as are the lost returns to the supplier, which depends on the supplier’s alternatives.

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3 Refer to page 42 of the ICN Merger Guidelines (2006)
4 A horizontal merger between suppliers might reduce the scope for such switching and therefore diminish countervailing power (Röller, 2004). See also Motta (2004), p.237 where it is noted that '[s]trong buyers can constrain upstream market power by threatening to withdraw orders from one seller to give them to another or by threatening to start upstream production itself.'
5 This is the use of a credible threat to vertically integrate into the upstream or to sponsor upstream entry as sources of countervailing buyer power (Röller, 2004). The credibility of this threat would depend largely on the barriers to entry in the market.
Bypass and commitment

An upstream monopolist can exert market power as it has no close competitors and therefore its customers do not have alternative sources of supply. The upstream monopolist’s product may however not be a pure essential good in the sense that there is often competition from inferior goods and services (Rey and Tirole, 2006: 13). A monopolist’s buyer power can therefore be countered through the credible threat of the customer switching to imperfect alternatives (outside options) or ‘bypass opportunities’ available to the consumer. Indeed, the threat of such bypass is at the heart of the countervailing power of downstream buyers and enables them to push for lower prices from the monopolist. In this regard, bargaining power of the downstream firms associated with the threat of bypass would generally be expected to be pro-competitive.

This outcome is contingent on the credibility of the buyer’s threat to turn to what is, for it, a less desirable source of supply, and the cost it imposes on the monopolist and the credibility of the monopolist in threatening to bear this cost. This is similar over space to Coase’s analysis of a durable good monopolist’s problem in pricing its product over time. If buyers of a durable good know that once customers have bought at the monopoly price the supplier will drop the price to attract additional sales, the buyers will delay their purchases, essentially mis-representing their preferences. The monopolist needs to commit to not reducing its price in future in order to get the monopoly pricing and profit today.

In the cases we are considering, for the buyer to accept the monopoly price it needs to know that the monopolist is committed to reduce supply or supply less attractive customers (such as those further away) in response to the buyers’ options to bypass, (see also Gual et al., 2005). As Rey and Tirole (2006: 14) note, vertical integration is an important means for the monopolist to do this. It allows the monopolist to supply its own affiliate(s) and avoid being subject to the hold-up of demand for its upstream product by buyers, as it can sell through its own downstream channel (including into different, segmented, markets).

Interestingly, in both the CAH/Botash and Sasol/Engen mergers, the Tribunal identified the theory of harm relating to the vertical aspects of the mergers to be that of a foreclosure strategy by the upstream monopoly post-merger. We argue that the nature of buyer power in these mergers also required understanding them in horizontal terms.

3. Sasol-Engen

This transaction concerned the refining and bulk supply of fuel products at the upstream level and the wholesale and retail marketing and distribution of these products at the downstream level. The major oil companies are bulk suppliers of fuel in the upstream market where they have refining capacity and, through their marketing arms, they are customers of fuel in other parts of the country where they do not have refining capacity but have developed retail networks.

The refining and marketing capacities of the South African oil companies are not well balanced. Shell, BP and Engen have refining capacity on the KwaZulu-Natal coast and Caltex has a refinery based in Cape Town. Sasol has the synfuels production facility inland at Secunda and is the majority owner, with Total having the minority stake, of the Natref refinery at Sasolburg. This means that Sasol has 82 percent of refining capacity inland, while the other oil companies have to buy from it in order to supply to customers in the inland

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6 Or ‘bottleneck good’, that is, an input in the production process that is necessary for the downstream firms production (Gual et al., 2005: 26).
7 Competition Commission case number 2004Nov1304; Competition Tribunal case number 101LMDec04. This section draws largely from the tribunal report on the merger
market, or have to transport product from the coast. The largest market for fuel is in the inland region with over sixty percent of national demand.

The configuration of fuel production and supply are intricately linked with Sasol's historical role as a state-owned company and producer of liquid fuels from coal. Substantial investment by the state for strategic reasons to reduce dependence on imported crude oil created a low cost liquid fuels producer inland. Sasol was privatised at the end of the 1980s but the regulatory dispensation continued to protect its position. The Main Supply Agreement (MSA) required the other oil companies (OOCs) to purchase Sasol's product in the 'Sasol Supply Area', according to their market shares. In return, Sasol was limited from expanding its own commercial and retail sales. Sasol was limited from expanding its own downstream operations to 9.23 percent market share in the retail market and to a limited volume in the commercial market. Purchases by the OOCs accounted for about 90 percent of Sasol's white fuel output. Price regulation meant they were guaranteed a return on this product calculated based on a rate of return on marketing assets. The MSA thus effectively provided for an allocation of markets between Sasol and the other oil companies – allocating Sasol to the inland upstream market and the OOCs to the inland downstream market.

Prices were based on an imputed import-parity based ‘Basic Fuel Price’. However, there could be discounts off this price. At one stage Sasol was offering some discount to oil companies off the inland BFP but these were rejected by the OOCs. Sasol subsequently exported its product at times at margins below those which would have been gained by selling product to the OOCs at these discounts – at times selling at export prices for deep sea sales from the coast. Sasol also cut back Natref production, to 'prop up' the BFP wholesale price. Sasol's strategy documents cited in the witness transcripts state that Sasol “may refuse to supply and cut back Natref if dispute [with the OOCs] is based on price”.

OOCs as buyers in the inland area could look to their alternative of transporting product from the Durban refineries. The attractiveness of this as an alternative to buying volumes from Sasol depended on whether those refineries were long on supply (with product being sold into lower priced export markets) and on the availability and cost of logistics to transport the product inland. The most cost effective method of transport is by pipeline (the Durban Johannesburg Pipeline, DJP). Rail and road are other, more expensive, possibilities. Around the time of the merger, the inland market was short, requiring some rail and road to be utilised in addition to the DJP, while the country as a whole was long, and there were exports from the coastal refineries.

Following indications from government that the fuels sector would be deregulated and pipeline capacity between the coastal and inland regions would be expanded Sasol took proactive steps to protect its inland position by giving notice to end the MSA and opening merger discussions with Engen. Sasol Oil and Engen proposed to set up a joint venture (JV) called Uhambo Oil Limited (Uhambo). This was a vertical merger of the main inland refiner (Sasol) with the largest marketer and retailer of fuel products in South Africa including in the inland region (Engen). However it was also potentially horizontal in nature at both the upstream and downstream levels. Given Sasol’s relatively small position in marketing and retail, the main concern was the effect of the merger at the refinery and bulk supply level.

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8 See the non-confidential transcript of Mr. Reid, for the Tribunal hearings; 101LMDec04
9 Mr. Gumede of the DME spoke to documentation which indicated that deregulation would have a likely impact on the wholesale margin and pump price of approximately 11c each, the combination of which would further impact the BFP by 5c thereby reducing prices by approximately 27c per litre (See the non-confidential transcript of Mr. Gumede, for the Tribunal hearings; 101LMDec04).
10 According to the Tribunal the South African government had stated its clear intention to de-regulate the retail market, also a measure resisted by Sasol as it would have lead to downward pressure on inland pricing in particular.
Post-merger, Uhambo would comprise the white fuels produced by Sasol Oil at Secunda, Sasol’s 63.64 percent share of the Natref refinery as well as Engen’s Refinery in Durban upstream. Downstream Uhambo’s retail network would comprise the marketing network and service stations controlled by Engen and the small percentage controlled by Sasol. The transaction would have constituted a significant consolidation of the South African petroleum industry.11

Tribunal’s decision

The merger was blocked by the Tribunal, owing to foreclosure concerns in the inland market for diesel and petrol. The Tribunal found that the logistics constraints on moving product from the coastal to the inland market meant that there was a separate inland market. In this market, the Tribunal found that the merger would create the potential for Sasol to foreclose the OOCs by selling to its own marketing and retail network (acquired from Engen). The Tribunal found that Uhambo could have credibly threatened to refuse to supply the OOCs, and had the incentive to do so as the merger would have entitled Engen to the exclusive supply of Sasol fuels from Secunda for its downstream operations inland for 10 years. In addition, the Tribunal found that the OOCs ability to impose costs on Sasol by not supplying the volumes Sasol required for its coastal retail network was diminished by the merged entity including Engen’s Durban based refinery.

The Tribunal found that the inland supply which was previously constrained by agreement through the MSA, was later constrained by logistical capacity – the inland marketers may import product from the coast, but because of inadequate logistical capacity they were only able to supply a portion of their needs. The cancellation of the MSA meant that Sasol would no longer be confined to supplying the OOCs inland. The majority of Sasol’s product could be absorbed by the Engen downstream operations, which would bolster Sasol’s bargaining position. The Tribunal concluded that the merger would result in the dominant inland refiner merging with the considerable share of the inland and national downstream markets controlled by Engen.

The Tribunal thus assessed the merger as a vertical merger in the inland market of South Africa. The Tribunal identified the KwaZulu Natal (KZN) and inland refineries as being in different geographic markets and providing no horizontal competitive rivalry to each other because of the logistics constraints. Although the OOCs were trucking some product from the coast required to service their inland clients, the Tribunal held that this did not mean that the OOCs could effectively service their inland requirement with their own product.

The Tribunal found that the inland pricing was under threat owing to the Government’s intention to deregulate the market and the announcement of a new pipeline between the coastal KZN and inland areas. The Tribunal concluded that Sasol aimed to protect their pricing with this JV. The JV would absorb the bulk of Sasol’s product through the Engen retail operations and this, along with the logistical capacity constraints, would have meant Sasol would be able to apply pressure on its other customers to maintain inland IPP. While the new pipeline would allow the OOCs to bring more product inland, the merger would enable Uhambo to place its product through its own marketing network (acquired from Engen). Sasol was not otherwise able to absorb its upstream output via organic growth of its marketing operations following the termination of the MSA. This organic growth was constrained by the ‘Ratplan’ (by which new petrol forecourts were approved). Sasol maintained that the new pipeline and deregulation would put it at the mercy of the other oil

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11 There have been several acquisitions in the marketing segment of the fuel supply chain. The target firms in these transactions have generally been relatively small, black-owned entrants into the industry, while the acquiring firms have been one or other of the much larger, vertically integrated oil companies.
companies owing to the coastal companies being able to transport product to the inland region thus putting Sasol at risk of not being able to offload its product at the retail level.

Discussion

The Tribunal considered Sasol’s market power inland and the countervailing power of the OOCs. In this regard, its decision took into account the ability of Uhambo to credibly threaten to foreclose the OOCs and divert bulk supplies to its own marketing operations as part of maintaining prices at inland BFP. For Sasol to credibly threaten to divert fuel away from its inland wholesale customers it required alternative outlets for these fuels to ensure that it was not subject to the bargaining power of these current customers. The best option in this regard was to secure inland off-take. This would weaken the OOCs’ bypass threat as Sasol could sell directly into the retail market and, with its significantly lower costs of product produced inland, edge out competition in this region at the downstream level.

In addition, Sasol's timing of the cancellation of the MSA was such that it would have been a number of years before the additional pipeline infrastructure was in place for coastal fuel to be a more viable alternative to inland purchasers. Sasol was released from the constraint on not increasing its marketing operations (and gaining a larger share of what were profitable activities at this level) while the OOCs were also released from buying Sasol’s product but with relatively weak bargaining power unless they can threaten to transport product from the coast.

The threat by the OOCs to bypass Sasol depended on an inferior alternative due to the logistics constraints. Once the capacity of the DJP was exhausted, the OOCs had to turn to rail and road. The OOCs could impose a cost on Sasol, as Sasol either had to reduce production or transport its surplus production to coastal and/or export markets. There was a degree of uncertainty on both sides – as to the OOCs ability to move product by road and rail, and as to Sasol’s ability to find other markets (such as overland exports).

A crucial part of the OOCs imperfect alternative was the availability of coastal volumes, and the alternative price for it. This price would be that of the next best alternative price – the deep sea export price. While the BFP was based on import parity, and included the pipeline transfer price in the inland BFP price, surplus volume in the hands of the OOCs at the coast meant their alternative was an export price. The OOCs had a ‘willingness to pay’ based on their own alternatives. Sasol had a ‘willingness to accept’ which depended on how it constructed its alternatives to selling to the OOCs. The merger changed both of these calculations.

The supply and demand balance in the coastal market was thus an essential part of understanding the bargaining power of the OOCs. Without coastal capacity, the logistics constraints did not even come into play. The merger would mean that Sasol acquired a very large part of the Durban refining capacity and, by reducing its own supplies into the South African coastal market, it could ensure that there were not volumes in the hands of the OOCs which they would otherwise have to export. The rivalry that was being reduced by the merger was of an alternative source of bulk supply. Without this the OOCs had no buyer power. The merger substantially removed this alternative (by combining Engen’s refinery), which was in a horizontal relationship to Sasol’s own bulk supply. By first engaging in market definition without working through the nature of competitive rivalry the Tribunal saw the merger only through a vertical lens. Understanding the nature of competitive rivalry in a bargaining framework suggested an important horizontal dimension to the merger which, on this version of the relevant market, would incorporate the merging of Sasol’s inland refining capacity with Engen’s large coastal refinery.
4. **CAH-Botash**¹²

This transaction concerned the production of chemical grade salt and the consumption of this salt in the chlor-alkali process. CAH’s operations include Walvis Bay Salt Holdings ("WBSH"), a salt producer based in Namibia, and NCP Chlorchem (NCP), the only inland South African chlor-alkali producer apart from Sasol. Botash, the target firm, is a soda ash producer in Botswana manufacturing salt as a by-product of these operations. Both these firms, WBSH and Botash, supplied Sasol's chlor-alkali plant at Sasolburg.

The relevant product market was defined as that for the supply of chemical grade salt. This was the only product, apart from food salt¹³, in which the merging parties overlapped. Chlor-alkali plants require high purity, bulk chemical grade salt supply. Chlor-alkali plants are the largest consumers of salt in South Africa. Along with water and electricity, chemical grade salt is a main and essential input into the chlor-alkali process. There are no substitutes for chemical grade salt in this process which is used to manufacture caustic soda, and chlorine and PVC further downstream.

The geographic market was found to be limited to the inland region of South Africa owing to the large transport costs of this product. The coastal areas of South Africa were not included in the geographic market as Botash prices at the coast would have included an additional road cost to transport the sale from the inland region. Botash prices would have been higher than those of WBSH to such an extent that coastal customers had never considered sourcing salt from Botash. The merging companies, when considering the inland-coastal market split, only overlapped in the inland region. WBSH and Botash were the only current suppliers of chemical grade salt to the inland region of South Africa. Sasol indicated that they maintained both Botash and WBSH, a significantly higher priced product, as suppliers to ensure their security of supply.

WBSH was found to be an effective competitor in this market owing to the fact that Sasol consistently sourced substantial amounts of product from this firm. The market was defined to include WBSH even though, in terms of price, they were a significantly inferior alternative to Botash for inland customers such as Sasol. These price differences, which are in excess of the SSNIP test, would have set WBSH and Botash in different markets. Sasol, however, bought salt from both Botash and WBSH and mixed these products before use.

Apart from the security of supply concerns¹⁴ Sasol appeared to have little incentive to source from both suppliers. Botash was cheaper and could meet all its requirements.

However, Sasol transparently sourced from the more expensive WBSH in order to build its reputation of credibly threatening to switch suppliers. This was done in order to counter Botash’s market power. Sasol’s credible threat of sourcing from inferior alternatives to bypass Botash’s product meant that Botash’s prices were substantially lower than the imperfect alternative which otherwise would set the ceiling for Botash’s pricing. WBSH was therefore included as an effective competitor by the Tribunal in this market because of Sasol’s strategy to develop its buyer power position.

Botash’s locational advantage means that the transport costs associated with delivering salt to the inland South African market were distinctly lower than those associated with WBSH salt. Botash delivered bulk chemical grade salt to Sasolburg via rail. WBSH had to ship product from Walvis Bay in Namibia to Richards Bay in KZN and then truck up product to the inland area, as rail logistics between the coast and inland regions are poor. Owing to this

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¹² Competition Commission case number 2009Mar4368; Competition Tribunal case number 34/LM/Apr09.

¹³ The merging parties each held a very small market share in food grade salt and so the possible impact of the merger on this market was held to be negligible.

¹⁴ Botash had the capacity to supply Sasol’s entire demand (it had large stockpiles of raw salt that could be converted into chemical grade salt) although the issue of sufficient rail capacity concerned Sasol on this count.
locational advantage, Botash was able to secure a significant margin on its chemical grade salt sales to Sasol and as such was shown to exercise its market power. Botash, being separated from WBSH by significant cost differences, could have established itself as a monopoly supplier to the inland market.

It is important here to understand the factors constraining Botash from realising monopoly profits (at prices closer to those charged by WBSH). Firstly, Botash has large stockpiles of raw salt and continues to produce these volumes owing to salt’s production as a by-product of its primary production of soda ash. These stockpiles, if not disposed of, could create an environmental hazard. Secondly, Botash did not have alternative sources of demand pre-merger for its chemical grade salt. This meant that although Botash should have been able to exert its market power to secure monopoly profits from its salt sales to Sasol, Botash’s pricing was constrained by its lack of outside options to dispose of these large quantities of salt. Lastly, Sasol’s inferior alternative supplier in WBSH provided it with an outside option such that it could threaten to switch to WBSH or lower its demand from Botash, in order to secure lower prices from Botash.

In the bargaining between Sasol and Botash we can characterise Sasol as having had a high ‘willingness to pay’, which is the price they would have to pay for alternative supply (given that this is effectively an essential product for the chlor-alkali process). Botash had a low ‘willingness to accept’ price which was set by the alternatives available to them (salt being a by-product that had to be disposed of either by not producing it and losing soda ash sales, or selling to the next best alternative outlet for this product which Botash did not have). Sasol, in order to strengthen its countervailing power did not just threaten to source from WBSH but in fact consistently sourced from WBSH. Importantly, Botash did not know the prices Sasol paid to obtain salt delivered from WBSH. This goes directly to the credible threat to resort to alternatives (as, for example, identified in the ICN Merger Guidelines), including the attractiveness of those alternatives. The bargaining led to a price between Sasol’s willingness to pay and Botash’s willingness to accept.

The proposed merger would have reduced the actual duopoly of suppliers to the inland to a monopoly. It was established that the merged entity would be able to exercise more market power – as the only supplier of chemical grade salt to the inland market. The removal of an effective competitor upstream would have led, according to economic theory, to the ability of the merged entity to exercise increased market power and unilaterally set prices. In an important sense WBSH was providing effective competitive discipline to Botash because it bolstered Sasol’s countervailing power. The merger removed the significant competitive discipline of WBSH and hence would likely lead to higher prices of chemical grade salt. In addition, Botash’s supply options for the inland South African region would include NCP, a sister company post merger.

A change in the balance of bargaining power (between the market power of the seller and the countervailing power of the buyer) would have likely led to changes in pricing. Botash could increase its salt prices to at least WBSH level as there would no longer have been asymmetries of information in terms of the pricing of the merged entity. Although this might have meant that the merged entity would have found it difficult to increase prices beyond WBSH prices (at international levels) – the favourable pricing terms that Sasol had established with Botash would be eroded.

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15 Post-merger it was envisioned that Botash would supply its sister company, NCP, inland.
16 Additionally, Sasol had previously sourced chemical grade salt from Dampier, an Australian firm about eight years before the merger for a short period. This supply was not sustainable, according to Sasol, because of the price difference between Dampier and the Southern African suppliers. The price difference between WBSH and Dampier’s product was not large but the substantial physical barriers, such as supply lags and payment terms, to source from Australia were high enough to rule out international firms as effective competitors. Other international sources of chemical grade salt were also assessed.
**Tribunal finding**

The Commission initially recommended that the Competition Tribunal prohibit this merger based on the likelihood of a significant lessening of competition combined with the absence of mitigating factors. The creating of a monopolist inland would have enabled this entity to unilaterally raise prices of its product. In this case these price increases would have stemmed from a combination of an increase in market power for the merged entity and the simultaneous loss of countervailing power on the part of Sasol.

Sasol signed a long term supply contract with Botash, before the Tribunal hearing, which guaranteed the supply of the chemical grade salt they required at 2009 prices with an annual maximum price adjustment factor built in. This agreement restricted the ability of the merged entity to raise prices to Sasol for at least 10 years. Therefore the harm that may have resulted from the increased market power of the merged entity and the resulting increase in prices was no longer a concern to the Commission. In addition the merging parties agreed to extend these favourable supply terms to any other entrant in the inland market of South Africa which required chemical grade salt.

The Tribunal accepted the proposed conditions and cited the countervailing power argument as a “key aspect” of the analysis\(^ {17} \) – this position was used in order to evaluate whether the conditions were likely to protect Sasol and potential future entrants from the effects of this merger. The Tribunal accepted the proposed conditions and approved the merger on this basis.

**Discussion**

The Botash case clearly illustrates the bypass mechanism and how inferior alternative products can be used to bolster countervailing power and extract lower prices from a monopoly upstream. It is also evident that, had Sasol not continued sourcing from WBSH\(^ {18} \), then WBSH would not have been included in the defined market. By considering Sasol’s strategic incentives for sourcing from this inferior alternative supplier, the Tribunal found that WBSH effectively constrained Botash pricing as its closest rival and therefore formed part of the “appropriate frame of reference” for analysis of the competitive effects of this merger. This was, however, not dependent on Sasol actually sourcing from WBSH but dependent on Sasol establishing that it could source from WBSH in order to exert competitive discipline on Botash.

Botash was aware that WBSH sold a more expensive, if identical, product to itself and that it was the cheapest supplier to the inland market. Botash was also aware that chemical grade salt was an essential input into the chlor-alkali process. From this standpoint, if Botash could have committed to pricing marginally below the WBSH delivered price to Sasol then Sasol would not have gained from actually sourcing from WBSH. Botash would then have achieved its monopoly profits.

In order for Botash to set these prices (i) Botash had to be credibly able to commit to them, through reducing supply or supplying other markets; (ii) Botash had to know the approximate delivered price of WBSH salt to Sasol. This last point was dealt with in the parties as well as the Commission’s analysis. The asymmetries of information between the Botash and Sasol regarding WBSH prices were a key factor in Sasol being able to negotiate significantly lower prices from Botash compared to WBSH.

\(^ {17} \) Competition Tribunal’s reasons for decision, 14 May 2010. Case number 34/LM/Apr09

\(^ {18} \) Sasol sourced from WBSH in order to establish a credible threat of switching suppliers to restrain Botash from achieving its monopoly profits.
5. Comparative discussion and conclusions

In both the CAH/Botash and Sasol/Engen cases we find that an analysis of bargaining power played an important part in assessing effects of the merger. However, in the Sasol/Engen merger, by not taking into account the relationship between bargaining power and the nature of rivalry in the market, the Tribunal defined a narrower geographic market and concluded that the effects of the merger were largely vertical. Had the Tribunal recognized the competitive constraint that the OOCs placed on Sasol owing to their credible threat of supplying the inland with an imperfect alternative product, the upstream market definition may have been extended to include the coastal regions and, therefore, Engen’s refining capacity in Durban. As already shown, this consolidation of the upstream market would have been a strong argument in itself to block this merger on a horizontal consideration of the market.

By comparison, the Tribunal’s acknowledgement of the competitive constraints that WBSH, as an inferior alternative, placed on Botash’s pricing to Sasol led the Tribunal to primarily consider the horizontal aspects of the merger and therefore the merger being one from duopoly to monopoly. WBSH constrained Botash in that Sasol had an outside option with which to threaten Botash. Sasol was able to actually source and threaten to switch its custom from Botash to WBSH after developing a reputation for using more expensive sources of supply. Sasol was able to use these options (its countervailing power) as well as its knowledge of Botash’s own lack of alternatives, to negotiate better prices from Botash. WBSH was included in the market even though – in a static analysis – WBSH would not qualify to fall into the same market as Botash owing to the large price differential between the two - a price differential which resulted from Sasol being able to resort to WBSH as part of its bargaining strategy.

These mergers demonstrate that rather than seeing countervailing power as a separate item on the list of factors to be considered, it is important to understand bargaining power as part of the nature of competitive rivalry. This includes defining the effective rivals in the market, and hence as part of market definition. In doing this, one can assess the effect the merger is likely to have on competition. Key features include the alternative sources of supply available to buyers, the alternative sources of demand to sellers, cost structures, and information asymmetries.

Both of the mergers also illustrate that apparent monopolists have avenues through which to respond to bargaining power exerted by buyers. Rey and Tirole (2006) indicate that a monopolist can re-establish its position and extract its monopoly profit under these conditions by engaging in exclusionary conduct, vertical integration and limiting its output to maintain high prices. The Tribunal identified vertical integration and the possibility of foreclosure in both the Botash/CAH and Sasol/Engen mergers. Both of these mergers therefore also illustrate factors which allow for or restrict the exercise of market power, with Sasol being a supplier in one, and a buyer in the other.
References


