Australian Competition & Consumer Commission

25 March 2010

Statement of Issues — BHP Billiton Limited and Rio Tinto Limited — proposed iron ore production joint venture in Western Australia

1. Outlined below is the Statement of Issues released by the Australian Competition and Consumer Commission (**ACCC**) in relation to the proposed iron ore production joint venture in Western Australia **(proposed JV)** between BHP Billiton Limited and Rio Tinto Limited.

2. A Statement of Issues published by the ACCC is not a final decision about the ACCC's assessment, but provides the ACCC's preliminary views, drawing attention to particular issues of varying degrees of competition concern, as well as identifying the lines of further inquiry that the ACCC wishes to undertake.

3. In line with the ACCC's *Merger Review Process Guidelines* (available on the ACCC's website at www.accc.gov.au) the ACCC has established a secondary timeline for further consideration of the issues. The ACCC anticipates completing further market inquiries by 14 April 2010 and anticipates making a final decision by 28 April 2010. However, the anticipated timeline can change in line with the *Merger Review Process Guidelines*. To keep abreast of possible changes in relation to timing and to find relevant documents, interested parties should visit the Mergers Register on the ACCC's website at www.accc.gov.au/mergersregister.

4. A Statement of Issues provides an opportunity for all interested parties (including customers, competitors, shareholders and other stakeholders) to ascertain and consider the primary issues identified by the ACCC. It is also intended to provide the joint venture parties and other interested parties with the basis for making further submissions should they consider it necessary.

The parties

5. BHP Billiton Limited (**BHPB**) is the world's largest diversified resources company. BHPB is a dual listed company comprising BHP Billiton plc (listed on the London Stock Exchange (**LSE**)) and BHP Billiton Limited (listed on the

Australian Securities Exchange (**ASX**)).[1] Both companies share a single board of directors and management team.

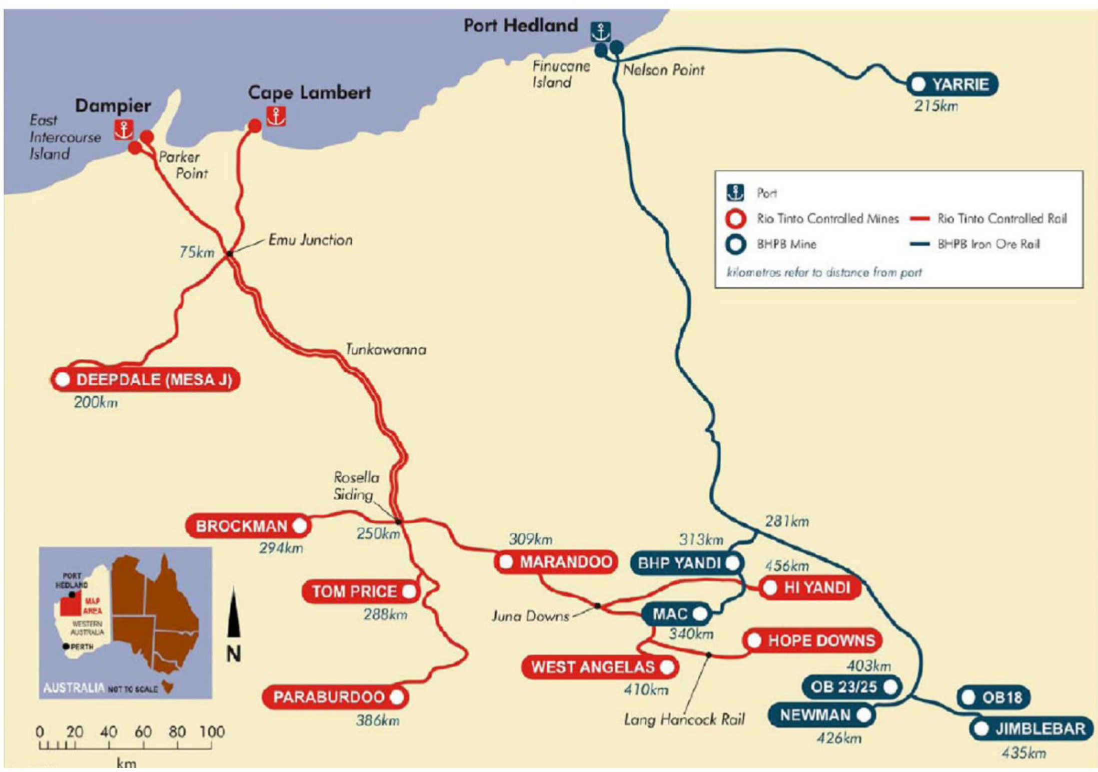
6. Rio Tinto Limited (**Rio Tinto**) is a diversified mining group with global interests and operations. Rio Tinto is a dual listed company comprising Rio Tinto plc (listed on the LSE) and Rio Tinto Limited (listed on the ASX).

The transaction

7. On 5 December 2009, BHPB and Rio Tinto signed an agreement to combine their iron ore assets located in Western Australia (**WA**) in an unincorporated JV, subject to regulatory approvals. Under the terms of the proposed JV, each party is entitled to acquire 50% of the iron ore produced at approximately the cost of production. Each party is to retain its own independent iron ore marketing function.

8. The iron ore assets captured by the proposed JV include assets arising from the parties' production operations as well as shipping terminals, port facilities and rail infrastructure. The overlap between the two parties is depicted in figure 1.

Figure 1 **BHPB and Rio Tinto's iron ore mining operations in the Pilbara**



Source: JV parties.

[1] BHP Billiton plc also has American Depository Receipts listed on the New York Stock Exchange and has a secondary listing on the Johannesburg Stock Exchange.

9. While the proposed JV does not extend to the parties' international iron ore production assets, the majority of the parties' iron ore assets are located in the Pilbara region of WA.

10. The parties have submitted that the commercial rationale for the proposed JV is to bring more low cost iron ore to market, more efficiently. The parties submit that this objective will be achieved by realising production, resource and development synergies estimated to have a net present value in excess of US$10 billion.

Market inquiries

11. On 7 December 2009, the ACCC commenced market inquiries regarding the proposed JV.

12. Responses were received from, and discussions were held with, a range of market participants, including suppliers and customers of iron ore, industry organisations, government departments and overseas competition regulators.

Industry background

13. Iron ore is a globally traded commodity used almost exclusively in the manufacture of steel. Steel mills generally use a mix of the following three forms of iron ore:

    - lump – a 'direct shipping' form, between five and 30 mm in diameter;
    - fines – a 'direct shipping' form, less than five mm in diameter; and
    - pellet – a processed form, generally between 16 and 20 mm in diameter.

14. Iron ore lump may be fed directly into a steel-making blast furnace without further processing. However, smaller iron ore particles — fines and super fines[2] — tend to clog blast furnaces and must be agglomerated before being fed into a blast furnace. The two most common methods of agglomeration are sintering, which produces an artificial lump called 'sinter,' and pelletising.

15. World production of iron ore was estimated to be approximately 1,930 million tonnes (**Mt**) in 2009. Production has decreased by 12.7%, compared with 2008 levels, which has been attributed to the global financial crisis (**GFC**).

16. Of global seaborne iron ore, the majority is exported from Brazil and Australia to China and East Asia.

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[2] Another type of iron ore is 'super fines' which is mainly produced in China for Chinese steel mills. Super fines are generally less than one mm in diameter and need to be processed (agglomerated and concentrated) prior to being used in a blast furnace.

17. The majority of iron ore is supplied under long-term contracts. Steel mills and iron ore suppliers typically prefer long-term contracts for security of supply and investment certainty.

18. Traditionally, iron ore supplied under long-term contracts was priced according to global benchmark prices. Global benchmark prices for each form of iron ore are determined by annual negotiations between the main global suppliers and the main steel mills and generally reflect a consensus as to the balance between supply and demand over the coming year. The first price settlement has traditionally flowed through to all iron ore supplied under contracts.

19. Increasingly, iron ore supplied under long-term contracts is priced according to an index pricing mechanism. Index prices tend to be calculated with reference to a certain number of spot market transactions for a particular type of iron ore. Currently, there are three indices published on a regular basis — Platts Daily Iron Ore Report, the Steel Index published by Steel Business Briefing and the Metal Bulletin Iron Ore Index.

20. The main global suppliers of iron ore fines are BHPB, Rio Tinto and the Brazilian supplier —Vale S.A. (**Vale**). BHPB and Rio Tinto are the main global suppliers of iron ore lump.

21. Other global suppliers include the Australian producer Fortescue Metal Group (**FMG**), the South African/Brazilian producer Anglo American, and the Brazilian producer CSN.

22. While the majority of iron ore is exported out of Australia, iron ore is also supplied to customers in Australia at prices that are linked to global iron ore prices. Effects on global iron ore prices flow through to the price paid by Australian steel mills. Furthermore, since iron ore is a significant input into the production of steel, the price of iron ore also has an impact on the price of steel and other steel-based products consumed in Australia.

23. In Australia, the only two significant consumers of iron ore are OneSteel and BlueScope Steel. OneSteel is vertically integrated into iron ore supply, with its own mine in the South Middleback Ranges of South Australia. BlueScope Steel is not vertically integrated and sources iron ore from a range of suppliers, including BHPB.

The 2008 review

24. The ACCC reviewed the proposed acquisition of Rio Tinto by BHPB in 2008 (**the 2008 review**). The ACCC commenced the 2008 review on 6 June 2008 and announced its decision to not oppose the transaction on 1 October 2008. Following that decision, BHPB withdrew its proposal to acquire Rio Tinto.

25. The ACCC's primary focus in the 2008 review was whether the proposed merger was likely to result in a substantial lessening of competition in a market in Australia. In assessing this question, the ACCC considered, among other things, BlueScope Steel's position as the only significant customer of iron ore in

Australia. The ACCC also considered whether there would be effective competitive constraints on the merged firm post-acquisition.

26. During the course of the 2008 review, BlueScope Steel entered into a 10 year contract with BHPB for the supply of iron ore lump and iron ore fines.[3] It noted, in its press release in September 2008, that the contract was expected to 'maintain BlueScope Steel's competitive position in the industry'. It did not indicate any concerns to the ACCC about the proposed acquisition.

27. In relation to the competitive constraints on the merged firm post-acquisition, the ACCC considered that a number of independent capacity expansion projects would be likely to constrain any attempt by the merged firm to withhold supply from iron ore markets by making it unprofitable to do so. The ACCC was also of the view that the merged firm would face uncertainty in terms of identifying opportunities to withhold supply and in terms of identifying its competitors' likely responses.

28. Accordingly, the ACCC concluded that there was insufficient evidence available to support a finding that the proposed acquisition was likely to substantially lessen competition in Australian iron ore markets.

The present review

29. In the present review, the ACCC has received new information suggesting that the competitive constraints identified in 2008 by the ACCC have not come online as anticipated.

30. Indeed, a number of existing suppliers have delayed, cancelled or reduced their capacity expansion plans, and some potential suppliers have delayed, cancelled or reduced their entry plans. It is likely that a number of these changes are the result of the various effects of the GFC.

31. Also during the GFC, both Rio Tinto and Vale cut production substantially. In contrast, BHPB maintained production and iron ore sales. While the production cuts might reflect the large drop in demand, they might also reflect strategic behaviour with the purpose of limiting the decline in iron ore prices. If the ACCC were to find evidence and information that the GFC-related production cuts were made by Rio Tinto and Vale for the purposes of limiting the decline in prices, it would indicate that:

- there are opportunities for large, low cost iron ore producers to withhold supply; and
- the responses of competitors do not effectively constrain this conduct.

32. The combination of these developments exposes Australian steel mills to potential price increases if the proposed JV were to proceed. Indeed, BlueScope

[3] BlueScope Steel Media Release, *BlueScope Steel Concludes Major Iron Ore Contract*, 18 September 2008.

Steel, the only significant Australian customer of the proposed JV, has recently stated publicly that it has concerns about the proposed JV.[4]

33. The new information outlined above has given the ACCC cause to examine the ability and incentive of the proposed JV to profitably withhold supply in the future.

Areas of overlap and market definition

34. The ACCC has no information to suggest that the market definitions adopted in its review of the proposed acquisition in 2008 should be altered. The ACCC is therefore considering the impact of the proposed JV in the markets for:

- the global seaborne supply of iron ore lump;
- the global seaborne supply of iron ore fines;
- the national (Australian) supply of iron ore lump;
- the national (Australian) supply of iron ore fines;
- the supply of rail services in the Pilbara, WA;
- the supply of port services in the Pilbara, WA;
- the acquisition of iron ore tenements in the Pilbara, WA; and
- the acquisition of iron ore mining inputs in the Pilbara, WA.

Statement of issues

35. For the purposes of this Statement of Issues, the issues in this matter are divided into two categories, 'issues that may raise concerns' and 'issues unlikely to raise concerns.'

Issues that may raise concerns

Supply of iron ore lump and iron ore fines

36. The ACCC's preliminary market inquiries indicate that the proposed JV may raise competition concerns in relation to the global seaborne and the national (Australian) markets for the supply of iron ore lump and iron ore fines.

37. In these markets, the proposed JV would aggregate the production activities of two major suppliers of iron ore lump and iron ore fines. The JV would become the largest producer in these markets.

[4] Matt Chambers, *BlueScope lashes BHP-Rio link*, The Australian, 16 February 2010, p. 21.

38. Post-JV, Vale would have the next highest share of production in the supply of fines on a global basis, while FMG would be the next largest producer of fines on a national basis.

39. In relation to the supply of lump, Indian producers would have the next largest share on a global basis. There are no other Australian producers of lump.

40. Currently, there is a strong degree of competitive rivalry between BHPB and Rio Tinto in each of the relevant markets. The two suppliers have a number of similarities—in terms of iron ore quality, infrastructure, cost structure and distance to customers—and compete effectively on the basis of:

- *volume* — BHPB and Rio Tinto compete to be first to market with iron ore through production and capacity expansions;
- *price* — BHPB and Rio Tinto compete during benchmark price negotiations, in attracting customers to sign up to differing price mechanisms under long-term contracts, as well as in negotiating spot market transactions with customers; and
- *quality* — BHPB and Rio Tinto compete to provide differentiated iron ore products whose quality is suitable and attractive to steelmakers.

41. The ACCC considers that barriers to entry and expansion in the relevant markets are significant. Entry involves:

- *long lead times* — the development of a new 'greenfield' mine would take 10 to 15 years; and
- *significant sunk capital costs* — the costs associated with each stage of a project is substantial: exploration, mine development and the establishment of associated power, rail and port infrastructure.[5]

42. During market inquiries, interested parties expressed concerns and provided evidence to illustrate that, post-JV, competition between BHPB and Rio Tinto with respect to volumes, price and quality will be substantially reduced. Market participants noted that separate marketing functions would not ensure that effective competition *on any level* remained between BHPB and Rio Tinto post-JV.

43. The cuts in production by some of the large, low cost suppliers of iron ore during the GFC was raised by several market participants as being indicative of these suppliers' existing ability and incentive to profitably withhold supply. These market participants argue that the proposed JV would increase the ability and incentive for these suppliers to run a successful withholding strategy in the future.

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[5] The ACCC notes that there is potential for a rail access regime for rail haulage and/or track access to be established in the future. The ACCC is aware of the matters currently being heard by the Australian Competition Tribunal. If some form of rail access regime is established, it may lower barriers to entry and expansion for Fortescue Metal Group and other junior miners in the Pilbara.

44. Market participants were also concerned that, post-JV, the JV entity and Vale are more likely to tacitly collude by coordinating their decisions relating to price, volume and/or quality.

45. Some market participants also argued that the JV will be able to more profitably manipulate the supply/demand balance under an index pricing system compared with a benchmark pricing system. That is, the JV can more profitably withhold production as the feedback in terms of increased prices is more immediate under the index pricing system.

46. The GFC may have reduced the likelihood of potential and existing suppliers overcoming barriers to entry and expansion in the relevant markets. To date, the ACCC has seen some information that a number of prospective iron ore projects have been delayed or cancelled. At this stage, the nature and extent of these delays and cancellations are uncertain.

47. Indeed, the ACCC has also seen some contradictory information that some iron ore projects are proceeding as intended, and notes some new projects that have recently been announced. The ACCC will use the next phase of its inquiries to assess the possibility that these projects may be capable of constraining the JV from profitably withholding supply in the short and long term.

48. The ACCC understands from information it has received from the market that steel mills, particularly Chinese steel mills, have recently taken steps to facilitate the introduction and expansion of new independent sources of supply by signing off-take agreements and investing in iron ore mines. Market inquiries also indicated that further investments by steel mills in related infrastructure had been contemplated.

49. To the extent that the proposed JV would enable BHPB and Rio Tinto to withhold supply in global seaborne iron ore markets, it would have the effect of increasing the prices paid by Australian steel mills, and consumers of finished steel products.

<u>Areas under further investigation</u>

50. The ACCC requires further information from interested parties to determine whether the proposed JV is likely to result in a substantial lessening of competition in the global and the national (Australian) markets for the supply of iron ore lump and iron ore fines.

51. A key area under investigation relates to the JV's ability and incentive to *unilaterally* implement a successful withholding strategy in markets for the supply of iron ore lump and fines. The JV could withhold by decreasing current levels of production and/or delaying future capacity expansions.

52. The ACCC is also considering whether there is increased potential for the proposed JV and Vale to *coordinate* their decisions on product volume or quality, post-transaction.

53. In this regard, the ACCC is investigating whether the behaviour of the large, low cost suppliers during the GFC illustrates that these suppliers already have the ability and incentive to withhold supply profitably. The ACCC's inquiries are therefore focused on whether the proposed JV would have the effect of increasing the ability and incentive to withhold supply in the short term or delay capacity expansions in the long term.

54. The ACCC is also examining whether the developments since the ACCC's merger review in 2008, described above, have altered the competitive dynamic in the relevant iron ore markets in a way that is neither insignificant nor transient.

55. Accordingly, the ACCC is seeking information and evidence from market participants on the following issues:

- whether there is evidence that the proposed JV will have an increased ability and incentive to withhold supply in the short term or delay capacity expansions in the long term;
- whether the behaviour of some of the large, low cost suppliers during the GFC is indicative of these suppliers' existing ability and incentive to withhold supply profitably and, if so, whether the proposed JV would increase this ability and incentive;
- whether there is evidence that the JV entity and Vale have an increased ability and incentive to coordinate their supply decisions;
- whether the GFC has reduced the likelihood that potential and existing suppliers can overcome barriers to entry and expansion;
- the nature and extent of independent entry or capacity expansion projects that have either been delayed, cancelled or down-sized;
- the nature and extent of independent entry or capacity expansion projects that will proceed as intended; and
- whether the recent activity of Asian steel mills facilitating the introduction and expansion of new supply sources would effectively constrain the JV from employing a withholding strategy.

Issues unlikely to raise concerns

56. Based on market inquiries, the proposed JV appears unlikely to raise substantial competition concerns in relation to the issues set out below. Nonetheless, the ACCC will accept further submissions from interested parties on any of the following issues and will revisit them if it considers further consideration is warranted.

Acquisition of iron ore tenements in the Pilbara, WA

57. The ACCC considers that the proposed JV appears unlikely to raise competition concerns in relation to the acquisition of iron ore or rights to extract iron ore,

from owners of tenements in the Pilbara, WA. Market inquiries indicated that such competition between BHPB and Rio Tinto appears to be limited.

Supply of port services and supply of rail services in the Pilbara, WA

58. The ACCC considers that the proposed acquisition appears unlikely to raise competition concerns in relation to the supply of iron ore rail services and the supply of port terminal services in the Pilbara, WA. Market inquiries indicated that such competition between BHPB and Rio Tinto has been limited to date, and is likely to remain so in the future without the proposed JV.

ACCC's future steps

59. The ACCC will finalise its view on this matter after it considers market responses invited by this Statement of Issues.

60. The ACCC now seeks submissions from interested parties on each of the issues identified in this Statement of Issues and on any other issue that may be relevant to the ACCC's assessment of this matter.

61. Submissions are to be received by the ACCC no later than **14 April 2010**. The ACCC will consider the submissions received from the market and the parties in light of the issues identified above and will, in conjunction with information and submissions already provided by the parties, come to a final view as to the appropriate course of action to take to resolve any competition concerns that remain.

62. The ACCC intends to publicly announce its final view by **28 April 2010**. However, the anticipated timeline may change in line with the *Merger Review Process Guidelines*. A Public Competition Assessment for the purpose of explaining the ACCC's final view may be published following the ACCC's public announcement.