

Mitsubishi in Mexico

A covenant of salt

An unusual Japanese-Mexican venture runs into trouble with auditors
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HALFWAY down Mexico's Baja California peninsula is a dazzling sight; the world's largest sea-salt plant, owned jointly by the Mexican government and Mitsubishi Corporation, Japan's largest trading house. Salt flats covering an area a third the size of Tokyo stretch as far as the eye can see, producing about half of Japan's salt imports. Its advocates say the raw material has a rare quality. The white crystals, dried by the sun, are drawn from seawater in an inlet of the Pacific coast so pristine that grey whales travel from the Arctic to breed there. Yet for all its allure, the place is immersed in a bitter dispute over how to value the world's only edible rock.

For millennia, salt has been among the world's most sought-after commodities. Roman soldiers, it is said, were sometimes paid in it. Animals trampled the outlines of today's roads looking for saltlicks. Though salt has as many as 14,000 industrial uses, from making detergents to de-icing roads, it is so cheap to make that the cost of getting it to market may be more than the cost of producing it. Yet, Mitsubishi, which for almost 40 years has had exclusive rights to buy the Mexican salt and sell it around the world, has at times acquired it at below even its paltry production cost.

This year, Mexico's federal audit body, the ASF, highlighted what it said were inequalities in the relationship between Exportadora de Sal (ESSA), 51%-owned by the government, and Mitsubishi, with 49%. These, it said, had in recent years cut ESSA's profits to Mitsubishi's advantage, even as production volumes rose. It said that during 2013, half of 26 export contracts between ESSA and Mitsubishi were priced at between \$10 and \$15.03 a tonne, which was below that year's \$15.25-per-tonne cost of production, in breach of Mexican law.

It noted that two Mitsubishi employees sat on ESSA's board, which has responsibility for approving prices, even though they also represented ESSA's main customer. It called this a presumed conflict of interest. (Since then, the roles of board member and company official have been split). Japanese employees provide all of ESSA's market research, liaise with the ultimate buyers of its product in Japan and oversee the quality of the salt. The auditor noted that they were also responsible for charging ESSA more than \$10m for price adjustments, quality shortcomings and shipping delays in favour of Mitsubishi, though the Mexican firm could provide no justification for the penalties. In total, unexplained costs were the equivalent of almost nine-tenths of ESSA's 166m peso (\$13m) net profit in 2013, the ASF said.

Given Mitsubishi's presence as a shareholder with board representation, the auditor says that ESSA ought to have had some mechanism for assessing its prices relative to international norms for salt exports, but it was found to lack one. The auditor said the average price of \$17.50 a tonne paid by Mitsubishi in 2013 compared with data showing the price of similar salt in America and China ranging from \$50 to \$100 a tonne.

Mario Cantú, a government official who is ESSA's chairman, says such calculations are nonsense, because there is no internationally recognised price of salt; and the comparisons fail to reflect the huge disparity in transport costs between different regions. But when ESSA's former director-general, Jorge López Portillo, tried to bypass Mitsubishi last year and negotiated higher prices with other clients, he says he was fired by the

Commented [C1]: First indication of an issue. You should start asking questions in your mind before you read further:
•How are they able to do this?
•How does this link to the joint venture arrangements being discussed?

Commented [C2]: The organisation (ESSA) had profits cut, but one of the two shareholders has benefited. This is indicating some type of conflict is occurring.

Commented [C3]: Why would you be selling below cost to a customer?
How did this customer (who is also one of the two shareholders) negotiate such a low price?

Commented [C4]: Nominee directors (see Study Guide page 183 PDF version).
When powerful stakeholders appoint nominees to a board they are supposed to act for the corporation they are directing, not for the organisation that 'nominated' them. Nominee directors have potential conflicts of interest between the two organisations.

Commented [C5]: Not having independent verification or separation of duties here is risky – as they may act for the Japanese shareholder instead of ESSA.

Commented [C6]: \$10 million transfer without substantiation has occurred. This relates to lack of financial controls/systems. Directors are expected to act in the best interests of the organisation and be informed about what is going on.

Commented [C7]: This is not just a minor issue occurring.

Commented [C8]: Lack of independence – processes or systems are not in place to prevent conflicts or abuse.

Commented [C9]: The chairman rejects the claims, yet when an employee was able to show that higher prices were obtained, that employee was fired (discussed later in this paragraph)

government, along with several of his colleagues. Both he and the government have threatened to sue each other. (Mitsubishi has kept out of the spotlight, and did not respond to several e-mails from us requesting comment.)

Commented [C10]: Treatment of employees – demonstrates the difficulty of acting ethically.

ESSA is a rare beast: a state-controlled company whose minority shareholder is also its main client, in countries with very different business cultures, where diplomatic as well as commercial relations are at stake. What is more, the company that ships ESSA's salt to Japan and elsewhere is a 50-50 joint venture between Mitsubishi and the Mexican government. Mr López Portillo says the Japanese firm decides on the shipping costs, with its Mexican counterpart having little say in the matter.

Commented [C11]: Further complications indicating additional conflicts.

In the industry at large, pricing is confusing, with values ranging widely from salt in solution costing as low as \$8 a tonne to vacuum-processed salt, as used in the pharmaceuticals industry, costing \$200—not to mention some gourmet French varieties that are priced like precious spices. According to Roskill, a market-research firm in London, Japanese customers who buy imported Mexican salt typically pay almost three times as much as the export price that Mexico earns from them, simply because of the shipping costs.

That said, the price of imported Chilean salt in the United States is only a fraction higher than the price at which it leaves Chile, even though it also has a great distance to travel. Yet, according to Mitsubishi documents, transport charges for Mexican salt from Baja California to the American west coast come to \$16 a tonne—almost the same price as the salt itself.

Mr Cantú, who is also chairman of the shipping company, Baja Bulk Carriers, denies that its costs are too high. However, he acknowledges that Mitsubishi "plays with two hats" as both board member and client. "It's a very fine dividing line." He says a formula has been created to ensure ESSA no longer sells below cost price, and there are also discussions about changing the terms of the contract with Mitsubishi, or selling the government's stake altogether given that salt is hardly a strategic industry. If the government sells, Mitsubishi would be the most likely buyer—especially if it could acquire the remaining shares in ESSA as cheaply as it buys its salt.

Commented [C12]: The chairman, who earlier in the article was quoted as saying the 'calculations relating to the average prices were nonsense' is now shown to have an additional potential conflict. Acting as the chairman of the shipping company (major supplier) suggests it would be extremely difficult for this person to act in the best interests of ESSA.

Commented [C13]: This may eliminate the overall conflict – as long as it is sold at an appropriate price.

QUESTIONS:

1. Answer the following questions:
 - a. List 5 issues linked to governance and explain in detail why these are problems. Provide study guide references where relevant.
 - b. Describe 2 ethical issues you can identify and evaluate the treatment of employees and whether this has been appropriate
 - c. Explain how would you resolve this situation – what type of governance structure and benchmarking mechanisms would you suggest be used?

1a. List 5 issues linked to governance and explain in detail why these are problems. Provide study guide references where relevant.

List and explain. To answer this properly you should provide a list. This can be dot points. This is the first part. But, the second part means you have to go further – explaining why something is an issue. This means linking the case facts and the theory together.

- i) Nominee directors and a potential conflict of interest
- ii) Treatment of major shareholder
- iii) Treatment of employees
- iv) Lack of financial controls
- v) Chairman lacking independence and potential conflicts

There are other issues as well, including breaches of the law (selling below cost), board members potentially failing in their directors duties (such as acting in the best interests of the organisation and lack of care). However, if you are asked for 5 issues, then list the most important 5 – if you just write a long list of more than 5, the other items may be ignored – so make sure you identify the most relevant.

Explanations:

- i) Nominee directors have great difficulty acting in the best interests of the company they are supposed to be directors for. This is because they are nominated by a powerful stakeholder group (in this case, the major customer who also holds a 49% shareholding). In this situation, there appears to be a strong conflict of interest, and these directors may be acting for Mitsubishi (the nominating stakeholder) not ESSA, who they owe their duties to. This is directly linked to the duty to avoid conflict of interests, and also to act in the best interests of the organisation (see Study Guide page 183 PDF). Although this is based in Mexico, if we look at the ASX Principles as an example of best practice, we see this also does not align with ASX Principles 1 and 2, which focus on laying solid foundations for management and oversight, and structuring the board to add value, nor Principle 6 which focuses on respecting the rights of security holders.
- ii) The major shareholder (The Mexican government with 51%) is not receiving a fair share of the profits as a result of the activity that is occurring. For example, \$10 million in unexplained costs and selling below cost have both harmed profits. This indicates that the directors are not acting in the best interests of the organisation (because this would lead to better results for the shareholder, not worse). This also does not meet the requirements in the OECD Principles (Principle 2 specifically, which focuses on the rights and equitable treatment of shareholders, as well as Principle 6, which considers the responsibilities of the board).
- iii) Employees who attempted to obtain better prices were fired. This indicates significant levels of conflict and inappropriate behaviour. For example, ASX Principle 3 requires entities to act ethically and responsibly, and this has not occurred here.
- iv) Lack of financial controls is highlighted in several ways, including the \$10 million in extra costs that are not substantiated, the low prices obtained, and the lack of reference to external benchmarks when setting prices. Directors have a duty to be informed about the corporation's operations, prevent insolvent trading and act with care skill and diligence.
- v) The chairman is not independent, as they are also a government official (the Mexican government is also the majority shareholder) and is also the chair of the shipping company (a supplier). Relying on the FRC Code or ASX Principles as best practice, this does not align with the FRC Code (A.3.1 requires the chairman on appointment to be independent) or the ASX Principles (The chair should be an independent director).

1b. Describe 2 ethical issues you can identify and evaluate the treatment of employees and whether this has been appropriate

There is a conflict of interest which creates an ethical issue for the nominee directors and for the chairman.

- Mitsubishi nominee's director's on Essa's board want to benefit Mitsubishi(customer) with the lower salt price possible, in detriment of Essa's corporations; **Versus** their director's duties to Essa

- Mario Cantu, a government official and chairman of Essa and the Shipping Company, holds 3 hats, what interest should he put first (ESSA's profits, or the shipping company's results?).

- The fair treatment of employees is also an ethical issue, as people were fired for attempting to perform their jobs properly. This highlights the trade-off for these people between their integrity and self-interest.

The treatment of employees is not acceptable because it involves taking action against them to protect vested interests that are not behaving appropriate. There is not valid foundation for removing them from their roles.

1c. Explain how would you resolve this situation – what type of governance structure and benchmarking mechanisms would you suggest be used?

There are a lot of potential answers here, including very specific ones relating to board structure or using sub-committees, as well as broader recommendations.

For example:

- Essa board of directors should be formed with majority of independent directors, and an independent Chairman nominated; like suggested on the UK FRC code and the ASX principles and recommendations; Members to be chosen based on their skill and diversity to be considered.
- Following the recommendations, you could also create three committees to support the board; a nomination and remuneration committee as per recommendations, minimum of 3 directors, with majority being independent directors, and the audit committee should have only independent directors; Either the remuneration and audit committee should have at least one member with recent relevant financial experience;
- Remove the nominee directors. The two Mitsubishi directors should not being involved on transactions that their conflict of interest would affect their judgment like commercial dealings with Mitsubishi.
- Set proper mechanisms in place for determining prices: Essa's salt price to Mitsubishi would be calculated based on its cost production cost and its sustainability cost considered. The prices the market is paying for it would be considered as benchmark.
- Review of shipping costs and using an independent supplier
- Making Mitsubishi either purchase the organisation outright, or sell off some or all of its shareholding to reduce its power and influence.