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De Beers' – control in question

by Ken Gooding

De Beers of South Africa dominates world trade in rough diamonds. During the past sixty years the company has kept a grip on the market through its Central Selling Organisation (CSO), but today the future of this "cartel" is under heavy pressure and its future is far from clear.

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Nearly everyone knows that de Beers of South Africa dominates world trade in rough, or uncut, diamonds. De Beers, itself, claimed in December that its 1997 rough diamond sales of 4 640 MUSD represented about 60 per cent of the global total.

However, not many people understand just how this domination is achieved.

De Beers' keeps its tight grip on the rough diamond market through its Central Selling Organisation (CSO), sometimes called the "diamond producers' cartel". De Beers prefers to say the CSO operates "a single channel marketing system".

The difference is important. In a cartel, producers meet to allocate output quotas and hope that, by limiting supplies, they can keep prices reasonably high. Nicky Oppenheimer, grandson of De Beers founder and now chairman of the group, suggests cartels never work. He points to OPEC (the Organisation of Petroleum Exploration Companies) as an example of how badly a cartel can perform when producers constantly fail to keep to their allocated quotas.

In contrast, diamond producers have to decide whether the CSO can do a better marketing job than they can do themselves. If they decide to sign a contract with the CSO, they must then leave the CSO to get on with its job. They have no say in the way it operates.

At present the CSO has contracts with Botswana, in value terms the biggest gem diamond producer, Namibia, Russia and, of course, with De Beers' own mines in South Africa.

The CSO is based in London and Switzerland and also has "buying offices" in all the main diamond producing territories.

It has three main functions.

The most important is to buy from producers and market their rough diamonds in a way that reflects demand fluctuations.

It also must maintain a strong balance sheet and reserves to operate a buffer stock mechanism so that it can stockpile diamonds in bad times and release them to the market in a carefully controlled way when demand picks up. It must be well financed and well organised so that it can mop up rough diamonds to maintain market stability should there be an unexpected flood of stones arriving on the market.

Thirdly, it advertises and promotes sales of polished diamonds in jewellery. As long ago as 1948 an American advertising agency invented for the CSO the durable slogan, "A Diamond is For Ever". The CSO still uses this in its advertising and spends about 200 MUSD a year promoting gem diamonds.

Gem diamonds are different from most other minerals in that they are not homogeneous. Unlike gold, for instance, they do not have a standardised unit price. Each diamond has to be classified and valued individually and different diamonds of the same price are not necessarily tradable substitutes.

In broad terms diamonds are either cutable gem or industrial. Industrial are either too small or flawed or so opaque and imperfect as to be unsaleable as polished stones. Cutable diamonds are differentiated and valued by shape, size, colour, and purity. When polished, they are also differentiated by make or quality of polishing.

De Beers says there are more than 5 000 selling categories in rough diamonds and nearly as many for polished. So sorting rough diamonds requires experience and skill and the CSO is the world's main repository of this expertise.

It employs about 600 diamond sorters in London

Once the CSO has collected the diamonds and sorted them, the stones are offered to a select group of diamond traders at ten "sights" or sales a year.

Only about 100 traders are involved in this process. Each trader is offered a box. Inside each box is a mixture of diamonds from all over the world, parcelled up by the CSO so as to balance what it perceives to be global demand and what the traders have actually asked for. The traders must either accept all the diamonds or reject the entire box, they cannot pick and choose from the box. In good times a trader might hand over 25 MUSD for a box – and he cannot take the diamond away until his money is in the CSO's bank.

At the end of 1997 diamond traders complained that they could not make a reasonable living because the margins were being badly squeezed. The CSO reacted partly by cutting back the number of diamonds in each box at the "sights". This was a perfect example of how the organisation attempts to keep supply and demand in balance.

The "diamond cartel" has survived and even thrived for more than 60 years because gem diamonds are of no practical use to mankind. Nicky Oppenheimer once said: "Diamonds do not make engines run faster or planes fly further or higher. Unique among major raw materials, the gem diamonds has no material use to material man." Also, the rough diamond market is small enough (between 5 000 and 6 000 MUSD a year) to be controllable.

Nevertheless, the future of the cartel is far from clear and it is under tremendous pressure at present.

Its relationship with Russia, a relationship which worked well even when South Africa and the Soviet Union were at opposite ends of the political spectrum and deals had to be completed through a tortuous trail of intermediaries, is now in doubt. For most of 1997 the CSO dropped its formal links with Russia, claiming that Russia had not lived up to the terms of their previous contract. A new deal was thrashed out and began in November, but it is for one year only. The CSO wants to be sure that the Russian authorities do have enough grip on their diamond industry to keep to the new agreement and the Russians want to be sure that arrangements in place to give them a bigger say in rough diamond marketing really do work. These two, big diamond producers have to learn to trust one another all over again.

Also in 1997, the Argyle mine in Australia, in volume terms the world's biggest, quit the cartel.

Argyle insisted it had been let down by the CSO when the market was flooded with small rough diamonds from Russia's stockpile that by-passed the CSO when they were exported. Argyle says it will be better off financially doing its own marketing from now on.

There is extra significance to Argyle's move because it is 60 per cent owned by Rio Tinto, the world's biggest mining company and a group that is soon to start mining diamonds on its own account.

Rio will be mining diamonds in Canada's Northwest Territories where another substantial group, Broken Hill Proprietary, Australia's biggest company, is also about to go into diamond production.

The CSO has been in discussions with both groups but there is a substantial barrier to either of them allowing De Beers to do all their rough diamond marketing – the attitude of the US authorities, who are very suspicious of any organisation that looks remotely like a cartel.

De Beers and the CSO have been very careful not to have any assets in the US for that reason and claim that the US authorities have no jurisdiction over them.

On the other hand, both Rio and BHP have substantial operations in the US. For this reason most analysts suggest that neither one will be able to give all its diamond business to the CSO. Some say that a maximum of 50 per cent is all that either would be likely to allocate.

There has even been some talk about a possible rough diamond price war because both Rio and BHP have the financial muscle to take on De Beers should they be inclined. But a price war is extremely unlikely because the combatants would have little to gain. The rough diamond business is unique in that nobody wins – producers or consumers – if the price of this product, which has no practical value and is used solely for adornment, goes down. ■