GUEST EDITORIAL

UNDERSTANDING ECONOMIC REGULATION AND COMPETITION IN A DEVELOPING ECONOMY: INTRODUCTION TO SPECIAL ISSUE

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The most widely regulated markets are natural monopoly markets, where regulators impose limitations on monopoly behaviour regarding price, quantity or entry and exit into the market (Viscusi et al., 2000). A critical element of regulation is identifying the essential facilities or infrastructure where competition is not possible and enforcing measures to make sure access is provided on fair terms to different participants, along with ensuring appropriate incentives for investment. The articles in this special issue analyse how these challenges have been addressed by different regulators. There is also a strong link here with competition law provisions prohibiting abuse of a dominant position. Economic regulation and competition law enforcement is particularly important where there are entrenched dominant firms, which are also often vertically integrated into a range of related activities and may have incentives to exclude rival actual and potential participants. However, the case for economic regulation is much wider than simply constraining market power; it can also rest on information imperfections, the existence of incomplete markets and externalities, and the resulting income and wealth distribution effects (Jalilian et al., 2006).

Regulation theory can be viewed from several perspectives. The normative perspective seeks to determine when regulation should be introduced and what optimal regulation should be while the positive perspective focuses on economic, political and legal forces that lead to regulation, and influences the institutions and their performance (Joskow & Rose, 1989). The articles in this special issue cover both perspectives – some examining the political economy of regulation, while others assess regulatory performance in normative terms.

Typically regulation in economies with mature infrastructure, built by state-owned enterprises and now privatised, emphasises allocative and productive efficiency. Regulation is portrayed as addressing market power and market failures. This implies that the norm is perfectly functioning competitive markets. Given that market power and market imperfections are intrinsic to a market economy, it makes sense to see economic regulation more broadly – as the set of rules within which businesses make investment, production and supply decisions. Viewed in this way, competition enforcement is part of economic regulation.

In addition, in developing countries such as South Africa, where the historic provision of infrastructure itself is part of a skewed economy which favoured particular interests, the role for economic regulation cannot be divorced from economic policies to change the development path. Stimulating investment in line with a more broad-based development path is thus a key consideration. Note that positive externalities, and social discount rates that are lower than private discount rates, imply on-going state support for investment in expanded provision and pricing. In the absence of such support, firms will under-invest and mis-price services relative to their returns to the economy. This is the case even where the firms are state-owned but run on a corporate basis with investments based on narrow cost recovery from immediate users. Regulation is part of the choices about changing incentives to alter the development path of the economy, for example, in deciding about relative energy prices, incentivising renewable energy and about pricing and access to transport infrastructure.

Choices about economic regulation and competition law can be likened to deciding on the 'economic constitution' of a country (Gerber, 2010). These are part of a set of rules and institutions which influence whom has access to economic opportunities and on what terms and whether, in the terms of Acemoglu and Robinson (2012), the economy tends towards being inclusive or extractive. It is about processes and outcomes. Effective regulation achieves the policy objectives set by government for the regulator (Jalilian et al, 2006).

The articles in this special issue are drawn from papers presented at the second South African Economic Regulators Conference held on 18 and 19 March 2014 in Johannesburg with the over-arching theme of expanding investment in infrastructure to meet the challenges of inclusive growth. The conference was co-hosted by the National Energy Regulator of South Africa together with the University of Johannesburg's Centre for Competition, Regulation and Economic Development.

The article by **Montmasson-Clair and Ryan** examines an important policy success story in the form of South Africa's Renewable Energy Independent Power Producer (REIPP) procurement programme. The REIPP programme stimulated investment in renewable generation at quite competitive prices, in other words with low effective subsidies. Montmasson-Clair and Ryan analyse why the programme was successful, achieving falling prices for the power purchased in each successive procurement round, with every round being over-subscribed and with a high success rate for chosen projects. The findings highlight the way in which a clear policy framework with hard commitments created the competitive space for the bidders to come forwards with financed projects. Cooperation between the key stakeholders – Eskom, the regulator and the private sector – was critical to the success of the programme, as was flexibility in implementation such that the lessons from each round of procurement were learned and incorporated into subsequent rounds. Whilst the authors acknowledge that there is still room for improvement, the programme provides a great example of what can be achieved through forward-thinking and responsive policymaking, which incorporated multiple goals and took into account a range of stakeholders with different interests. It also highlights that the private sector does have appetite for investing in power generation in South Africa and can respond quickly once a clear mechanism for participation has been provided. The article draws out the lessons learned in a simple manner which can inform future projects of a similar nature, such as, other large infrastructure development programmes.

Sithebe and Kolobe's article also deals with the electricity sector, but considers the structure of the industry and asks the question of how the sector could best be organised in order to promote competition, drawing on international experience and learnings. The authors argue that the key constraint to the development of independent power generation has been uncertainty around the policy framework. In this context, REIPP is seen as the exception that proves the general rule - a successful, albeit small-scale, example of how private players can be effectively brought into the electricity generation market to the benefit of competition. In assessing the possible impact of the vertical separation of Eskom's activities, Sithebe and Kolobe draw from international experience in their finding that it may be a necessary but not sufficient condition for successful entry in generation. Vertical separation needs to be carefully implemented with regard given to the industry context and supported by regulation in order to be successful. Sithebe and Kolobe note that vertical integration is also present in the piped gas sector, where Sasol Gas has a virtual monopoly over the upstream market and is also vertically integrated into the downstream market.

Mondliwa and Roberts pick up the issues of regulation of liquid fuels. Their analysis finds that regulation has favoured the up-stream refiners, setting prices for many years that were in fact above the actual cost of importing fuel. This highlights the importance of information asymmetries between regulators and those they regulate. Mondliwa and Roberts also argue that the security of supply concerns under apartheid have been used to continue to justify restrictive regulations when in fact ensuring supply can as readily be achieved through efficient logistics to source imported fuel. Indeed, there are strong threads of continuity and the authors suggest revisiting the recommendations of the 2007 Windfall Tax Task Team for a substantially revised regulatory framework as the apparent National Treasury conditions have not been met.

Ismail, Mabuza, Pillay and Xolo assess the reasons for delays and cost overruns in major infrastructure projects against different models for the funding and financing of infrastructure investments. The article presents an alarming view of cost overruns in recent major infrastructure projects which have varied from 21% to 1329%. Five out of the ten projects considered by the authors ended up costing more than double the initial budget for the project. This is extremely concerning in the context of recent concerns about the level of government spending and the affordability of sharply increasing user fees for different types of infrastructure. The authors conclude that inefficient infrastructure delivery, particularly from SOEs, leads to the inefficient pricing of the relevant asset. This is particularly problematic where the allowable revenue model is used to determine pricing, as CAPEX for infrastructure, including overruns and unnecessary additional costs, is reflected in the institution's asset base and hence in prices and is passed through to consumers. Problems which occur in practice seem to include inefficient procurement and contracting methods, project overruns, and inefficient funding mechanisms such as in the case of the Gauteng toll roads. There appear to be important lessons for government departments and SOEs to learn in terms of how to plan and manage such projects in future so as to minimise costs.

The articles by **Ratshisusu** and **Sylvester** address the role of the competition authorities in addressing the conduct and market power of companies. Ratshisusu analyses the experience of bid-rigging in construction, which raises the costs of building infrastructure. This article details how and why collusion has been found to be widespread across the industry, in a number of countries. Ratshisusu then reviews the fast-track settlement process of the Competition Commission of South Africa which played a big role in uncovering the extent of the conduct and how it worked in practice. A range of practices are explained such as 'cover pricing' and 'loser fees' by which firms gave the appearance of competition while actually replacing rivalry between themselves with a common understanding. In addition to vigilance by the competition authorities, Ratshisusu points to a number of policy implications such as better procurement practices, more effective monitoring by the Construction Industry Development Board as the body with regulatory oversight and support for new entrants and the growth of smaller firms.

Sylvester addresses the specific issue of special cost advantages in relation to excessive pricing cases under competition law, which is where the competition authorities are effectively playing the role of a 'regulator of last resort'. The article considers the finding by the Competition

Appeal Court (CAC) in the Mittal case that special cost advantages should be excluded from the cost build-up of the dominant firm. It is argued that the cost advantage cannot simply be added back-in to the costs as this fails to take into account that the firm would have taken different decisions, except under very restrictive assumptions. Sylvester also notes that there may be cost advantages, such as industrial policy support, which in a concentrated sector in South Africa are effectively just to a single firm while in another country or sector is to a set of firms. The CAC approach makes this distinction between support to a single firm or to an industry of material importance and, argues Sylvester, will severely restrict government's ability to develop downstream industries supplied by a monopolist.

The two articles by **Tregenna and Kwaramba** examine the work of the International Trade Administration Commission (ITAC) in undertaking tariff investigations and recommending decisions. The first paper considers two investigations, relating to paper and poultry, to critically assess the way in which ITAC has undertaken its evaluation under the broad guidance of the country's trade policy. They find that ITAC made thorough investigations before recommending changes in tariffs, however, did not fully appreciate the impact of existing trade agreements which affected the outcomes. Tregenna and Kwaramba also note that ITAC should work more closely with other bodies analysing firm behaviour, in particular, the Competition Commission. The second article analyses the role and capacity of ITAC. It compares the semi-independent institutional framework to other developing countries and assesses the robustness of ITAC's decisions to legal challenges over time, finding that ITAC's decisions have become more robust. The development of internal capacity to analyse corporate financial information has been crucial in this performance, in common with other economic regulators.

The articles in this volume, whilst covering diverse subject matter, all deal with a common theme in that they highlight the challenges with economic regulation in South Africa currently. As noted above, the more positive REIPP experience serves to emphasise the shortcomings in other areas, however, it does provide a model for what can be achieved with clarity of purpose, policy certainty and commitment, and effective and flexible implementation. In order to create a vibrant and dynamic economy where strong competitive rivalry can deliver inclusive growth and broader participation, we need to learn from this type of example. Hopefully the insights from the various papers in this special issue can help to identify solutions which can take us closer towards achieving these goals.

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