Remarks on
"Economic and social regulation"

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It's a great pleasure to join everyone here this morning. My remarks today are not intended to be exhaustive as neither the time nor the nature of the subject permits.

Of all my remarks today, there is one additional caveat before I get started, the remarks that follow are my own, and do not necessary reflect the views of the Commission.

Today's topic – water and sanitation economic and social regulation – is very important to all of us and is close to my heart given that South Africa has a history of denying the majority of citizens access to water and sanitation. Over the next fifteen years, the Commission's mission is to undertake "Competition Regulation for a Growing and Inclusive Economy".

Now as many of you know, apart from being considered as one of the basics human rights, water supply and sanitation is also considered as a natural monopoly. This limits the role of competition in the water sector, not only because of the natural monopoly characteristics of the industry (high fixed costs, inelastic water demand, inelastic supply, and economies of scale up to a fixed point) but also because government laws, regulations and low pricing deter entry.

However, while we recognise that competition may not yield the most favourable outcomes in many areas of the water sector, there are certain areas of the water supply and sanitation chain in which efficiency can be improved and in which competition can play an important role.

So let me start painting the picture by first pointing out that when water supplies are plentiful, there are two economic regulation problems that arise (1) setting an appropriate consumer price that will cover fixed costs, extraction and maintenance and (2) enhancing productive efficiency.

But when water supplies are limited, the main challenge relates to the allocation problem of determining who will receive water. For example, providing one consumer with additional water means depriving another consumer of that water. When situations like this arise, markets are often the standard way of solving the resource allocation problem, but markets will lead to socially inferior outcomes in the water sector.

There are three primary consumers of water, that is, households, industry and agriculture. These consumers also produce wastewater as result of their activities.

The biggest challenge to designing a regulatory and pricing scheme relates to the fact that water policy is often driven by multiple objectives which include public health, environmental protection and affordability for households, particularly the poor. These objectives sometimes conflict with each other.

The role of competition law and policy in the water sector currently is probably relatively limited. So, what now? Perhaps it is worth considering some ways in which competition might play a helpful role in increasing efficiency in water supply and sanitation chain.

On the demand side, one mechanism that is used to prod the water sector towards more efficient outcomes is metering.

The attraction with metered pricing is that it becomes an important mechanism for reducing the use of water. Simply put, the objective of metering is to ration water by price. Metering also allows for consumers to face different payments for their different quantities of water and sanitation usage.

Competition distortions may follow metered pricing. For example, from time to time the Commission receives complaints, which allege that metered prices are excessive. Competition law provides that a dominant firm may not charge an excessive price to the detriment of consumers. An “excessive price” is defined as a price for a good or service which (1) bears no reasonable relation to the economic value of that good or service; and (2) is higher than the value.

The competition policy challenge that arises in this instance is that municipalities and water boards exercise jurisdiction and further, competition authorities do not have the jurisdiction to hear matters related to the exercise of public powers except where the state exercises its power through a vehicle such as a firm.

Another and perhaps serious objection to metered pricing that makes it very controversial is the fear that low-income households will be deterred from using water if they are metered.

On the supply side, no one doubts that privatisation of water supply and sanitation in an unregulated natural monopoly could lead to excessively high prices. Therefore, regulation of prices is likely to remain the best option.

However, since 1996 and in an effort to achieve private sector competitive incentives under regulated prices, one solution that has been adopted in the water sector by some municipalities is concession operation, in which the local government or the municipality maintains ownership of the infrastructure of a water supplier while a private firm operates the system and maintains the infrastructure.

Potential private firms compete with each other to offer the best deal to the municipality (and ultimately consumers) and the private firm which offers the best deal to the municipality and consumers is chosen.

Such a semi-competitive solution effectively presumes that government operation of water infrastructure leads to inefficient operations. The jury is still out on this and hence there is hesitance among municipalities on whether and how to engage the private sector.

According to the OECD, there is some evidence to suggests that public water companies are actually more efficient than private companies on average but that public operations have a broader range of efficiency levels. The OECD also cites one study in the US, which compared public and private US water companies and found that government operation is 23% less costly than private operation.

This debate remains unsettled, because there are others who also argue that private firms in most cases tend to be asked to run the more difficult utilities and that this explains the difference between the public and private firms.

As most here will know under a concession system, the private firm operates, manages, maintains and takes the commercial risks associated with the operation of the water utility, while the municipality owns the underlying assets.

In other words, competition occurs when the municipality decides which private firm to select. The biggest challenge in this instance relates to bid rigging.

Bid-rigging occurs when two or more firms agree that, in response to a call for bids or tenders, one or more of them will (1) not submit a bid, (2) withdraw a bid; or (3) submit a bid arrived at by agreement.

For example, in the construction sector, the Commission first initiated an investigation in February 2009 regarding tenders for the construction of 2010 FIFA World Cup stadia. The second investigation was initiated in September 2009 and covered all big and small tenders for construction projects. During the investigation of these projects the Commission received approximately 150 marker applications (intention to apply for leniency) and 65 CLP applications which implicated the majority of medium and large firms in bid rigging conduct. This indicated how widespread bid rigging was in the construction sector.

In relation to concession competition two large potential problems arise. The first is from long-term contracts. The issue with the long term contracts is that they yield infrequent competitive tendering processes. Long term contracts create incentive to invest in maintenance and this creates a trade-off between investment incentives on one hand and effective competition, on the other hand.

The second challenge relate to post-signature renegotiation which may distort competition ex post. This is especially true when contracts are long in duration.

As most here will know, sanitation plants take dirty water and sewage and clean it so that it can be released back into the environment without significant harm. There is vertical separation between waste water treatment and water supply functions and generally water bills include separate charges for water provision and for sanitation. This suggests that there are no real significant economies of integration between water provision and wastewater processing.

So on the face of it, is there a possibility for multiple firms to compete for wastewater processing? Wastewater concessions are in existence in some cases and sometimes take the form of a competitive tender with a build-operate-transfer contract. In this instance, the private firm builds and operates a facility for a period of time which allows the private firm to recoup its investments. After, the agreed period, the facility is transferred fully to the municipal authority. Again the problem of bid rigging arises.

However, this type competition which can be described as competition for the market does not generally create horizontal wastewater treatment competition. There is also an open question as to whether such competition is possible in the first instance?

It seems to me that the alternatives for bringing competition into the water market are aimed primarily at increasing productive efficiency rather than solving the allocation problem. Further, the natural monopoly problem and government regulations suggest that competition models are likely to remain difficult to implement.

Yet, the role of competition authorities in the water sector is likely to remain important and complementary to the regulatory authorities, helping to achieve a growing and inclusive economy. One function of the Competition Commission will be to ensure compliance with competition law particularly and in relation to bid rigging whenever concession competition is introduced.

The Commission has also examined and will continue to closely scrutinise mergers relating to inputs into water supply and water treatment since the materials and equipment are supplied by private companies.

It is also important to highlight that the Competition Commission can examine, and address, wider market problems using its market inquiry powers. Market inquiries can identify concerns that arise because of the inherent characteristics of a market, which may be structural, or as a result of public restrictions on competition. They also increase market transparency.

Thank you for listening.