

The role of regulatory bodies



Executive Summary

This paper is an attempt to study role of CCP with reference to its coordination with other departments and regulatory bodies in Pakistan and an effort is made to review the existing literature and evidences regarding the role of CCP in performing its activities and its establishment. Successes and failures review and their underlying reasons are identified. Thus providing the base for suggestions and policy guidelines.

Market failures induce governments to intervene in the markets through regulatory bodies. Governments intend to minimize the abuse of dominance in different sectors of economy. In Pakistan many regulatory bodies are working in the energy, financial, aviation, media and telecommunication sectors. Competition Commission of Pakistan is one such regulatory body that was brought into existence to replace Monopoly Control Authority in the year 2007. The main purpose of the CCP is to safeguard the interests of the consumers along with introducing healthy competition among the players of the economy.

CCP during its short span after formation has intervened in different areas including the cement, sugar, fertilizer, aviation, education and textile sector. Performance review of the CCP revealed that it has succeeded in few positive interventions in the short-run. However long-run sustainability could only be ensured if it is provided with a comprehensive legal framework, research based interrogative framework and proper infrastructure and human resources.

CHAPTER 1

Introduction

On November 2, 2007, Competition Commission of Pakistan (CCP) was established under the Competition Ordinance, 2007. This Ordinance's was promulgated to ensure the provision of a sound legal framework to sustain a business environment based on healthy competition among the market forces thus improving economic efficiency, developing competitiveness and shielding consumers from anti-competitive practices. Prior to Competition Ordinance, 2007, anti-monopoly law namely ' Monopolies and Restrictive Trade Practices (Control and Prevention) Ordinance (MRTPO) 1970' was practiced to curb such practices and The Monopoly Control Authority (MCA) was responsible to carry out the operations under this Law.

Market economies are theoretically, based on the principal of free movement of forces of demand and supply. But sometimes, to safeguard the interests of the common / to support economy or to protect the markets from malpractices, government intervenes in the markets through different sources. A recent and prominent example of such market intervention was the acquisition of Merrill Lynch & Co. for about \$50 billion by The Bank of America, as the credit crisis hit this Co. (One of America's oldest financial company). The Bank of America (Central bank of America) agreed to pay 70 percent higher price than the actual value of the share of the company.

In Pakistan, regulatory bodies have been institutionalized from time to time to effectively implement the government policy and authority. Many of these regulatory bodies have been formed in different areas of economy including banking, electronic and print media, energy and tariff sector and consumer

protection. However many agencies in the past, considering the role of regulatory bodies, have been recommending to carry out impact assessment studies to verify their impact on the economy.

Before discussing the role of these regulatory bodies in regularizing the functions, it's imperative to present the clear idea about the market failures / distortions that prevail in the markets. After that the focus will be made on the working of the Competition Commission of Pakistan (CCP) considering its successes and failures through comparative and qualitative analysis.

Chapter 2 is a brief review of the theories regarding the prevailing market failures in the economy. Chapter 3 covers the methodological framework and analytical framework of the study stating the hypothesis of the study and data collection techniques. Chapter 4 details the working of different regulatory bodies in multiple sectors of the economy. Chapter 5 is a review of the history and development of anti-trust laws and working of competition commissions around the world. After the global comparison, background of CCP's formation, its working, successes and failures are discussed.

CHAPTER 2

Market Failures

The normative theory of market-failure predicts that interventions in the market through regulation will be instituted to improve economic efficiency and to protect social values by adopting correcting mechanism to curb market imperfections. Thus market failures could be viewed as scenarios where individuals' pursuits of pure self-interest lead to market inefficiencies – that can be improved upon by pursuing the societal point-of-view

2. 1 Types of Market Failures

Six types of market-failures exist generally: Natural monopoly, Externalities, Public Goods, Asymmetric information, Moral hazard, Transaction costs.

Anyone of these six failures legitimates regulation.

2. 1. 1 Natural Monopoly

In natural monopoly situations the monopolists will raise their costs and tariffs because they lack incentives for efficiency and are interested in the maximization of profit. A monopoly may not always give birth to inefficiencies, for example a natural monopoly, does not necessarily follow that there is substantial economic inefficiency. A monopolist can however, create artificial barriers for other firms to enter into the markets thus giving birth to inefficiencies and to curb the “ threat” of potential competition or a monopolist may choose to use a pricing policy, involving fixed charges and a higher unit price, which can earn uneconomic profits to him and cause potential loss to the consumers.

2. 1. 2 Externalities

While in negative externalities, too much is made. Negative externalities such as air pollution occur when the producer cannot be charged all the costs without involving the external cost in the calculations, the producer manufactures more of the good than is socially beneficial.

2. 1. 3 Public Goods

A pure public good is one whose consumption by one person does not reduce its availability for others. But in case of private goods, such as an apple, it may not be available for consumption by others. When a person consumes a

good such as national defense or a radio broadcast, however, the amount of the good available for consumption by others is not diminished.

An associated fundamental problem centers on the “revelation of preferences” for public goods. If those who benefit from a public good are asked to contribute an amount reflecting their valuations, an individual may decide to free ride on the payments of others. If individuals could be excluded from consuming the public good the revelation and free-rider problem could be resolved – at least in principle.

2. 1. 4 Asymmetric Information

If people have access to different (private) information sources or they have been provided different information at the time they act, markets may not perform efficiently, and the informed players of the market, mostly the large producers, could exploit the situation. This phenomenon could also occur when sellers have incomplete information about customers. When market participation has incomplete information and acquiring information is impossible or difficult, markets may not function efficiently. Such a situation thus warranted the provision of information through regulation.

2. 1. 5 Moral Hazard

Moral hazards refer to the presence of incentives for individuals to act in ways that incur such costs, generally for society as a whole, which they do not have to bear. For example, a rickshaw driver does not care for the excessive smoke and pollution due to the weak engine since he has not to pay for the pollution. In case of medical insurance, the individual may not have the proper incentive to take socially efficient preventive measures,

since she/he knows that the cost of any illness or accident will be covered by insurance.

Regulation is one response to moral hazard problems, but regulations, sometimes, do possess few hazards thus minimizing the efficacy of these regulations. In a controversial article[1], Peltzman argued that the automobile safety regulation induced drivers to take more risks, thus reducing the effectiveness of mandatory safety standards. Adoption of over-ambitious safety standards by the EU in response to the SPS measures is another example. The principal means of dealing with moral hazards is to structure incentives so that the induced behavior is taken into account. Moral hazard can also be addressed by monitoring the behavior of individuals to increase the likelihood that they take proper care.

2. 1. 6 Transactions Costs

Market failures can also result from costs associated with making market transactions. To the extent consumers and producers incur costs in becoming informed about market opportunities and completing market transactions, markets will not perform efficiently. Regulation to reduce those transactions costs then can only improve efficiency. For example, in the auto industry global auto emissions standards can enhance efficiency, as auto producers would not have to produce different models for different states. Markets however can resolve some of these problems. For example, if consumers can sully the reputation of the firm by informing other consumers that the firm shirked on quality, consumers will not purchase from that firm

Another situation where the producers / suppliers could create market inefficiencies is the formation of cartels. This situation occurs where the conditions of oligopoly[2] exists.

2. 2 Cartels

A cartel is a formal (explicit) agreement among competing firms. It is a formal organization of producers that agree to coordinate prices, marketing and production. Companies involved in cartels reach upon a mutual agreement on price fixing, total industry output, market shares, allocation of customers, allocation of territories, bid rigging, establishment of common sales agencies etc. The aim of such collusion is to increase individual members' profits by reducing competition. Laws governing the market and preserving the consumer rights, forbid cartel since these would create a net social welfare loss to the society as a whole. Another argument is that cartels always lead to a loss-loss situation in the economy.

A cartel is a type of market distortion in which members of the cartels tend to maximize private gains on the cost of social welfare. Most cartels fall into one of two categories. One is the Price-Fixing Cartel and the other is The Market Sharing Cartel.

2. 3 Regulation to Curb Market Distortions

Before discussing the practices / policies / measures that have been adopted by the modern day economies, it's imperative to present a concrete idea, how different schools of economic thought have dealt with this issue?

2. 3. 1 Classical perspective

Under the doctrine of laissez-faire, antitrust is seen as unnecessary as competition is viewed as a long-term dynamic process where firms compete against each other for market dominance. In some markets a firm may successfully dominate, but due to superior skill or innovativeness. However, according to laissez-faire theorists, when it tries to raise prices to take advantage of its monopoly position, it creates profitable opportunities for others to compete. A process of creative destruction begins which erodes the monopoly. Therefore, government should not try to break up monopoly but should allow the market to work.

The classical perspective on competition was that certain agreements and business practices could be an unreasonable restraint on the individual liberty of trades and people to carry on their livelihoods.

2. 3. 2 Neo-classical synthesis

Neo-Classicals advocated the government based antitrust policies to regulate the free market mechanism. A simple neo-classical model of free markets holds that production and distribution of goods and services in competitive free markets maximizes social welfare. This model assumes that new firms can freely enter markets and compete with existing firms, or to use legal language, there are no barriers to entry. By this term economists mean something very specific, that competitive free markets deliver allocative, productive and dynamic efficiency.

2. 4 Why are cartels bad?

Cartels inhibit competition since there is little or no incentive to lower prices or provide better quality goods or services through operating efficiently or

investing in technology and innovative processes. As a result, consumers are hurt and there is likely to be harm to the economy as well. In particular, cartels cause harm in the following ways[3]:

- (a) Businesses pay higher prices which result in higher business costs. These higher costs are eventually passed on to consumers by way of higher retail prices.
- (b) Cartel members have less incentive to innovate or produce better quality goods or services.

Cartels can also affect the economy as a whole. Apart from consumers, downstream firms may, due to higher costs or reliance on local products that are not as innovative as those in other countries, be less internationally competitive. Competition not only spurs lower prices and better quality of goods or services; it also helps boost production as consumers may be inclined to buy more at lower prices.

2. 5 How to spot a cartel?

Although cartels may occur in almost any industry and can involve goods or services, certain markets may be more susceptible to cartels because of the nature of their industry structure and the way they operate.

Markets having few competitors dealing in products with more or less similar characteristics which are more likely to give rise to cartels provided that high barriers to entry for other potential entrants exists and have established communication channels.

CHAPTER 3

Methodology

The study will be a review study to check the validity of research hypothesis given below

3. 1 Research Hypothesis

H0: Regularity bodies especially the Competition Commission of Pakistan has not performed as per their designated portfolio

H1: Regularity bodies especially the Competition Commission of Pakistan has performed as per their designated portfolio.

3. 2 Methodological Framework

Since the time series data series analysis involves a larger dataset for econometric / statistical analysis to generate unbiased / efficient estimates but no time series data is available in case of Competition Commission of Pakistan, assessment of the performance will be based on researcher's judgment regarding the annual performance of CCP keeping in view the well established judgmental parameters of assessment. Researcher will base his conclusions / recommendations on the personal interviews, review of literature, case studies and secondary data available through different sources.

Anti-trust laws usually interfere in the existing price levels of the specific essential commodities. So the effectiveness of these bodies could be judged by the level of the prices for the commodities which could be monitored under the anti-trust laws.

3. 3 Analytical Framework

The study has focused on the historical development of the competitive laws locally and internationally, existing anti-cartel / anti-competition approaches, major interventions made by the CCP and their impacts. Conclusions and recommendations have been made on the basis of the reviews of the relevant literature.

3. 4 Sources of Data / Information

To review the literature / reports to review global experiences on competition laws, historical development of CCP, type of market interventions, CCP has made in the recent past and other relevant information, different secondary sources were employed including online information / reports / journals and printed material available the CCP library.

To investigate into the bottlenecks of the existing system along with the problems, primary as well as secondary data sources were used. To collect primary data, officials of the CCP were interviewed using well structured questionnaire.

CHAPTER 4

Market Regulations in Pakistan

In Pakistan, regulatory authorities have been institutionalized from time to time to effectively implement the government policy and authority, Many of these regulatory bodies have been formed in different areas of life including banking, electronic and print media, and energy and tariff sector and consumer protection. A brief description of few important regulatory bodies working in Pakistan is as under;

4. 1 Pakistan Electronic Media Regulatory Authority (PEMRA)

PEMRA was established in 2002 under the famous PEMRA ordinance. Main purpose to formulate the authority was to facilitate the working of private electronic media and was assigned with facilitating and regulating the establishment and operation of all broadcast media and distribution services in Pakistan established for the purpose of international, national, provincial, district, and local or special target audiences.

PEMRA's mandate is to

- Improve the standards and flow of information, education and entertainment ;
- Expand the choices available to the masses in the media for national and international news, current affairs, precise religious knowledge and much more including technology, economic and social sector concerns;
- Facilitate the devolution of responsibility and power to the grass roots;
- Ensure accountability, transparency and good governance.

4. 2 National Electronic and Power Regulatory Authority (NEPRA)

NEPRA was established through an act, called Regulation of Generation, Transmission and Distribution of Electric Power Act, 1997. Its basic objective was to develop and pursue a regulatory framework which could ensure provision of safe, reliable, efficient and affordable electricity to the consumers. The body is authorized with the task of determination of tariffs for various types of consumers and setting terms and conditions for them to purchase electricity, transmission and distribution companies, and to present their recommendations to the federal government for notification and possible implementation.

As a result of the conditions imposed by the international financial institutions to accelerate the process of privatization, WAPDA was split into eight distribution companies (Discos) last year, again following a decision taken by NEPRA. These companies were given administrative and to some extent financial powers.

4.3 Oil and Gas Regulatory Authority (OGRA)

Oil and Gas Regulatory Authority (OGRA) has been set up under the Oil and Gas Regulatory Authority Ordinance dated 28th March 2002 to encourage competition, enhanced private investment and ownership rights in the industry, protect the public interest while respecting individual rights and provide effective and efficient regulations.

Consequent upon the establishment of OGRA on 28th March, 2002 the Natural Gas Regulatory Authority (NGRA) was subsumed by the OGRA. All properties and works done by the NGRA were transferred to and protected under the OGRA Ordinance. OGRA was, therefore, in a position to start its functions in respect to natural gas immediately upon its establishment.

4.4 Securities and Exchange Commission of Pakistan (SECP)

The Securities and Exchange Commission of Pakistan (SECP) was set up in pursuance of the Securities and Exchange Commission of Pakistan Act, 1997. The SECP became operational in January 1999. It was initially concerned with the regulation of corporate sector and capital market. Over time, its mandate has expanded to include supervision and regulation of insurance companies, non-banking finance companies and private pensions.

SECP is entrusted with the responsibilities of the development of modern and efficient corporate sector and capital market, based on sound regulatory principles, that provides impetus for high economic growth and foster social harmony in the country.

Another task is to develop an efficient and dynamic regulatory body that fosters principles of good governance in the corporate sector, ensures proper risk management procedures in the capital market, and protects investors through responsive policy measures and effective enforcement practices.

4. 5 Pakistan Telecommunication Authority (PTA)

The Pakistan Telecommunication Ordinance 1994, established the primary regulatory framework for the telecommunication industry including the establishment of an authority. Thereafter, Telecommunication (Re-Organization) Act no XVII was promulgated in 1996 that aimed to reorganize the telecom sector of Pakistan.

PTA's functions are, to regulate the establishment, operation and maintenance of telecommunication systems and provision of telecommunication services in Pakistan and to promote and protect the interests of users of telecommunication services in Pakistan. To promote rapid modernization of telecommunication systems and telecommunication services and to make recommendations to the Federal Government on policies with respect to international telecommunications.

In exercising its functions and powers under the Act, the authority shall ensure that rights of licensees are duly protected and all of its decisions and determinations are made promptly, in an open equitable, non discriminatory,

consistent and transparent manner. PTA will also ensure that the persons affected by its decisions or determination are given a due notice thereof and provided with an opportunity of being heard.

4. 6 Stat Bank of Pakistan (SBP)

Before independence on 14 August 1947, the Reserve Bank of India (Central Bank of India) was the central bank for what is now Pakistan. In May, 1948 Quaid-a-Azam took steps to establish the State Bank of Pakistan immediately. These were implemented in June 1948, and the State Bank of Pakistan commenced operation on July 1, 1948.

Under the State Bank of Pakistan Order 1948, the state bank of Pakistan was charged with the duty to “ regulate the issue of bank notes and keeping of reserves with a view to securing monetary stability in Pakistan and generally to operate the currency and credit system of the country to its advantage”.

A large section of the state bank’s duties were widened when the State Bank of Pakistan Act 1956 was introduced. It required the state bank to “ regulate the monetary and credit system of Pakistan and to foster its growth in the best national interest with a view to securing monetary stability and fuller utilization of the country’s productive resources”. In February 1994, the State Bank was given full autonomy, during the financial sector reforms.

On January 21, 1997, this autonomy was further strengthened when the government issued three Amendment Ordinances (which were approved by the Parliament in May 1997). Those included were the State Bank of Pakistan Act, 1956, Banking Companies Ordinance, 1962 and Banks Nationalization Act, 1974. These changes gave full and exclusive authority to the State Bank

to regulate the banking sector, to conduct an independent monetary policy and to set limit on government borrowings from the State Bank of Pakistan.

Further, The State Bank of Pakistan performs both the traditional and developmental functions to achieve macroeconomic goals. The traditional functions, may be classified into two groups:

1. The primary functions including issue of notes, regulation and supervision of the financial system, bankers' bank, lender of the last resort, banker to Government, and conduct of monetary policy.
2. The secondary functions including the agency functions like management of public debt, management of foreign exchange, etc., and other functions like advising the government on policy matters and maintaining close relationships with international financial institutions.

The non-traditional or promotional functions, performed by the State Bank include development of financial framework, institutionalization of savings and investment, provision of training facilities to bankers, and provision of credit to priority sectors. The State Bank also has been playing an active part in the process of islamisation of the banking system.

CHAPTER 5

Review of the Competition Regulation Authorities

In the first part of this chapter, a global review of the principles and achievements of the competition regulatory authorities is presented. Second part of this chapter is dedicated to the performance review of the Competition Commission of Pakistan (CCP) including the background, achievements and failures.

5. 1 Review of the Global Experience:

Laws governing competition are found in over two millennia of history.

Roman Emperors and Medieval monarchs alike used tariffs to stabilize prices or support local production.

Modern competition law begins with the United States legislation of the Sherman Act of 1890 and the Clayton Act of 1914. While other, particularly European, countries also had some form of regulation on monopolies and cartels, the US codification of the common law position on restraint of trade had a widespread effect on subsequent competition law development.

A general overview of the differences between American and European monopolization laws revealed that American courts have taken a relatively conservative approach toward monopolization law, in the sense of showing reluctance to penalize a firm simply because of its monopoly status, and of allowing wide scope, at least at the level of pure legal doctrine, for efficiency defenses to be asserted. Europe, in comparison, has taken an interventionist approach.

Global Reviews of Empirical Evidences of Perceived Benefits

1. In Australia[4], a study conducted by OECD, estimated an increase of AS 7000 per annum in the average house hold income due to the imposition of competition laws. Another study, in 2005 estimated a gain of about 5. 5 percent of the GDP due to the laws.
2. In New Zealand and U. K, it has been claimed in different studies that an average increase of 2. 5 percent in the employment rate could be attributed to the efficient implementation of anti-trust laws during the period of 1978-98.

3. In USA, during the decade of 90's, estimated gains from decentralization of cartels and large industries had resulted in about 4 percent per annum increase in the productivity of these industries.

5. 2 Competition Commission of Pakistan (CCP)

Competition Commission of Pakistan (CCP) was established on 2nd October, 2007 under the Competition Ordinance, 2007. Major aim of this Ordinance is to provide for a legal framework to create a business environment based on healthy competition towards improving economic efficiency, developing competitiveness and protecting consumers from anti-competitive practices.

Monopolies and Restrictive Trade Practices (Control and Prevention) Ordinance' (MRTPO) 1970

Prior to Competition Ordinance, 2007, Pakistan had an anti-monopoly law namely ' Monopolies and Restrictive Trade Practices (Control and Prevention) Ordinance' (MRTPO) 1970. The Monopoly Control Authority (MCA) was the organization to administer this Law.

5. 2. 1 Reasons for the Establishment of CCP

Upto the year 2006, Monopoly Control Authority was performing its functions under the auspicious of the MRTPO, 1970. But in the fast changing global and national economic environment, government and policy makers started realizing that the MRTPO, 1970 was inadequate to address competition issues effectively. Many reasons have been quoted in the literature regarding the incapability of MPTRO to handle the new scenarios of economic fronts. Few of them were

i) the 1970's law was out of date for a modernizing and rapidly transforming market economy;

ii) due to several limitations to check horizontal cartelization in the law, the MCA was not able to meet the expectations of businesses and the consumers at large;

iii) first generation reforms that liberalized the economy and unleashed the power of the private sector required a competition policy framework that could promote and protect competition and innovation.

Considering the above, Government of Pakistan launched a program to develop Competition Policy as a key “ second generation reform” initiative. Towards this end, the Ministry of Finance and the MCA worked with the World Bank and the Department for International Development (DFID), UK. As a result of these efforts, Competition Ordinance, 2007 replaced the MRTPO.

Competition Ordinance, 2007 considers the current economic realities as well as corrects the deficiencies of the MRTPO related to definitional aspects, coverage, penalties, and other procedural matters. The law seeks to prohibit abuse of market dominance, certain types of anti-competitive agreements, deceptive market practices, and mergers of undertakings that substantially reduce competition. This is combined with major emphasis on advocacy role of the Commission to promote voluntary compliance and to give a ‘ competition face’ to micro and macro-economic policies.

An important aspect of the new law was the use of ‘ carrot and stick” approach that made it at par with the modern competition regimes. The law provides for higher fines combined with imprisonment for non-compliance; on the other hand, sophisticated leniency provisions that may eventually

lead to no fines and imprisonment, subject to certain conditions. To maintain high standard of evidence for unearthing secret cartels, the Competition Commission has legal powers to conduct searches and inspections’.

Promulgation of Competition Ordinance, 2007 and establishment of a credible Competition Commission will go a long way to develop, competition culture and conducive environment for business activity in Pakistan.

5.3 Achievements / failures of CCP

It may be recalled that the commission has in the less than last two years of its existence moved against cartelization in various sectors, collusive tendering, abuse of dominance, unacceptable concentrations, and deceptive marketing practices. The parties affected include several banks, cement companies, the largest refinery, the stock exchanges, cellular companies, a leading business school, a government sponsored trust, several newspapers, a professional association, and two fertilizer companies held by an army trust and sugar mills. Commission has been conducting competition impact assessment of 15 leading sectors of economy.

The laws governing the regulations and workings of CCP enable it to proceed on methodological basis against any of the sector to check the possibilities of collusion. The sectors so far under analysis included fertilizer, sugar, civil aviation, banking, vegetable ghee, auto parts manufacturing, automobile, wheat, cement, drinking water, educational institutes and textile sectors.

Although CCP has been playing a pro-active role in investigating the abuse of dominance position by market leaders in almost all sectors of the economy,

yet the inquiry reports and interventions made by the CCP in the cement and fertilizer manufacturing sector, civil aviati