

**Barriers to entry and implications for competition policy**

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**Abstract**

Competition requires rivals. While this rivalry may come from imports, the development of local capabilities and productive capacity, including by black industrialists in the South African context, implies understanding barriers to entry for local producers. Barriers to entry are also critical for the correct balance between the risks of over- and under-enforcement and are one reason why it has been recommended that countries should adopt different standards for competition evaluation. This chapter draws on studies of barriers to entry in different markets in South Africa to consider the nature and extent of these barriers and the implications for competition policy. It highlights issues related to regulatory barriers, consumer switching costs and branding, routes to market, vertical integration, as well as economies of scale and access to finance.

**JEL classification**

**L1, L5, L52**

## 1. Introduction

The way the economy works in terms of microeconomic outcomes is the product of many small decisions and some big ones. There are also 'non-decisions', where the established trajectory continues because no decisions are taken to change its direction.

This chapter draws on a series of studies of barriers to entry to markets in South Africa to consider the nature and significance of the range of often mutually reinforcing microeconomic factors which stack-up to block greater participation in the economy by people as entrepreneurs/producers. Taken together they warn against the temptation to look for a 'silver bullet' and instead highlight the need for concerted action across different fronts to alter the economic landscape. For example, finance is often highlighted as the main block to new businesses and, indeed, the sunk investments required to get commercially viable enterprises off the ground means finance obviously matters. But, providing development finance without addressing the other barriers to effective entry is likely to be a waste of money.

It is evident that major changes are needed in the trajectory of the South African economy. The existing structure of ownership and control excludes the majority and provides ammunition for those who argue that in reality the only way to gain access to wealth is through corruption and rent-seeking. Competition law has broken-up cartels and achieved lower prices for consumers but it has largely not opened-up markets to smaller firms such that they have the possibility to become effective competitive rivals.

While the high levels of inequality, poverty and unemployment clearly require actions which extend far beyond the scope of this contribution, there are important debates about competition and inequality. Meaningful access to economic opportunities through reducing barriers and proactively supporting rivals can play an important part in changing the structure of the economy.

The structure of the economy and barriers to entry and growth are relevant to inequality.<sup>1</sup> A lack of competition means entrenched incumbent interests can continue to earn high profits with low levels of investment and little effort and innovation. Dominant firms may be able to entrench their positions and the supra-competitive rents being earned, creating long-term problems in the performance of the economic system (Geroski and Jacquemin, 1984: 22). Baker and Salop (2015) have argued that a more permissive stance to dominant firms (specifically in the USA) has increased the prevalence of market power and its exertion, with the returns going largely to the wealthy.

A productive and inclusive economy means that effort, innovation, and creativity are rewarded. Put differently, competition is fair. Performance competition means competing on offerings to consumers based on production capabilities rather than 'handicap competition' where firms seek to undermine their rivals (Gerber, 2010). Improved production capabilities result in increased productivity, improved quality and design of better products. However, along with persistent and extremely high levels of concentration South Africa has had poor productivity performance over the past two decades (see also Aghion et al, 2008).

Competition law and policy is about setting the rules for the market economy and the rules can be changed in order to shift the balance in favour of different outcomes, such as constructively opening up markets. It is not simply limited to enforcement against egregious offences such as hard core cartels that can be compared to racketeering or fraud. It also does not mean arbitrary actions against companies. The issue is whether the current rules mean

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<sup>1</sup> See North et al. (2009) on elements of creating 'open access orders', Acemoglu and Robinson (2012) on inclusive instead of extractive growth and Stiglitz (2015) on the need for more and better regulation of banks and monopolies. Of course, there are many contributors to inequality, including inherited wealth which is of great relevance in South Africa (see Orthofer, 2016).

the economy rewards effort, innovation and creativity. In economies with higher levels of concentration and less robust competitive self-righting mechanisms (such as higher barriers to entry) stronger policies may be required towards abuse of dominance (Vickers, 2007; Brusick and Evenett, 2008). The balancing of the probability and costs of over and under enforcement (Type 1 and Type 2 errors) implies that different stances should be adopted across countries because of their different characteristics (Evans, 2009).

The competitive market mechanism should be evaluated in terms of its accomplishments in promoting individual freedoms (to produce, develop productive capabilities, and make autonomous choices), as opposed to the conventional framework of welfarist assessment (Sen, 1993). Sen distinguished the 'opportunity aspect' relating to the range of choice, and the 'process aspect' which includes decisional autonomy not restricted by interference from others (Sen, 1993). Each of these is directly relevant for the choices made regarding competition provisions. With direct reference to competition law, Atkinson (2015) argued that competition policy should explicitly take distribution into account, both for fairness considerations and because it will mean a more dynamic economy. Salop and Baker (2015) adopt a similar position, recommending a rebalancing of the standards used to judge dominance and its abuse, and that inequality be a goal of antitrust.

In assessing barriers to entry, the studies drawn on here generally considered commercial businesses which do have the product and service offerings necessary to be competitive, but which face barriers in being able to effectively compete. The rivals' offerings need not be identical to the incumbent. Indeed, one of the important values of opening markets to competition is to enable entrepreneurs who are in touch with the preferences of important groups of consumers to bring to market products and services customised to these preferences. For example, in supermarkets the new rival Fruit & Veg City recognised the gap and provided an offering which emphasised seasonal local produce at substantially lower prices without the uniformity of appearance and packaging being adopted in the main supermarket chains.

The studies cover telecommunications, banking, airlines, supermarkets, agro-processing, liquid fuels, renewable energy and beer.<sup>2</sup> In some studies there was as focus on entry at a particular market level or segment while others, such as telecommunications and agro-processing, reviewed developments more broadly across the sector. The relevant competition cases in each area were reviewed as part of the studies.

The different types of barriers to entry and growth are considered in sections 2 and 3, drawing from the studies. Section 4 then considers evidence on the gains from competition and how important entry barriers are, before section 5 considers what can be done to address these obstacles and change the path of the South African economy.

Perhaps unsurprisingly, the insights emphasise the need to make improvements across a number of areas which together will make a big difference, but individually will likely have little impact. While entrenched incumbents is the broad picture which emerges there are important examples of entry and growth, some of which have been covered in the studies. Others include the impact of Sephaku's entry in cement, truly a case of an African industrialist (Dangote of Nigeria is the major investor) and one which has, combined with the ending of a cartel, reduced cement prices by a substantial proportion making housing provision more affordable (as discussed in section 4).

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<sup>2</sup> The majority of the studies were supported with funding from National Treasury being firm-level studies of entry experiences (Capitec, Fruit & Veg City, Soweto Gold, low cost airlines) and sector studies of telecoms and agro-processing (see <http://www.competition.org.za/barriers-to-entry/>). CCRED has also undertaken studies of liquid fuels, mobile money and renewable energy (Paelo et al. 2014; Robb and Vilakazi, 2015; Montmasson-Clair, 2014, and Montmasson-Clair and das Nair, 2015), which are drawn on here.

## **2. Routes to market, consumer awareness and switching costs**

What constitutes entry barriers remains a contested area in economics. Carlton and Perloff (2004) following Stigler (1968) define barriers as costs incurred by an entrant which were not incurred by the incumbent. This allows for substantial advantages where the incumbent was able to recoup its investment costs while the prospective rival incurring the same costs is likely to be deterred, including because of possible strategic behaviour by the incumbent. From the point of view of outcomes we are interested in situations where an incumbent is able to make supra-competitive returns (with possibly very large efficiency losses for the economy) unthreatened by likely entry (Gilbert, 1989).

Sunk costs are typically considered as barriers as these are costs which cannot be recouped if entry fails. Some sunk costs are exogenous, incurred due to the nature of the product and the set-up costs required to produce at minimum efficient scale. Other sunk costs are influenced by the incumbent such as the level of spending on advertising.

Our studies highlighted that, in practice, there are a range of barriers to entry relating to the ability to reach consumers which are not well appreciated. These barriers are due to the fact that manufacture of the good or supply of the service is often only the first step. It is critical that the business must be able to distribute and retail to consumers where many obstacles may exist.

Studies of consumer behaviour have highlighted the importance of perceptions and brand awareness, as well as the (in)convenience in switching (see Mehta, 2013). The behaviour of consumers provides the justification for advertising which can be a very large and sunk cost which needs to be incurred in order to enter effectively, building the necessary brand awareness. Consumer inertia is substantial, including due to information asymmetries and convenience. Recognising the knock-on costs this implies in terms of weaker competition (and the potential exploitation by incumbents) is to realise the potential benefits from proactive interventions. Related to consumer behaviour and advertising are the costs associated with packaging, promotions and display. We consider insights from the studies relating to barriers in retail and distribution, and network industries.

### ***Retail and distribution***

Supermarkets and distribution arrangements quite literally shape the routes to market for products. For supermarkets themselves there are also questions of entry barriers. The study of supermarkets (Das Nair and Dube, 2015) highlighted the importance of location in appealing to consumers. Transport costs and time can be reinforced by habit and convenience which means consumers gravitate to shopping malls. In South Africa exclusive leases have blocked rival supermarkets as well as grocers, bakeries and butcheries from shopping malls. Such leases are a straightforward block to entrants in accessing potential markets and mean they have to look at alternative and inferior locations.

The justification for exclusive leases is that they support investment in shopping malls as they ensure an anchor tenant. This applies in some locations and for a period, but not to support the ubiquitous practice for durations that last decades. It is also not clear that it justifies outright exclusivity as opposed to long-term leases for prime space in a given mall.

National supermarket chains command advertising space and seek to channel footfall through promotions even while the price of the supermarket 'basket' is not necessarily cheaper. Lower prices of promotional products (or 'loss-leaders') may be outweighed by the other items a consumer purchases once having been attracted to the store.

For producers of consumer goods such as food products, the costs of packaging, advertising and display can be very large and are important for establishing brand awareness. For agro-processing companies the ability to access the major supermarkets is an important

consideration (Ncube et al, 2016). There are a number of practices which make it difficult for smaller brands to establish a presence, including category management practices of supermarkets where the organisation of a set of products in the supermarket is handed over to a lead supplier. For example, in milling products the smaller rivals struggled to get space on shelves and the 'gondola ends', the special displays at the end of rows which have much greater visibility and are exclusive to one supplier.<sup>3</sup> One of the most important aspects of the support to smaller suppliers agreed as part of the Walmart/Massmart merger has been the shelf-placement of these products ensuring consumer awareness.

The example of beer, as a consumer product, highlighted the advertising and promotional costs required to establish a brand and the scale economies associated with advertising expenditure which does not necessarily increase proportionate to sales but is necessary at low sales to establish the product in the market (Matumba and Mondliwa, 2015). Beer also has to be in fridges/coolers in taverns and bars, on draught (on the bar top), for consumers to buy it. The same applies to other products, such as cool drinks, as well as more broadly to display space in outlets. Exclusive arrangements typically in place mean that small rivals are shut-out from a large number of outlets. In some countries competition enforcement has addressed this, however, the South African Act requires demonstrating a *substantial* lessening or prevention of competition which has been interpreted as showing that there would have been lower prices and higher quantity supplied in the market in the absence of the conduct. Small rivals can often not prove their product would be cheaper and there would be more supply to the market as a whole, while large firms claim their conduct aids the efficiency and lowers costs in their own supply chain.

It is notable that mergers have addressed the participation of small local suppliers in value chains in at least three major transactions, but under public interest rather than competition concerns: Walmart/Massmart, Coca-Cola/SABMiller and AB-InBev/SABMiller.

### **Network industries and utilities**

Network effects mean there are natural first-mover advantages as consumers value the number of members a network has. This is reinforced where investment is required in the extension of network infrastructure such as ATMs and branches in banking and mobile phone masts in telecommunications. Regulation to ensure inter-operability and the terms on which this happens is critical for there to be effective competition in such industries.

Banking services require people being able to obtain cash and make payments and the study of Capitec's entry (Makhaya and Nhundu, 2015) found branches and an ATM network remain critical in South Africa. However, allowing cash back at point-of-sale (supermarket tills), as has been possible for a number of years, means an ATM network can be by-passed while mobile payments opens up opportunities to use more cost effective solutions and points the way to substantially cheaper 'branchless banking' models.

In banking switching costs are also significant and consumers do not readily switch to rivals even where they may be offering cheaper prices and better products and services. Consumers find it difficult to compare bank charges and services across banks, and banks spend large amounts on advertising their brand simply to establish and maintain their reputation.

In Capitec's case it is notable the company first they attracted customers to micro-loans, while customers retained their own bank account if they were already banked. Customers were only converted to also use banking services once becoming familiar with Capitec through the loans. The very long time it took Capitec to be an effective rival is also significant, with very little progress from 2001 up to around 2008, before the take-off thereafter. In many respects it appears to be the exception that proves the rule. It had a banking licence from its parent while

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<sup>3</sup> These are also paid for by the supplier.

other potential entrants have had their licence applications turned down. It also benefitted from the reputation of its main owner. And, it had a base of micro-loan clients. Even with all of these advantages it struggled to gain a foothold and took around ten years to make a meaningful competitive impact.

There are also substantial network effects and switching obstacles in telecommunications. This is reinforced by large promotions and advertising expenditures which arguably obscure rather than assist in understanding the range of options of offer. Customer inertia can be compounded in mobile telecommunications by network operators which can make the switching process difficult and inconvenient even while number portability has been enforced. This has been compounded by a range of strategies targeted at contract customers, in which Cell C's share is much smaller than in pre-paid, despite MTN and Vodacom's prices being substantially higher in contract customers (Hawthorne et al., 2016). There are a range of strategies such as on-net discounts which firms can use to lock-in the network effects which operate in telecoms.

In electricity supply, access to market has been an important obstacle for renewable energy independent power producers who require access to the grid to be able to sell the power generated (Montmasson-Clair and das Nair, 2015). There have been concerns around Eskom's incentives to undermine independent generators which led independent power producers to seek guarantees from National Treasury. These concerns appear to have been born out over time.

Control over critical marketing and distribution infrastructure has also been a concern, excluding smaller grain traders and undermining smaller millers' ability to compete. A few large traders dominate South African markets, one of which has been found to have abused its dominance in silos to benefit its trading arm (Ncube et al, 2016). The way the silos and the futures exchange (SAFEX) operate means that substantial deposits are required to be able to trade (reportedly of R1mn for accessing silos).

The existence of critical infrastructure and facilities, along with network effects, are rationales for regulation to ensure competition. Regulation can, however, itself can be a barrier, such as where onerous licencing conditions block entry. In banking, applications for licences from major supermarkets and telecommunications firms appear to have been turned down. Similarly, banking regulations have prevented the growth of mobile money transfer by mobile network operators. Ineffective regulation has also played an important part. This is where some potential improvements can be made quite quickly, such as in the area of telecommunications, as we discuss below.

### **3. Scale economies, learning effects, time to build footprint, reach scale and patient capital required**

Economies of scale and scope apply where there are fixed costs (and common costs in the case of multi-product firms), being costs which do not increase proportionately with output. The larger the scale of operation the lower are average fixed costs. Strictly speaking these may not be entry barriers as a firm can enter at a size which reaches minimum efficient scale if it can raise the finance to do so. However, financial market imperfections mean that entrants who are potentially efficient competitors are unlikely to raise the capital required for large-scale entry at the outset. These imperfections impact most where there are potential competitors with a strong proposed offering, not yet proven, and yet little finance of their own. A proportion of the costs are likely also to be sunk meaning they cannot be recovered if the firm exits.

Scale and scope effects further mean that strategies can be employed by incumbents to undermine the rival's access to segments of market demand such as to ensure the rival operates at below installed capacity, so raising its average costs. This can prevent a potentially efficient competitor from becoming an effective competitor in practice. The smaller rival is

challenged under the competition law tests in South Africa to demonstrate what would have been the case. Larger rivals, such as entrants from an adjacent market, are better placed to be able to show what might be. However, the record is that coordination (whether explicit or tacit) has been widespread meaning that it is precisely the smaller maverick firms which may be required to bring effective competitive rivalry.

Economies of scale have been highlighted as important across the studies. These effects are obviously very large in mobile telecommunications and retail banking. In supermarkets there are large scale effects in distribution, in particular, the investment in distribution centres. It is estimated that supermarkets can obtain cost savings of up to 10% from suppliers in the form of distribution allowances, warehousing allowances and pallet discounts when goods are sold to a supermarket's distribution centre rather than direct store deliveries. Independents have been able to overcome this to an extent through buying groups, while fresh produce markets also play an important role.

In manufacturing activities such as dairy, poultry and beer, there are economies of scale in processing and packaging facilities. In poultry these effects are greatest in breeding and abattoirs which means independent broiler producers may be subject to market power at different levels of the value chain. In dairy production, the processing of value-added products necessary to diversify away from being reliant only on commodity milk production requires larger scale investments (in powdered milk, yoghurts and cheese).

Scale effects are smallest in airlines. Interestingly, it is also in this sector that the most overt anti-competitive strategies have been sanctioned under the competition law.

It is important to appreciate that building competitive capabilities is more than simply attaining minimum efficient scale and also involves a learning-by-doing process. This refers to the range of internal practices and knowledge which need to be developed to operate efficiently. It is also necessary to take into account the building of external relationships for supply, such as building a distribution and retail footprint. As with economies of scale and scope, these are not barriers in their own right but reinforce existing advantages of incumbents and provide opportunities for them to undermine entrants.

For example, in poultry, the systems and flow of production (from breeding stock at great-grandparent, grandparent and parent levels, through to broilers) means it takes three years or more to become competitive. This is reflected in the experience of an entrant (GFC), which was already vertically integrated into the production of the main components of feed. The incremental building of capabilities by Soweto Gold highlights a similar need for 'patient' finance to support the growth of brewing, packaging and distribution over a number of years. Industrial policies and long-term development finance are required to support the development of productive capabilities.

The experience of Capitec suggests the time period in banking is more in the order of a decade (Makhaya, Nhundu and Guma, 2015). Similarly, while we talk of Fruit and Veg City as an entrant it is important to remember it started in the early 1990s and took close to a decade before it could make a significant impact, and then start moving to the supermarket format in the form of Food Lovers Market (das Nair and Dube, 2015).

### ***Vertical integration***

Vertical integration is another reality which is emphasised in a number of the case studies. An entrant at just one level of the supply chain is reliant on their integrated rivals for key inputs and/or key markets. Again, this provides incumbents with a potential lever over entrants and smaller rivals to undermine them. Alternatively, the rival has to enter simultaneously at the different levels as a vertically integrated operator, significantly increasing the entry costs.

In poultry, the successful entrants have been those operating in feed and/or the supply of breeding stock which then move downstream into broiler production. Competition cases have addressed restrictive vertical arrangements where these have undermined rivals.<sup>4</sup> However, it is notable that, while vertical integration provides a possible anti-competitive lever, full vertical integration in poultry does not appear necessary for efficient production as a more competitive market has seen vertical dis-integration of some companies and a focus on core competencies.

In telecommunications, the failure to implement local loop unbundling mean rivals to Telkom in delivering fixed line services, such as 'value-added network services' (VANS), have been dependent on the incumbent and main rival (Hawthorne et al., 2015). The slow moving Telkom has undermined entrepreneurial activity across a range of these services. Long-running competition cases have slowly unlocked parts of these activities. Similarly, Eskom's integration has, as noted above, proved a major obstacle to independent power suppliers. While there may be good arguments in theory for integration, in practice, it has undermined investment in alternative sources of generation. A state-owned transmission and distribution system could act in the public interest to support upstream investment in generation of renewable energy.

Vertical integration into distribution and restrictive practices at retail level has been highlighted above as being potential obstacles to rivals in beverage supply.

#### **4. What are the gains from competition and how important are the barriers?**

In the studies undertaken here, the success of some entrants points to the magnitude of the effects through simple 'before and after' assessment. The impact of entry indicates what is at stake if entrants are blocked or undermined, as well as pointing to the much greater benefits that could have been realised if entry had been earlier and wider in reach.

The impact assessments of cartels around the world have typically found mark-ups of 15-25% over what a competitive price would be.<sup>5</sup> Higher mark-ups have been found in several South African studies.<sup>6</sup> This does not take into account the effects on quality and variety, nor does it place any value on the benefits to the economy of wider participation in terms of production.

It is worth remembering that the point of a cartel from the perspective of its members is to behave like a monopoly (or a dominant firm with substantial market power). Several of our studies have considered where dominant incumbents have substantial unilateral market power while others have found that entry barriers have shielded a small group of 'insiders', who tacitly coordinate or at least do not vigorously compete with each other, from competition.

The studies suggest similar orders of magnitude of benefits from competition from entrants to the benefits from cartels being ended. In other words, increased competition from entrants means substantially better prices for customers, as the benefit of the entrant is felt in the lower prices and better service that results from the incumbent(s). In services (banking, telecoms) which are at the core of economic activity the benefits brought by more effective competition from entrants imply very wide-ranging effects on economic participation. And, while changes to bring more competition have brought improvements, the point is that these could have been earlier and bigger. Even apparent success stories such as firms with the advantages of Capitec and FVC took a substantial period (around a decade or more) to get to the market presence where they had a material impact. The experiences also point to the much wider impacts which could be realised.

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<sup>4</sup> Such as the settlement of the case against Astral.

<sup>5</sup> See the papers by Connor which draw together studies from around the world.

<sup>6</sup> Khumalo et al. (2014), Mncube (2013 and 2014).



Capitec's existence as an effective rival has realised major savings for consumers as average bank charges on the lowest priced bank account came down by around 40% in nominal terms from 2010 to 2014, with estimated annual saving of close to R20bn in 2014 when compared against 2010.<sup>7</sup> It has also stimulated the extension of services to the previously unbanked and, as such, increased financial inclusion.

Similarly, in telecommunications both in mobile and fixed line services, the greater competition in recent years highlights just how damaging the blocking of entrants has been. South Africa's broadband has been poor and expensive and is becoming more so relative to our peers. The reduction in mobile call termination rates through enabling Cell C to be a more effective competitor induced the two lead MNOs to reduce rates, with blended average retail prices for Vodacom and MTN more than halving from 2010 to 2015 as lower call termination rates meant network effects were reduced and Cell C could compete more effectively (Hawthorne, 2016). This realised a consumer saving estimated to total R47bn from 2010 to 2015, just for the subscribers of Vodacom and MTN. There has also been a strong response in terms of much greater telecoms usage. Again, the effect of changes to ensure that the small rival could be a more effective competitor is felt in the response induced from the incumbents.

The impact of FVC is more difficult to quantify, however, it is evident that it provided a cheaper basket of products and a wider range of choice. Each person who elected to shop at FVC was obtaining lower priced food than they would otherwise have done (including because they were now able to conveniently source fresh produce which may have been a lower perceived quality). There have been large benefits also in the response from the major chains. FVC is reported to have been able to sell fresh fruit & vegetables at 20-25% lower prices than the national chains due to direct procurement from the municipal markets and cost containment measures. The implication is greater demand and market opportunities for farmers.

In agro-processing, Lethabo milling undercut the main maize meal brands by 35% when it first entered, although it is not clear if this price effect will be sustained. The entry in poultry of CBH after a competition case ensured it could bring in a new breed (effectively being an entrant at that level of the value chain) led to around R1bn of consumer savings per annum relative to the previous years, as margins were reduced implying a previous mark-up of around 7%.

In airlines, the entry of rival carriers has been found by the competition authorities and the courts to have brought savings to consumers, which were undermined by SAA's anti-competitive conduct.

In liquid fuels, rivalry from independent traders has seen discounting on diesel prices at pump as well as to commercial customers such as road hauliers. In beverages, rivalry in beer has been very limited, as entrants have largely failed to break into the mainstream market. In soft drinks, the potential competitive significance of smaller independent producers was recognised in the public interest remedies in the Coca-Cola/SABMiller merger.

The renewable energy independent power producers programme brought about significant learning over time and lower prices for power to be supplied by these generators.

It appears that while the ending of cartels in concrete pipes (Khumalo et al, 2014) and cement (Govinda et al. 2016) brought lower prices, entrants had a further substantial impact. In the case of cement, the estimate of cartel mark-ups range from 7.5% to 9.7%, based on data from 2008 to 2012, with the cartel ending with the dawn raid towards the end of 2009. Nominal producer prices increased negligibly over 2013. However, the entry of Sephaku cement and commercial production coming onstream in the first half of 2014 saw prices fall in real terms by a further 10% from January 2014 to June 2016, suggesting the mark-ups under the cartel

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<sup>7</sup> Makhaya and Nhundu (2015), see figure 13.

when compared to effectively competitive levels where firms are investing in improved facilities may be closer to 20%.<sup>8</sup>

The impacts of entry on market prices and outcomes highlight that the value of support to entrants and smaller rivals is much greater than the revenues earned by these firms. This is not just the case in terms of price. There can also be a huge impact in terms of different business models, products and services being introduced by entrants. This is a further argument for development finance for entrants, which takes greater risks than would be commercially justified.

The importance of nurturing more effective competition has been recognized in actions in other countries also. For example, the UK is working to support 'challenger banks' to bring greater rivalry to the big four established banks in that country.<sup>9</sup> This includes proactive measures to enable easier switching by consumers. The interventions illustrate the value of providing independent information on the comparability of offerings (such as price comparison websites for bank charges) and regulating *for* switching, with penalties if firms are obstructive.

## **5. What can be done, by whom?**

A critical insight is that interventions need to be on a number of fronts as they are mutually reinforcing. Just as the barriers have a cumulative effect, so addressing one area in isolation will make little difference. This is perhaps most evident in the area of finance, long highlighted as an obstacle to entrants. Our analysis indicates that providing development finance to firms without considering the challenges such as routes to market will mean the companies are set up to fail and the funding provided will be lost. A broad raft of complementary measures is therefore required to open up access to markets.

There are a number of rules which determine how markets work. The rules are in the form of national economic regulation (such as banking, telecommunications and energy), the Competition Act, and local regulations such as governing urban planning. These can tip the balance in favour of one side or the other. Incumbents have a natural advantage in shaping the rules in their favour through influencing the terms of the debate and more direct lobbying. Note, this is not about more or less regulation, but different regulation. In some cases regulations blocking entry can be removed, in others, proactive regulation *for* competition may be required given market failures and intrinsic obstacles. For example, it is necessary to ensure entrants have access to essential facilities and to enable consumer switching on a timely and efficient basis.

### ***Supermarkets and routes to market***

The area of retail, and supermarkets, in particular, is so important that it warrants a special focus. Supermarkets are the route to market for a wide range of suppliers. The Competition Commission's market inquiry (underway in 2016 and 2017) is an important opportunity to address the range of issues.

In terms of opening up supermarket rivalry, addressing exclusive leases is critical. This can be through the market inquiry resulting in legally enforceable undertakings by incumbent supermarkets to either not enter into leases with exclusivity clauses, or mandate the reduction of the duration and scope of the clauses in instances where such leases have already been entered into.

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<sup>8</sup> The producer price index for ordinary and extended cement fell from 106.7 in January 2014 to 100.9 in June 2016, while the index for all building & construction (used as a deflator) increased from 110.7 to 115.9 over the same period. It is likely that the entry of Sephaku saw lower prices (below long-term levels) as an entry strategy but not that these would be sustained for two and half years.

<sup>9</sup> <http://www.ft.com/intl/cms/s/0/d2520afa-8b78-11e4-ae73-00144feabdc0.html#axzz3bVko6jM8>

In other countries, measures have been largely put in place under the competition regime. In the UK, the Competition Commission made an order to this effect in its Groceries Market Investigation Order of 2010 following recommendations for an investigation from the former Office of Fair Trading.<sup>10</sup> In Australia, following the inquiry by the ACCC, the major supermarket chains, a wholesaler and other retailers *voluntarily* provided court-enforceable undertakings which phased out exclusive lease provisions over a number of years.<sup>11</sup>

Urban planning by municipalities can have a major impact in ensuring open and flexible retail space and a mix of formats, as well as tackling exclusivity directly through planning policies. In other countries, such as Australia and the UK, urban development has played a key role in opening up markets in retail to wider participation and ensuring competition to incumbents. This requires municipalities to play a role in opening up markets, possibly under guidance from national government and the competition authorities.

The contribution of fresh produce markets in providing market opportunities to both farmers and retailers needs to be fully appreciated. They are an alternative to the private distribution arrangements of the national chains who would otherwise have even greater power as the route to consumers for farmers, and able to extract terms from the exercise of this power. Indeed, the example of FVC and the potential for further expansion of independent retailers indicates that support should be provided to fresh produce markets to expand their position, recognizing the spin-off economic benefits. In simple terms, rivalry from FVC has meant significantly lower prices to consumers and a greater range of options for suppliers.

In more expansive terms, local sourcing targets could be agreed with retailers, with a focus on small and medium manufacturing businesses, learning the lessons from the Massmart Supplier Development Fund. The playing field for smaller players and new entrants can be somewhat levelled by mandating or facilitating voluntary codes of conduct between producers, wholesalers and retailers. From the perspective of small and medium suppliers, such codes of conduct serve to protect them against possible abuse of market power of large supermarkets. This is similar to what has been done in the UK, through the UK's Groceries Supply Code of Practice which stipulates that retailers are required to comply with the Groceries Market Investigation Order of the former Office of Fair Trading. This Code is enforced in the UK by an independent Groceries Code Adjudicator, set up specifically to oversee the relationship between supermarkets and their suppliers and housed within the former OFT.

In Ireland, plans to institute a mandatory Code of Conduct in the grocery sector, to be overseen by the Department of Enterprise, Trade and Employment, led to regulations in 2016.<sup>12</sup> In Spain, a new act focusing on measures to improve the functioning of the food chain was promulgated in 2013 which uses a mixed model of regulation and self-regulation (through voluntary codes of conduct) to govern commercial relations between the agents in the food chain.

### ***Reorienting government support***

The system of incentives for investment by smaller businesses does not appear to be working well. Many firms interviewed in the studies reported that accessing the incentives was time consuming and cumbersome. The firms thus tended to access incentives using consultants for the investments they would be making in any case. The incentives did not change their

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<sup>10</sup> <https://www.gov.uk/government/publications/groceries-market-investigation-controlled-land-order-2010>.

<sup>11</sup> <https://www.accc.gov.au/media-release/further-agreements-address-restrictive-supermarket-leases>

<sup>12</sup> Statutory Instrument No.35 of 2016, Consumer Protection Act 20007 (Grocery Goods Undertakings) Regulations 2016.

decision. There are also obvious linkages between development finance and government incentives which need to be strengthened.

There are a number of factors related to the effectiveness of incentives and the way they impact on competition. Some of the issues are simply to do with the complexity of the programmes and the challenges small firms face in accessing them. In addition, the lessons from the case studies are that a deliberate emphasis should be placed on supporting competitive rivalry and, where large incumbents benefit most from incentives, on clear, monitored conditions which take competition concerns into account. Improved transparency and reducing complexity can also aid in monitoring incentives linked to such conditions.

Second, there is a very important role for local government which may often be overlooked. The access to infrastructure and physical space is a critical aspect of being able to supply goods and services and reach consumers. In the case of telecommunications metros can open up ducts and poles to lower the costs of rivals putting in fibre cables. In retail, the configuration of retail space and planning requirements is potentially a strong lever to ensure that large incumbents cannot lock out smaller rivals. Fresh produce markets have also played an important role in the growth of independent chains and in ensuring they can source from diversified farmers.

### ***Development finance, venture capital, and patient capital***

Financing entry and expansion is a critical part of the puzzle. In particular, the barriers identified above point to the need for 'patient capital' given the time to build the scale and reach required to be competitive in many areas, and the appetite for risk in financing rivals taking on powerful incumbents. The studies also raised the issue of financing rivals at different levels of a value chain.

The ability to take a long-term view is already an important characteristic of the IDC, although more can be done in terms of the IDC's understanding of market and industry specific dynamics and the requirements of smaller businesses. As with the allocation of incentives, it is easier to lend for investments by incumbents which would likely have been made anyway.

A bigger change can be made in providing finance for riskier investments. In this regard, it must be born in mind that increasing competitive rivalry has gains which go far beyond the returns to the entrant. The impact on market prices and dynamism affects customers of all the firms. This suggests support for entrants is warranted where there is a substantial risk involved. The question is how to finance this, and how to evaluate the applications.

On the first, the experience with the funds from the Pioneer Foods competition settlement is a possible model which can be developed. Penalties from competition cases could be channelled into a development finance fund for rivals and entrants, especially black industrialists. This is in line with the objectives of the Competition Act in opening up the economy to participation by all.

In terms of the second question on the evaluation and criteria to be followed, it is important to assess the potential for firms to be effective competitors, with the offering, scale and expertise required. The point is to provide the long-term finance for the necessary learning and capability development. There is learning also in the financing evaluation and monitoring involved. Finance should not therefore be provided to just one or two entrants but to those who meet the criteria, in the recognition that some will inevitably fail but, it is not possible at the outset to predict which, and the contestation between rivals is part of the process.

In addition, it must always be kept in mind that finance, without the complementary measures to address the range of barriers to entry and growth, will not be an effective intervention.

### ***Regulating for competitive rivalry***

The regulatory provisions in network industries such as telecommunications and banking should be changed to favour rivals. In mobile telecommunications regulations can allow for services based competition by Mobile Virtual Network Operators, while ensuring a fair return on the infrastructure investments of the MNOs. Spectrum allocation can be made through transparent auction processes set-up to encourage entrants while raising funds for the firms.

Local regulations at the municipality level can open up basic facilities such as poles and ducts throughout towns and cities to those wishing to cable.

In energy, including electricity and gas, the historic bias has been to the major incumbents on the promise that they would invest and ensure security of supply. This bias has come at a substantial cost. Independent traders and suppliers have been blocked from pipelines and port facilities. In electricity generation, rivals have not necessarily had access to the grid on an equal footing.

### ***Amendments to the competition act***

A country's competition regime can be understood as an 'economic constitution' of a country as it is the high level framework for markets (Gerber, 2010). The South African Competition Act embodied a number of trade-offs which were the result of negotiation of the legislation in Nedlac. The most important of these is the inclusion of public interest conditions in mergers while the abuse of dominance provisions are weaker than, for example, in Europe. The big business negotiating team perceived this as an exchange – a concession being made on one hand (in mergers) to achieve their main objective on the other (weak abuse of dominance provisions).<sup>13</sup>

The alternatives for the abuse of dominance provisions are clear. The European approach, followed by most of the world, is to have an over-arching prohibition of abuse of a dominant position with a non-exhaustive specification of different types of conduct which might constitute an abuse. The EU Guidance on Enforcement Priorities for abuse of dominance sets out steps in determining whether the undertaking(s) are dominant and whether the conduct represents an abuse. The undertaking is entitled to compete 'on the merits' but has a *special responsibility* not to allow its conduct to impair genuine undistorted competition. Individual competitors are not protected but rather the competitive process, and dominant undertakings are burdened with additional responsibilities in this regard.

On the grounds that this would create uncertainty for dominant firms as investors, the South African Act watered this down. The Act specifies particular and discrete forms of conduct which constitute an abuse of dominance and has a catch-all provision for which there is no penalty for a first offence. Moreover, as the Act allows for an efficiency defence by the dominant firm, the Competition Commission will generally have to prove that the conduct had the effect of substantially lessening competition such as to outweigh any claimed efficiency rationales.

Countries such as Japan and South Korea adopted particular approaches to competition in line with their industrial policies. The objectives of the South Korean Fair Trade Commission (KFTC) are to encourage free and fair competition, prevent the concentration of economic power and thereby promote 'balanced development'. This is because the early stages of rapid industrialisation were viewed as 'unbalanced', requiring an active competition policy addressed at dominant firms in that country. The mandate of the KFTC therefore includes evaluating 'unreasonable' practices and 'unjustifiable' restrictions on competition (Fox 2003; KFTC, 2011).

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<sup>13</sup> See Roberts (2000).

The difference in the approach adopted in these countries is well explained by Kyu-Uck Lee (1997, as cited in Fox, 2002), who observes the following regarding competition law and policy in Korea:

‘Competition is the basic rule of the game in the economy. Nevertheless, if the outcome of competition is to be accepted by the society at large, the process of competition itself must not only be free but also conform to a social norm, explicit or implicit. In other words, it must also be fair. Otherwise, the freedom to compete loses its intrinsic value. Fair competition must go in tandem with free competition. These two concepts embody one and the same value. This may be the reason that competition laws of several countries such as Korea and Japan clearly specify ‘fair and free competition’ as their crown objective...

...[I]n a developing economy where, incipiently, economic power is not fairly distributed, competition policy must play the dual role of raising the power, within reasonable bounds, of underprivileged economic agents to become viable participants in the process of competition on the one hand, and of establishing the rules of fair and free competition on the other. If these two objectives are not met, unfettered competition will simply help a handful of privileged big firms to monopolize domestic markets that are usually protected through import restrictions. This will then give rise to public dissatisfaction since the game itself has not been played in a socially acceptable, fair manner.’ (emphasis added)

The choices can be simply framed as follows.

- ***Does the law address harm to the competitive process or just the effect (interpreted as outcomes) of competition?***

The South African law provides for effects-based tests, while harm to the competitive process implies valuing participation and the intensity of actual and potential competition in its own right. The latter approach implies wording such as the lessening, prevention and distortion of competition would be used. The South African Act effectively privileges as complainants large rivals (likely to be multinational firms) who are able to demonstrate a significant effect. Potentially efficient smaller firms have little, if any, chance of demonstrating a significant effect. The participation of this class of rivals has no merit in itself (due to e.g. bringing different choices to consumers) and, by their nature, they will probably grow incrementally and are likely to enter through targeting a market or consumer segment and hence not be impacting across the market. They will also not achieve cost efficiencies until they reach minimum efficient scale. As *potentially efficient* competitors, the effects are speculative.

- ***Do anti-competitive effects have to be substantial?***

In examining the (possible) anti-competitive effect, is it specified as ‘substantial? This has been interpreted as requiring demonstration that prices would be lower and quantities supplied would be higher absent the conduct.<sup>14</sup> Or, are the effects also understood in qualitative terms such as the range of choices on offer to consumers, and whether competition has been distorted in blocking rivals without due justification? In many other countries, the test is not subject to the additional hurdle of substantial, meaning simply an implied test of materiality (or at least non-trivial).

It should be noted that an approach which adopts the restriction, prevention or distortion of competition as a standard does not mean efficiency-enhancing restrictive arrangements are outlawed. Rather, arrangements which undermine the competitive process have to be justified.

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<sup>14</sup> See the Competition Appeal Court decision in SAB case (Case 129/CAC/Apr14), para 50 and 60.

The difference this makes is perhaps most evident in considering issues such as exclusive supermarket leases in shopping malls and distribution and display arrangements (for soft drinks and beer). These arrangements can distort competition by completely blocking rival retailers from shopping malls, and rivals suppliers from display in small outlets. However, the Competition Commission in South Africa would have to show that the anti-competitive effect is substantial. In other countries, the 'prevention, restriction or distortion of competition' test means the onus is on the firms to prove how long and the nature of exclusivity that is required for the efficiencies claimed. The implication has been that in a number of jurisdictions including Europe, Chile, Mexico and Singapore the competition law has opened up fridge/cooler space to rivals in soft drinks and beer, and exclusive arrangements regarding retail space and land have been curtailed.

The introduction of the market inquiry provisions in South Africa do provide for assessing the prevention, restriction or distortion of competition but there are no binding actions or sanctions that result from inquiries. Follow-through by other branches of government with relevant powers is critical. For example, urban planning can impact on supermarket location and rivalry.

## **6. Conclusions**

The South African economy has been characterised by widely observed high levels of concentration and low productivity. The dynamism that should come from entrants and smaller challengers with different business models and improved products and services has been lacking. Unfortunately, the studies highlight that when big decisions have been made regarding regulation they have generally gone along with the interests of the large incumbent(s). This has sometimes been linked to a black economic empowerment 'quid pro quo', where the state continues to protect the incumbent in exchange for more black suppliers or shareholding. This in fact reinforces the dominant firm or firms' power, as it is entrenched as the gateway to opportunities. Other interventions to open-up markets have been piecemeal and unsurprisingly have had little impact.

In addition to the effects of scale and network economies, the studies highlighted the importance of routes to market and consumer behaviour. Retail and distribution arrangements, including supermarkets, play a critical role in the ability of suppliers to access customers. Coupled with consumer inertia this means new entrants and smaller firms have to incur high costs to build brand awareness and market presence no matter how good their products are. Vertical integration compounds the challenges facing entrants while regulation of sectors such as telecommunications has not assisted rivals seeking to enter at one level and being dependent on incumbents for network services.

To open-up access to the South African economy three main areas need to be addressed. First, the *ex ante* 'rules of the game' in the form of economic regulation need to favour entrants and ensure incumbents can be effectively challenged. For example, steps taken in liquid fuels should be built on to enable independent suppliers access to key facilities. In telecommunications, the allocation of spectrum should take fostering greater rivalry into account, while local governments can open up ducts and poles to rival providers. In finance, regulations to support mobile money and branchless banking will widen opportunities. Measures also include soft regulation such as codes of conduct for supermarket chains.

Second, more effective *ex post* enforcement against anti-competitive conduct which excludes smaller rivals is required. This would be aided by amendment of the Competition Act to ensure that the competition process is protected and the ability of smaller participants and black industrialists to enter and grow can be given weight in decisions.

Third, there is a range of proactive enabling measures which can support rivals. This includes making funds available for risky investments in the forms of entrants. Such a development finance facility could be based on competition penalties. Development finance should also

consider the different levels of the value chain.<sup>15</sup> Complementary measures can be taken at local government level to configure space and open-up critical infrastructure to rivals.

Lastly, it is notable that in several markets entrants have come from elsewhere on the continent (such as Sephaku/Dangote in cement and Choppies in supermarkets). The potential for African industrialists to be part of a more dynamic economy, including the greater competitive rivalry which can come from regional integration, should not be forgotten.

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<sup>15</sup> The Industrial Development Corporation in South Africa has begun to do this.



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