

## **CAN A REGULATED PRICE BE EXCESSIVE AND ANTI-COMPETITIVE- SA EXPERIENCE IN THE GAS INDUSTRY**



**ACER WEEK, March 2015**  
**National Energy Regulator of South Africa**

## Relevance of the paper: Snapshot

### Regulatory mandate on gas prices

Approve maximum prices of gas

Monitor the actual prices determined by gas traders through commercial negotiations with individual customers

Investigate customer complaints relating to, amongst others, unreasonable or excessive prices imposed by licensed gas traders

### Problem:

The Gas Act

- Does not define “Unreasonable or excessive price” , nor
- provide guidance on under what circumstances can a gas price be viewed as ‘unreasonable or excessive’

### Challenge:

- Gas prices in SA are regulated
  - Can they be excessive?
    - Under what circumstances?
    - how do we determine that the gas price is excessive?

### Purpose:

To demonstrate in the South African context the potential areas or circumstances that are likely to cause the regulated gas prices to be excessive; and where these prices can become anti-competitive

Regulatory framework in terms of the Gas Act, 2001

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- Gas pricing regulatory framework
- Questions to address
  - Can a regulated price be excessive?
  - Can a regulated price be anticompetitive?
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## INTRODUCTION

- The National Energy Regulator of South Africa (NERSA), a Schedule 3A Public Finance Management Act, 1999 (Act No. 1 of 1999) Public Entity was established on 1 October 2005 in terms of the National Energy Regulator Act, 2004 (Act No. 40 of 2004) to regulate:
  - Electricity industry (Electricity Regulation Act, 2006 (Act No. 4 of 2006))
  - Piped-Gas industry (Gas Act, 2001 (Act No. 48 of 2001))
  - Petroleum Pipelines industry (Petroleum Pipelines Act, 2003 (Act No. 60 of 2003))

## REGULATORY MANDATE IN TERMS OF THE GAS ACT

- Objectives of the Gas Act include:
  - Promote orderly development of the gas industry
  - Development of a competitive gas market; Facilitate investment; Promote competition
  - Access to gas and essential gas facilities
- Functions include:
  - Licensing gas infrastructure
  - Approval and monitoring of gas prices and tariffs
  - Compliance monitoring and enforcement
  - Investigations and dispute resolution
- Mandate to conduct investigations on amongst others unreasonable or excessive prices or tariffs

- Facilitation of investment, entry and promoting industry growth through
  - Licensing of new gas infrastructure; and trading activities
  - Approval and monitoring of maximum prices and transportation tariffs
    - Reflective of costs, risks and economic value of the product
  - Enforcement of third party access to existing essential infrastructure

## GAS PRICING REGULATORY FRAMEWORK

- Section 21(1)(p) empowers NERSA to approve maximum prices for all classes of customers' where there is inadequate competition in terms of the Competition Act
  - Regulation 4(3)(a), the Regulator must, when approving the maximum prices, be objective i.e. based on a systematic methodology applicable on a consistent and comparable basis
  - Regulation 4(4) allows for returns or profit commensurate with risk
  - Maximum prices methodology 2011
- Section 4(h) of Gas Act also requires Energy Regulator to
  - 'monitor and approve, and if necessary regulate, transmission and storage tariffs'
- Total price charged to customer: price + tariffs
- Prices refer to 'charges for gas'
- Tariffs refer to 'charges for gas services'

- Trading Margin = {Trader Operating Expenses + ((Gas Cost of Sales + Trading Regulated Asset Base + Trader Working Capital)\* Trader WACC) + Trader Tax ± Clawback}

= **Max total price for class**

- **Discounts**

Customer discounts  
based on section 22  
provisions

**Total max price for piped-gas**

+ **Trading margin**

+ **Distribution**

+ **Transmission**

+ **Maximum price for Gas Energy**



- Effect of NERSA powers in terms of section 21(1)(p)
  - to control/regulate gas prices within the confines of section 22, discrimination provisions
  - to set the price at the maximum level
- The challenge is to find the right maximum price level so that price is not high or low, taking into account that there is no adequate competition in the industry
- **What tells us the maximum price is at the right level?**
  - Willingness of current customers to buy and prospective customers to switch to gas
  - Willingness of gas suppliers to supply and attract entry into the market; looking at the economic value of gas
  - Affordability of gas – traders buying from the dominant trader are able to on-sell

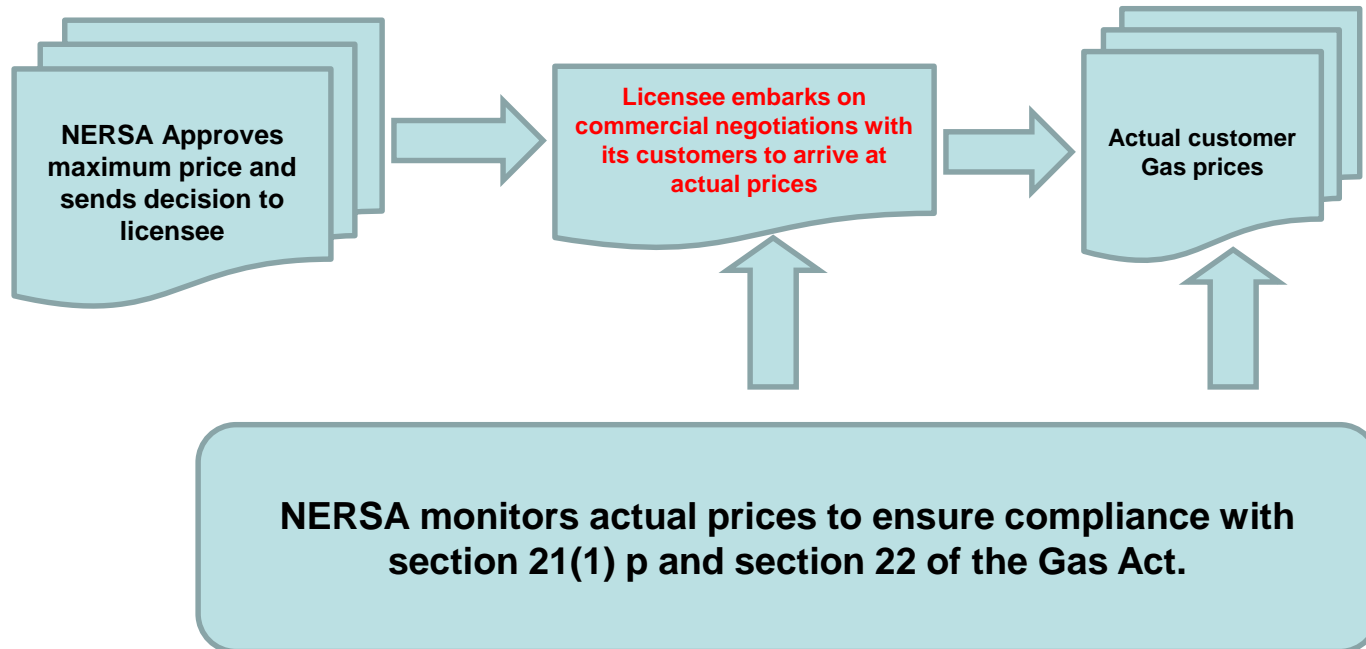
- **How do we test it?**
  - Price benchmark with other energy indicators to find the economic value for gas in the absence of a competitive and matured markets
- Maximum price of Gas Energy formula

$$GE = w_1 CL + w_2 DE + w_3 EL + w_4 HFO + w_5 LPG$$

CL= coal, DE =diesel, EL= electricity, HFO = heavy fuel oil, LPG = liquefied petroleum gas, w1-w5= weights for CL, DE, EL, HFO and LPG

- Gas price is still low compared to some of the alternatives
- Price benchmark is unlikely to place the price at an excessive level

## ■ Gas pricing process



- Actual prices for gas are negotiated between traders and customers
- NERSA enforces the provisions of section 22 of the Gas Act to ensure that actual prices set by licensees are determined in compliance with the objectively justifiable and identifiable differences set out in this section.

- Looking at the above pricing process, there is a potential for prices to be excessive
- Section 31(1)(b) of the Gas Act gives NERSA powers to, amongst others, investigate customer complaints relating to excessive prices imposed by gas traders

## **Problem statement**

- The term “excessive price” is not defined in the Gas Act
  - Rely on guidance from the Competition Act, 1998
- It is also not clear under what circumstances can the actual price determined within the confines of the ceiling or maximum price approved by NERSA may be viewed as excessive

## **Objective**

- To demonstrate in the South African context the potential areas or circumstances that are likely to cause the regulated gas prices to be excessive; 12 and where these prices can become anti-competitive

- Essential elements of excessive pricing in terms of the Competition Act
  - Price must have been charged by a dominant firm as defined in the Competition Act
  - Price must be shown to bear no reasonable relation to the economic value of the good or service concerned (unreasonably higher than the economic value of the good or service concerned)
  - Price must be detriment to consumers

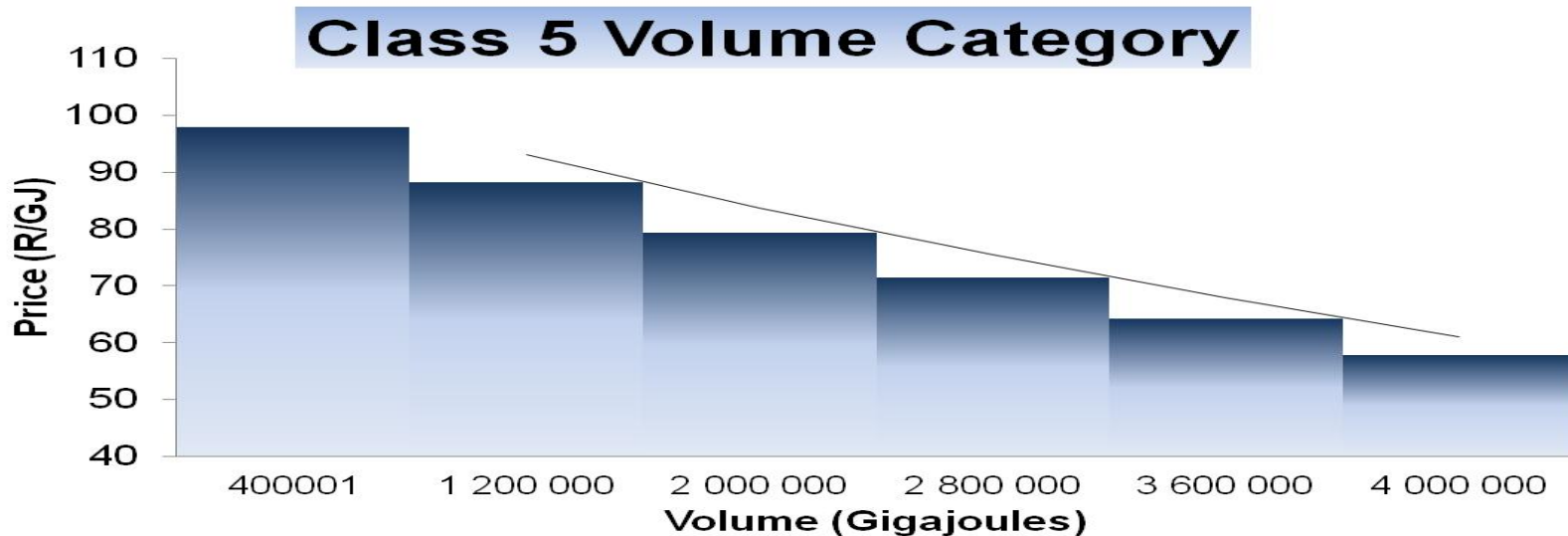
## CAN A REGULATED PRICE BE EXCESSIVE?

- Theoretically, an actual price set at a higher rate than would otherwise prevail in a competitive market may be regarded as excessive, if it is found to be-
  - Potentially affecting or likely to potentially affect the consumers negatively; and/or
  - Having the effect or likely to have the effect of undermining the competition theory that markets should be described such that no participants are large enough to have the market power to set prices

## PRACTICAL POTENTIAL CAUSES OF EXCESSIVE PRICING

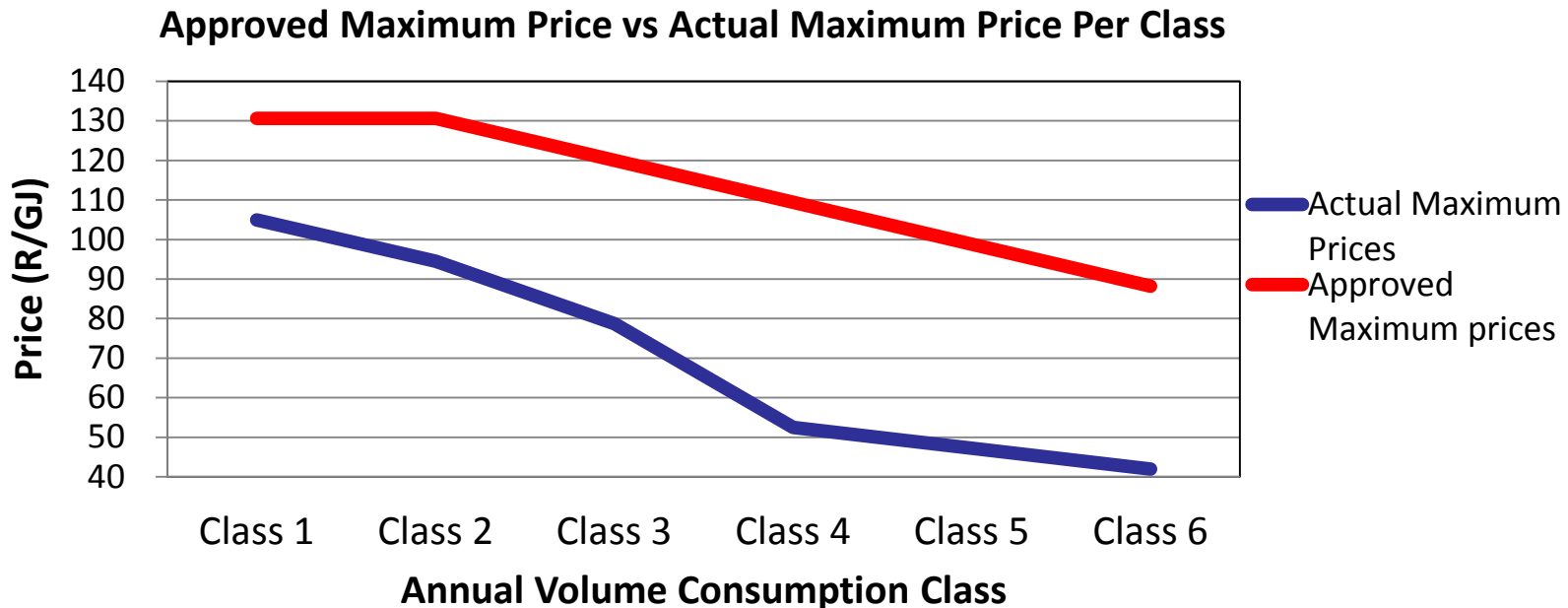
### (1) Declining pricing mechanism could lead to excessive pricing

- Price excessiveness can also be looked at the determination of the actual price within the confines of the maximum
- It could occur if the weighted average is calculated based on small volume categories and escalated to the relevant gas consumption category



## (2) Price discrimination could be an indicative of excessive pricing

- The high price differential between customers in the small volume category and customers in the large volume category could indicate an excessive price
  - Differentials are not based on cost of supply to each customer or customer class/ category





### **(3) Trading Margin has the potential to make the price excessive**

- Trading margin (additional layer on the total maximum price charge) reward for non network assets
- Its determination relies on information supplied by traders (calculation of operational assets)
  - Potential for traders to overstate the cost
  - NERSA conducts efficiency test and only reward cost if prudently incurred
- Trading margin may lead to collusion (acquit cooperative arrangement/ conduct)
  - Dominant trader can embark on profit margin squeeze by competing aggressively and undercut other traders downstream, however this is not happening in SA
  - **Experience in SA:**
    - The dominant trader share 50% of its profit with other competing traders downstream
    - This gives the dominant trader control to oversee prices in the entire value chain
    - This may encourage other traders to keep gas prices at higher levels
    - Sharing of the trading margin is uncompetitive

## CAN A REGULATED PRICE BECOME ANTI-COMPETITIVE?

- Price discrimination prohibited in section 9 of the competition Act
- It is viewed as an anti-competitive practice unless justified under the grounds of section 9 of the Competition Act and section 22 of the Gas Act
- Price discrimination can be an indicator of market power
- **Experience in SA:**
  - **Market value pricing:** Discriminatory pricing was allowed during the 10-year Special Regulatory Dispensation period, where the pricing principle was based on cost of alternative energy source of an individual customer
  - **Discrimination in terms of section 22 of the Gas Act:** Discriminatory pricing based on the volume category of customers is legal in terms of our legislation
  - Discriminatory pricing gives traders the power to charge different prices to similar individual customers, leading to unfair competitive outcomes

## CONCLUSION

- Yes, it is possible that a regulated price can be excessive and anti-competitive
- The current market structure and regulatory framework leave room for such conduct to happen
- Continuous monitoring of the actual prices is key to ensure that such form of abuse is prevented from occurring
- Strong enforcement mandate that allows Regulators to reverse the economic harm that is likely to be caused by this conduct is also an imperative (powers to instruct a licensee to reimburse or refund customers where excessively priced)

### Ongoing research...

- Currently studying the method(s) to use for determining excessive prices in the SA piped-gas industry...

# **THANK YOU**

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