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Too small for competition?

ECONOMIC REFORM IN MINI-MARKETS

More and more emerging markets are restructuring, re-regulating and privatising their power sectors. One important difference between these and other more developed markets is the size of national demand. Critics often argue that competition is not possible in small markets where economies of scale mean that one or two companies will dominate supply. Frontier's experience is different.

The restructuring that has taken place in the UK, Australia and other developed energy markets has spread – in different forms and for different reasons - to many parts of the world. It is also taking place in a number of other sectors, such as telecommunications, water and transport, but energy reform is possibly the most widespread. Frontier and its staff have worked in a number of small emerging markets on projects involving the reform and regulation of many sectors, notably electricity. A few of these are summarised below, along with some comparators from the developed world.

Country	Installed capacity (approx, MW)
Cambodia	160
Dominica	25
El Salvador	960
Guyana	180
Malawi	300
Uganda	270
New Zealand	8,000
Portugal	10,000
Thailand	16,000
UK	70,000

Source: Frontier Economics and Energy Information Administration

Compared to countries with more developed markets, many emerging economies have low levels of installed capacity. In many cases installed capacity is less than total demand (i.e. there is rationing of electricity supply). However, total demand is still very low relative to that in more developed markets. Under these conditions it is often argued that the typical approach to reform—breaking up the incumbent monopoly into competing generation units and regional distribution companies—will not work because:

- the resulting companies will be too small and fail to benefit from economies of scale; and
- new demand is rapidly exhausted and there is little switching between suppliers, so that total demand is served by one or two incumbents.

Evidence from around the world suggests that well-implemented reforms—including the introduction of competition and regulation where appropriate—benefits consumers by removing existing inefficiencies and providing clear incentives to meet demand[1]. Many of these countries witness power shedding at peak times despite consumers being willing to pay higher prices because installed capacity cannot meet demand.

Consequently, the governments of many emerging economies are looking at reform options that include the introduction of competition. This raises the question: are some markets too small for competition?

WHAT IS COMPETITION?

The key to introducing effective competition in small markets lies in recognising that there are many different types of competition that can be introduced. Competition can be:

- *in* the market - the familiar form of competition, between companies trying to sell similar products;
- *for* the market - competition to enter a new market which may be continuous pressure (known as contestability) or an occasional contest to enter the market, after which there is a monopoly for some period; or
- *comparative* - a regulated form of competition in which the prices that supplier are allowed to charge are based on the performance of other regional monopolies.

WHAT CAN BE DONE?

When governments begin the reform process they are often only thinking of competition in the market. This is much more difficult to implement in its classic form in smaller markets—although countries such as Uganda and El Salvador have attempted such an approach. However, competition in the market can be implemented through auto-generation, or self-generation.

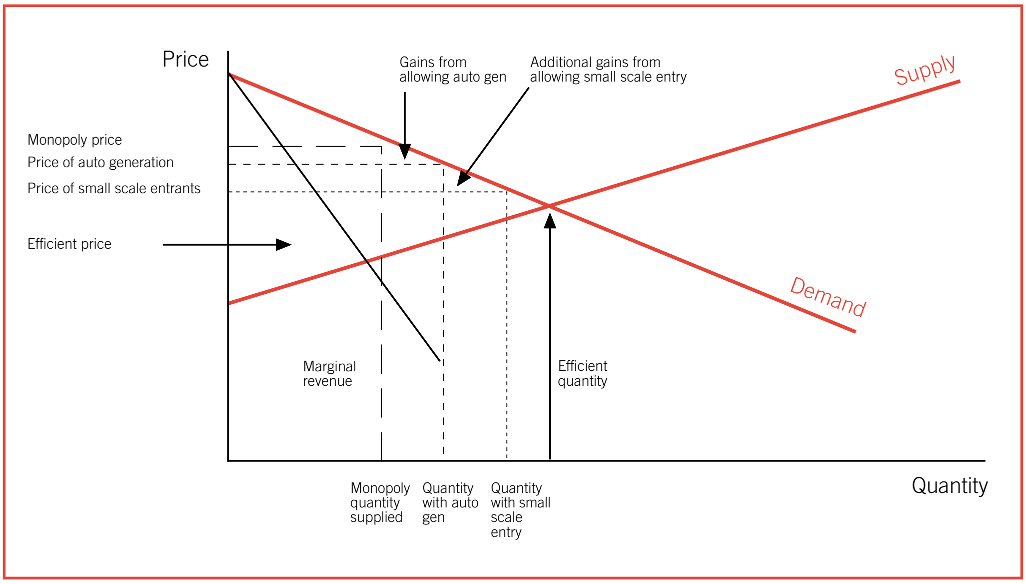
Auto-generation occurs when electricity consumers (often large companies or hotels) install their own generators. Advances in modern technology mean that units generating substantial amounts of electricity can be quickly and relatively cheaply installed and run on the companies' premises. This option provides important discipline to incumbent utilities by setting a maximum price of supply. It is vital that reform legislation, which often provides for some measure of exclusivity, allows this form of competition in the market.

Competition for the market can also lead to many of the same pressures on performance and, therefore, have many of the positive effects. For example, in Cambodia the poor performance of the government-owned electricity company has left the door open for numerous small-scale electricity suppliers who supply small communities unconnected to the national grid.

There are over 200 rural electrification schemes of one sort or another. These range from private initiatives set up by entrepreneurs to meet local demand to co-operatives set up by local residents. This form of competition for the market between small companies provides incentives for the ongoing supply of electricity. Some of these markets are even contestable.

A danger encountered in the reform process is that these small-scale competitors may be eliminated by the emergence of larger, regional monopolies. Reform and privatisation initiatives often include some element of exclusivity (e.g. a regional monopoly for the privatised utility). This works to decrease existing competition and may harm consumers. Small markets often have small-scale competition and reforms should encourage such competitors to enter the market. Panama has reached an interesting compromise under which incumbents have exclusive rights to supply within 100 metres of the existing network, beyond which supply is open to competition.

The combination of these forms of competition can be quite powerful, as the chart illustrates. However, they depend on the absence of long-term contracts that entrench exclusivity of supply.



In the absence of these options, comparative competition could be introduced to provide greater incentives for efficient provision. While considerably less effective than actual competition, it is better than trying to regulate a monopoly in a vacuum.

Too small for competition?

In the Caribbean countries mentioned above, and many others, a single, often vertically integrated, company provides electricity to the country[2]. It is often argued that the size of the markets and limited opportunity for growth, because the islands have a small population, prevents the implementation of competition. While there is strong evidence that auto-generation plays an important role, even if real competition is limited comparative competition can be used to provide incentives for improved company performance.

Many of the Caribbean islands have electricity sectors with similar structures. By comparing the utilities in a rigorous manner (e.g., through a formal benchmarking exercise), incentives similar to those found in a competitive market can be created. The combination of allowing auto generation and comparative competition can be used to drive productivity improvements in these smaller economies.

Finally, ensuring competitive procurement of new services (e.g., a new generator, or a new distribution company) also helps to ensure prices reflect the cost of supply. In some countries, such as Argentina, long-term contracts are re-bid at more frequent intervals to help to ensure that the most efficient company is operating the assets.

THE COSTS

There some costs to introducing competition. The short-term cost is that the privatisation of a monopoly will bring greater revenue to the government than the privatisation of a company that must compete for customers. However, this short-term gain is likely to be outweighed by the longer-term benefits of more efficient pricing. Many of the additional costs of competition (e.g. setting up the markets, drafting relevant codes) also exist under a monopoly regime but in an alternative form (e.g. monitoring the monopoly)[3].

CUT TO SIZE

The key to introducing competition into small markets is recognising there are many forms of competition. Choosing the appropriate form and implementing it effectively within the appropriate regulatory framework will provide lasting benefits to the residents of small countries.

SOURCE	1. *Many of these countries witness power shedding at peak times despite consumers being willing to pay higher prices because installed capacity cannot meet demand.* 2. *There are some isolated suppliers in Guyana and elsewhere.* 3. *There may be some cost savings from a monopoly (e.g., the elimination of any eliminates need for advertising and promotions) but these are unlikely to outweigh the benefits discussed hereabove.*
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