The Relationship Between Competition Policy and Regulation in the Brazilian Economy[1]

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Abstract

Within and outside the OECD there has been a trend to introduce greater competition into regulated sectors[4]. The introduction of competition has required establishing new regulators or seriously rethinking what regulators are doing, bringing up for discussion important questions regarding the proper relationship between sector-specific regulators and economy-wide competition agencies.

Despite the fact that institutional and historical differences have been taken into consideration while determining how countries organize competition and regulatory policy functions, it is clear that: (i) competition agencies have a comparative advantage when it comes to antitrust analysis ensuring that anti-competitive conducts and merger review process do not undo the benefits from introducing greater competition into regulated sectors; (ii) sector-specific regulators have a comparative advantage in obtaining and analysing the cost data needed for economic regulation and for some aspects of access regulation and (iii) due to the synergies that arise from the regulatory and competition functions, competition agencies and sector-specific regulators must co-operate closely.

In Brazil, the creation of the National Competition and Consumer Protection Agency – ANC, which is supposed to occur soon, will not change the pattern of interaction between the competition authority and the sector-specific regulators regarding the competition protection function in the regulated sectors: the competition law applies fully to those sectors, the competition authority is in charge of its enforcement and is supposed to count on the cooperation of the regulatory agencies.

[4] The Relationship between Competition and Regulatory Authorities – Executive Summary and Background Note. In The OECD Journal of Competition Law & Policy. Volume 1, nº 3, 1999, p. 169 to 219.

Resumo

Tanto dentro quanto fora da OCDE observa-se a tendência de introduzir uma maior concorrência em setores regulados[5] da economia. A introdução da concorrência nesses setores tem implicado a criação de novos órgãos reguladores ou a reavaliação do papel dos órgãos reguladores setoriais existentes, o que tem trazido à discussão questões importantes relativas ao adequado relacionamento entre órgãos reguladores específicos e órgãos encarregados da defesa da concorrência na economia como um todo.

Apesar de diferenças históricas e institucionais terem sido levadas em consideração na determinação de como os países organizam internamente as funções regulatórias e de defesa da concorrência, pode-se afirmar que: (i) órgãos encarregados da defesa da concorrência na economia como um todo possuem vantagem comparativa para realizarem análises antitruste, de modo a garantir que análises precisas acerca de condutas anticompetitivas e de atos de concentração não eliminem os benefícios advindos da introdução da concorrência em setores regulados; (ii) órgãos reguladores setoriais possuem vantagem comparativa na obtenção e análise de dados de custo necessários para o exercício da regulação econômica e para alguns aspectos da regulação de acesso e (iii) em virtude das sinergias existentes entre as funções regulatórias e de defesa da concorrência, os órgãos reguladores setoriais e os órgãos encarregados da defesa da concorrência devem atuar de forma cooperativa.

No Brasil, a criação da Agência Nacional de Defesa do Consumidor e da Concorrência-ANC, que deve ocorrer nos próximos meses, não deverá acarretar alteração no padrão de interação que já existe entre os agências reguladoras setoriais e os órgãos encarregados da defesa da concorrência no País no que diz respeito à defesa da concorrência em setores regulados: a Lei de Defesa da Concorrência permanecerá integralmente aplicável àqueles setores e o órgão encarregado da defesa da concorrência – a ANC – será responsável pela aplicação da Lei de Defesa da Concorrência, devendo contar com a colaboração das agências reguladoras setoriais.

[5] The Relationship between Competition and Regulatory Authorities – Executive Summary and Background Note. In The OECD Journal of Competition Law & Policy. Volume 1, nº 3, 1999, p. 169 to 219.

I – Introduction

A large number of countries have embarked in recent years on ambitious programmes aimed at narrowing the scope of economic regulation and ensuring that regulations better serve public interests, process which is referred to as "regulatory reform". This is due to the fact that regulations can become an obstacle to achieving the very economic and social well being for which they are intended. Regulations might, for instance, impede innovation or create unnecessary barriers to trade, investment, and economic efficiency and protect sectors or activities unnecessarily from competition. Thus, one of the principal objectives behind the reforms has been to broaden the scope for private markets to allocate resources thereby improving general economic efficiency.

These reforms have occurred especially in the network infrastructure industry and have included market opening privatization, rethinking universal service obligations, liberalizing restrictions on entry, prices and normal business practices.

For this reason, important debates have occurred about the degree to which sectors being opened up to greater competition should also be subject to general competition laws and about the division of labour between wide competition agencies and specific regulators involved.

I I – The Recent OECD Recommendation Regarding Regulatory Reform

According to OECD[6], there are at least three good reasons to why carry out a regulatory reform:

1. Regulation can reduce economic efficiency. Economic efficiency can be improved by giving greater play to market forces through relaxing governmental restraints on technology choice and on new entry or new forms of competition. Regulators lack the information and incentives to encourage the use of best available technologies and the discovery of improved technologies or might regulate more in the interest of some or all of the regulated firms than for the welfare of the public they are created to protect.

2. In many network infrastructure industries, technological change has altered the natural monopoly aspect of the network, minimizing the need for regulation.

3. Markets composed of a number of substitute products could extend across two or more regulated industries thus creating a potential for competitive distortions arising from different sectoral regulation. This problem is now being aggravated by a growing tendency for the same company to be involved in more than one regulated sector. For example, telecommnications companies, cable TV firms and internet service providers are increasingly engaged in offering services extending across the three areas.

[6] The Relationship between Competition and Regulatory Authorities, op.cit., p.179.

The importance of the introduction of competition into regulated sectors has became such a consensus that OECD has recently recommended its members to adopt market opening and competition enhancing regulatory reform, with more effective application of competition law. Among its policy recommendations, the OECD Report on Regulatory Reform[7] mentions:

> ***"Reform economic regulations in all sectors to stimulate competition, and eliminate them except where clear evidence demonstrates that they are the best way to serve broad public interests.***
>
> - *Review as a high priority those aspects of economic regulations that restrict entry, exit, pricing, output, normal commercial practices and forms of business organization.*
>
> - *Promote efficiency and the transition to effective competition where economic regulations continue to be needed because of potential for abuse of market power. In particular: (i) separate potentially competitive activities from regulated utility networks, and otherwise restructure as needed to reduce the market power of incumbents; (ii) guarantee access to essential network facilities to all market entrants on a transparent and non-discriminatory basis; (iii) use price caps and other mechanisms to encourage efficiency gains when price controls are needed during the transition to competition.*
>
> ***Review and strengthen where necessary the scope, effectiveness and enforcement of competition policy.***
>
> - *Eliminate sectoral gaps in coverage of competition law, unless evidence suggests that compelling public interests cannot be served in better ways.*
>
> - *Enforce competition law vigorously where collusive behaviour, abuse of dominant position, or anticompetitive mergers risk frustrating reform.*
>
> - *Provide competition authorities with the authority and capacity to advocate reform".*

I I I – The Role of The Competition Authority in the Regulatory Reform

Competition agencies have a very important role to play in the regulatory reform. These bodies have expertise in identifying and helping to eliminate market power which, if left unchecked, would greatly reduce the benefits of regulatory reform. This is particularly relevant because firms used to operating as monopolies or being co-ordinated by regulators may think it is "normal" and profitable to continue in their pre-regulatory reform ways of operating.

[7] OECD. The OECD Report on Regulatory Reform, 1997. (http://www.oecd.org)

The contribution of the Competition agencies also extend to the matters of industry structure, like the need to horizontally or vertically split dominant incumbent firms, and on issues involving stranded costs or the implementation of universal service obligations. They can help ensure that the methods for recovering stranded costs and for assuring universal service do not lead to unnecessary competitive distortions. They may also be able to assist in eliminating deceptive marketing practices which directly harm consumers and tend to distort the competitive process in markets being opened up.

IV - How to Introduce Competition to Network Infrastructure Industries: The Division of Tasks Between Competition Agencies and Regulators

It is possible to enumerate a few preliminary tasks to foster competition in network infrastrcture industries[8]. These tasks don't fit especially a competition authority or a regulator, although the outcomes would probably be more successful if the competition body were listened:

1. The removal of legal barriers to entry;

2. Where the incumbent is publicly owned, taking steps to assure new entrants that will operate as a commercial entity and in particular will not benefit from having its deficits automatically and continually underwritten by the government;

3. Abolishing any favoured access the incumbent may enjoy to government controlled or owned scarce inputs, and ensuring that such resources will eventually be allocated to the producers who can make most efficient use of them;

4. Making any vertical and horizontal splits deemed advisable to help deal with situations where the incumbent owns "essential facilities" which new entrants require to compete but cannot economically duplicate;

5. Dealing with stranded costs and abandoning or restructuring universal service obligations so that incumbents do not lose business to less efficient new entrants; and

6. Taking measures to offset artificial incumbent advantages (other than those linked to ownership of crucial inputs).

It should be realized, however, that introducing competition in sectors previously dominated by state owned or heavily regulated vertically integrated firms and protecting consumers from supracompetitive pricing are difficult tasks requiring a very broad range of expertise and experience.

[8] The Relationship between Competition and Regulatory Authorities, op.cit., p.180.

Besides dealing with the structural, stranded cost and universal service issues, there are four tasks typically needing careful attention during and after the transition from government ownership or heavy regulation to the competitive regime:

1. "Technical regulation" - setting and monitoring standards so as to assure compatibility and to address privacy, safety, and environmental protection concerns;

2. "Economic regulation" - adopting cost based measures to control monopoly pricing.

3. "Access regulation" - ensuring non-discriminatory access to necessary inputs, especially network infrastructures;

4. "Competition protection" - controlling anti-competitive conduct and mergers.

Because **technical regulation** requires on-going monitoring and application of sector-specific expertise, having little relevance to competition questions, it can be assumed that this function will be conferred on a set of sector-specific regulators.

As to the other functions, who takes care of what depends on a variety of a country's peculiarities regarding legal framework and regulatory history. The model adopted can vary from country to country, but in general it can be said that:

Economic regulation seems to be better placed in sector-specific regulators. Such regulation is on-going rather than periodic in nature, and heavily based on sector-specific knowledge.

The objective of **access regulation** is to promote and to protect competition in certain situations where access to a portion of a vertically integrated incumbent firm's assets is vital to the development of a satisfactory level of competition. If, because of experience with abuse of dominance cases, competition agencies are more suited to performing this task than are sector-specific regulators, it is also true that ensuring a level playing field requires processing a large volume of cost data in order to set access terms, and then following up with continuous monitoring to ensure compliance with those terms, which are functions that seem more in tune with what sector-specific regulators normally do. Who is better suited for the task is not clear.

As to the **competition protection** function, compared with sector-specific regulators, competition agencies are better suited by their accumulated expertise, experience and basic institutional characteristics ("institutional culture") to protect competition from anti-competitive behaviour and to review mergers. Thus, this function should be in charge of the Competition Authority. This aspect will be discussed in details.

The competition authority enjoys an overwhelming comparative advantage when it comes to merger reviewing and investigating and prosecuting anticompetitive conduct cases. These

functions are its core functions and it has the experience, the expertise and the proper people required for the task.

If this affirmative is true in general, it is particularly important in reference to regulated sectors, where an inappropriate antitrust analysis might undo the benefits expected to flow from the introduction of greater competition. The effect of the economies of scale over the costs per unit of the infrastructure services, as well as the relevance of high production costs of the distribution networks required to reach the customers lead to the fact that private conducts and mergers are specially risky to the public's interest in this sector[9]. On the one hand, the cost reduction makes a pulverized supply structure inefficient and makes all mergers useful in thesis. On the other hand, taking into consideration the naturally high concentration of the supply, probably the additional market power created by a merger in this sector is higher than in other sectors.
In reference to institutional differences between the competition authority and the sector-specific regulators, it is important to point out that despite the fact that both could presumably be able to hire appropriate expertise, the experience and institutional cultural differences between them are not easily eradicated.

There is a significant risk that trying to change or mix institutional cultures could compromise abilities to perform core functions. Five aspects of experience and institutional culture seem particularly important:

1. Sector-specific regulators are often charged with attenuating the effects of market power, while competition agencies focus on reducing such power. This tends to produce quite different views on the extent to which market power can be managed for the public good;

2. Sector-specific regulators typically impose and monitor various behavioural conditions whereas competition agencies tend to opt for structural remedies;

3. Sector-specific regulators generally apply an *ex ante* prescriptive approach while competition offices, except in the merger review process, apply an *ex post* enforcement approach;

4. Sector-specific regulators typically intervene more frequently and require a continual flow of information from regulated entities, while competition offices rely more on complaints and gather information only when necessary in connection with possible enforcement action;

5. Finally, sector-specific regulators are typically assigned a considerably broader range of goals than competition agencies are asked to pursue, so they may become more adept at trading off conflicting goals.

Another point is that sector-specific regulators deal with many specific and complex issues that are extremely sophisticated and time consuming, which require high investments in training

[9] Corrêa, Paulo. La Relación entre la Agencias Reguladoras y la Agencia Antimonopolio: el Caso de Panamá, 1999, mimeo.

people. Therefore, considering the expenditure of both financial and human resources necessary to create antitrust units inside the sector-specific regulators and thinking that the antitrust analysis does not differ very much form one sector of the economy to the other, the competition protection function in regulated sectors, should stay inside the economy-wide competition agency. This is specially relevant when dealing with scarce resouces realities.

In addition, if each sector-specific regulator were to take care of the competition protection function within it's own sector, the integrity of the whole national competition policy would be affected once different regimes – by sector – would coexist. This would also lead to legal uncertainty.

As to the regulatory capture problem, it should be also understood that economy-wide agencies tend to be more immune than sector-specific regulators. Compared with sector-specific regulators, senior decision-makers at agencies covering the whole economy are less likely to have the kind of in-depth industry specific knowledge, contacts, and outlook that would make them particularly valuable later on as employees with or lobbyists for those they are currently influencing. There is also the higher degree of ongoing interdependence between regulators and regulated firms which tends to make capture a greater risk for regulators. With the passage of time, there is a risk that along with sharing similar information about an industry, regulators will come to share the industry's perspective. This could include its fear of fostering greater competition.

Therefore, considering the competition agency's comparative advantage regarding antitrust analysis, the economy of resources, the integrity of the national competition policy, the legal certainty aspect, the institutional characteristics of the competition agencies and the probability of regulatory capture, the competition agencies are better suited to be in charge of the competition protection function in regulated sectors.

Notwithstanding, whatever is the division of labour between competition agencies and regulators, it is far from important to take into consideration that synergies exist between competition protection and economic regulation and also between both of those functions and access regulation. For this reason, co-operation and co-ordination are vitally needed to avoid inconsistent, investment discouraging application of the policies.

If competition protection is separated from access and economic regulation, there are a large variety of ways to do this ranging from informal co-operation to rights to make submissions and on to legally required consultation.

There is also a need for co-operative links to be forged between competition offices and sector-specific technical regulators. Co-operative links are needed not just to avoid resource duplication, but also to ensure that technical regulators take proper account of the ways in which the adoption and enforcement of technical standards can be used to distort or restrict competition.

Whenever access and economic regulation functions are located outside the competition agency, that agency should be extensively involved in any periodic reviews of whether such regulation is justified by continued market power. Competition agencies should be better placed than regulators to decide this question and should have less self-interest in unnecessarily continuing regulation. It follows that they should play an important role in administering any sun-setting provisions. It should be realized that in a small number of countries, regulators are statutorily required to forbear regulating once a sector is sufficiently competitive, and competition agencies are involved in determining whether that threshold has been met.

IV – The Brazilian Case: Competition Policy and Regulation

The Secretariat for Economic Monitoring (Seae) of the Ministry of Finance, the Secretariat for Economic Law (SDE) of the Ministry of Justice and the Administrative Council for Economic Defence (CADE), an independent body administratively linked to the Ministry of Justice, are the brazilian competition authorities and constitute the *Sistema Brasileiro de Defesa da Concorrência (SBDC*). Seae and SDE have analytical and investigative functions while CADE is an administrative tribunal. CADE´s decisions can only be reviewed by the Courts.

There are no specific exemptions from the competition law for any of the regulated sectors; law n. 8.884/94 on its face applies fully to them and also to privatizations, which means that those transactions are considered as mergers.
This means that the competition protection function in the energy sector is assigned to the competition authorities, which work in a cooperative basis with the independent regulatory agencies.

Many sectors of the Brazilian economy, formerly characterized by state-owned or publicly sanctioned monopolies, are undergoing restructuring. State-owned assets have been privatized, government controls have been removed, and new entry has been permitted. In some sectors, new, independent regulatory agencies have been created. The pace of reform varies from sector to sector, however.

The following sections will describe the process of regulatory reform in the energy sector in Brazil.

IV.1 – Electricity

A regulatory agency responsible for the electricity industry was created in 1997 (Agência Nacional de Energia Elétrica – ANEEL). It is overseeing the privatization and liberalization of the industry, which is proceeding rather slowly. Ninety percent of the country's electrical generation capacity is hydroelectric. These plants, which are almost all state-owned, are very large, and located far from the country's population centers. The largest hydro sites in the south

and southeast sectors – the most populous ones – have been developed. There are two nuclear plants in the country, one of which has yet to become operational. ANEEL has a thermal power development program underway, utilising gas-fired plants, which is projected to account for about 12 per cent of the country's capacity. Privatization of the big hydro plants has proceeded slowly, but ANEEL recently announced that the three largest hydro companies, Furnas, CHESF and Eletronorte, which account for more than 50 per cent of the energy generated in Brazil, will be privatized in 2001. These privatizations are an essential step in the restructuring of the electrical sector in Brazil.

The transmission grid is also state-owned. There are plans to separate it from generation, privatize and regulate it. There are 11 new lines being added to the grid, the rights to which are being auctioned by ANEEL. Privatization of distribution assets is proceeding more quickly; approximately 60 per cent has been privatized.

ANEEL is working toward competition in the wholesale market in the shorter run, which would permit distributors and large consumers to contract directly with generators. Retail competition is farther away. Retail customers continue to be subsidized to some extent. There is much to be done to reach the goal of wholesale competition, however, including the difficult task of separating and privatizing the existing large, vertically integrated state-owned utilities and re-working the many large, long term supply contracts that now exist.

The law establishing the new electricity regime requires ANEEL to give effect to competition in the industry where possible. ANEEL has entered into co-operation agreements with all three competition agencies. The parties have agreed to share information and technical expertise; ANEEL has pledged to work with SDE in its conduct investigations, and it provides technical opinions to SDE and CADE on mergers and privatizations in the industry, which are fully subject to the competition law. ANEEL has also pledged to develop relationships with the other national regulatory bodies, ANATEL and ANP.

In sum, regulatory reform in the electricity supply industry has begun, but is proceeding slowly, as it faces significant problems in separating and privatizing the vertically-integrated, state-owned utilities. The plan includes the now-familiar concepts found in many national restructuring programs in electricity, separating the potentially competitive markets of generation and distribution from the transmission grid and promoting competition in contracting between generators and wholesale, and ultimately retail, customers. ANEEL has established formal relationships with the competition agencies and as the pace of privatization and restructuring increases in the next few years is prepared to work with them in matters of competition policy.

IV.2 – Natural Gas and Petroleum

The Hydrocarbons Law of 1997 created a regulatory agency to oversee the natural gas and petroleum markets, the Agência Nacional de Petróleo – ANP. The state-owned firm Petrobras

had been a monopolist in the production, refining and pipeline transportation of these products. The 1997 law officially ended that monopoly, but Petrobras, still state-owned, continues to be the dominant firm in these markets. ANP is implementing some reforms pursuant to the new law, but the progress is slow.

IV.3 – Natural Gas

Brazil is not self-sufficient in natural gas. It imports a substantial portion of its requirements from Bolivia. Recently a new pipeline from Bolivia was completed and a 30 year supply agreement was reached. In the south, construction of a new pipeline from Argentina is underway. The pipeline systems in the north and the south of the country are not integrated, but there are plans to do so. Brazil consumes relatively little natural gas for a country its size (little is required for heating, for example), but there are plans to expand its use, principally for electricity generation. A program is underway to construct 50 new terminals along existing and new pipelines, at which there will be gas-fired generating plants.

Until the 1997 reforms, Petrobras had a monopoly in exploration and development of natural gas fields in Brazil. Now all domestic reserves are considered property of the government. The Ministry of Mining and Energy awards concessions, by means of auctions, for exploration. Petrobras continues to conduct most of the exploration and development, however. Petrobras also controls most of the transmission pipelines in the country. The 1997 law requires that production and transmission facilities be separated into different legal entities, but does not forbid cross ownership of these entities. Thus, Petrobras continues to control both markets.

ANP has promulgated rules relating to cross-ownership and self-dealing, but currently they do not extend much beyond the obligation to report such relationships or transactions. An important issue facing ANP is ensuring open access to the transportation pipelines; capacity in the system is constrained at some locations. ANP is working on access regulations; currently, pipeline operators are required to publish information on available capacity.

The government has historically controlled natural gas prices, a joint effort of the Ministries of Finance and Mining and Energy. Currently the price of domestically-produced gas is subject to price cap regulation to the city gates, where state regulation takes over. There is no price regulation of imported gas. A deregulation plan in the process of implementation envisions that consumers and distributors will eventually be able to contract directly with suppliers. A special rule on prices (Joint Rule 3) applies to the 50 new terminal operators. It was felt that some sort of price guarantee was necessary to induce investment in these facilities. Those prices are pegged to a reference price based on a basket of international prices of oil. Transportation prices continue to be regulated by ANP.

A unique situation involving local distribution networks exists in Brazil. The constitution reserves to the states the right to control these networks. Accordingly, reform at this level is

evolving differently in each of the 27 states, and at different paces. In some, the state continues to operate the network; in others there has been privatization and regulation; and in some the right to operate the network is granted by concession.

IV.4 – Petroleum

The situation in petroleum resembles that in natural gas in many respects. A substantial portion, up to 40 per cent or so, of the country's oil requirements is imported. The former Petrobras monopoly was officially eliminated by the 1997 Hydrocarbons Law, but it retains virtual monopoly power in domestic crude production, refining and transportation. As in natural gas, rights to explore domestic oil reserves are now awarded by government concession. Petrobras has won most of the concessions, however.

The ex-refinery prices for the principal refined products are established by Ministries of Finance and Mining and Energy. The tariffs for pipeline transportation of refined products are established by ANP. Rules for open access to oil and refined products pipelines are under final discussion within ANP. It is expected that the rules will establish a transition phase during which open access will not be mandatory, with ANP continuing to establish the tariffs.

ANP approval is required for the construction and operation of pipelines and terminals, which is open to any Brazilian company. As in natural gas, ANP rules require that the ownership and operation of pipelines and production facilities be in separate legal entities, but the rules do not prohibit cross ownership of such entities.

The competition law applies to the oil and gas sector in most respects. The hydrocarbons law explicitly requires the promotion of competition in the sector. As with telecommunications and electricity, working groups between ANP and the competition agencies have been created. There have been a few competition cases in oil and gas. Some mergers have come before CADE, and as noted above, a cartel investigation of gasoline retailers is underway in SDE.

In sum, reform in the natural gas and petroleum industries has begun, but much remains to be done. ANP and the government face difficult decisions regarding the privatization of Petrobras (there is no timetable for this privatization, which may be the most difficult and controversial of all in Brazil), the separation and regulation of its transportation monopolies and the introduction of competition in oil refining.

IV.5 – The National Competition and Consumer Protection Agency - ANC

There is an important role for a competition agency in every country as the advocate for competition policy in all aspects of government operations, especially including legislative

activity and regulation[10]. Government officials and regulators outside the competition agency may be unsophisticated in competition policy and unaware of its importance to their activities and to the consumers who are their constituents. Competition is possible in most aspects of every economic sector, including so-called "network industries," in which some parts may have natural monopoly characteristics. The competition agency can make a significant contribution to regulatory policy in such sectors by intervening, either formally or informally, in major decisions by the regulator for the purpose of encouraging policies that foster competition wherever it is possible.

In August 11 th, 2000, the President signed a Decree creating a interministerial working group to review the institutionality of the SBDC. According to the Decree, the main task of the working group was to prepare a law integrating in one agency, SEAE, SDE and CADE. It also establishes that this new body will be in charge of consumer affairs.

The working group was formed by the three members of SBDC and officials from the Ministry of Planning, Budget and Administration; the Ministry of Industry, Foreign Trade and Development and the Civil Cabinet of the Presidency. The proposed Law was subject to public discussion for 90 days and is now undergoing the last revision, after what will be sent to the Parliament.

As to the assignment of the competition protection function in the regulated sectors, nothing is supposed to change: the competition law applies fully to those sectors, the competition authority is in charge of its enforcement and is supposed to count on the cooperation of the regulatory agencies.

[10] Clark, John. Competition Policy and Regulatory Reform in Brazil: a Progress Report, 2000.