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LATIN AMERICAN COMPETITION FORUM

-- Session I: Competition Principles in Essential Facilities --

Contribution from Honduras

8-9 September 2010, San José (Costa Rica)

The attached document from Honduras is circulated to the Latin American Competition Forum FOR DISCUSSION under session I of its forthcoming meeting to be held in Costa Rica on 8-9 September 2010.

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Session I: Competition Principles in Essential Facilities

-- CONTRIBUTION FROM HONDURAS --

Commission for the Defence and Promotion of Competition

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THE TRANSITION FROM REGULATION TO LIBERALISATION OF MARKET PRICES FOR LIQUID FUELS IN HONDURAS: ANALYSIS OF ESSENTIAL ASSETS

I. Introduction

1. It has been several decades since the world launched efforts to liberalise markets and introduce competition in industries that had been typically served by monopolies or oligopolies operating under economic regulation. The progressive opening of global markets to flows of goods and services has given the market a growing role in allocating resources and in achieving greater business efficiency.

2. Latin America has been no stranger to this process. Since the 1980s it has seen a growing trend toward liberalising its markets. A key feature of its industries has been the presence of important investments in infrastructure, which has become an essential facility for reaching final consumers and allowing competitors to expand their businesses.

3. In times of economic crisis, there has been a recurrent tendency to recommend interventionist policies, and in particular to provide greater protection for certain markets, especially those consisting of economic agents who enjoy some negotiating clout within the state apparatus, and/or to impose restrictive measures on the exercise of free competition, under the argument that if such policies are not adopted the firms participating in those markets will be doomed to bankruptcy or to forcible exit from the productive system, leading to a substantial increase in unemployment rates. In its 1997 report on regulatory reform, the OECD declared the following:

> *"Despite the fact that almost all economic activity today occurs in markets where competition can work efficiently, economic regulations that reduce competition and distort prices are pervasive. They take many forms at various levels of government, ranging from legal monopolies that block competition in entire sectors, to a host of less visible restrictions on starting up and operating businesses, such as quotas on business licenses and shop opening hours. Yet economic regulations have often proven to be extremely costly and ineffective means of achieving public interest goals. In the absence of clear evidence that such regulations are necessary to serve public interests, governments should place a high priority on identifying and removing economic regulations that impede competition."*

4. In this context, governments need to set aside the conventional tools of intervention (economic rules and regulations, subsidies, state monopolies) in markets where competition is possible and desirable and replace them with fine-tuned and efficient mechanisms to guarantee the healthy functioning of markets.

> *"Competition is the guiding principle of any market economy. Defending competition is everyone's job, that of society in general and of the public authorities who legitimise state intervention in the economic field. This means that when the state regulates it must regulate in favour of competition and not against it. The goal of the state should be to promote and protect workable, sufficient and effective competition."*

II. Regulation

5. Regulatory policy takes two general forms. "Economic" regulation controls profits, sets prices and determines who may participate in a market or use a particular resource. "Social" regulation controls the flow of products derived from production, sets health and safety standards for products and workplaces, restricts the information that vendors convey through their advertising and other means, and establishes requirements to protect buyers from fraudulent, discriminatory or incompetent [sic] behaviour by firms. All these policies have a profound impact on prices, costs, product quality, the dynamics of competition, and the allocation of resources within the economy.

6. The conventional economic argument citing "the public interest" for imposing price regulations is based on failures in unregulated markets, which may not behave competitively under certain circumstances. While the market may fail if consumers are poorly informed, the "natural monopoly" or "natural oligopoly" has historically been the most important argument for introducing price regulation (Schmalensee 1979).

7. These stories of market failure have many defects, even when presented as a theory of economic regulation or as a political theory of regulation. In the first place, if economic models incorporate a significant degree of imperfect information or economies of scale and hidden costs, the results will diverge from the ideal of perfect competition. But these models do not provide a clear way of identifying unregulated industries whose performance is so poor as to justify price and entry controls. Because competition on real markets will be imperfect in some way, the "market failures" approach can produce arguments for regulating nearly every industry, if it is assumed that regulation can reduce market imperfections without raising costs.

8. Second, price regulation is also imperfect. Regulators may be ill-informed about the "efficient costs" and "optimum prices" of services. Moreover, it can increase costs, slow the growth of production, and promote cross subsidies, thereby affecting some consumers. Moreover, regulatory procedures that seek to identify the correct costs, impose proper prices and determine the optimal number of firms will create incentives to inefficient production and may discourage or distort technological changes that could benefit consumers.

9. Third, even in cases where imperfect regulation is less costly than imperfect competition, the changes that take place in the conditions of supply and demand may lead to a different conclusion. Today, reasonable regulation does not necessarily mean that the regulation and the market it regulates must be fixed for ever. In many cases, regulatory statutes do not merely ask regulators to identify markets where competition is largely imperfect and to regulate them for a time until competition can be confidently restored – they in fact presume a permanent state of regulation. Consequently, meaningful deregulation requires a new law, if it is not to be quashed by the courts.

10. In many cases, regulation is adopted in response to: private interests, inflationary increases (economic shocks), technological changes, moral hazard (financial system), a firm that earns high profits, or where productivity in the industry or in other sectors depends on the regulated market.

III. Free Competition

11. Competition improves the welfare of all consumers. The sum total of the benefits obtained by all consumers is very great, although the benefit obtained by each may be very small, and so its importance may not readily be recognised. On the other hand, the introduction of competition is injurious, in the short term, for those who previously produced or provided the service in a monopolistic situation or under a regulatory scheme. The total injury is small when compared with the total benefit to consumers but, for the firm that was protected from competition, the injury may be very significant in the short term.

12. In a situation of competition, a firm can earn money if it creates a new product, if it reduces costs, if it treats its clients better, or if it improves its productivity. Obviously, a firm will reap a benefit if it is more successful than others in meeting consumer needs. But with competition, it is impossible to make a profit without providing a service to consumers. On the contrary, when there is a monopoly or a restriction on competition, there are additional possibilities of making a profit that are not beneficial to society. In a sector where there is no free competition the firm may price its goods higher, it may treat its customers worse, it may offer poorer quality – in other words, it can act against general public interests while making money at the same time.

13. Fernández Ordóñez notes that when any sector commits to liberalisation, the positive effects will normally be distributed throughout the economy (in the form of greater efficiency, greater growth, greater employment, etc.), while the negative effects will be concentrated precisely in the sector being liberalised (essentially in the form of reduced employment and the closing of inefficient firms). Hence, it will be difficult to persuade people of the benefits of liberalisation when they see that competition, for example, is cutting jobs in a given sector. It has been demonstrated that the benefits exceed the costs and that, in the long term, everyone wins.

14. The most interesting aspect of competition policy, and what differentiates it from other policies such as taxation, is that, fortunately, the introduction of competition is not a zero-sum game, i.e. it is not a policy where some gain what others lose. As economists demonstrate, everyone can emerge a winner if competition is introduced in the market. But if liberalisation policies and competition are introduced without allowing time for redistributing these gains, and for agents to adjust to the new situation, there will normally be a sharp reaction against those policies.

15. Today there is debate over the pace at which these new steps in the liberalisation process should be applied. However, it is satisfying to note that almost no one is suggesting any backtracking in the introduction of competition in those sectors where it has already been introduced. The quality and diversity of the goods that consumers enjoy today, the intensity of investment, unprecedented for many years, and the increase in innovations are effects that cannot be de-linked from the introduction of competition and the liberalisation of markets in recent years.

IV. From Regulation to Liberalisation

16. Although governments have the power to regulate prices in order to protect consumers, the disadvantage of doing so is that, when faced with prices lower than what they would like to charge, firms may reduce the quality of the services or products they offer. They may also reduce the variety of their products, since established firms have little incentive to offer a greater variety under price controls.

17. In many countries, markets such as those for air travel and telecommunications have experienced clear changes in quality and variety once price regulations were relaxed. Moreover, the pace of entry of new firms may be lower in markets with regulated prices, because there will be less inducement in the form of profit opportunities. Generally speaking, the literature shows that, while governments may seek to achieve legitimate socioeconomic goals by controlling prices in some markets, those controls have a broad range of damaging effects in the long term, such as reducing the efficiency of production, discouraging the adoption of new technologies, and reducing the quality and variety of products. This implies that, in markets where there are possibilities for inter-firm competition to flourish, price regulation should be viewed with great scepticism and avoided as far as possible.

18. Liberalising a sector does not mean that competition will appear in it immediately. Liberalisation is the first step toward competition but it will take time for real competition to appear. Competition is slow in asserting itself because new firms need to make investments, sometimes big ones, in order to wrest market share from established firms.

19. Competition should not be introduced without first ensuring that the public objectives served by regulation will be maintained. Countries that have failed to observe this rule have found that if they do not take care to defend public objectives there will be a reaction against liberalising policies.

20. For this reason, a policy for introducing competition cannot be confined to liberalisation, but must be implemented jointly with a policy for securing public objectives such as regional balance or protection of disadvantaged groups so that, while enhancing the country's efficiency and wealth, the previous redistributive goals will be maintained. Indeed, the advantage of competition is that, by making production more efficient, it allows the social objectives pursued by regulation to be maintained and even enhanced.

21. In this respect, before taking any move to liberalise prices in the market, a number of aspects need to be assessed, such as: (a) market structure, (b) entry barriers, (c) entry of new firms into the market, (d) market power, (e) essential assets, (f) the possibility that deregulation may spark price increases; and (g) assessment of the type of liberalisation approach, gradual or simultaneous.

A. Market structure and degree of concentration

22. The following information needs to be ascertained:

- Number of firms in the market. The headcount of all firms in the relevant market. If a complete headcount is not possible, identify at least the main market representatives.
- Distribution of firms in the market, by size. It will usually be difficult to obtain every firm's market share. However, it should be possible to get an idea by grouping businesses into categories (small, medium and large) and the number of firms in each category.
- Concentration. The Herfindahl-Hirschmann concentration index (HHI.)) will usually be hard to obtain, as it is difficult to gather information on production levels of firms in the market. Where available, market shares of the main representative firms can be used for the calculations. However, it may be easier to calculate a simpler measure, such as the concentration index for four or five firms, which requires less information.

23. The specific thresholds for the market concentration level or the number of firms to be used will be decided by specific guidelines in each country.

B. Entry barriers

24. Generally speaking, entry barriers may be defined as factors that obstruct the entry of new firms into a given market. Assessing the scale of the entry barriers is important, as it provides a perspective of the degree of potential competition that firms already participating in the market may face. For example, if entry barriers are high existing firms may exhibit anticompetitive behaviour, raising prices and reaping greater profits without fear that their earnings will be eroded by new entrants. To put it another way, when entry barriers are lower, there will be greater room for competition, and this has a disciplinary impact on companies already in the market, restraining their exercise of market power.

C. Entry of new firms into the market

25. The entry of new firms will inject price competition, encourage innovation, create productive efficiency gains, and result in a greater variety and quality of goods and services offered. If market entry is relatively easy, participating firms will have fewer possibilities of exercising their market power. In effect, if they do so by boosting prices and making greater profits, they can expect new firms to enter the market promptly, eroding the profits of those already there.

D. Market power

26. While concentration data are a useful starting point for the analysis, it is important to note that a proper evaluation of effects on market power must take into account issues relating to entry barriers and the competitive conduct of established firms. For example, if there is a high degree of concentration in a given market, together with entry barriers that are hard to surmount, there is a considerable probability of detecting market power.

E. Essential assets

27. To understand the importance of certain assets today we must recognise a series of elements that sometimes play a key role, making those assets an indispensable part of a given market. Those assets combine with factors of geography, infrastructure and even transport in order to be deemed essential. In this section we offer a theoretical description of Essential Facilities (EF) as they relate to competition conditions.

28. To identify an essential facility we must examine certain conditions such as the market situation (market structure) as well as factors of capacity, access and availability relating to the attempt to establish the EF, which must satisfy the condition of being a "bottleneck" in the provision of a final good or service.

29. Among the characteristics of an EF are these: (i0 it is provided under conditions of monopoly; (ii) it is not currently available from any other source; (iii) a competing firm has no possibility of duplicating the EF, for economic reasons; and (iv) access to it is necessary to maintain downstream competition.

F. Possibility that deregulation will produce price increases.

30. The possibility of price increases under an economic deregulation scheme will flow, in part, from the market's potential for producing effective competition, and will be related to the previous items. For example, if existing firms have the capacity to limit entry or force the exit of firms from a market, there is a probability that prices will rise.

G. Determining the type of liberalisation scheme

31. The advantages and disadvantages of applying a gradual or simultaneous scheme for liberalising market prices must be assessed.

V. Liquid Fuels Market in Honduras

A. Market structure

32. Because of their many uses, petroleum derivatives are of undoubted importance for the economy. Currently the many uses of petroleum derivatives are vital to the functioning of a country, in terms of power generation, industrial development, diversified transport services etc., and this highlights the priority that must be given to ensuring optimal conditions for this item in the market.

33. According to data from the Petroleum Administration Commission (CAT), the market for oil derivatives in Honduras is approximately 54,000 barrels a day, amounting to 17.8% of consumption in Central America and Panama (304,000 barrels a day) and 0.2% of consumption in the United States, where the market is 22 million barrels a day. Consumption in Honduras represents only 0.05% of worldwide consumption.

34. Consumption is concentrated in four fuels that account for approximately 80% of the country's total consumption: bunker (35%), diesel (25%), superior-grade gasoline (11%) and regular gasoline (7%).

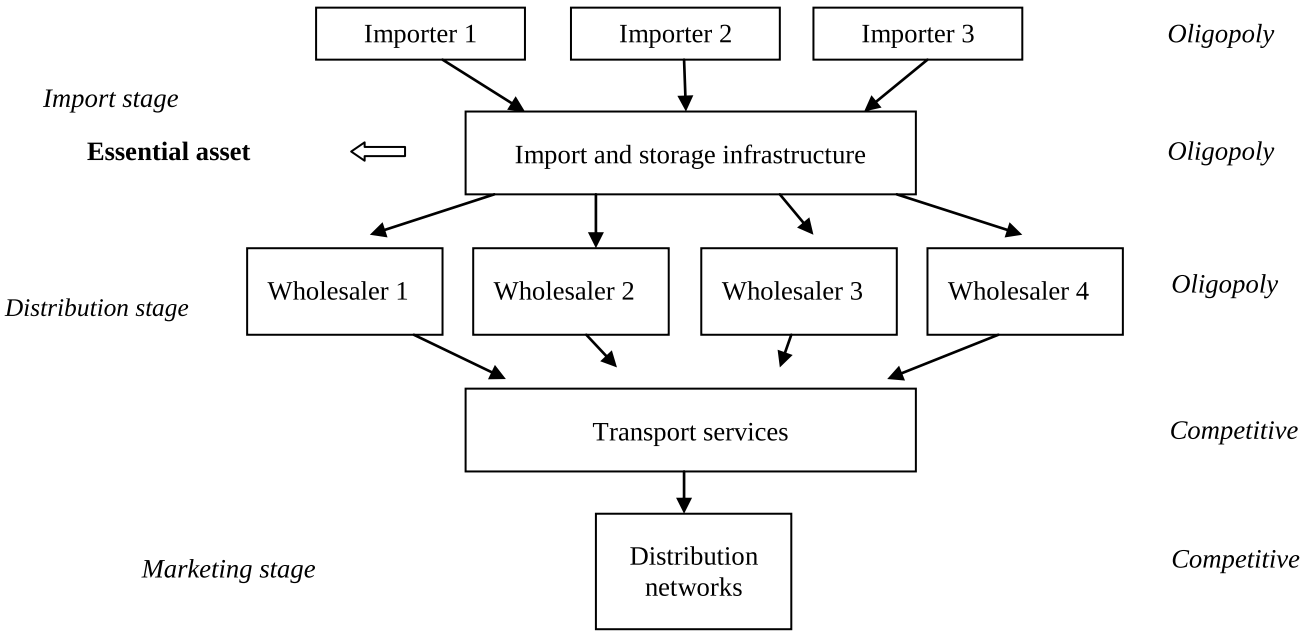
Ranking	**Fuel**	**%**
1	Bunker (fuel oil)	35.5
2	Diesel	25.5
3	Superior gasoline	10.7
4	Regular gasoline	7.4
6	Kerosene	1.8
7	Others	19.1
	Total	100.0

35. In Honduras, final consumer prices are regulated by the government. Gasoline, diesel and kerosene prices are adjusted, generally, every seven days. The system used in the country is based on an Import Parity Price (IPP) formula applied by the Government of Honduras, which contains different components that make up the structure of prices and are totalled to obtain the final price of the product. Those components are:

IPP formula: Liquid Fuels
US Gulf Coast Price (USGC spot)
+ Premium or – discount
= Price ex ship
Exchange commission
Demurrage
Inspection costs
Customs costs
Maritime terminal, storage and related services
Financing cost
= import Parity Price before taxes
Contribution for social programmes and road conservation
= Maximum selling price to wholesale distributors
Wholesale mark-up
Land transportation
Retail mark-up
= Final price to the consumer

36. To determine whether in Honduras there are structural conditions in the industry that would allow for a liberalisation process that would guarantee competitive prices, we must have a schematic vision of the industry. This will serve to inform the debate as to whether existing economic conditions are such that, in a context of price freedom, there would be sufficient competition to guarantee economically efficient prices.

37. The following diagram presents this schematic vision of the vertical and horizontal relationships. It highlights the relations that depend on some kind of essential infrastructure which, as noted above, can have consequences for competition in the industry.



38. The liquid fuels market in Honduras embraces four different items needed for the industry chain in this sector: importation, installations, transportation and distribution.

1. Importation

39. Importing firms sign private supply contracts with an international provider, which ensures them a regular supply in accordance with the monthly scheduling of shipments by the importer. In Honduras there are several importers of liquid fuel for marketing: Refinería Texaco, Petroleos del Atlantico (DIPPSA), Petroleos del Pacifico (DIPPSA), Esso Standard Oil Ltd., Shell Honduras SA, and Hondupetrol.

40. In addition to commercial importers, some power generators also import their own fuel. These are: Lufua, Enersa, Elcosa and Emce, which belongs to the Hondupetrol group.

2. Facilities

41. In order to import, firms require sea terminals and storage plants. The effective possibilities of entering the market and disciplining current importers with respect to collusive behaviour depend on having access to or developing import and storage facilities.

42. In Honduras, not all importers have their own facilities: some lease unloading and storage facilities from other importers or from the National Ports Enterprise (ENP). The infrastructure needed to import fuels constitutes the essential facility in the case of Honduras, because of the characteristics described in the previous section of this paper.

3. Transportation

43. Distribution operations require transport services. In Honduras there are no pipelines for transporting derivatives from the storage plants to consumption centres, and transportation is consequently done by tanker truck.

44. At this stage of operations, in principle, there should be no problems of competition in the industry. The structural conditions are propitious to a highly competitive market. In fact, tanker truck

investments are not indivisible, they are relatively low in comparison with the other assets required in the industry, and there are no economic barriers to entry in the transport industry. However, existing regulations in Honduras have generated distortions that affect the degree of efficiency in the industry.

4. Retail distribution

45. In Honduras, the retail distribution of oil-derived fuels is done via service stations, commonly known as *gasolineras* ("gas stations"), which dispense the various liquid fuels to the final consumer. There are approximately 407 stations nationwide: 95 of them belong to multinational companies, 256 are independently owned, and 56 belong to distribution companies.

Brand	**Number of stations**
DIPPSA	106
TEXACO	85
SHELL	82
ESSO	56
COPENA	25
PUMA	24
PEHON	12
A PETROLEUM	11
PETROGOLF	6
Total	**407**

B. Entry barriers and entry of new firms into the market

46. The possibility for new importers to enter the market is essential so that potential competitors can reduce or counter the market power of existing importers. This possibility is affected by the level of investment that firms must make to develop and build facilities. The necessary investment is calculated at approximately $7.5 million for a terminal and storage plant with a capacity of 250,000 barrels.

47. The investments required for importing oil derivatives by sea are high. Consequently, while there are no barriers to entry for new importers, they need a great deal of capital to invest in sea terminals and storage facilities, with the latter being particularly important because this is a prerequisite for issuance of an import license.

48. This situation is considered a "bottleneck" to market entry for potential importers. Entry is difficult because of the high levels of investment needed for development and construction in order to duplicate the essential asset, which in this case consists of sea terminal and storage facilities.

49. During the last two years the Petroleum Administration Commission has received one application for a fuel import permit, which was denied because the applicant did not have the requisite storage facilities nor any "cohabitation" (*convivencia*) contract with existing firms.

50. This shows the relative immobility of players in this industry. The sunk costs that a firm must absorb are such that entry is very difficult. In addition, the existing structure of the market is rigid: there are five importing firms, four of which share facilities through "cohabitation contracts".

C. Market power

51. The degree of concentration must be examined at different levels of the market so as to determine which is the most concentrated segment.

52. For these purposes we shall examine the import volume of each of the importing firms, storage capacity by type of fuel, and the number of service stations.

53. The fuel market chain in Honduras, in contrast to other countries in the region which have their own refinery, comprises only three segments: the import segment, the wholesale distribution segment, and the retail distribution segment, which sells the product to the final consumer. However, it must be noted that this chain has varying degrees of vertical integration.

54. Horizontal relationships are essential for determining the degree of concentration that may exist among firms. Market power could facilitate collusive agreements between the different firms. Such agreements are illegal, and so we shall refer here to tacit collusive agreements, which do not require explicit contracts among agents.

55. The fewer the number of market participants the lower will be the costs of a concerted pricing policy, because the costs of negotiating and overseeing collusive agreements will be lower.

Concentration Index
Liquid Fuel Importers
Import Volumes 2008

Firms	Imported volumes	Share	HHI
Hondupetrol	3,592,250	32.8	1,077.2
DIPPSA	2,864,961	26.2	685.2
Refineria Texaco	2,704,513	24.7	610.6
Esso Standard Oil	1,783,348	16.3	265.5
Total	**10,945,072**	**100.0**	**1,561.2**

Concentration Index
Liquid Fuel Facilities
Nominal Storage Tank Capacity 2008

Firms	Imported volumes [sic]	Share	HHI
DIPPSA	833,000	37.11	1,377.4
Refineria Texaco	793,340	35.35	1,249.4
Hondupetrol	618,100	27.54	758.4
Total	**2,244,440**	**100.00**	**3,385.3**

Concentration Index
Retail Distribution
Stations Nationwide 2008

Firms	Number of stations	Share	HHI
DIPPSA	106	26.0	678.3
TEXACO	85	20.9	436.2
HONDUPETROL	82	20.1	405.9
ESSO	56	13.8	189.3
COPENA	25	6.1	37.7
PUMA	24	5.9	34.8
PEHON	12	2.9	8.7
A PETROLEUM	11	2.7	7.3
PETROGOLF	6	1.5	2.2
Total	**407**	**100.0**	**1,800.4**

D. Determination of the type of liberalisation scheme

1. Gradual liberalisation

56. A gradual liberalisation of prices in the hydrocarbons industry implies that the various regulated prices (supply price, wholesale mark-up, freight and retail mark-up) are liberalised at different times and in a sequential manner.

a) The advantages of this option are:

   i) It facilitates supervision of the liberalisation process by the sector authority. With a sequential liberalisation of prices it will be much easier to identify potential problems of competition that may emerge in the industry. For example, if initially only the supply price is liberalised, i.e. the price at which importers may sell to distributors and marketers, and if mark-ups rise, then it will be clear as to which link in the industry must be addressed

   ii) If the last price to be liberalised is the price to the public, there is less risk that price liberalisation will affect the final consumer.

   iii) The political costs that the government might have to bear in the liberalisation process could be lower at any point in time because there would be fewer potentially opposed interest groups.

b) The disadvantages of gradualism are:

   i) If the price to the public is not liberalised, the process will not translate into concrete benefits to the public. This would make it less attractive and its benefits would not materialise.

   ii) Keeping prices to the public regulated and intermediate prices and mark-ups free will signify a source of conflict among different agents participating in the industry, i.e. importers, wholesalers and retailers. All of these will compete for any rent implicit in having final prices fixed and intermediate prices free.

   iii) The political costs that the government might have to bear in the liberalisation process will extend over time as there will always be new interest groups that might oppose liberalisation process.

   iv) The process of reform would be delayed and could be compromised, depending on the political cycle in the country.

2. Simultaneous liberalisation

57. Simultaneous liberalisation of prices in the hydrocarbons industry implies that the different regulated prices (supply price, wholesale mark-up, freight and retail mark-up) are liberalised at the same time.

a) The advantages of this option are:

   i) From the economic viewpoint there are no grounds for choosing any specific sequence for liberalising prices in the industry. This is because it is essentially an industry with a high degree of vertical integration. Simultaneous liberalisation in this context would be more appropriate.

ii) If all prices are liberalised simultaneously, the benefits of greater competition will translate into concrete short-term benefits to the public. This will make the policy more attractive, and it should be feasible to secure popular support for the market liberalisation measure.

iii) The political costs that the government might have to bear in the liberalisation process would not be extended over time.

iv) The process of liberalising the sector would not extend over time, and there is less likelihood that it will be hostage to the political cycle in the country.

b) The disadvantages of this option are:

i) The simultaneous liberalisation of all regulated prices would impose a greater supervision effort on the sector authority.

ii) The pressure exerted on the government by different organised interest groups opposed to liberalisation will coalesce immediately, requiring a greater effort to make the change politically viable.

VI. Recommendations

58. In light of this price regulation scheme, and within the framework established by the Defence and Promotion of Competition Act, recognising that [the existing] regulation does not allow for greater competition, which would result in lower prices and higher quality of service, we recommend that Decree PCM 002-2007 of 13 January 2007 be amended to eliminate the regulation of maximum prices for liquid fuels (diesel and gasoline) to the final consumer, and that those prices should instead be the result of the free play of market supply and demand.

59. Considering the advantages and disadvantages of the gradual and simultaneous liberalisation options, a simultaneous process of price liberalisation would seem the preferred option.

60. Once a price liberalisation policy is in place, the degree of opposition to it will depend on how product prices behave on international markets. That opposition could last longer if, in the period immediately following price liberalisation, international markets rise as they are doing now.

61. Given the concentration that currently exists at the import stage (storage, an essential asset) and in order to ensure successful implementation of the price liberalisation scheme, the following measures should be taken:

- With respect to importers:
  - Facilitate the construction of at least one new "white flag" liquid fuel storage terminal, meaning that it would be obliged to sell or supply under nondiscriminatory conditions to any distributor.
  - For the import of liquid fuels, the government will need to establish an institutional scheme for open access and use, which would include technical, economic and quality conditions as well as the obligation to provide the necessary importing and storage facilities so that, if there is available capacity, potential entrants will enjoy access to and use of the facilities of existing operators under open, nondiscriminatory conditions, at rates that reflect a fair price.

- With respect to wholesale distributors:

  – Under the principle of *isonomia* (equality of rights), establish via the institutional scheme the concept of equality of competitive prices, technical and marketing conditions, and quality during the same period for all retailers of the same brand, ensuring that wholesalers will sell to all service stations under the same flag, under the same conditions, such as volume, term, quality and price.

  – Through the institutional scheme, require all wholesale distribution firms to determine precisely and clearly the basic or net price, either cash or term, for each of the fuels marketed. That price must be public for all service stations, and the conditions of sale must be precise, general, reasonable, nondiscriminatory and public.