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COMPETITION AND COMMODITY PRICE VOLATILITY

Contribution from Kenya

-- Session I --

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COMPETITION AND COMMODITY PRICE VOLATILITY

-- Kenya¹ --

1. Background

1. Kenya's economy is largely dependent on agriculture and its linkage industries. In 2010, the sector's contribution to GDP was 24% making it the second largest source of income after the services sector. Notwithstanding the notable decline in dependency on agriculture from a high of 85% in the 1980's and 75% in the 2000's, the economy remains vulnerable to commodity supply shocks meaning that any market failure in the agriculture sector always has serious ramifications to the country's economic growth.

2. The major staple in Kenya is maize [corn]. Maize farming is mostly rain-fed therefore making the activity susceptible to the vagaries of weather which have in the recent past become very common. For example, in 2004 and 2010, acute rain shortage led to a dip in the supply of maize. This led to volatility in prices of the commodity and its by-products i.e. maize flour, corn oil and animal feeds. In 2008, the competition agency conducted a study of the maize sector after the prices of maize and maize meal prices increased by over 50%. The study findings linked the price hikes to supply constraints which were caused by several factors: the destruction of maize in stores and the interruption of maize planting activities following the political unrest linked to the disputed 2007/8 general election; increased costs of inputs such as diesel and fertilizer which minimized mechanized farming and utilization of fertilizer to boost yields and productivity; refusal by most farmers to supply grain to the largest buyer, the National Cereals and Produce Board, (NCPB), which is also the statutory strategic grain reservoir, due to what they termed as non-commensurate prices; additionally, NCPB which enjoys the monopoly on importation of strategic food such as maize could not assuage the situation mainly because it lacked adequate capacity, in terms of budget and systems, to mitigate the price increases. This scenario was further aggravated by the long and bureaucratic process of maize importation, high demurrage costs due to congestion at the only sea port of Mombasa, and other infrastructural inefficiencies which were passed on to consumers in the form of high prices.

3. The price escalations were also attributed to external factors such as the economic cycles linked to the growing demand for commodities from major economies, notably the BRIC countries for use in bio fuel and cattle feed production. In addition, exchange rate fluctuations played a role, as major commodity markets denominate prices in USD or Euro. Speculative activities by investors who deal with commodities and commodity derivatives accelerated and amplified the number and magnitude of price swings that were unrelated to market fundamentals.

4. Price fluctuations have also been significant in the energy sector where the price of petrol and petroleum products have increased dramatically in the past decade owing to the rising international crude prices, the inefficient refinery, lack of adequate alternative sources of energy e.g. geothermal, solar and wind power, and also infrastructure inefficiencies - the national pipeline company lacks sufficient transport capacity and the railway system is not a credible alternative. The high prices in this sector also contribute

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to increased prices of agricultural commodities e.g. maize, since diesel is used by tractors and gasoline is used in transporting agricultural products to the markets. The infrastructure bottlenecks in the port of Mombasa have also had some ramifications in prices in the neighbouring countries which import their commodities through the port. These countries also have similar climatic conditions as Kenya's, which means that their commodity prices are also usually high making it difficult for Kenya to rely on them for any kind of assistance.

2. Involvement of the Competition Agency

2.1 Maize sector study

5. The competition agency undertook two investigations, one at its own initiative following the increased maize and maize flour prices in 2008 and the other in 2011 on the directive issued by the Minister for Finance², following 'increased costs in the prices of essential commodities'. The need to undertake the study of 2008 was buttressed by a media report alleging that cereal millers were operating a cartel since *"75% of the milling firms belonged to three families who also controlled the importation, transportation and distribution of maize and wheat besides having vast interest in other food items such as rice. In addition to hoarding allegations, the families were also planning to build a second bulk grain handling facility at the port of Mombasa to gain control of the food market and therefore deter small and medium firms from participating in the sector"*³

6. In cognizance of the fact that maize is a local staple and the public outcry was likely to degenerate into a national security matter, the competition agency intensified investigations in the sector narrowing on leads that the millers' trade Association could have been responsible for propagating anti-competitive conduct. The study revealed that the milling sector had 98 firms, most of which were operating below capacity because of shortage of maize caused by reasons highlighted in chapter 1 above.

7. Specific sections of the trade Association's constitution were found to have anticompetitive effects. For example, the main object of the Association was *'to create a forum for millers of wheat and other cereal crops with a view of harmonizing, monitoring, evaluating and stabilizing, marketing, distribution and pricing of products arising there from'*. Specific clauses also allowed for sharing of market data. Another anomaly was that the trade association was registered under the Companies Act as a private company limited by shares. This meant that membership was limited to fifty (50) members. Additionally, membership was restricted to millers with a milling capacity of at least 50 metric tons per day. This portrayed the Association as an exclusive membership club and not a trade association. The exclusivity clause was used to unjustifiably lock out eligible and willing persons from joining the Association and was therefore in breach of the competition law.

8. The investigations further unearthed 3 merger transactions that had been consummated without the agency's authorization. The agency is reviewing these transactions with an objective of invoking the provisions of the law. The agency also ordered for the deletion of the contentious clauses contained the Association's Articles and Memorandum. The Association was required to register itself under the appropriate law, the Societies Act, in tandem with its activities as a trade association.

9. Notwithstanding the above achievements, some legislators attempted to introduce a Bill in Parliament to control prices of essential commodities e.g. maize as a way of addressing the price challenge. This move was opposed as populist and not workable by the Competition Agency, sections of Government, consumer bodies and other stakeholders.

² Business Daily Newspaper April, 2011.

³ Daily Nation Newspaper March 21, 2009.

2.2 *Petroleum sector study*

10. A number of studies have been undertaken in this sector as a result of allegations of ‘cartel activities.’ The allegations are made by politicians whenever local prices increase regardless of their cause. Two studies conducted in 2005 and 2008 by an inter-ministerial taskforce and the competition agency respectively shed more light on the market dynamics.

11. The studies were also carried out owing to the importance of petroleum as the leading source of commercial energy that accounts for about 80% of the country’s energy requirements. The study revealed that the sector continues to face several challenges such as inefficient refinery, poor roads and rail network to facilitate quick transportation, and a capacity constrained national pipeline company.

12. Other findings of the two studies indicated that the petroleum market is oligopolistic. Nonetheless, a number of independent oil marketers which had entered the market were subjecting the big firms to price competition. The study demystified the cartel allegation after it found out that prices differed across similar outlets and different geographic markets suggesting that there was some level of competition. The study recommended that the Government should, among others, facilitate the entry of independent oil marketers and enhance the upgrading of infrastructural facilities, right from the port of entry to the regional depots. The government was also urged to explore alternative energy sources to mitigate effects of dependence on international crude.

3. **Advocacy activities and challenges**

13. The Agency, through these studies, highlighted the importance of a strong and modern competition regulatory framework to realize the benefits of a market based economy. This led to the review of the then competition law resulting in the enactment of the current Competition Act, and a new regulatory agency.

14. The agency also persuaded the Executive to oppose the initiative by the Legislature to impose controls on the price of maize because it was likely to lead to emergence of parallel markets and also attract a lot of resentment from farmers who needed to recoup their production costs through better prices.

15. However in 2011, the Government, due to increased pressure from the Legislature, introduced price regulation for petroleum products. A formula to calculate prices and which is provided for under the Energy Act was invoked by the sector regulator, the Energy Regulatory Commission (ERC). The competition agency advised against this move when it was brought up for discussion. It advocated for the empowerment of independent oil marketers because of their role in moderating fuel prices. It also recommended for improvement of the supply chain infrastructure, from the port to the regional collection depots.

16. Despite the use of the formula, petroleum prices have continued to increase reflecting the prevailing market conditions. Currently there are calls by the same Parliamentarians⁴, for the disbandment of ERC because it is believed to have failed to tame the rising fuel prices. Fortunately, there are initiatives towards improving the petroleum supply chain, through increased funding to improve the port jetties and the pipeline capacity. Also, the government is investing in the exploration of alternative sources of energy, especially wind, geothermal and solar.

17. In the maize sector, the Government has undertaken measures to ensure adequate supply of maize, rather than setting prices. This has been through increasing (a) the budget for provision of

⁴ Daily Nation 17th November 2011.

affordable inputs [maize seed and fertilizer]; (b) the acreage under irrigation farming rather than relying on rain fed agriculture and (c) the uptake of maize reserves and storage facilities. Due to the fact that these measures are long-term, Legislators re- introduced The Essential Goods Act, with the aim of controlling the retail prices of essential commodities e.g. maize flour, petrol, rice and edible oils. However, through the agency's initiative, and the support of the Executive, the Law was watered down by requiring the Minister for Finance to consult 'the industry while setting the maximum prices'. The Constitutionality of the Act is also a matter of discussion in some quarters since the new Constitution recognizes a market-based economy.

4. Challenges and the Way Forward

18. The main challenge facing the agency in its advocacy initiatives is the demand by politicians for quick solutions to price increases even when the causes are not related to lack of competition. Nevertheless, the competition agency has proposed measures to be undertaken in respect of addressing supply shocks in the two sectors to ensure that the prices volatilities are managed.

19. In the petroleum sector, the Agency has successfully advocated for the improvement of the supply chain infrastructure which, due to its inefficiency, has been causing prices to rise. Also, the refinery, which is a toll-refinery, will be transformed into a merchant refinery and the jetties used in offloading the products at the port of Mombasa are earmarked for modernization. The agency has also approved three acquisitions in this industry **with conditions**, to tame possible abuse of dominance by the larger oil marketers. In addition, the Government has increased the budgetary allocation and also provided guarantees towards the development of alternative sources of energy. This will minimize demand for petroleum products and hence temper the price spikes.

20. Regarding maize production, the Government has increased funding for initiatives aimed at increasing and sustaining supply and also minimizing its demand. These measures include increasing acreage under irrigation; increasing budgetary allocation for provision of fertilizers and seed and also for uptake and storage of the maize. The government is also investing heavily on roads to facilitate quicker access to markets and to minimize the cost of transporting maize grain from the farms to the markets. To facilitate marketing and to guard against exploitative middlemen, the Government is encouraging the formation of cooperatives for small scale farmers.

21. However, the above measures, in the case of maize, are facing serious challenges due to fast pace of population growth that has put a lot on strain on agricultural land. Farms have been subdivided to small acreages that are not efficient for production. Similarly the over use of the same land has diminished the fertility of the soils further reducing crop yields. Government has therefore to step up its population control campaigns, while encouraging land consolidation where possible.

22. The fuel price problem has also affected agricultural production because costs of production have increased. This translates to higher output prices.