

Competition and Regulation in India 2009

Leveraging Economic Growth
Through Better Regulation

Edited by
Pradeep S Mehta



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– A CURTAIN RAISER

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FOREWORD

A competitive business environment is central to fostering the gains of productivity and efficiency. If market imperfections are mitigated this substantially improves the bouquet of choices for consumers and provides better prospects both for assured availability and affordable cost of goods and services. An appropriate regulatory culture which harmonises often conflicting objectives is crucial for building responses to evolving challenges. The ultimate aim is to promote innovation and spur the animal spirit of entrepreneurs while making consumer sovereignty the centre piece of regulatory culture.

The conventional wisdom in the competition law literature acknowledges two dominant streaks – the US antitrust and the European Union competition law model. Until 1975, many believed that these were the only two competition law models available. Contrary to this belief, India had a *sui generis* model of competition law as early as 1969 in the form of the Monopolies and Restrictive Trade Practices (MRTP) Act.

The competition law in India is primarily governed by the Competition Act, 2002; an act that attempts to make a shift from curbing ‘monopolies’ under the archaic MRTP Act, 1969 to curbing practices having ‘adverse effects on competition’ and promoting and sustaining competition. While a majority of the procedural provisions of the Act with respect to setting up the Competition Commission of India (CCI) have entered into force, several substantive provisions of the Act dealing with ‘anti-competitive agreements’, ‘abuse of dominant position’ and ‘regulation of combinations’ have yet to take effect.

The history behind the Indian strand of regulation has a close relationship to the advent of progressive liberalisation, privatisation and global integration which gathered momentum in 1991. The optimal strategy for allocation as well as distribution of resources became increasingly based on the market economy. Nonetheless, there is a growing realisation that the textbook model of perfect competition does not exist in reality. Besides, competition law and

policy comprise just one of the intervention strategies employed to address market imperfections which may result in welfare-reducing monopolies.

Literally, 'regulation' means 'influencing the flow of events'. Under this broad definition, regulation has been in existence since time immemorial all around the world. There are several reasons why economic regulation emerged along with the process of liberalisation in India. The significant arguments for economic regulation revolve around: (a) a remedy for information failures; (b) the prevention of abuse of market power; and (c) the correction of externalities and market failure.

Ensuring fair competition remains a key regulatory challenge in India. As we are aware, a competition policy has emerged as an important aspect of international and domestic business, and the primary purpose of competition policy is to improve economic efficiency so that consumers benefit from lower prices, increased choices and improved quality. A competition policy is no doubt a broader concept that includes aspects of regulatory reform, demonopolisation and liberalisation. These are designed to address anti-competitive behaviour and policies, including rent seeking grant of monopoly power and unduly restrictive government regulation.

While modern, liberalised economies have increasingly relied upon markets for allocation of resources, markets many a time fail and lead to undesirable consequences. Globally, it is understood that a new regulatory state has arisen pursuant to the emergence of a 'risk society'. India is no exception. In the past few years the Indian economy witnessed a massive growth spurt. While this has lifted millions of people from poverty levels; it has also led to other concomitant challenges. The country has seen several economic wrong-doings and scandals during the period of economic boom. Significant government involvement marked by the dominance of large state owned public enterprises and over involvement of the government cutting across sectors have not only stifled competition but also led to poor services and fewer choices for the end user. This underscores the need for a sounder economic regulatory regime and regulatory reforms to adopt the best practices in regulatory architecture for ensuring distributive justice to all.

The sector-specific regulator is closest to the sector and would naturally be a repository of pertinent information available within that sector. It would be more in tune with the business needs of the sector. With several regulatory authorities cropping up simultaneously, it is natural that they might end up having overlapping jurisdictions. Establishment of a competition authority by

itself does not resolve all problems relating to creation of competitive conditions. Regulation must also keep pace with innovation, not stifle an innovation culture.

I am indeed happy that CUTS International is bringing out this report, the second in the series, to explore issues relating to sector regulation pertaining to power, ports, higher education, agricultural markets and civil aviation besides dealing with the issue of 'quality of regulation'. This study is an important contribution towards enriching the available literature in the public domain and encouraging a dialogue to promote a healthy and competitive environment as evolving an appropriate regulatory culture is always a learning curve.

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INTRODUCTION

The recent financial meltdown and the global recession it has sparked off have highlighted the inability of markets to do it alone. In fact ‘markets’ or ‘regulation’ are not mutually exclusive as many free marketers might have us believe. The recently highlighted logic for regulation of financial markets can also be brought to bear on infrastructure sectors to yield policy advice.

The important lessons that can be gleaned from the recent recession and case studies of infrastructure sectors in this volume and elsewhere are: it is important to have fair competition, not totally free competition; it is equally important to have appropriate market correcting regulation, not over or under regulation.

Contrary to what many free marketers think, the rationale for regulation is built firmly into the foundations of neo-classical economics. Neo-classical economics talks about three classes of market failures: natural monopolies, asymmetric information and externalities. These describe scenarios in which markets do not serve us well and have to be regulated. Such regulation can take various forms – restriction of competition in the first case, information disclosures, screening mechanisms etc. in the second case and taxation of production or consumption activity in the third.

However, there are other ways in which regulation can be useful. Note that neo-classical economics builds up an ideal of perfect competition which maximises economic welfare (the sum of producer and consumer welfare) in the absence of market failure. In real life we do not find perfect competition being accurately depicted by economic behaviour but only see approximations of it.

The deviations from perfectly competitive behaviour are often unavoidable: distances among sellers, differences in product technologies etc. In yet other cases these are not unavoidable but acceptable: distinctive packaging and

customer services that go with the product are often used to capture markets. However, there are others which are considered as unfair or a breach or “accepted norms” – predatory pricing, tied sales, misleading advertisements etc. In other words, these are practices considered ethically wrong as these are used to out compete rivals and have nothing to do with ‘productivity’ or ‘efficiency’ – characteristics valued by consumers.

Thus, the objective of regulation is two fold: to deal with market failures and prevent ‘unfair competition’ or equivalently to ensure ‘fair competition’.

Given that the regulatory apparatus is a necessary and important component of the system of economic governance in any country, it is important to evaluate its features: its adequacy as provided by law, effectiveness after being set up, awareness of consumers and other stakeholder groups about its availability and usefulness, and their perceptions about regulatory effectiveness.

The *Competition and Regulation in India* series serves the mentioned purpose for the Indian economy. The 2007 Report has already been published and deals with the subject of regulation using a broad brush discussing the need for competition policy and law, its evolution in the Indian context and throwing light on anti-competitive practices that are important in the Indian context. The perceptions of stakeholders about the status and implementation of competition law and policy in India is also captured. Section 1 discusses the main contributions of this report.

While competition law and policy which applies to the entire economy is important, so is sector regulation. Sector regulation can take account of the specific technical nuances that characterise a sector and modify the behaviour of actual and potential participants. The 2009 report therefore focuses on the evaluation of sector regulation in India. The quality of regulation in five sectors – power, ports, higher education, agricultural markets and civil aviation – is evaluated by this report.

Before embarking on the evaluation of quality of regulation in these selected sectors it is necessary to define ‘regulatory quality’ and delineate and elaborate on its various aspects:

- The appropriateness of regulation, i.e. both over and under regulation are harmful
- The suitability of regulations, as these appear on paper, for dealing with problems of market failure or anti-competitive practices characterising this sector, if any

- Given regulatory laws, the success of the regulator in implementing these and underlying reasons

Section 2 elaborates on the transition from the 2007 report to 2009 report and the concept of ‘quality of regulation’ which is a building block for the sector studies in the latter report. The choice of sectors for this report is also explained.

Section 3 elaborates on the main findings of the 2009 report and highlights the specific regulatory problems facing each studied sector. In addition, the trends available from the perception and awareness analyses in the first and second phases are also highlighted.

Section 4 suggests the way forward in terms of research, advocacy and outreach.

1. Status of Competition and Regulation, 2007: Highlights

Broad Overview of the Report

The first edition of the ICRR lay down the rationale for a holistic competition regime in India – both sector specific regulatory laws and competition law and policy are needed to promote fair competition in all sectors. The justification for competition law and policy and the associated principles provided by this document formed the basis for a successful campaign for a National Competition Policy (NCP) for India. In fact this report was motivated by the success of an earlier path breaking study of the competition and regulation scenario in India: ‘Towards a Functional Competition Policy for India’.

However, the report had many other contributions. For the first time an attempt was made to assess the awareness and knowledge of people about anti-competitive practices and the need for and state of regulation in the country. These were compiled in the form of summary measures. Perceptions about the state of competition and regulation in the country were also similarly recorded.

Below we look at some of the highlights of the report in terms of concepts explained, analysis carried out and conclusions drawn.

Rationale for Competition law and Policy

The report outlined rigorously the rationale for a competition law and policy – the need to tackle anti-competitive practices and discourage the use of unfair means by firms against consumers, the inculcation of a competitive spirit in the market etc. The linkages between a vibrant competition policy and enforcement of competition law on one hand, and acceleration in economic growth, high quality of life and greater economic efficiency on the other, were also spelled out. In the process certain common myths were highlighted and countered – for instance, competition law and policy favours foreign firms over domestic ones, is a tool for the rich, does not encourage public participation etc.

Nine Principles of Competition Policy

The policies of the Central Government were also evaluated by the report in terms of their tendency to generate anti-competitive outcomes, and nine principles of a competition policy were laid down – competitive neutrality; facilitation of access to essential facilities, provision of facilities for easy movement of goods and services; separation of policy making, regulation and operation; facilitation of free and fair market processes; balance between the needs for competition and an intellectual property rights (IPRs) regime; creation of a transparent, predictable and participatory regulatory environment; public justification of deviation from competition principles; and respect for international obligations.

History of India's Competition Regime

A sketch of the history of India's competition regime and its possible future was also discussed. The emphasis was on explaining the transition from the Monopolies and Restrictive Trade Practices Act (MRTPA) 1969 to Competition Act, 2002 (CA02) and its amendment in 2007. The shift from the former to the latter was explained on the basis of the demands of the consumer movement for effective regulation of anti-competitive practices such as cartels, refusal to deal, anti-competitive mergers and acquisitions (M&As), abuse of dominance etc. These demands first led to the amendment of the MRTPA in 1984 to bring in consumer protection provisions against Unfair Trade Practices (UTPs), and then in 1991 to bring the state sector into its ambit.

The shift from MRTPA to CA02, which is explained well by the report, finally came about because of change in the government's stand in response to lobbying efforts by CUTS and consequent recognition that enhancing

competition is more important than checking monopoly – the MRTPA in its enthusiasm to check monopoly had placed a restriction on dominance rather than its abuse thus throwing away the baby, in the form of competition, with the bathwater.

The report then goes on to describe and analyse the proceedings of the Raghavan Committee which was subsequently set up to draft a new competition policy and law. The committee heard various interest groups and came up with a concept bill which postulated the staggered implementation of a new competition law with a cooling off period of three-four years in which advocacy efforts would be undertaken to popularise the new law and invite debate on it.

The Concept bill was revised and finally a draft Competition Bill was placed for adoption by the Parliament in 2003, which was adopted as Competition Act, 2002. The appointments were challenged in the Supreme Court, which reminded the government about the doctrine of separation of powers between the executive and the judiciary. Consequently several amendments were carried out in 2007.

A few major changes were introduced. The authority was split into two: a Competition Commission, headed by an expert, to regulate, and a Competition Appellate Tribunal (CAT), headed by a judge, to adjudicate. Other than that, the selection procedure was legislated as against the earlier one where the government did things in an arbitrary fashion, which actually lead to the challenge in the apex court. However, one major change involved making all merger notifications mandatory as against the earlier provision of these being voluntary, which actually had all big business houses up in arms.

The report, however, notes that CA02 did bring about many groundbreaking changes: extra-territorial jurisdiction which would allow the competition authority to check abuses abroad with an effect on India; the shift from the structural approach of checking dominance to the behavioural approach of checking abuse of dominance etc.

The report also points out a major failing of the competition law as finally passed: it did not postulate a completely neutral and representative procedure of selecting the chairmen and members of the competition agency and continued with the tradition of appointment directly by government.

Institutional and Administrative Challenges Facing the Competition Enforcement Machinery

The report lists the various institutional challenges faced by the Competition Commission of India (CCI) – building its own dedicated staff, effective advocacy through the media and interactions with other agencies, inculcation of a healthy competition culture etc.

The report also mentions many administrative limitations of the CCI – the power with Central Government to supersede it, the need for CCI personnel to get clearances for foreign travel from various branches of the government, its inability to raise its financial resources which were to be fixed by the Central Government, its subordination to policy directives issued by the government etc.

Major Anti-competitive Practices in the Indian Economy

A broad overview of anti-competitive practices and associated challenges was also provided by the report – cartelisation, abuse of dominance and other abuses.

Cartelisation

The significance of cartels as a collusive weapon used by a group of firms against others as well as to exploit consumers is explained in detail in this report through illustration as well as analyses. A classification of cartelising behaviour is presented and estimates of economic loss from known cartels serve to illustrate the danger that these pose for economic health.

Important cases of cartel like behaviour in India, such as that in the cement industry, are pointed out. The oral and implicit nature of most cartel agreements is stressed – this characteristic makes it very difficult to apprehend wrongdoing firms.

The provisions of the new competition law to tackle cartels are highlighted by the report, thereby helping to build awareness about the subject. These are a great improvement over the power given to the Monopolies and Restrictive Trade Practices Commission (MRTPC) to give ‘cease and desist’ orders – the MRTPC could only ask colluding firms to modify their collaboration so that it did not remain prejudicial to the public interest; no immediate punitive action could be taken. Such action could be taken only if the collusive agreement continued in its original form despite orders. Failures of the MRTPC to tackle evident cartelising behaviour are also highlighted.

The CA02 marked a significant change from this lenient and ineffective treatment of cartels by laying down strict criteria to identify cartels – the presence of agreements, arrangements or understanding to control production/distribution or limit price; and the use of identical terms of trade/prices.

The report also highlights the one disadvantage that CA02 has *vis-à-vis* MRTPA – the inability to carry out dawn raids, i.e. unannounced visits to the offices of suspected cartel operators to seize documentary/electronic evidence of a cartel agreement. On the other hand, its provisions also imbue it with a certain advantage. These include leniency provisions which imply that the first (or even the first two or three) out of colluding parties participating in a cartel to cooperate with an inquiry is (are) rewarded with a significant reduction in punishment.

Abuse of Dominance

The MRTPA punished large market shares or dominance. The report highlights that this is inappropriate in conditions when markets might be linked to each other or when the perceived contours of a market hide several segments, each dominated by a different firm. Moreover, it is quite possible for a firm to become dominant in a market on account of its superior productivity or the superior quality of its products,

The report thus elaborates on the rationale for CA02 – it is not dominance per se that it is bad but its abuse that should be punished. The report then goes on to provide a clear definition/classification of abuses of dominance and their illustration in the international and Indian context: exploitative abuse (tying or bundling product sales, predatory pricing, IPR abuses etc.) and exclusionary abuse (competitors are prevented from market participation through exclusive dealing arrangements with distributors or exclusive agreements with input suppliers).

A Campaign for State Level Competition Agencies

The report highlighted the fact that anti-competitive practices were rife at the local level and a central competition agency was ill-equipped to deal with such violations of competition law. It therefore called for state level competition laws and agencies better equipped to deal with local competition abuses as well as protect local consumer interest.

Perception Analysis

The basic conclusions were that the level of awareness of competition policy issues was neither very good nor bad. In general, it recorded the perception that competition and regulatory authorities had been ineffective in checking anti-competitive practices.

Other Sections

Brief accounts were provided of the status of competition and regulation in two utility sectors: electricity and telecommunication as well as social sectors – education and health. In the former, barriers to competition were highlighted while in the latter anti-competitive practices and quality problems arising due to lack of regulation were emphasised.

A Summary of Contributions

The main accent of the 2007 report was thus on regulation and policy that affects the entire economy, i.e. competition policy and law. The rationale for such law and policy was elaborated on (this chapter only provides a flavour of the subject matter addressed) with an associated discussion of anti-competitive practices that such law/policy might help to prevent/control. The components/principles underlying an ideal competition policy were also laid out and recommendations made for the future.

An attempt was also made to ascertain the perceptions of stakeholders about existing regulation as well as the state of competition in the Indian economy. This exercise was seen as part of an ongoing process – future evaluations could be combined with this one to yield a trend.

Some attempt at sketching sector regulatory problems was also made in this report but the analysis was intentionally superficial and imbued with the objective of providing a picture of prevalent anti-competitive practices, barriers to competition and regulatory problems with implications for competition.

The Transition to the 2009 report

The 2007 report accomplished a lot for a single volume. But uncovered ground still remained. Competition law and policy which was the principal focus of this report is only one component of the regulatory structure that binds the functioning of the economy. Equally important are sector regulators – individual sectors have their own technological characteristics (existence of

a natural monopoly, the structure of a network industry, propensity to generate asymmetries of information etc.) which, in turn, determine the nature of regulation. The second report makes sector regulation its primary focus. It also goes much beyond depicting the state of the world in sectors and tries to pinpoint the institutional and other root causes of that state.

Note that the state of each sector and therefore its regulation is determined by the state of the economy (average level of affluence, income distribution etc.) and polity – in short, political economy issues. Such political economy issues not only determine the content of regulations on paper but also their implementation. Political economy and implementation issues thus formed an important part of the 2009 report.

Evaluation of the state of regulation has to be preceded by a definition of the quality of regulation. Three characteristics determine the quality of regulation:

1. It should be appropriate as both under and over regulation are dangerous, i.e. regulation without market failures or its absence in the presence of market failures might be harmful for the economy and impede economic growth
2. The implementation of the regulation: Successful implementation of regulation requires financial and functional autonomy of the regulator (which, in turn, depends on security of tenure of members, a mature political system as revealed by an arm's length distance between the line ministry and the regulator, earmarked sources of funds for the regulator etc.) as well as effective coordination and delineation of functions among sector regulators and competition agencies
3. The pro-competitive nature of regulations

These aspects of quality of regulation are studied in the 2009 report – each sector study comments on the appropriateness of regulation in the initial sections on regulatory trends; a section is devoted to implementation modalities and associated mentioned attributes; finally, a competition assessment of regulation looks at the ways in which these laws restrict or promote competition.

Thus, to summarise, the 2009 report tries to examine the evolution of regulation/regulatory problems from a political economy perspective and assess the quality of regulation in terms of the suitability of content for tackling market failures, the effectiveness and independence of the regulator and the extent to which the set of sector regulations fosters competition.

The actual selection of sectors was done on the basis of discussions of a meeting of the National Reference Group (NRG) members – a collection of distinguished professionals from varied backgrounds linked to infrastructure and regulation in different ways. The group comprised lawyers, competition law experts, academicians, past regulators and former civil servants.

A cross cutting theme to characterise across all sector studies in this volume was selected: the effect of various dimensions of policy on competitiveness in the provision of infrastructure service and access to it. This cross-cutting theme explains the nature of terms of reference formulated for this study with accent on implementation modalities, political economy issues and competition assessment.

The selection of sectors was therefore based on perceptions about the importance of the above in determining regulatory outcomes, i.e. those sectors in which actual physical performance indicators and access to service were affected significantly by the above factors were selected. The sectors selected were higher education, power, ports, agricultural markets and civil aviation.

2. Competition and Regulation in India, 2009: Conclusions and Recommendations

Overview

Experts, both within and outside CUTS, were selected carefully to carry out the sector studies. The draft papers relating to sector studies were subjected to stringent review by selected experts and the NRG. Based on these comments the papers were revised to meet the high standard set by the NRG and the experts. What emerged was therefore an outcome of the collective wisdom of a large number of professionals with experience in the field being researched. The stringent review process therefore facilitated, if not ensured factual correctness, analytical rigour and methodological consistency.

Accompanying these sector studies was a perception survey with a scope far exceeding that for the first report. Not only was the awareness of people about competition and regulation issues gauged and their opinion about the state of competition in India elicited, but also there was a separate section dealing with gleaning of opinions about the state of regulation and actions needed to improve it.

Thus, the perception survey served two important objectives. By continuing to assess the perceptions and awareness of people about the state of

competition and regulation in India it facilitated an understanding on how things had changed relative to the base levels assessed in the first report. Second, statistical analysis of answers to sector-specific questions served as a useful companion to the sector studies themselves – helping to check the findings of these studies and at other times offering explanations for these.

We now look at the main conclusion and policy recommendations emerging from these studies.

Higher Education: Need for Freer Entry and Tighter Checks on Quality

Overview

It was found that the higher education sector is beset by major problems. There are problems of quality – higher education being offered is of mediocre or poor quality with the exception of a few institutes such as the IITs and IIMs. There are imbalances in demand and supply – a large army of graduates in non-technical areas faced with scarcity of employment opportunities co-existing with excess demand for technical skills despite the spurt in vocational education.

The enrolment rate in higher education is still very low despite significant growth in recent times. It compares very poorly with even other East Asian emerging economies at one-third of the level in Philippines and half of that in Thailand.

Much of the problems of undersupply can be attributed to the entry barriers characterising this sector. A university can be set up by legislation only – either Parliamentary or State. Those set up under the latter can operate within the state only. Such lack of competition not only affects the amount of education supplied but also its quality. Below we look at the various issues covered by this sector study.

Barriers to Competition

Competition in the price and quality space is needed to generate consumer satisfaction. However, regulations in this sector often impose controls on fee charged. The low level of fees implies that the quality of education on offer is also poor. Only select educational institutions like IITs and IIMs can offer good quality education despite low fees because of generous government subsidy.

Government subsidy to select institutions coupled with fee control for all violates the principle of competitive neutrality – a level playing field, where

private educational institutes can compete with government supported ones, does not exist. This chokes competition by restricting private entry and reduces quality of education. The situation has been exacerbated by restrictions placed on foreign players in terms of fees charged and the content of syllabi. This has discouraged foreign entry into the Indian higher education sector.

Incentive Problem

The study comes out in favour of allowing profit making in education and reinvestment of surpluses for capacity enhancement. It is felt that opportunities for profit making and reinvestment of surpluses coupled with quality checks would enhance both the quality and quantity of education supplied.

The report does recognise the need to provide access to higher education for all but concludes that control of fees is not the way to do it as competition in provision of higher education and therefore, its quality is sacrificed at the altar of access. The National Knowledge Commission (NKC) has come out with recommendations for a system which can facilitate access without compromising competition and quality. In the proposed system educational institutions would be free to set a fee of their choice. Those unable to pay these fees directly could approach commercial bank for loans. A well funded National Scholarship System for deserving economically backward candidates would also be set up as a part of this system. The recommendations of the NKC deserve careful consideration according to this sector study.

Political Economy Issues

Much of the poor performance of the higher education sector can be attributed to political economy issues and poor regulatory design. While government patronage is often necessary for the development of higher education because of the considerable externalities characterising this sector, the role of politicians and bureaucrats in the evolution of this sector has been far from positive. The authors of the study are quite emphatic in their conclusions that higher education policy has been a product of the government's own interests and whims rather than a clear welfare enhancing vision.

The authors conclude that all education policy and regulation have been motivated to increase bureaucratic and political control over this sector and often even to use educational institutions as a breeding ground for politicians. The situation has improved since the 1980s with the inflow of private and foreign investment. But government has again made an entry through the back door – politicians and civil servants establishing non-profit trusts to acquire land and start their own educational institutions.

Inappropriate Regulatory Structure

Another factor contributing to poor performance is the inappropriate regulatory structure and assignment of regulatory functions. There has been considerable overregulation of 'whom educational institutions can teach', the content and quality of their syllabi and fees charged. On the other hand, there has been an under regulation of teachers, teaching and research.

A complex and confusing web of multiple regulatory agencies and ministries bind the functioning of educational institutions. Overlap in roles, lack of coordination among agencies and inadequate awareness about one's role characterises these regulatory agencies. Thus, many clarifications come from courts rather than legislators or regulators. While higher education is constitutionally a state subject effective control is exercised by the Central government and related governing institutions.

The recommendations of the NKC try to provide a way out of this quagmire caused by the presence of multiple regulators. It recommends the constitution of an umbrella regulator called the Integrated Regulatory Authority for Higher Education (IRAHE) which would be the only agency to accord degree granting power, monitor standards, settle disputes and license accreditation agencies. It would operate on the principles of competitive neutrality. The role of the University Grants Commission (UGC) would be restricted to that of making grants.

However, there is a contradiction between the posited autonomy of the IRAHE and the processes relating to appointment of its members as recommended by the NKC. These recommendations leave enough room for political interference in nomination of these regulators and therefore enough room for manipulation of the entire higher education system by politicians, as we see in other sectors too.

The recent recommendations by the Second Administrative Reforms Commission (ARC) are however not consistent with those of the NKC. It is not in favour of an umbrella regulator and recommends a separate body for each professional field of study. This would supposedly be consistent with the principle of decentralisation and therefore encourage better governance.

However, the ARC does recommend standardisation of regulatory design by law and urges uniformity in the composition and structure of the apex regulatory bodies managing various fields. Apart from licensing functions all other regulatory functions relating to any professional field would be

performed by the concerned apex regulatory body – laying down norms and standards, updating curricula, undertaking faculty improvement, research facilitation and other key issues.

Summary

In short the authors of this study feel that a complete overhaul of regulatory design to facilitate both autonomy and clarity in mandates is necessary to improve the higher education system. This would improve the quality of regulation and therefore of education. There is a need to dismantle regulations that deter entry into the sector and reduce flexibility in offering tailor made instruction; at the same time there should be a strong accent on accreditation and regulation of education quality.

Two others recommendations emerge for promoting competition in the higher education system. First, a strict adherence to the principles of competitive neutrality is considered as being necessary for promotion of competition in this sector. However, this needs to be backed up by liberalisation of fee control and recognition of the right of educational institutions to make profits. These measures would induce competition but not necessarily choke access. The role of the government lies in being in a facilitator of commercial loans or scholarships for deserving needy students.

Power Sector: Need to Overcome Implementation Failures

The power sector constitutes the backbone of the economy. A one percent gross domestic product (GDP) growth is usually associated with a one percent increase in power consumption. To sustain the current rate of growth of per capita income till 2050, power consumption needs to increase twelve times from its present level. Thus, growth in power consumption constitutes a binding constraint on economic growth.

Growth of the power sector in turn depends on the inflow of private resources to this sector, given limited government resources. But private investment in turns hinges on the soundness of the regulatory framework governing this sector. Thus, an examination of regulatory content and design is important.

Evolution of the Power Sector

For many years after independence this sector remained largely a government monopoly in terms of both ownership and control. The State Electricity Boards (SEBs) constituted integrated set ups at the state level and combined generation, transmission and distribution functions.

A huge amount of public money found its way into this sector and average annual growth rate between 1950 and 1995 was around eight percent per annum – an impressive achievement which, however, must be evaluated in the light of the low initial base of 2000 MW for the entire country.

However, inadequate finances implied poor quality of equipment and infrastructure and therefore electricity supply. Political economy issues were at the root of these inadequacies. Equity considerations were cited to provide rural power at extremely low tariffs and often free of cost. However, only the rural rich could avail of the power supply as the poor could not meet installation costs. The large gap between cost and revenues implied growing deficits of electricity boards and often adversely affected their capacity to provide power to distant villages. As of now, 30 percent of rural households have been electrified.

Restructuring of the Power Sector

The inability of the power sector to meet the aspirations of the population and its poor financial health led to its restructuring. The restructuring was two fold: establishment of an independently regulatory body at the state level linked to a Central regulator and unbundling of SEBs into different companies to perform the functions of generation, transmission and distribution.

Unbundling of an integrated set up into various elements was undertaken with an intention of introducing competition into individual elements, wherever possible. After unbundling, generation and distribution are being considered as competitive segments with multiple potential operators while transmission is being regarded as a natural monopoly.

The objective of introducing competition into generation and distribution segments has often been frustrated. The poor financial position of distributing state companies often deters private entry into generation as payments for energy sales are considered insecure.

Open access to the common carrier for all industry players is often not available and deters competition. Though the Electricity Act, 2003 requires the Electricity Regulatory Commissions (ERCs) to facilitate open access, implementation is poor and this objective is often not realised. Local distribution companies force captive power plants to sell only to these companies by denying access outside the state; the result is low prices for the generating company because of the resulting monopsony and consequently, low capacity utilisation.

Yet another barrier to competition in the electricity sector is the continuation of exclusive power purchase agreements (PPAs) which limit sales by generation companies to distribution companies operating in the concerned state. Finally, principles of competitive neutrality are violated regularly as government assistance is provided only to public sector distribution companies.

Regulatory Design and Implementation

The study points out gross inadequacies in regulatory implementation resulting in a lack of regulatory autonomy. The Electricity Act 2003 requires constitution of an independent committee for the selection of regulators (through a stipulated process within a stated period of time) and grants members immunity from removal except in the case of proven misconduct. However, such provisions are often flouted: vacancies continue to exist indefinitely and politically motivated appointments to the ERCs are made. Merit is given the short shrift.

The lack of financial autonomy of ERCs also prevents their independent functioning as most of these have not utilised the right provided by the Electricity Act, 2003 to raise revenues through levy of license fees, regulation fees etc. Capacity building is consequently adversely affected. Government imposed ceilings on salaries also hamper their efforts to attract good human capital.

The resulting adverse impact on functioning of ERCs is evident. Distribution companies have been forced by many state governments to supply free power while the ERCs remained mute bystanders. Even the recommendation of the Act to pay subsidy amounts in advance to distribution companies have been flouted by the state government.

Finally, even though ERCs have provided avenues for consumer participation in regulation, lack of capacity in this regard has prevented consumer bodies from playing a significant role. ERCs can be faulted for not making adequate efforts for capacity building and disseminating the required regulatory information.

Conclusion and Recommendations

After independence for many years the electricity sector remained an integrated set up. Large amounts of public money facilitated expansion. However, a politically motivated tariff structure resulted in regular deficits and consequently poor infrastructure, quality of power supply and rural spread.

The malaise was sought to be overcome through reform which comprised of unbundling of the power supply set up and suitable introduction of competition into the separated elements. However, the flouting of open access principles, continuation of exclusive power purchase agreements, lack of competitive neutrality and legal violations by state governments have deterred private entry and hampered competition.

The important lesson to be gleaned from this is that regulations that are good on paper often do not have the expected impact because of poor implementation. Though ERCs are supposed to be independent of the state governments, in practice they often function as government agents. State governments have been very active in constraining the independence of ERCs by ensuring appointment of former civil servants as regulators. The ERCs themselves have contributed to this tendency by not making use of the powers granted by the Electricity Act to realise financial autonomy.

It is essential that civil society plays a more important role in regulation as necessary powers are granted by the Act. Greater participation by stakeholders in regulation can prevent regulatory capture by governments.

Agricultural Markets in India: Ill Conceived Regulation

Overview

Agricultural markets in India are characterised by fragmentation and the presence of long chains of intermediaries linking the farmer to the ultimate consumer. Moreover, fragmentation provides a bargaining advantage to buyers/traders of produce who extract surpluses from sellers/producers because of their advantageous positions. The actual producer, the farmer thus gets only a small proportion of the expenditure incurred by the consumer. This implies that he is often pegged back to a subsistence level of revenues. Reinvestment into agricultural activities is poor and therefore technological dynamism is lacking. This constitutes a rather convincing thesis of agricultural stagnation.

Quite obviously regulation can play a remedial role in this regard by facilitating competition and regulating middlemen. Better infrastructure and information flows can also bring about better integration of hitherto fragmented markets. This should result in higher prices at the farm gate which in turn can bolster the income levels of farmers and farm investment. This would inject the much needed dynamism into Indian agriculture. Such dynamism can help maintain the tempo of overall economic growth as agriculture constitutes 25 percent

of Gross National Product (GNP) and around 60 percent of the economy's labour force.

The importance of appropriate regulations for creating the right set of market incentives for farmers cannot be overemphasised. Regulations should stimulate competition by dismantling barriers to entry to agricultural markets as well as enable a reduction in the length of the chain of intermediaries separating the final consumer from the farmer.

The concerned sector study in this volume examines the political economy of agricultural markets, analyses the state of regulation in this sector in the light of desired characteristics and comes up with recommendations for future regulation/ regulatory mechanisms.

Political Economy of Agricultural Markets

The study indicates how the existence of a farm constituency that demanded support in the form of output and input subsidies ultimately depressed public investments in agriculture and led to stagnation. Under such a situation, the government tried to build up its support among farmers by ensuring fair and remunerative prices through the Agricultural Produce Marketing Committee (APMC) Act and its amendment.

The Present State of Regulation

Regulation of agricultural markets is governed by the APMC Acts. The basic objective of these acts was to provide fair competition through mandatory auctions of produce in regulated markets. This was meant to generate fair and remunerative prices and to ensure full accrual of payments to the grower without their being whittled down by leakages to intermediaries.

However, implementation left a lot to be desired. Traders had to buy licenses in order to trade, a fact which limited their number and therefore competition for the produce. Producers were also required to sell their produce only to licensed traders in the regulated market area.

Thus, the APMC Acts actually kept the monopsony elements created by market fragmentation alive though these did confer some benefits on the seller through the use of accurate weights and scales, a fair dispute settlement mechanism, better storage facilities and reduction of levies.

The APMC Act was sought to be amended and a model law – State Agricultural Produce Marketing (Development and Regulation) Act, 2003 – was made.

This provided for the setting up of private markets, direct purchases by consumers from farmers and contract farming. The objective was to increase avenues to the farmer for selling his produce and thus ensure more remunerative prices.

The Way Forward

The sector study makes concrete recommendations for enhancing competition in agricultural markets with favourable implications for the remuneration received by farmers.

First, it is essential to remove the restriction on mandatory selling and buying in regulated markets. Instead regulated and unregulated markets should be allowed to co-exist. Such co-existence would increase competition for the farmer's produce.

These regulatory changes should be accompanied by competition enhancing infrastructure changes. The farmer should be provided with information about alternative options to sell (for example, through computer kiosks or through cell phone messages). He should also be given the option of postponement of sales after harvest through provision of warehouse facilities.

In this context the author introduces the concept of "Certified Warehouse Receipts" (CWRs). These receipts, to be provided by warehouses, would be backed by a legal framework. Receipts would state the quantity and quality of produce stored by the farmer in the certified warehouse.

The receipts can be an instrument for ensuring loan compliance. If a farmer takes a farm related loan and fails to repay, the system dictates that the produce automatically becomes the property of the lending bank. Alternatively, he can sell the receipt to a trader who then not only acquires ownership of the produce but also the farmer's liability.

Thus, the system of CWRs meets multiple objectives. Storage facilitates postponement of selling and makes distress sales unnecessary. Consequently, the farmer gets better prices. CWRs ensure that risk in lending to farmers is reduced through greater compliance. This is important as weather and other random factors make agriculture a highly risky activity. Third, the reduction of risks ensures greater lending to farmers from the organised financial sector and reduces dependence on informal money lenders charging exorbitant rates of interest. In summary, higher prices and lower interest burden have salutary implications for the economic situation of farmers and the rural economy.

Futures markets offer another channel for protecting the farmers against price risks. However, there is a need for sound regulation as these can be manipulated for speculative purposes.

In Summary

Agricultural markets in India are characterised by the existence of long chains of exploitative intermediaries separating farmers from consumers and robbing them of a large proportion of final consumption expenditure on their produce. Recent regulations enacted by the government have strengthened the position of traders by imposing licensing requirements though these have also helped in shortening the chain of intermediaries. Clearly, much more is needed.

Regulated markets should be supplemented by unregulated ones to enhance selling options for the farmer. Information about markets needs to be conveyed to the farmer through electronic and other means to increase the selling options at his disposal. Storage facilities which facilitate postponement of sales also benefit the farmer by enhancing his flexibility in responding to market signals. Future markets, another instrument, can allow him to hedge market risks. Finally, the system of CWRs can simultaneously reduce lending risks for banks and price risks for farmers, thus helping to alleviate market failure in the formal credit market. This implies a greater reliance of the farmer on formal credit relative to informal credit available only at exorbitant rates. The farmer thus benefits immensely.

Ports: Need for More Uniform Regulation

Overview

Ports constitute an important medium for international trade. About 95 percent of India's trade by volume and 77 percent by value moves through Indian ports. Around 75 percent of India's port traffic is handled by its 12 major ports. The compounded annual growth rate (CAGR) of container traffic handled by Indian ports over the past five years (2002-07) was 22.9 percent. Thus, the port sector has gained in importance in recent times and this trend is expected to continue into the future.

Regulatory Framework: A Critique

All Major Ports are administered by an autonomous body called Tariff Authority for Major Ports (TAMP) constituted in 1997 while minor ports are administered by the state maritime boards. TAMP regulates both vessel related and cargo related tariffs and stipulates conditions governing application of such rates. Usually cost plus methods are used to fix tariffs. TAMP involves

users in interactive consultation exercises which have a bearing on regulatory decisions.

Recently TAMP has issued guidelines for upfront tariff setting on PPP projects. The involved port trusts would have to specify the upfront tariff in the bid document which would constitute a ceiling on the actual tariff. The upfront tariff would be adjusted every five years and take into account technological developments. Actual tariffs charged would be indexed to inflation.

By setting only ceilings on tariffs, TAMP has seemingly facilitated competition between ports. But its autonomy from the government and ability to enforce regulation is in doubt. Appointment, removal and terms and conditions of employment of officers and members of TAMP are controlled by the government. Moreover, the government has the power to supersede the decisions of TAMP regarding tariff fixation.

The author of this sector study feels that in view of the growing importance of ports as a medium for container trade and increasing globalisation of the Indian economy, there is a need to have a unified authority to regulate all Major Ports and Minor Ports in the coastal region of the country and also Dry Ports (such as Inland Container Depots and Container Freight Stations) to facilitate efficient multimodal transportation in the country. Regulation should ensure a proper balance between long term public responsibilities (safety, environmental protection etc) and normal shorter-term business objectives, and should promote competition by facilitating greater access.

In Summary

The role of ports in national economic activity has increased dramatically in the recent past and should increase further in the near future, given the country's enhanced outward orientation. A number of progressive changes have been made in the regulatory environment, which include tariff liberalisation. A provision has been made only for fixation of tariff ceilings and not actual tariffs for PPP projects, thus providing for competition between ports. Further, all Major Ports have now been put under the same tariff authority, TAMP, since 1997.

However, there is scope for greater consolidation as the 187 Minor Ports of the country are regulated by individual state maritime boards and follow their own rules regarding tariff fixation. In any case, even the TAMP needs to shift from cost plus norms to normative methods for fixation of tariff ceilings in a bid to encourage efficiency. There is also a need for greater autonomy of

TAMP as the employment conditions of officials/members are currently controlled by the government which also has the right to supersede its decisions. With the government having considerable shipping interests of its own it becomes very hard for the regulator to adhere to principles of competitive neutrality.

Civil Aviation

With the termination of government monopoly in the airline sector and its opening up to private competition, certain positive changes have been noticed: increase in passenger traffic and reduction in fares.

However, the competition generated has been marked by various imperfections. While traffic on profitable popular routes has increased considerably that on less profitable routes has contracted. Government airlines still continue to be associated with staff strength completely out of proportion to fleet size i.e. these have not responded adequately to competition from private airlines.

Private operators have taken advantage of lax competitive response from government airlines by fixing their tariffs just below government tariffs for equivalent service or by providing slightly better quality of service for the same tariff. Competition has failed to maximise efficiency and minimise costs in the sector.

There are other sources of anti-competitive tendencies. The opening of large green field airports has been accompanied by the closing of existing airports because of a rule that prohibits airports from being located within 150 kilometres of each other. This has resulted in regional monopolies in the supply of airport facilities, enabling airports to charge prices far in excess of competitive levels which have in turn resulted in higher passenger fares and lower capacity utilisation of aircrafts.

The government monopoly in air turbine fuel (ATF) is yet another source of anti-competitive tendencies as it results in a price of ATF which is far in excess of international levels. This generates an upward pressure on passenger fares. Yet another regulation which generates an anti-competitive tendency is the ban on investment by foreign airlines in the domestic airline sector. Such investment could have been a medium for transfer of sound business practices.

Important regulatory changes are in the offing with the passing of the Airport Economic Regulatory Authority (AERA) Bill which has set up an AERA.

However, the accent on inclusion of retired government servants in the regulatory authority and significant powers provided to the Central Government to remove AERA's members from office implies that in reality such autonomy would be absent.

The study concludes by making several recommendations targeted towards removing barriers to competition:

- comprehensive regulatory/policy framework that stimulates cost cutting, price reducing and quality enhancing competition through an integrated coverage of aviation and airport infrastructure issues
- rationalisation of pricing of ATF
- permission for entry of foreign carriers into domestic aviation
- multi-airport approach for urban areas

Perception and Awareness Surveys

The survey carried out in 2006 for the 2007 report dealt mainly with perception and awareness regarding competition issues whereas the 2009 report not only replicated the 2006 effort in 2008 but supplemented it with a survey on the state of sector-specific regulations. In both years the questionnaire surveys prepared for stakeholders from business were slightly different than those for other groups of stakeholders (CSOs, academia, government servants, media and technical experts), given the more substantial interest of business in competition issues (attitudes can vary from a dislike of competition in the case of big business to very strong support for it in the case of small business).

The 2008 survey revealed almost universal improvement in perception and awareness over 2006 levels with regard to the competition situation. The only exception to this trend was business's perception that the impact of government practices on competition had worsened.

In higher education, stakeholders expressed the view that the 'requirement for passing of legislations to establish universities' and 'lack of competitive neutrality' were powerful entry barriers. Technical education provided in the country was judged as mediocre. Business people opined that the sector should be exposed completely to the free play of market forces whereas others considered 'exit examinations' and 'monitoring of infrastructure' as useful regulatory measures. The National Assessment and Accreditation Council (NAAC) won overwhelming support for continuation as accreditation authority. Finally, 'lower fees for needy students' were the single most popular

option among stakeholders for achieving the right balance among access, quality and cost.

As regards the port sector, it was felt by a majority that competition is practically absent and an umbrella regulator is needed. Moreover, a protectionist tendency by itself or in combination with poor inland connectivity is a good explanation for this lack of competition.

With regard to agricultural markets, a popular perception was that licensing requirements for traders have hurt farmers. Another popular opinion was that dissemination of information (through computer kiosks) might improve their situation.

'Excessive subsidies' were a popular explanation for poor expansion of private capacity in power. The lack of success of power regulators was attributed almost equally to vote politics, poor adaptation by public utilities to the regulatory environment and the absence of regulatory independence.

3. Lessons Learnt: A Synthesis of Study Findings

Competition and Regulation in India, 2007 was focussed almost entirely on the state of competition in the economy. Evolution of competition law and policy in the Indian economy was studied and recommendations were made for the future, taking into account the strengths and weaknesses of the economy and past history, particularly with regard to anti-competitive practices. A survey was also carried out to assess the perceptions and awareness of stakeholders about these issues.

The focus of the 2009 report on the other hand was on sector regulation in due recognition of the important role played by such regulation in maximising economic welfare in concert with competition law and policy. The perception and awareness studies for the 2007 report were replicated in the 2009 report. As regards perception and awareness about the state of competition, the broad trend showed considerable improvement. An additional component recorded perceptions about sector-specific regulations.

Studies of sector specific regulation concentrated on political economy underlying such regulation, efficiency in implementing regulatory laws and the implications of current regulations and their implementation for the level of competition in the economy.

In general, there is a consensus among the findings/recommendations made through sector studies conducted by experts and those expressed through the survey. For example, in agriculture license requirements for traders were considered by both the study expert and stakeholders as competition reducing. In ports, the expert and stakeholders both favoured the creation of an umbrella regulator. Excessive subsidy to certain groups in the supply of power was again criticised by both and also considered an impediment to the expansion of private capacity.

In higher education, loans for needy students were advocated by the sector study as well as the stakeholders as a means to balance access, quality and cost. This consensus in the recommendations and views expressed through sector studies and surveys reinforce our belief in the usefulness of both.

The quality of regulation is seen as varying a lot from sector to sector. In the case of higher education, the view of the experts conducting the sector study was that barriers to competition are very strong and effectiveness of the regulatory authority is poor. There is a need to enhance quality by doing away with bounds on fees and providing a level playing field for all potential entrants – private, foreign or public. In the case of ports it was recognised that substantial improvements in the regulatory environment have been made; yet regulatory independence is absent and there is considerable heterogeneity in regulation across ports. Considerable entry barriers exist and competitive neutrality is again absent.

In the case of agricultural markets, the expert attributed the low level of competition to their fragmented nature and poor infrastructure, both physical and for communication. Newly passed regulations were evaluated as being counterproductive as licensing requirements for traders in regulated markets have actually converted traders into monopsonists. The recommendations were for less restriction on trading and better physical and communication infrastructure which allow the farmer to earn higher revenues from his produce through better and more varied access to markets.

The study of the power sector highlighted the supercession of regulators by the government and the faulty practices of excessive subsidy and provision of employment which have impoverished electricity boards and created a crisis of confidence among potential private entrants into the sector. Government operationalisation of open access is faulty and renders it ineffective. In civil aviation deregulation was evaluated as being only partial

as airports continue to be regional monopolies and the supply of fuel a public monopoly.

Thus, in a nutshell, some sectors like civil aviation, ports and power have made some headway in modernising regulation while others like higher education and agricultural markets lag behind. Though so called ‘independent regulators’ have been established in all mentioned sectors barring the last, in reality functional and financial autonomy in regulation are lacking in all of these.

In general, entry barriers exist in all sectors to some degree and these can at least be partially attributed to lack of regulatory independence. Both entry barriers and lack of regulatory independence are also linked to political economy factors. For example, the higher education sector is controlled by bureaucrats and politicians through restrictive regulations which make it almost impossible for commercially oriented private players and foreign players to operate.

In the power sector, the rural rich have lobbied effectively for subsidised tariffs citing egalitarian considerations and the resulting impoverishment of state electricity boards has kept private players away from this sector. In the ports sector, the government has given itself powers to remove members of the regulatory authority and facilitated violation of all principles of competitive neutrality to support its own shipping interests.

Negation of pressures exerted by powerful vested interest groups as well as facilitation of independence of sector regulators are two related tasks which should figure prominently on the agenda of reformers.

4. Recommendations for Future Research and Outreach: A Long Road Ahead

The task accomplished by the two reports in the *Competition and Regulation in India* series has been considerable; however, the unexplored terrain still remains vast.

First, many sectors remain unexplored. Petroleum and natural gas promises to be an important sector in the Indian context because of multiple products produced through a vertically linked production process, the recent discovery of natural gas reserves, the significant entry of the private sector through establishment of large refineries, the importance of transport fuels etc. The

Petroleum and Natural Gas Regulatory Board is still in its infancy. In the future as more developments and data emerge, the analysis of the regulatory environment in this sector promises to be a valuable but complex exercise. The same is true of the coal sector because of the importance of coal in the Indian context. Other sectors which can also be studied include primary education and retail sectors. Both play a significant role in the Indian economy from the point of view of human capital formation and demand generation respectively.

While the reports in this series have so far concentrated on infrastructure sectors, it has to be recognised that other components of the economy have to be nurtured as well to support the development of infrastructure. For example, the recent financial meltdown, by choking private spending on infrastructure, has demonstrated that the regulation of the financial sector is also important for competition in the infrastructure sector and therefore for economic development. Thus, a study of the regulatory environment in the financial sector might be in order.

A similar case can be made for studying the regulation of corporate governance. A lack of regulation of corporate governance can spell disaster for the health of individual investors. Moreover, there is always the risk of private infrastructure contracts not being honoured because of dishonest corporate practices, as illustrated by the *Satyam* scandal and its link to *Maytas*, an infrastructure provider.

Finally, there is scope for applying tools which have never been used in the Indian context. For example, Regulatory Impact Analysis has not been used in the Indian context because of lack of data on costs and benefits of regulations. Exhaustive primary surveys are needed to collect credible data on these variables. Such cost-benefit analyses are necessary for scientific choice among candidate regulations or for passing judgement on existing ones.

Another competition issue which has not received elaboration in this series is the scope for simulating competition in natural monopolies through public-private partnerships (PPPs). This is particularly relevant in the case of sectors such as railways and highways, which again remain unexplored in this series. Of particular importance are the negotiation and renegotiation of contracts underlying PPPs which should be tailored to maximise social welfare. Research should deal with the formulation of such contracts and their negotiation.

Thus, the scope for future research, in terms of unexplored sectors, unused research methods and exploration of new methods of collaboration between private and public parties, remains vast. However, research only constitutes the creation of knowledge; its use for purposes of dissemination, advocacy, creation of awareness and capacity building are equally important.

The knowledge created through these two volumes when disseminated in print, through seminars etc would go a long way in creating a competition culture in the country. At present, the participation of stakeholders, especially consumers, in the regulatory process remains rather weak. The active dissemination of mentioned knowledge can go a long way in stimulating the necessary interest and participation of various groups of stakeholders in the regulatory process. The balancing of interests through varied participation should bring about changes in the right direction – more independence for regulators, diminished regulatory capture and new regulatory laws which are in the broader interests of economic development and in tune with changes in technology.

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