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Constitutional Court ruling ushers in new era for energy regulation in South Africa

By Stephen Labson

31 Jul 2019

A recent judgement of South Africa's Constitutional Court involving the country's energy regulator signals a new found willingness by the courts to scrutinise the way regulators set prices and tariffs. This added level of regulatory accountability can only bode well for major sectors of South Africa's economy that are subject to economic regulation.

Industrial users of gas have brought the energy regulator's methodology under the scrutiny of the courts.

The statutory powers of regulators such as South Africa's National Energy Regulator (Nersa) are extensive. Importantly, these powers typically apply to the development of the regulatory frameworks and methodologies in which regulated prices and tariffs are set.

As a check on these powers, provisions of law allow for review of administrative actions taken by regulators. But until now few cases dealing with regulated prices and tariffs have been heard by the courts. Where the courts have reviewed regulatory price determinations, they have typically deferred to the expertise of specialist regulators on matters not explicitly prescribed in statute.

There is a well established body of administrative law that provides reason for this hesitation of the courts 'to step into the shoes of the regulator'. But the unfortunate consequence of this hesitancy has been that regulators have had almost absolute discretion in the development regulatory methods and the determination of regulated prices within South Africa.

A complaint of a group of seven industrial gas users has changed all of this.

A bit of background

The origins of this case date back at least to the October 2011 publication of the regulator's methodology to approve maximum prices of piped gas in South Africa. This was followed by the March 2013 determination to approve Sasol Gas (Pty) Limited's maximum prices for gas piped from its Mozambique production fields.

Facing increasing prices associated with the decision, a group of seven industrial gas users applied to the Gauteng Division of the High Court of South Africa to review and set aside the regulator's methodology and maximum price decision.

The complaint got off to a slow start. The High Court refused to consider the merit of the case. Based on its finding that the 2011 methodology was the administrative action to be challenged, the High Court ruled that the industrial users had breached an established 180-day rule for application to the courts.

The complainants then turned to the Supreme Court of Appeal. The appeal court found that the 2011 methodology document was not of direct and immediate consequence. It also found that the 2013 price determination was the relevant milestone to apply the 180-day rule. With the appeal launched within the required time frame, the appeal court then set out to review the merit of the case.

Lifting the veil

The appeal court scrutinised the technical underpinnings of the decision at a level of detail far greater than had been observed in the few cases of its kind that had preceded it. It was rather critical of the regulator - finding that it had "… decided to apply a criterion which it could not define and did not understand".

Linking process to purpose

Whereas the majority court ultimately found the maximum price decision to have been irrational, it did so on different grounds to those of the Supreme Court of Appeal. In writing the judgement Justice Khampepe framed the relevant question before the Court as

> *"whether the means (including the process of making a decision) are linked to the purpose, or ends."*
>
> Even though the majority court found no cause to rule on the methodology employed by the regulator *per se*, it did find it an essential element of the process, and therefore subject to review.

The Constitutional Court accepted the regulator's stated aim

> *"to replicate competitive market outcomes in approving maximum prices"*
>
> There seems to have been agreement that this competitive market standard follows from provisions of the Gas Act. These provisions require that maximum gas prices must first be approved by the energy regulator where there is inadequate competition in the market.

The court then referred to the overly familiar (and misunderstood) observation that in

> *"competitive market conditions, a firm prices its products at the level where the price equals the marginal cost."*
>
> With this and related observations in mind, Justice Khampepe wrote that "(o)ne of the most relevant factors in the regulator's entire equation…. ought to have been Sasol's own marginal costs of production.

Established case law was then cited pulling together purpose, process, and an observable factor needed to complete the connection in that

> *"…. a failure to consider a relevant material factor in the process of coming to an administrative decision can render the decision irrational."*
>
> Given that the energy regulator had failed to consider this mandatory input (that is, marginal cost) linking the process (that is, methodology) to purpose (that is, price obtained in a competitive market) the majority court found that it had acted irrationally in approving Sasol's maximum gas price.

The Constitutional Court set aside the 2013 decision and ordered the energy regulator to reconsider.

Now what?

It is not entirely clear how the regulator is to use Sasol's marginal cost in determining maximum allowed gas prices. A literal interpretation of the judgment would suggest that prices be set at Sasol's marginal cost. But the court would be well aware that this is a recipe for disaster: Sasol would not recover its fixed costs of production, to say nothing of exploration costs and associated risk, and so on.

But if the regulator employs an approach other than that suggested by Justice Khampepe, will the courts accept it as capable of mimicking the outcome of a competitive market?

Resolving these issues is likely to lead to a more fundamental issue being reconsidered – defining the purpose (or standard) against which regulated prices are to be set in South Africa.

If international experience provides any guidance, this may take decades to resolve.

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