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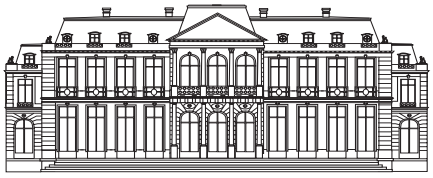

Organisation de Coopération et de Développement Économiques

in co-operation with the Finnish Ministry of Trade and Industry

OECD Advisory Group on Privatisation (AGP)

Twelfth Plenary Session

Regulation, Competition and Privatisation

Helsinki (Finland)
17-18 September 1998

SYNTHESIS NOTE

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Introduction

The twelfth meeting of the OECD Advisory Group on Privatisation (AGP) took place in Helsinki (Finland) on 17-18 September 1998, on the subject of "Regulation, Competition and Privatisation". The meeting brought together high-level privatisation officials and policy makers from non-member countries (Albania, Argentina, Brazil, Bulgaria, Chile, Estonia, Georgia, India, Latvia, Mongolia, Romania, Russian Federation, Slovak Republic, Slovenia, Ukraine and Uzbekistan), experts from international organisations (World Bank, EU Commission) with senior privatisation officials and other representatives from 22 OECD Member countries (see attached final List of Participants).

Several papers were presented and discussed at the meeting. Panels focused on different aspects of the issues at hand (see attached final Agenda) while the general discussion was lively and yielded important conclusions. Overall, the meeting was considered very successful by participants, who also expressed their satisfaction with the increasing role of the AGP as the main international forum for privatisation issues. The present Note attempts to synthesise the main points brought forth by participants during the discussion. It is drafted under the responsibility of the Secretariat.

General Conclusions

There is overwhelming evidence that privatisation has had positive effects on *incentives, profitability and performance of privatised enterprises*. When private incentives are allowed to work and corporate governance improves, productive efficiency at the firm level increases. This, in turn, boosts competitiveness in the relevant product and factor markets. In other words, when privatisation is aimed at firms in competitive markets, it always contributes to the further development of competition in these markets.

Until recently, many infrastructure areas were considered to be "*natural" monopolies*, i.e. sectors in which economies of scale and scope allowed for only one producer. However, recent technological developments have challenged most of these assumptions about natural monopolies. It seems that in the vast majority of infrastructure sectors, some degree of competition is a feasible and efficient solution.

However, competition and other privatisation objectives may sometimes be uneasy policy bedfellows: this might be the case in the area of the infrastructure and utilities sector of the economy where, historically, market structures have tended to be monopolistic. *Incumbent firms* may often argue successfully that the purpose of privatisation is to strengthen them, through a vastly increased possibility to tap international capital markets, so that they may become global players; that in view of intense global competition and/or ongoing regional liberalisation they need to maintain their dominant position at home, by regulatory or other de facto obstacles to market entry; that maintaining the firm as such (i.e. avoiding any pre-privatisation restructuring of the hitherto monopoly) will create added gains for shareholders and thereby contribute to the development of the capital markets; and, most importantly, that there are still vast parts of their activities where a monopoly is still the "natural" outcome of the market.

On the other hand, in the absence of competition, *consumers* are set to benefit much less from increased efficiency at the firm level, in terms of lower prices and better services. Privatisation will produce fewer benefits for the economy as a whole, as allocative efficiency might not improve significantly. The industry might show much more inertia towards rationalisation and adjustment to new technological and global market developments due to the presence of a large incumbent, develop considerably higher entry barriers and lower contestability. Finally, the existence of large monopolistic incumbents, might make the work of the regulator more difficult as there is less transparency, wider information asymmetries and the possibility of capture is greater.

Whatever the chosen trade-off between preserving the incumbent firm and promoting competition, the first step to a successful privatisation in the infrastructure sectors is the clear *separation between regulatory and commercial functions*. This implies, on one hand, the creation of an arm's length relationship between the state as regulator and the firm as producer of goods and services; and the creation of a clear differentiation between shareholder and regulatory functions within the state. Corporatisation might be a long and complicated process, as in many cases privatised firms are often the successors of government departments. Furthermore, the process of corporatisation and commercialisation has affected not only the structure of the relevant sectors, but has also altered the role of the state in the economy and the profile of state institutions.

Privatisation creates *new performance benchmarks for remaining SOEs*. The "equilibrium of inefficiency", faced by many countries in their public sectors, is upset and important incentives are created for better performance even before privatisation. Insider expectations as to the future of the company (and of themselves) radically change and a competitive market for managers emerges, even within the public sector. A robust and credible privatisation programme thus delivers a lot of its benefits before the actual sale of a company. Even companies that are not programmed for sale are subject to increased corporate governance rigour as the state has fewer firms to police and its outlook on what commercial entities should be doing is changing.

Competition and Privatisation: The evidence

Evidence from countries that have implemented privatisation programmes in the 1980s (most notably, the U.K. and Chile) consistently shows that, *where privatisation resulted in the direct introduction of competition, the benefits to the consumers and the economy as a whole were considerable*. Prices fell, even in comparison to pre-privatisation prices which usually were artificially low. Services improved and in most cases exceeded the minimum quantity and quality standards set by the state at the time of privatisation. The range of products and services available to consumers (both industrial and retail) increased. The levels of post-privatisation investment seems to suggest that the whole economy is benefiting from a much better (and better maintained) infrastructure; and that this is a sustainable, long-term trend.

Where privatisation was not followed by the introduction of competition in the sector the evidence is less clear. The services offered have improved in the vast majority of cases, in terms of both quality and scope and investment has picked up. Prices, however, have shown much more resilience than their equivalents in the competitive segments of the industries concerned. Even where regulation was effectively and credibly introduced before privatisation, regulators often miscalculated the potential of the privatised firms for achieving big efficiency gains and limiting entry. Important information asymmetries contributed to these miscalculations. In short, private monopolists are much more efficient than their SOE counterparts in reducing productive inefficiencies but are also much better at extracting rents.

Delaying or rationing the introduction of competition (when competition can be introduced) by tightly limiting entry *does not seem to bear any significant results in the long run.* Rationing of competition has resulted in an effective containment of the "junior" competitor in the market and the emergence of de facto oligopolicstic co-ordination, as experience in the UK and Chile shows. Making licensing requirements more complicated and raising other administrative hurdles, in addition to the presence of a large incumbent, might deter entry altogether as seems to have been the case in Japanese telecoms. On the other hand, there is some wisdom in designing an orderly opening of markets to competition *ex ante* (i.e. before privatisation takes place), and providing for a short timetable for transition. Benefiting from the hindsight of earlier privatisation efforts, Brazil seems to be taking this approach.

Putting a new regulatory framework in place before privatisation is one of the most important prerequisites of the successful privatisation of infrastructure industries. This is the case when natural monopolies are privatised, but it seems to be required also for industries that are potentially competitive. Thus, *regulation is not only needed in the place of competition but also in order to introduce competition.* These are two distinct goals and this distinction should be reflected in the regulatory tools and institutions (discussed below).

Notwithstanding the importance of competition for consumer welfare, *attracting investment in infrastructure in some developing and transition economies might be an urgent, paramount concern to policy makers.* This has resulted in sales based on future investment commitments by the buyers coupled with serious long-term limits on competition provided by the state. Moreover, the hasty nature of these transaction often resulted in ineffective regulatory arrangements prior to the sales. Priming expediency over longer term structural health is not very wise; it seems that in most cases, the state finds itself becoming a hostage to such situations or, alternatively, investors find themselves trapped in an investment and regulatory environment which is much different from what they had initially expected. It might be preferable to obtain lower financial return from the sale of a concession, than to agree to limit competition in the medium/long term.

While *long -term contracting in the context of concessions* (i.e. where the assets remain under the ownership of the state) can be a solution in natural monopoly sectors in need of fresh investment, such practices remain vulnerable to considerable moral hazard and provide ample opportunity for strategic behaviour on behalf of the parties. In this respect, it is important to agree *ex ante* on clear dispute resolution mechanisms and exit arrangements for the incumbent firm, in addition to core regulation on prices and services. In any event, experience shows that even when problems do arise, the final outcome for the consumer under private arrangements is better in terms of availability/coverage and quality of services. Such was the case of the water concession in the metropolitan area of Argentina.

Restructuring the sector (as opposed to the company) by breaking up vertically integrated monopolies has been employed by several countries (such as the U.K. Argentina and, more recently, Brazil) starting in the late 80s, in order to introduce and encourage competition in upstream or downstream markets. The results from some of the earlier experiments with radical pre-privatisation sectoral restructuring, such as the U.K. electricity sector, are very encouraging. Competition seems to have developed and the impact on prices and services has been very positive. On the other hand such a radical upsetting of the industrial landscape might also be much more controversial and less consensual from a political perspective as it is bound to challenge a lot of vested interests. Another important concern, of a more economic nature, is that such restructuring might destroy existing economies of scale. While this might be the case sometimes, it seems better to err on the side of more competition. As the U.K. electricity industry experience shows, the market is quick in restructuring and consolidating itself in ways that are probably more efficient than existing vertical integration within SOEs. The freeing of infrastructure assets resulting

form sectoral restructuring is one of the driving forces behind the emerging global utility companies; they are presumably better at achieving higher productive efficiency, have lower cost of capital and utilise global resources better than protected national companies.

From state to market: the case of telecoms

The telecommunications industry as been one of the sector where rapid technological change has brought the biggest changes in the last few decades. *Technology coupled with deregulation has led to the emergence of intensely competitive market, in areas such as international and mobile telephony.* But even in areas previously thought of as natural monopolies such as fixed line services, competition is now becoming more vigorous, as technology drives down the size of scale economies needed for an efficient presence in the sector and large potential competitors such as cable TV operators are *ante portas.*

Privatisation has played an important part in this change; the size of telecom assets that has come to the market during the last decade is more than USD 180 billion -- in 1997 alone it totalled 40 billion. Access to international capital markets has created several global, competitive companies out of hitherto inefficient state monopolies. This, in turn has increased the momentum for globalisation in the industry and has put further pressure on laggards to privatise and allow for competition.

In the past, many countries had their telecoms organisations integrated with postal services as part of the government. In the run up to telecom privatisation, most countries separated the two services in the context of corporatisation of the telecom carrier. This seems to have been a correct solution: *telecom privatisation seems to have been far more palatable politically than post privatisation*, even though postal services are becoming a competitive industry. This is mainly due to largely misplaced fears about the availability of universal post services. On the other hand, where such separation did not occur prior to privatisation (as in the case of Netherlands), subsequent attempts to separate the two businesses have met with problems and friction between the company and the regulator.

The rapidly changing market structure and technological landscape has affected *the way regulation is designed and implemented*. Countries that have recently faced the introduction of regulation, such as Germany, have had to allow for increasing flexibility in their framework. Price-related regulation seems to be of a somewhat lesser concern for most of the sectors of the industry; interconnection, standardisation and third party access are, on the other hand, burning and complicated issues that the regulators have to face. Addressing them effectively has been a key factor of success in introducing competition (such as in Finland) or a failure to achieve this (as seems to be the case in Japan).

Finland and, to a degree, Sweden adopted a very particular model of telecom reform. They introduced genuine competition at all levels (including fixed line telephony) early on; and the state showed the unusual virtue of consistently maintaining an arm's length relationship with its company(ies), thereby nourishing a genuine level playing field. This has brought substantial benefits to consumers without the state having to transfer ownership. Privatisation has only now become the order of the day. This is largely *due to the need for a broader corporate finance base for firms*, in the face of increasing global competition. In fact, there seem to be only two ways through which national companies can survive in the new context: either merging with a larger multinational player or acquiring a broad investor base among domestic and international, retail and institutional investors.

Regulatory tools and institutions

While there is widespread agreement that specific regulation is needed in most infrastructure/utility sectors, the institutional modalities of its implementation are widely debated. Sector-specific institutions can claim better knowledge of the details of the industry and less important information asymmetries regarding the costs of firms; they are also much better placed to oversee technical aspects of industry standards or third party access regulation. On the other hand, sector-specific regulators are much more vulnerable to capture by the enormous firms they regulate, especially in developing and transition economies. A single regulator (usually, the competition authority) might also achieve economies of scale in countries where the specialised human resources needed to fulfil these tasks are scarce. Finally, coherence in the design and implementation of competition policy might also argue in favour of the general competition watchdog being responsible for industry regulation.

A solution for developing and transition economies might be to adopt industry-specific regulation only when regulation is supposed to remedy the absence of competition, as information asymmetries between a natural monopoly and a non-dedicated institution might be too high. On the other hand, when regulation is there to encourage the emergence of competition the general competition authority might be better placed to play this role, while a narrower, technical role might be envisaged for line ministries/agencies in setting standards and licensing requirements. In any event, the objective of regulation should be narrowly framed; privatisation should not result in over-regulation of the industry.

Where industry-specific regulators co-exist with competition authorities, there is very often a separation and sharing of remedial powers, especially as regards structural remedies. It is important that adequate mechanisms for a smooth co-ordination of action are put in place so that strategic behaviour by the regulated companies can be minimised.

Another source of potential problems in the institutional coverage of regulation is the often vague division of competencies between the central government and regional authorities, especially *in federal states*. These loopholes have been a cause of serious post-privatisation problems in the Brazilian electricity industry and in Russia, in most infrastructure sectors. Under these circumstances, the presence of a strong central authority to oversee, co-ordinate and harmonise regional regulators is of great importance.

The institutional profile of the regulator has also been the object of extensive policy reflections. In contrast to line ministries, *independent regulators* are usually able to attract high level expertise as they have more flexible rules on human and financial resources; they are also further away from the political process which renders them more committed to the usually narrow mandate of the regulator. On the other hand, independent institutions might escape accountability even though their goal is to protect the public interest. It is, therefore, very important that clear lines are established especially as regards the Parliament, to which such institutions should ultimately be accountable, and the judiciary, which should be responsible for reviewing their individual acts and decisions. However, judicial review should not be an opportunity for creating delays and bottlenecks in the course of regulatory oversight, as has been sometimes the case in Chile. Adequate safeguards, possibly including special review procedures, should be put in place so that strategic behaviour and opportunism by the regulated firms are minimised.

Direct price controls on privatised infrastructure firms would cancel a lot of the gains achieved though privatisation. Yet, there is a need to protect consumers from these natural or de facto monopolies, at least until an adequate and sustainable level of competition has been achieved. To this end, two main methods have been developed: *Rate of return regulation* is based on modelling the rate on return on assets that a fictional efficient firm would have managed in the sector. Practice has shown that the theoretical

attraction of this model is very often cancelled by its extremely complicated details; the assumptions on costs and performance are very often far from the truth as regulators become victims of important information asymmetries.

The other main method, *price cap regulation*, consists of the much simpler calculation of the maximum price increase allowed over a period of time. It consists of subtracting a given rate of efficiency gains that is expected from the privatised firm from the average inflation rate over a given period (RPI-x). Overall, price caps have worked more effectively than rate of return regulation. Nevertheless, the actual determination of the efficiency gain(x) is an issue of intense negotiation between the parties. The result has often been its underestimation. In addition, if price caps are to function properly, a rate adjustment period is needed in the run up to privatisation and the establishment of the new regulatory system, so that prices better reflect market conditions. In many countries pre-privatisation prices were totally unrealistic as they were based on heavy direct or hidden subsidies.

Universal service concerns have often been cited as obstacles to privatisation. However, there is little evidence that such problems have materialised. In the vast majority of cases the availability of services has got much better with privatisation than it was under state ownership. Yet, from a political perspective, there might be a need for explicit inclusion of relevant clauses in the mandate of the regulator and/or in the terms of license/franchise to industry participants. There are cases where the availability of services may be of real concern and will thus depend on subsidies. Making such subsidies transparent is an efficient way of dealing with the issue. Moreover, direct (reverse) bidding by potential entrants on the level of subsidies required to ensure a specific service, as has been the case in Chile, might ensure that universal service concerns are met without major efficiency losses. Nevertheless, practice indicates that rendering subsidies totally transparent may encounter serious political resistance as it impacts on the way power is exercised at a regional/local level. This is, once more, an indication of how deeply privatisation can affect the role of the state and political customs.

The periodicity of regulatory reviews is a tricky issue. Too long a period between reviews may hurt consumers as prices might incorporate higher rents for protracted periods of time; too short a period is bad for the firms as they cannot efficiently plan their strategy for the medium term. In any event, the regulator should have an on-going responsibility for monitoring the quality of services provided. *Dispute resolution* is also an area where a flexible yet effective framework is needed. While arbitration arrangements might in principle be a good substitute for slow court proceedings, especially in developing and transition economies, the experience in Chile has shown that a dispute settlement framework that is too open ended might result in opportunistic behaviour by the regulated firm.

Finally, the regulatory framework and institutions should themselves be subject to *sunset clauses*. Markets might become reasonably competitive and the need for industry-specific regulation may eclipse; or experience might show that new tools and institutions are needed in order to respond to rapidly evolving conditions.

Competition in the Privatisation process

In general, *competitive privatisation proceedings breed better outcomes for the sectors concerned.* Countries that have chosen to limit competition in the corporate control market for privatised companies by directly or indirectly preselecting the new private owners have very often found themselves troubled by political controversy and charges of low transparency, favouritism and even corruption; Russia is a case in point. Moreover, even where the state can be trusted to effectuate such operations with integrity and good

judgement, the resulting combinations might often reflect less the interplay of market forces in the sector and more the state's industrial policies.

Trade sales to strategic investors are especially vulnerable to competition failings. The state is often tempted (or captured into) selling its controlling stakes to local interests with negative results on the competitiveness of industry. That is why it might be advisable to require the involvement of competition authorities in the design of large privatisation transactions. Explicit or implicit limits on foreign participation in tenders is another common way of limiting bidder competition. While this is politically expedient, it does little to protect national interests since it prevents the emergence of efficient outcomes of privatisation processes. Foreign ownership, even in so-called "sensitive" sectors might bring substantial benefits to the domestic economy, as experience in Hungary and Estonia plainly demonstrates.

While trade sales in the infrastructure sectors might bring the benefit of fresh investment and a direct infusion of know how, they are less transparent in terms of their post-privatisation outcome. Regulators are therefore more keen to oversee firms that are publicly owned (i.e. quoted in exchanges), hence subject to a much wider and comprehensive set of disclosure principles. *Public offerings* are an open competitive procedure that allows share prices and company valuations to be shaped by the market. Building competition in the offering process itself, for example by creating tension between institutional and retail tranches in book building procedures, is important. This is because privatisation in many countries is the main engine for the development of the equity markets; and a competitive equity market is at the heart of financial resource allocation in the economy.

There is often a discussion as to *whether SOEs are appropriate buyers of privatised assets* in other countries. It might be argued that if their own objectives are still obscured by non-commercial considerations and their incentive structures are distorted, they will not be very efficient agents of change in privatised companies. Moreover, they might prove to be formidable lobbyists in their efforts to limit competition, as they are often backed directly by their government's diplomatic and political weight. In practice, however, these concerns might be overcome by the privatising government's resolve to resist capture. The questions to be asked, in addition to the ones that are put to all bidders, is whether these SOEs operate under investment constraints or other severe corporate finance handicaps in their home markets, in which case they might be unable or unwilling to contribute to the long term development of the privatised firm; and whether they have an experience in operating in competitive product and services markets.

Several countries have chosen to *protect privatised companies from the rigours of the post-privatisation market for corporate control*, through "golden share" provisions or blocking minorities that the state retains in these companies. Their main argument is that , because capital markets are relatively underdeveloped, there are fewer institutions/intermediaries willing to take a longer-term equity interests; as a result, important companies may be subject to an unstable ownership environment driven by short term considerations. The thrust of this argument is directly linked to the corporate governance debate on different models of ownership and control. In any case, it is worth pointing out that equity markets have developed considerably during the last few years and that intermediaries capable of assuming a longer - term, market-based ownership role are emerging; more of them can be expected to appear as pension reform towards fully funded systems progresses. Some countries (for example, the U.K.) have not used their golden share provisions as a corporate control device, allowing for mergers to take place. Overall it seems that these special shares are essentially of a political significance. On the other hand, longer-term ownership of minority holdings by the state might dampen competitive pressure from the capital markets and thus compromise the success of the firm's privatisation.

Finally, the introduction of competition in the choice of advisors and other outside agents in the privatisation process brings big savings to the government and helps to make the process much more efficient. The experience in Spain suggests that some of the basic costs, such as underwriting commissions, legal advice, advertising and marketing can be cut, in many cases, by more than half, if competitive open procedures are adopted for the procurement tenders.