

**PRIVATIZING NETWORK INDUSTRIES :  
THE COMPETITION POLICY PERSPECTIVE**

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<sup>1</sup> The views expressed in this note are those of the author and should not be attributed to the OECD or any of its Member countries.

## **1. Introduction**

In most countries the public utility sector accounts for a significant share of the national product and for an even higher share of the national capital stock. Furthermore, public utility services are essential inputs for virtually all economic activities. Therefore, the efficiency and the quality of such services have, directly or indirectly, a crucial impact on the overall competitiveness, as well as the growth and development of any economic system.

On the other hand, for a long time the common wisdom was that the specific technical and economic features of production in the public utility sector were such as to prevent the existence and development of competitive markets for the provision of these services, and to justify the introduction of extensive legal monopoly regimes, as well as complex and pervasive regulation of firms' behavior.

For those reasons, as competition policy analysis and thus regulatory reform have advanced over the last two decades, much of the attention has been devoted to the area of public utilities. Several factors have supported such changes. An overall re-assessment of markets' functioning and boundaries, due to changes in technology and demand conditions, which in a number of cases have made competition both feasible and desirable; a substantial downsizing of state ownership, largely imposed by budgetary constraints; a widespread dissatisfaction with the average quality of service provision; an increasing awareness of the social cost of legal monopolies, as well as of the shortcomings, and sometimes perverse effects of regulation; and a new political and cultural environment, in general more favorable to free enterprise principles.

The experiences of many OECD Member countries show that the transition from monopoly to competitive markets has followed different paths, both across individual countries and public utility industries, depending to a large extent on the specific economic, institutional, and social context. At the same time, however, some important lessons can be drawn which are relevant to the general design and the effective implementation of policies aimed at producing the benefits - in terms of larger output, lower prices, higher quality and wider consumer choice - that result from market-oriented reforms. Two issues, respectively concerning legal monopolies, and the role of privatization policy in reforming public utility industries, are particularly interesting from this point of view.

## **2. Reconsideration of legal monopolies**

A first point which is worth emphasizing concerns the general reconsideration by many countries of the existing boundaries of legal monopolies. This reconsideration largely originated from the perceived divergence between the scope of the exclusive rights granted to public utilities, and the traditional economic rationale of such exclusive rights, based upon the concept of natural monopoly.

Especially in Europe, where legal monopolies were usually held by state-owned enterprises, the exclusive rights of public utilities have over time extended to the supply of new products and services which, while not being explicit covered by the law, have nonetheless been assigned to the incumbent legal monopolist on the basis of broad interpretations of the original franchise provisions, without any necessary reference to the existence of possible and appreciable economies of scale or scope.

Even more important, this extension of legal monopoly regimes did not take into account that the boundaries of a natural monopoly are not fixed and cannot be determined once and forever; rather, these boundaries crucially depend on technology and market size, and may therefore change significantly both over time and across different economic systems. This implies that, particularly in dynamic industries where innovation in both products and production technology is important, and demand conditions are rapidly changing, the maintenance of legal barriers to entry is likely to entail significant social costs in terms of lower growth and innovation rates, higher prices, lower product quality and more limited consumer choice.

Indeed, it is by no means clear why exclusive rights should exist at all, even when they are limited to genuine natural monopoly areas. Whenever natural monopoly conditions prevail and sunk costs are significant, market mechanisms are themselves conducive to an efficient monopolistic market structure, without necessarily requiring any legal restriction of entry. This is all the more true in the case of public utilities, where the large dimension and the long pay-back period of sunk capital investments are usually such as to sufficiently protect the incumbent operator from potential competition, and to make the monopolistic structure of such industries largely self-sustainable.

The existence of distorted tariff structures, mostly related to the extensive cross-subsidies required to cover the cost of universal service obligations imposed on public utilities, has often be used to object to liberalization policies, since the elimination of the exclusive rights, by allowing competition to develop in the most profitable markets or segments, would prevent public utility companies from complying with such obligations, thereby undermining the achievement of the social goals assigned to them. The

possibility that a distorted tariff structure may invite inefficient entry cannot be ignored, and liberalization policies have usually required a general re-balancing of tariffs. The risk, however, should not be overestimated. Once again, given the huge sunk cost associated with entry into public utility markets, it is unlikely that such cream-skimming strategies could be easily and successfully implemented, unless the costs of universal service provision are extremely large. Furthermore, such costs could be covered through less distorting devices, such as direct public subsidies combined with bidding mechanisms to provide unprofitable services at lowest possible cost, which at the same time would be more transparent than hidden cross-subsidies. Finally, a greater flexibility in terms of price, quality and nature of services, might enable public utility companies to better tailor supply to consumer preferences, and to assure the provision of some demanded basic services at reasonably low prices, while still covering marginal costs.

Another argument put forward against liberalization, concerns the issue of stranded costs related to long-term sunk investments already made, or long-term contracts entered into by public utilities under the legal monopoly regime. The risks otherwise associated with such long-term commitments are largely absent as long as public utilities face no competition for final customers, and are allowed to pass on to them the relevant costs. Once exclusive rights are eliminated, however, new entrants may have a cost advantage over the incumbent, hence could easily undercut him. Stranded assets and contracts may therefore raise serious distributional difficulties, and compensation for stranded costs may be a necessary element for getting political support to reform. Appropriate design of the compensation scheme is, in some instances, an important part of the transition process from monopoly to competition. It is worth pointing out, however, that such problems do not exist when public utilities are state-owned companies. In such a case, indeed, the government could effectively write-off any losses and allocate them to taxpayers, or it may decide to privatize the company, letting the market assess the dimension of stranded costs, and discount them from the overall value of the public utility's assets to be sold.

### **3. The role of privatization policy in the reform of public utility industries**

Privatization is, in many respects, a key component of the liberalization and reform process of public utility industries, playing an important role in the transition from state monopolies to competitive markets.

First of all, natural monopoly in an industry (such as railways) does not necessarily exclude some substitution from other products/services (such as road or airline transportation). In such cases, the privatization of the public utility can help reduce the competitive distortions arising from the soft budget constraints usually associated with state ownership, and strengthen the utility's incentives to minimize costs and increase productive efficiency.

Even where natural monopoly services are not subject to such competitive constraints, however, privatization may still have a positive impact on productive efficiency, since exposing the utility to the risk of takeover allows market forces to exert control over the company's performance. This is particularly important in the context of public utility services, where taking over the incumbent is sometimes the only or easiest way to enter the market. Furthermore, an effective functioning of the market for control might also help the regulator, by providing him with indirect information about the profitability of the utility's business, which could be useful for the purpose of setting and reviewing regulated prices. It is therefore necessary that the privatization of public utilities be carried out in ways which would make the companies' ownership structure as "contestable" as possible, avoiding the introduction of golden shares or other constraining arrangements that would significantly and durably weaken the effectiveness of market mechanisms.

It should also be mentioned that state ownership, especially in Europe, has been for a long time conceived as an alternative to regulation, since it was alleged that it would have avoided the traditional conflict of interests between principal (regulator) and agent (the regulatee). The experience has shown, however, that state ownership, while not eliminating such a conflict, has led to an undue intermingling of functions, with the utilities often taking on the dual role of both players and referees. The privatization of such companies is therefore helpful to establish a more clear-cut distinction between commercial functions and regulatory powers, and to assure a more effective, transparent and impartial use of such powers.

Increasing utilities' incentives to minimize costs, adopt the most efficient production technology, and promote products best matching consumers' wishes, although important in itself, is nonetheless insufficient to assure an efficient allocation of resources, as long as such companies continue to hold significant market power. Liberalizing market entry is necessary to allow competition to develop and discipline the behavior of such enterprises. However, liberalization would still be largely ineffective, since the high degree of vertical integration of most public utilities industries provides the incumbent operator with both the power and the incentive to restrict market access through its control over some essential facility. On the other hand, the monopolistic structure of such markets makes regulatory bodies largely dependent on information provided by the regulated utilities themselves. This leaves them with a significant degree of control over the pricing of essential inputs supplied to competitors, especially in markets characterized by substantial economies of scope, where it is extremely difficult to devise appropriate rules for the allocation of common fixed costs among different uses.

A well designed privatization process can once again be of much help in dealing with such problems, as it might permit a prior restructuring of such monopolistic industries in ways that would facilitate entry and competition. A vertical ownership separation of natural monopoly activities - usually connected to the operation of network infrastructures - from potentially competitive businesses, would greatly reduce the network operator's incentive to restrict access to upstream and downstream liberalized markets. For the same reason it would also reduce the need for close regulatory control over the utility's behavior in order to detect and prevent hidden discriminatory practices. Finally, by simplifying the cost structure of the regulated utility, it would improve the information upon which regulators make their decisions.

Similarly, breaking-up the utility's assets in upstream or downstream potentially competitive markets prior to its privatization, allows competition to develop more rapidly, especially when entry into such markets (such as electricity generation) requires large scale fixed capital investments. Furthermore, when some of the utility's activities are characterized by natural monopoly conditions at the local level (such as for electricity distribution services), such a prior de-concentration would still be advisable in order to increase the number of possible independent sources of information for the regulator, and to facilitate the implementation of regulatory schemes based on the comparison of the individual companies' performance (yardstick competition).

It has been objected that, given the long depreciation period and the high specificity of most public utilities' assets, the vertical separation of such companies, coupled with entry liberalization, would significantly increase uncertainty, thereby reducing capital investments and increasing the required rate of return. The resulting higher cost of capital would ultimately be borne by final customers in the form of higher prices. While such concerns are legitimate, it is also reasonable to believe that as competition develops, derivative markets will also develop over time, allowing operators to enter into, and trade on futures contracts in order to spread the risks associated with highly volatile spot markets.

Sometimes, however, economies from vertical integration might be so important as to suggest not to separate the utility. This is certainly the case of telecom industry, where indeed it would even be difficult to conceive any vertical separation, given that in most instances network operation can hardly be distinguished from the provision of telecom services. This may partially explain why European state telecom companies have not undergone any major restructuring prior to their privatization. Other reasons, though, may well have justified such a choice. They particularly relate to the converge process in telecommunications, television and computer industries, largely driven by the economies of scope generated by technology innovation in transmission systems (optic fibers, digitalization, signal

compression, etc.). The possibility of providing telecom services through a number of alternative facilities (cable TV, computer, satellite, wireless and fixed telephony networks) has paved the way for the development of effective competition at the infrastructure level, thereby significantly expanding the number of actual competitors in the supply of most telecommunications services, and substantially reducing the need for long-term regulation of access to public switched networks.

#### **4. Conclusions**

Throughout many OECD economies, privatization has been, and will continue to be, a decisive component of policies aimed at increasing efficiency and quality, and promoting competition in public utility industries.

The change from state to private ownership usually strengthens utilities' incentives to minimize costs and improve performances, and reduces the distortions arising both from soft budget constraints and from unclear, and sometimes conflicting, government mandated objectives.

Well designed privatization policies, can also significantly facilitate the development of competition, by reducing barriers to entry, promoting less concentrated market structures, and reducing the risk of discriminatory behavior by dominant firms.

Finally, but equally important, privatization can increase the effectiveness of regulation, improving the information available to regulatory bodies, and enhancing the overall transparency of the regulatory process.

A consistent policy design is necessary, though, to achieve such welfare-enhancing results. The complementarity of privatization, competition and regulatory reform policies has to be fully recognized; the scope, method, and timing of the privatization process should carefully take into account, and adjust to, the specific regulatory framework of the markets where privatized companies are to operate, as well as the kind of competition constraints that they can be expected to face.

Clear and consistent policies will decrease the risk of mistakes. More important, they will reduce uncertainty and costs of the transition process, thereby increasing political support to market-oriented reforms, and facilitating their effective implementation.