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IN-DEPTH CONSIDERATION OF:
(i) COMPETITION AND THE REGULATION OF PRIVATIZED MONOPOLIES
(ii) SOCIAL IMPACT AND SOCIALLY-RELATED SUPPORT MEASURES

Issues paper by the UNCTAD secretariat

Introduction

1. The Ad hoc Working Group will take up two topics for in-depth consideration at its third session. These are (i) competition and the regulation of privatized monopolies, including the privatization of public utilities; and (ii) social impact and socially-related support measures. This note attempts to give an overview of the main issues relating to these two topics and raises certain issues for discussion. As this note touches also on competition policy, it should be borne in mind that issues relating to restrictive business practices are addressed fully in the Intergovernmental Group of Experts on Restrictive Business Practices.

2. As regards paragraphs 15 to 17 below, it should be mentioned that general issues relating to the techniques and financing of privatization were considered in depth at the second session of the Ad Hoc Working Group. However, there are certain specificities of public

utilities which may require particular attention. For example, restructuring of railways may take on a different dimension than that of, say, a trading enterprise. The private development of infrastructure through, for example, build- operate-transfer schemes is specific to public utilities, as is the issue of large flotations on the stock market in many countries.

Competition and the regulation of privatized monopolies

3. The strengthening of competition, a necessary condition for the achievement of efficiency gains, is a major objective of privatization. In fact, a major lesson drawn from privatization experiences suggests that, while ownership often matters, competition matters even more. The issue of competition is thus central to the process of privatization.

4. How the issue of competition is addressed depends on the nature of the market into which the public enterprise is to be privatized, i.e. whether the market is competitive or not. Where the market is competitive, i.e. where there are no barriers to entry, competition may be encouraged or strengthened through appropriate competition policy, including fair trading or anti-trust legislation, and by providing a supportive environment, including its macroeconomic aspects, for the development of entrepreneurship and of enterprises, including small and medium-sized firms.

5. Where a market is non-competitive or monopolistic, i.e. where a single firm can produce total industry outputs more efficiently than two or more firms, the issue is much more complex. Such a situation may arise because demand and cost/technological conditions or the small size of the market serve as effective barriers to entry. In this kind of "natural monopoly" situation, there is a potential conflict between cost efficiency and competition; while price competition might be enhanced by the presence of more firms in the market, more firms might lead to higher unit costs and thus to reduced cost efficiency. Thus, in privatizing a "natural monopoly", this competition/cost efficiency trade-off needs to be borne in mind. However, contestability may be introduced by the liberalization of entry, including the removal of any statutory restrictions, and the opening up of the market to foreign competition. Sometimes threats of entry may be sufficient as a form of competitive pressure. However, depending on the nature of the market or of the enterprise, a period of adjustment may be needed, during which the enterprise may be corporatized and placed on a sound financial footing, before it is subjected to the full force of competition. In fact, in simply opening up the economy to foreign competition, a

situation can arise where international competition may require a single enterprise to compete with foreign competitors, while domestic competition may be better served by the presence of more firms. Whatever the market outcome may be, contestability or the threat of competition will need to be part of it.

6. Public utilities may include both "natural monopolies" and competitive sectors. The "transportation networks" of public utilities, e.g. electricity transmission lines, gas and water pipes, telecommunications or railway networks, are "natural monopolies" in the sense that their extensive investment or "sunk" costs or economies of scale act as effective barriers to entry. However, other sectors of public utilities may be open to competition through interconnection to the networks. Thus, in electricity, generation and retail supply are contestable. In telecommunications, competition may extend beyond interconnection to the establishment of new networks, including mobile and fixed networks, supply of user equipment, value added services, etc. Like other "network" utilities, competition is also shaped by particular features of the industry, including, for example, economies of density. Further, new telecommunications network can be installed by using the grids of other industries, including electricity, railways and cable television; and a telecommunications company can also take advantage of its own network to enter the cable television business. In railways, in order to create a competitive environment (for yardstick or comparative competition) or in order to provide contestability, regionally-based services may be introduced. For the same reason, the management of the infrastructure may be separated from that of operations; and the latter may be split into separate entities for passenger and for goods transport and exposed to competition from other means of transport. However, a qualification needs to be added here. Where the markets for regionally-based services are small or where there are important operational economies of scale, splitting up of the operations into regionally-based services, while being good for competition, may be unfavourable for cost efficiency. Other means to provide contestability may be needed. For example, in railways, contestability may be introduced by the licensing of access to the railway network to a private sector operator to compete with the State-owned company.

7. In circumstances where contestability does not lead to reduced cost efficiency, competition in public utilities may be promoted by regulating the conditions of entry, including the terms of interconnection to the networks. Where a particular sector of a public utility is fully contestable, for example, the provision of value-added services or of user equipment in telecommunications, competition is the best regulator; however, appropriate competition policy may be needed

in order to safeguard competition against market failures. Competition policy may also be needed in order to supplement the work of regulatory bodies for public utilities and to deal with any regulatory failures on their part. Thus, depending on the situation and on the particular sectors of a public utility, competition, competition policy and economic regulation can all play a role in regulating the industry for efficiency.

8. The promotion of competition is, in any case, an important aspect of regulatory policy for public utilities, and its different dimensions, including the enabling environment for the development of enterprises and of entrepreneurship, are important aspects of the privatization of public utilities. Thus, the issue of competition as it relates to privatization covers not only competition policy but also the development of enterprises, including small and medium-sized companies, as important actors in enhancing competition (as well as in creating employment) and thus in ensuring the success of the privatization process both in the pre- and post-privatization phases.

9. The regulation of public utilities may include a number of objectives -- economic, technical, environmental and other aspects of public policy. Economic regulation is designed to protect consumer welfare in terms of prices, security and quality of service, as well as to promote efficiency, including through the promotion of competition where possible, and the encouragement of innovation and productivity growth. Technical regulation is concerned with the observance of technical, health and sanitary standards, including, for example, health standards in drinking water. Such technical regulation may be part of quality regulation. In the cases of electricity and water, economic regulation is closely linked to environmental regulation including pollution control relating, for example, to power generation or to sewage disposal. However, technical and environmental regulations are not confined only to public utilities. Regulation of public utilities may also include other aspects of public policy, including social or distributional objectives such as the subsidization (either through direct subsidies or otherwise) of essential services for certain social groups.

10. The form of economic regulation that is most commonly used to protect consumer welfare is price or price cap regulation, where a time-bound limit, linked to the rate of inflation, is placed on the maximum price that the enterprise or industry can charge for a "basket" of services. Another form is rate of return or profit cap regulation which provides for an adequate rate of return that the enterprise can earn on its capital. In this connection, the major problem is to determine a balance between prices and costs, including through direct

negotiations between the Government/regulator and the regulated enterprise, that will protect consumer welfare, while promoting sound investment in long-term growth. The relative merits, implications and costs of the various formulae used in terms of the objectives of economic regulation are questions that may be discussed. There is also the question of the treatment of environmental externalities as an economic cost.

11. There are certain requirements for successful economic regulation, including proper accounting procedures and standards, as well as industry-specific expertize on the part of the regulators, particularly as the availability of information on particular industries is often asymmetrical between the regulator and the regulated. The accounting and information needs of regulators in order to enable them to address issues like "cross-subsidization" (for example, of unregulated sectors by regulated sectors), the role of the media and of organized consumer groups, as well as the requirements for building up a confident, non-adversarial relationship between the regulator and the regulated (leading to a positive sum game) are some of the questions that may be addressed.

12. Other issues that need to be considered relating to public utility regulation authorities concern, inter alia, their power and independence, the risk of "regulatory capture" and the separation of regulatory from policy formulation functions. There is also the issue of whether regulatory authorities for public utilities may be combined for several industries, for example in the field of energy or of transport, and whether they may be located in the same institutional structure as the competition authorities. What implications such arrangements would have, and what "checks and balances" would be needed, particularly where the media is weak and where there are no well-organized consumer groups, are some of the matters that may be considered.

13. The questions of the types and number of authorities needed and of their institutional location are of particular relevance to developing countries and countries in transition. Their answers will depend on the objectives to be achieved, the regulatory capacity of the country, the resources available and the size and level of development of the economy, including its private sector. While many developed countries have a panoply of laws and authorities (fair trading, anti-trust and public utility regulatory bodies) to promote competition and to regulate public utilities and while they are able to attract the investment or the technology needed to enlarge the spheres of competition in public utilities such as telecommunications, this is not true for many developing countries or countries in transition. Such

countries may have to opt for solutions adapted to their own circumstances, needs and resources. However, whatever the solutions adopted, they will need to build up an adequate regulatory capacity, including legislation and institutions for the promotion of competition and for the regulation of public utilities. Even if these countries may only wish to corporatize their public utilities or to contract them out to private management, such capacity will still be needed.

14. In addition to the issues of competition and regulation, the privatization of public utilities, because of their size and importance in the economy, raises other important issues. They are considered in many countries as "strategic" industries which provide vital economic and social services. In some countries, the privatization of certain public utilities such as telecommunications would require a change in the national constitution. Thus, it may not be possible or easy to transfer full or majority ownership to the private sector. However, there are other options, including minority ownership transfer, corporatization, contracting out arrangements and joint ventures. Where public utility services are subsidized, there is also the question of the treatment of subsidies. While general subsidies cannot be justified on allocative efficiency grounds, specific subsidies, for example, those to compensate for diseconomies of density in rural areas, can be justified on social grounds. If not offset by economies of density in built-up areas, they may be paid for directly.

15. An important set of issues raised by the privatization of public utilities is financing; this relates to both the sale of public utilities and the private development of their infrastructure. As public utilities are usually large, the sales of even a proportion of their capital stock can involve large issues of shares and exert a heavy pressure on private sector financing. Thus, the size and timing of share issues, both in domestic and foreign capital markets, and the extent of foreign participation that may be permitted in keeping with the national interest, are all important matters that need to be addressed. There is a need, for example, to avoid destabilizing the domestic capital market by "crowding out" the supply of capital for other investment needs and thereby raising the long-term cost of finance. Again, because of the size of the transaction involved relative to the size of the domestic capital market or of domestic savings, some countries may find it difficult to privatize their public utilities through public offerings and may need to look for other options, including joint ventures with foreign investors. Contracting out is another option; where there is genuine competitive bidding for the franchises, such a procedure can provide periodic competition for the industries concerned. A non-privatization option, which can also serve as a preparatory step to divestiture, is corporatization; such an option has been used effectively in some developed and developing countries in order to prepare public utilities for their successful transfer to private ownership.

16. The private development of public utilities raises certain other issues, including the relative merits and feasibility of different options, including build-operate-transfer schemes, joint ventures and collaborative ventures among a number of neighbouring countries, as well as the nature of Government incentives and guarantees required to attract private sector participation and the particular industries in which such Government support may be needed. An appropriate regulatory framework may also be needed, as it can help potential investors to draw up their investment and business plans.

17. In view of their size and importance in the national economy, the privatization of public utilities involves far more complex and costly operations than that of privatizing a trading company, for example. Questions such as valuation, enterprise restructuring and industrial segmentation in order to enhance competition, method, timing and transparency of sale, underwriting, participation of foreign and "strategic" investors, safeguards (through, for example, the use of "golden shares") against undesirable corporate activity such as hostile takeovers and the concerns and interests of particular social groups (for example, rural populations) assume great importance and call for particular attention. In addition, there may be environmental aspects to be considered. For example, the private development of a motorway skirting a major city can result in the reduction of traffic congestion in the city, with beneficial effects on air pollution and fuel consumption. However, such benefits may need to be weighed against any disfigurement of the countryside. At the same time, because of their importance in the national economy and of the vital economic and social services which they provide, there is greater pressure than in a commercial privatization to show the benefits of privatization, as reflected in the increased supply and quality of services, their prices and in their economic impact (for example, on communications and other enterprise costs and thus on industrial and trade competitiveness).

Social impact and socially-related support measures

18. This is a vast and complex area which touches not only on employment issues but also more broadly on the social balance sheet of privatization in terms of its effects on employment, the provision of social infrastructure or services and of social benefits and costs linked to public utilities.

19. In terms of employment, privatization can have positive and negative effects. In the short-term, the positive aspects include improved terms of employment for managers and employees kept on the

payroll of the privatized enterprises; and access, sometimes free of charge, to a proportion of the shares of the privatized companies (an axiom of privatization policy in many countries). In the longer term, there may be employment gains resulting from increased investment and growth of such companies.

20. It should be mentioned that, in certain countries, privatization projects include arrangements to protect employment in the privatized enterprises for a specified period after privatization, ranging up to five years. Further, a favourable macroeconomic environment creating a climate of confidence for investment and providing alternative employment opportunities can help to smooth the implementation of the privatization process in terms of its employment aspects.

21. The major negative aspect is labour retrenchment, and this has occurred in a number of countries undertaking privatization programmes. However, such a negative impact may subsequently be offset by job-creating growth of the privatized companies or of other enterprises stimulated by the privatization process. In the meantime, it may be attenuated by privatization-induced socially-related support measures designed to help cushion the negative social impact of privatization. Such measures may include redundancy or severance payments, voluntary early retirement schemes, retraining or vocational training, counselling and support mechanisms for the promotion of entrepreneurship, the enhancement of productivity growth and the development of micro, small and medium-sized enterprises. Other measures may include public works programmes and short-time working or work-sharing arrangements.

22. The design or reinforcement of such support measures and their financing are some of the major issues involved. In this regard, without minimizing the importance of social compensation and protection measures, one needs to pay particular attention to services designed to increase the skills, mobility and employment prospects of workers, including those concerned with counselling and the training or updating of skills. Job creation measures, including the promotion of entrepreneurship and the development of micro, small and medium-sized enterprises, are of particular importance.

23. The question of the financing of such measures raises the issue of the use of the proceeds of privatization; for example, to what extent should they be used for this purpose and, where the resources allocated are not sufficient, what other help will be necessary and where they may be obtained. There is also the related question of whether part of the proceeds of privatization should be invested in

assets for longer-term productivity growth such as the development of infrastructural facilities and human resources.

Concluding observations

24.In addition to the issues concerning competition and regulation relating to the privatization of public utilities, and the social aspects, it may be useful to address the question of the development of micro, small and medium-sized enterprises as an important aspect of the privatization process, having regard to their role in promoting competition and in providing support to the process. In this regard, attention may be focused on privatization-led measures to promote job creation and the development of such enterprises, with reference to such issues as their access to finance, technology, government procurement, marketing and distribution channels as well as information, training and advisory services. The issue of regulatory and fiscal reforms in order to improve their access to resources and markets is important, as is the issue of financial intermediation, both formal and informal, for such enterprises.