

## **Foreword**

The Law and Governance papers commissioned by the British Council China are produced to raise awareness of the United Kingdom's achievements and in a manner which encourages mutual dialogue and partnership arrangements between China and the UK. These papers are meant for people involved in policy work, academics and the wider general public with an interest in economic and social reform. This edition of Law and Governance updates the first series commissioned by the British Council China in 1996. Since that edition which focused on UK innovations with New Public Management, the United Kingdom has moved in to what many commentators consider to be a 'post-privatisation' period. As such this second series focuses on the 'Modernising Government' agenda encapsulated in 1999 White Paper of the same name.

The British Council in China is well regarded for the support it has offered Chinese institutions in the development of the 'Rule of Law' and this still plays a significant role in our programme. Our programme currently supports partnerships under the following themes:

The Rule of Law and Access to Justice

Modernising Government

Private Sector Development and Regulation

Developing a healthy civil society

Martin Minogue, the author of this series of papers states that the United Kingdom has been at the forefront of innovative and creative reforms throughout the 1980's and 1990's but acknowledges that many of these reforms need to address the social, cultural and political context of countries which seek to learn from them. This is consistent with the British Council's purpose which is to 'To build mutually beneficial relationships between people in the UK and other countries and to increase appreciation of the UK's ideas and achievements'. I also wish to thank the China National School of Administration for kindly offering opinions on key strategic themes facing China which have been valuable in informing these papers.

It is hoped that readers of these papers will provide feedback to help us assess their utility. If you do have comments we would welcome them via our e-mail address.

Gary Hallsworth  
Director Governance and Development  
British Council, China

MARCH 2004

## LAW AND GOVERNANCE II

### PREFACE

This series of three booklets, or 'Information Packs', presents key themes in **Law and Governance**. The series is designed and edited by Martin Minogue, Director of Regulatory Governance in the Centre on Regulation and Competition(CRC), University of Manchester. The first issue, **Modernising Governance**, examined a range of public sector management reforms, in particular those UK-based changes that provided a leading model for public management reforms in developing countries.

This issue, **Private Sector Development and Regulation**, looks, by contrast, at the institutional and policy foundations of capitalist market systems. The issue begins with an explanation of the key concepts, privatisation, regulation and competition; the second section presents developments in these policy areas in the UK; and the final section analyses problems relating to the application in developing economies of these private sector- oriented policy reforms. This issue has been prepared by Paul Cook, Director of the CRC, and Professor of Economics and Development Policy in the University of Manchester.

Issue 3, **Law, Administration and Government**, which is planned to appear in July 2004, will analyse the ways in which legal systems and practices both support, and hold accountable, modern systems of constitutional governance.

In all three issues, the main focus is on institutions, policies and reforms in the United Kingdom system of law and governance, but comparisons are made with other systems of government, and there is analysis of the application to developing countries of developed country models.

**The Centre on Regulation and Competition, Institute of Development Policy and Management, University of Manchester was assigned by the British Council to collect and contribute all the papers for the Information Packs 2003-2004**

## **SECTION ONE**

### **PRIVATISATION, REGULATION AND COMPETITION**

This introductory section briefly examines the principal concepts—privatisation, regulation and competition—which form the basis for discussions of key relationships between state and market, and are necessary to an understanding of debates about the most appropriate and effective ways in which private sector development can be stimulated and guided.

#### **Privatisation**

Privatisation has been pursued by countries around the world for the last twenty-five years. In the 1980s it was most prevalent in the UK and other European economies and OECD economies. During the 1980s it increasingly spread to developing countries in Africa, Asia and Latin America, and to the transitional economies of Eastern Europe and Central Asia. Privatisation was part of a general concern about government that was overextended and wasteful, and a response to the perceived failures of state-owned enterprises. These concerns produced initiatives to reduce and ‘roll back’ the state.

In particular, policy-makers have had a variety of specific objectives in mind for privatisation. First, given the widespread evidence of the poor economic performance of state-owned enterprises, reflected in economic inefficiency, low productivity and lack of competitiveness, it was hoped that, by switching from state to private ownership, economic performance would improve. Second, many individual state-owned enterprises, and the state enterprise sector as a whole, have operated at a financial loss, requiring various forms of subsidisation, including direct transfers from central government. Privatisation was seen, therefore, as a means of reducing the fiscal burden associated with loss-making state-owned enterprises. Third, privatisation was sometimes used as a means of raising revenue, which could be used to finance a fiscal deficit and relieve the government’s liquidity constraint.

Fourth, privatisation has been adopted for broader macroeconomic reasons, for example, to increase the share of the private sector in the economy.

The theoretical argument for privatisation rests on the hypothesis that, in a competitive market environment, enterprise performance will be superior under private ownership, as compared to state ownership; in other words, property rights are assumed to be the primary determinant of enterprise performance. But where there are significant market failures, such as abuses of market power, the state-owned enterprise may produce socially efficient results which maximise social welfare, whereas the private manager will primarily maximise private profits. This case for state ownership assumes, therefore, that bureaucrats and politicians will act in a way that maximizes social welfare. State ownership has also been used to pursue other social objectives, beyond that of addressing market failures. These objectives have included reduced income inequality, increased employment, accelerated technology transfer, and regional development.

The idea that state ownership is the solution to market failure has been challenged on several grounds. First, it is argued that government can deal with market failure by regulating private enterprises and/or contracting with a private firm to provide the social product. A similar argument can be made with respect to social objectives, namely that there may be more efficient ways of achieving social goals than through state ownership. Second, the merits of state ownership are further challenged by those who argue that bureaucrats and politicians do not seek to maximise social welfare but instead act to maximise their own interests. From this public choice theory perspective, politicians and enterprise managers use state-owned enterprises to benefit themselves, at the cost of inefficient enterprise performance. A closely related argument draws on principal-agent theory, maintaining that the owners (principals) of state-owned enterprises have little incentive to monitor the managers (agents), with the result that the public enterprises have lower internal efficiency than private enterprises. With privatisation, management is accountable to new stakeholders, in the form of shareholders and private loan creditors, who in a more competitive market place for their outputs, will have a strong effect on management orientation, inducing structures and processes that act more efficiently. For both private enterprises and state-owned enterprises, then, ownership is then typically

separated from control. Since managers' objectives are likely to differ from those of owners, a conflict arises between the two groups. Advocates of privatisation argue that these problems are more acute, and thereby more costly, in public enterprises, where the threat of takeover or bankruptcy as a spur to managerial performance is absent.

The question of the relation of regulation and competition to privatisation has raised important issues in at least two respects. First, the notion of privatisation was often associated directly with competition, moving from state-owned enterprises with monopolies and restricted entry to private ones operating under competitive market conditions. Second, and alternatively, privatisation was not always assumed to guarantee an improvement in competitive conditions because many state monopolies were transformed into private ones, and not all of these were so-called natural monopolies. This raised new questions with respect to regulation and competition policy. How would natural monopolies operate in the private sector? Would sector regulation provide surrogate competition for them? Would competitive conditions eventually be encouraged and introduced? Would the issues surrounding the creation of non-natural monopolies, created as a result of privatisation, be dealt with?

## **Regulation**

Privatisation of natural monopolies, along with effective regulation, is intended to change the state's role from one of direct ownership and provision to one of establishing the regulatory framework (or 'rules of the game') for these newly created private sector enterprises. Private sector management, besides being accountable to shareholders and creditors, manages its enterprises according to the regulatory rules. The development of regulation in relation to privatised natural monopoly industries, in which essential services are provided through networks of telephone wires, gas pipes, and railway tracks, has therefore provided a significant challenge to policy-makers, not only in regulating the natural monopoly elements of these industries, but in opening up activities that have potentially contestable markets, where competition could act to improve efficiency. In addition, new technological

developments have been rapidly changing the perception of what was previously thought to constitute a natural monopoly activity, and further paving the way for the introduction of competition, which in turn has had implications for both the degree of state regulation and its duration.

The nature of the national regulatory framework that has developed for privatised utilities in developing countries has been affected by a country's capacity to implement a system of regulation and by the type of markets within which enterprises have functioned. The processes of regulation that have developed have differed widely in form and scope. Some regulatory systems have established *price cap* regulation, which effectively limits the price that can be charged for a particular service. This form of regulation is intended to provide incentives to reduce costs in order that the savings achieved can be used to increase profitability for the owners of the utilities. Other forms have commonly consisted of *profit regulation*, which imposes ceilings on the permitted rate of return, or *cost of service regulation*, in which the regulator approves a profit mark-up on an agreed cost of providing a service.

Similarly, there have been differences in the institutional arrangements for regulation. It has been quite common to establish a dedicated regulatory authority for each of the main utility sectors, as for example in the UK. In other cases, regulation for all utilities has fallen under the umbrella of a single institution. Some regulatory institutions attain a high degree of autonomy, and others are tightly controlled by government authorities. The scope of regulation has also varied. In some cases, as in the telecommunications sector, regulation has generally been comprehensive and has consisted of controls on entry into the market, rules for permissible pricing and business earnings, monitoring quality, and oversight of investment programmes. Alternatively, regulation has covered only some of the activities of an enterprise or sector.

Two key criteria have been applied to judge a good system of regulation: it should be one which enables the utility to raise finance for investment at an acceptable cost, and also provides incentives for efficiency in operations, pricing, investment and innovation. Regulation also has to satisfy the demands of both investors and

consumers, which can at times conflict. Consumers generally demand good quality service and low prices, whilst investors demand adequate returns on their stake.

## **Competition**

In general, the need to develop the private sector has largely been based on the assumption, most often unstated, that privately-owned enterprises operate under competitive market conditions. This can be seen in the lack of explicit attention being given to competition policy as a whole, particularly in its antitrust form (i.e. tackling anti-competitive practices and merger and monopoly activities of enterprises), and to the slow adoption of competition policy once decisions had been made to implement a more general approach to the regulation of competition, apart from the development of sector specific regulation for natural monopoly. In recent years, however, competition policy is rapidly being adopted in a whole range of economies with the encouragement of the international development agencies; this is an endorsement of the vital role that competition plays in the process of development.

Despite the centrality of the notion of competition in economic theory, and its practice, however, its meanings and the ways in which it is perceived to work and contribute to development, differ widely among theorists, policy-makers, bureaucrats and business people. Indeed the history of economic thought provides some deeply contrasting views about the meaning of competition. In turn, these competing views of competition have significant implications for the ways in which enterprises in the public and private sectors are perceived to contribute to development, and for the development of public policy approaches towards them.

For the classical economists writing in the nineteenth century such as Adam Smith, competition was a process of rivalry between participants in the market who would compete by changing prices in response to market conditions, thereby eliminating excessive profits and unsatisfied demand. By the late nineteenth century the analytical development of the concept of competition had moved towards an emphasis on the importance of different market structures, in which the organising

concepts of the market relied on equilibrium and organisation. This approach generated the view that a market could be defined as competitive when there was a significantly large number of sellers of a homogenous product, so that no sellers had enough of a market share to enable them to influence product price by changing the quantity that they put on the market. This idea was formally expressed in the notion of *perfect competition* which has survived as the standard model for analysis and has ever since had a profound influence on policy-making concerned with the regulation of competition.

The emphasis on market structure led to the development of the '*structure, conduct, performance*' approach to industrial organisation, which has had such a significant influence on current thinking on competition policy. In this approach, it is argued that the performance of an industry, largely measured in terms of profitability, varies with market structure, which in turn influences enterprise behaviour. In this way, competition policy aims at 'getting the market structure right' by reducing levels of market competition, which will influence the behaviour of enterprises and prevent abuses from a monopoly position.

The *Chicago school of antitrust*, as it has become known, challenged the notion that market behaviour and performance are related strictly to market power. In their view, competition is a process that can lead to a variety of market structures providing efficient outcomes. In contrast to the emphasis on the market structure approach to competition policy, profits earned by successful entrepreneurs are not viewed as inefficiencies but as signals that entrepreneurs are responding to changing market conditions. As such, competition policy ought to be predominantly directed towards removing constraints to the entry and exit of enterprises into and from a market.

Section Two now examines and analyses the application of these ideas in UK public policy practice.

## **SECTION TWO**

### **PRIVATISATION, REGULATION AND COMPETITION POLICY IN THE UK**

The main focus of this booklet is on privatisation, regulation and competition policies in the UK. Privatisation in the UK began more than twenty years ago. Many of the enterprises that have been privatised were previously in the private sector and had been nationalised because they were considered to be natural monopolies. It was felt that state ownership of enterprises, accompanied by forms of internal regulation exercised through government ministries or departments, would provide the most effective means of controlling problems that might arise from their market power. Privatisation in this context can, therefore, be viewed as a radical change in policy that both rejected the need for state ownership and challenged the notion of a natural monopoly. Of course, controlling market power was not the only objective embodied in decisions to nationalise industries. Important aspects concerned the need for more comprehensive planning and reconstruction, particularly in the infrastructure sectors, in the aftermath of the devastating effects of the 1939-45 War. Although the change in policy towards privatisation in the late 1970s was radical, it also reflected a shift in public opinion, as revealed by opinion polls at the time, towards a growing belief that private enterprises could be a more efficient means of delivering essential services.

The privatisation programme, which began in 1979 with the election to power of a Conservative government, under Prime Minister Thatcher, has evolved through numerous phases up to the present time. The consequence of these phases has been to significantly recast the private sector landscape in the UK. In the first phase of privatisation, which occurred between 1979 and 1983, the government sold public sector assets and public enterprises that were relatively small, and mainly operated in competitive markets. In this phase the sale of state-owned property, in the form of residential housing, was more significant than the sale of shares in enterprises. In this period, over a million state-owned houses were sold under the 'right to buy' scheme.

The second phase consisted of attempts to liberalise monopoly markets and sell off large state-owned monopolies. In chronological order it began with the sale of the state-owned telecommunications industry, gas supply, water and sewerage services, electricity supply, and more recently the railways. This phase is distinguished from the first because separate regulatory offices were established for each of the major privatised utilities. The third phase overlapped the second, and introduced schemes for contracting out, and the imposition of user charges, in particular making in-roads into what has been considered the state non-market sector, such as health and education. A fourth phase is emerging out of the relative failure of some areas of privatisation through the creation of new hybrids of privatised enterprises in the form of 'not for profit' or 'public interest' companies, such as those emerging in parts of the water and railways sectors.

The change in policy towards privatisation in general reflected the view that bureaucratic civil service cultures were not compatible with running enterprises that required heavy investment programmes. With particular respect to the natural monopoly utilities, the decision to privatise also implied a rejection of previous arguments that state-ownership was required to protect against the potential abuse of monopoly power. Whatever the rationale, however, it appears to have been largely invented after the process began and was not strongly evident in political mandates in the late 1970s. Since then, however, European Commission directives aimed at liberalising markets, initially in telecommunications and electricity but more recently in gas and railways, have added further impetus to privatisation.

A wide range of methods of sale was used in the privatisation of enterprises in the UK. The most important have been share flotation, direct sale, management buy-outs, forms of contracting out and leasing arrangements and public-private partnerships. Public offerings have been typically used to sell large scale state enterprises. Often the share offer was used as a means to raise additional capital, as well as transferring ownership of the enterprise. The sale of a state-owned enterprise to an existing private sector business (or to a group of institutional buyers, known as a trade sale) has occurred on a smaller scale than share flotations. An example was the initial sale of Rover Cars to British Aerospace.

Table 1 provides a list of the major enterprises sold by government. In some cases shares were sold in tranches. The accumulated share of the proceeds from privatisation over the period 1979-91 amounted to 11.9 per cent of the average annual Gross Domestic Product. Comparative figures with other OECD countries were provided in the first booklet in this series, **Modernising Governance**.

**Table 1: Major Privatised Enterprises in the UK, 1977-1997**

	<i>Date of first sale</i>	<i>Industry</i>
British Petroleum	1977	Oil
National Enterprise Board Investments	1980	Various
British Aerospace	1981	Aerospace
Cable and Wireless	1981	Telecommunications
Amersham International	1982	Scientific Products
National Freight Corporation	1982	Road Transport
Britoil	1982	Oil
British Rail Hotels	1983	Hotels
Associated British Ports	1983	Ports
British Leyland (Rover)	1984	Automotives
British Telecom	1984	Telecommunications
Enterprise Oil	1984	Oil
Sealink	1984	Sea Transport
British Shipbuilders and Naval Dockyards	1985	Shipbuilding
National Bus Company	1986	Transport
British Gas	1986	Gas
Rolls-Royce	1987	Aero Engines
British Airports Authority	1987	Airports
British Airways	1987	Airline
Royal Ordnance Factories	1987	Armaments
British Steel	1988	Steel
Water	1989	Water
Electricity Distribution	1990	Electricity
Electricity Generation	1991	Electricity
Trust Ports	1992	Ports
Coal Industry	1995	Coal
Railways	1995-7	Railways
British Energy	1996	Nuclear Electricity

## **Economic Regulation of Utilities in the UK**

The UK has adopted incentive based *price cap regulation* for its privatised utilities. This form of regulation was intended to mimic the incentives for cost efficiency found in competitive markets by setting a predetermined price cap, with incentives to

reduce costs in order to increase profitability. This was known as the RPI–X regulatory system (RPI refers to the retail price index, a measure of inflation). The system was designed to limit political interference in regulatory decision-making and to design a system to the needs of each industry. With this in mind, quasi-independent and sector specific regulators were provided with statutory powers at the time of privatisation. A list of the main agencies is provided in table 2.

**Table 2: Main UK Regulatory Watchdogs**

UK regulatory watchdogs			
<i>Agency</i>	<i>Date formed</i>	<i>Industry</i>	<i>Principal statutes</i>
<i>Economic regulators</i>			
Civil Aviation Authority	1971	Airports	Airport Act 1986
Office of Telecommunications	1984	Telecommunications	Telecommunications Act 1984
Office of Gas Supply	1986	Gas	Gas Act 1986
Office of Water Services	1989	Water	Water Act 1989
Office of Electricity Regulation	1990	Electricity	Electricity Act 1990
Office of Rail Regulator	1993	Railways	Railways Act 1993
Office of Gas and Electricity Markets	2000*	Gas and Electricity	Utilities Act 2000
Strategic Rail Authority			
Postcom	2000	Postal Services	Postal Services Act 2000
Office of Communications	2003*	Non-BBC broadcasting, radio, telecoms and radio spectrum	
<i>Quality regulators</i>			
National Rivers Authority	1989	Water	Water Act 1990
HM Inspectorate of Pollution	1987	All	Environmental Protection Act 1990
Independent Television Commission	1991	Terrestrial, Cable and Satellite Television	Broadcasting Act 1990
Radio Authority	1991	Radio	Broadcasting Act 1990
Broadcasting Standards Council	1990	Broadcasting	Broadcasting Act 1990
Office of the National Lottery	1993	Gambling (lottery)	Lottery Act 1993
Rail Safety and Standards Board			
<i>Competition regulators</i>			
Office of Fair Trading	1973	All	Fair Trading Act 1973
Monopolies and Mergers Commission	1948	All	Fair Trading Act 1973, Competition Act 1980
Competition Commission	1998	All	The Competition Act 1998

\* replaces separate regulators: see Box 1

**Box 1****Utilities Act 2000**

In recognition of the convergence of the gas and electricity markets, a single energy regulator, the Gas and Electricity Markets Authority, was established in November 2000. The offices of gas and electricity regulation have also been merged to form the office of Gas and Electricity Markets (OFGEM).

The Act also saw the establishment of the Gas and Electricity Consumers Council (also known as Energywatch). The Council's role includes providing a strong advocacy role for all consumers and to be able to obtain and publish information from energy suppliers and the regulator.

UK privatisation was not simply a matter of transferring ownership from public to private hands, but involved elements of market liberalisation and structural reform of the utilities. This aimed at facilitating the introduction of competition. Indeed, regulators had statutory duties to encourage competition. In this way the new regulatory regime did not view monopoly as a permanent feature, and regulation was intended to focus on the notion of regulating for competition. Initially, there was a view that regulation was temporary and once competition gained ground, regulation would not be necessary after seven years.

In reality the development of a fully competitive environment for the utility markets has proved difficult. Clearly, the degree of regulation in previously vertically integrated monopolies was underestimated. There has over time been a need to maintain constant regulatory pressure to reduce the dominant market position of the privatised enterprises, some of whom conceivably spend more on finding ways to circumvent regulation than the regulators spend on regulating. See table 3 for staffing and expenditure streams of the main sector regulators.

**Table 3: Staffing and Expenditure of the Regulatory Offices<sup>1</sup> 1984-96**

Year	Of tel		Of gas		Of wat		Of fer		Of reg(NI) <sup>2</sup>		ORR	
	Staff	cost	Staff	cost	Staff	cost	Staff	cost	Staff	cost	Staff	cost
1984/85	58	n/a										
1985/86	93	n/a										
1986/87	116	n/a	19	1,200								
1987/88	117	n/a	21	1,200								
1988/89	122	4,000	28	1,300								
1989/90	118	4,600	28	1,400	88	1,700 <sup>2</sup>		1,800 <sup>3</sup>				
1990/91	134	6,900	28	1,600	122	4,300	198	10,600				
1991/92	148	7,500	28	1,900	135	6,290	214	10,500				
1992/93	152	7,656	35	3,203	156	7,520	224	10,100	14	660		
1993/94	144	8,392	45	3,006	195	8,660	222	8,700	15	732	32	1,400
1994/95	164	9,330	64	4,486	182	9,225	217	8,700	15.5	897	75	9,026
1995/96		n/a	86	n/a	205	8,892		n/a		n/a	87	9,049

**Notes:**

1. Staffing in actual number, costs are gross expenditures in £000. Years are to 31 March. Staffing numbers are usually at 31 December in the year shown though sometimes only annual averages were reported. In the case of Ofwat the staffing figures are at 31 March. Of tel was established August 1984, Of gas August 1986, Of wat August 1989, Of fer September 1989 and Of reg (NI) March 1992.
2. Formerly Offer (N I) = Office of Electricity Regulation Northern Ireland.
3. 7 months only

Source: Annual reports of the regulatory offices

The very introduction of competition requires access to a network of pipelines, rail or electricity carrying wires which requires regulation. This is to define the terms of access and its cost (referred to as common carriage) and to ensure that a level playing field for competition for all competitors exists, and that it is maintained. There is the impression that 'regulation for competition' will be permanently required because network access rules need continuous monitoring and need to be industry specific. General competition law, as will be discussed later, cannot handle access issues. Regulation of prices, outputs, levels of service and quality are also needed to prevent abuse of networks. Regulatory policy has, therefore, developed towards regulating non-competitive markets (networks as a natural monopoly) and the establishment and regulation of appropriate structures to facilitate competition in potentially competitive sectors.

Three cases of privatisation and regulation are discussed below. These include the first and the latest major utility privatisations, telecommunications and railways respectively. These cases provide useful examples of the complexity of privatisation and regulation in the UK; and illustrate the relationship between regulation and competition, particularly with respect to the difficulties of introducing competition once privatisation was undertaken and regulation had become established. The third, involving airports, illustrates the complexity of the ownership issue itself.

## **Privatisation and Regulation of Telecommunications**

Telecommunications in the UK was privatised in 1984 and new regulation was introduced with the Telecommunications Act of 1984. Box 2 shows the pre-privatisation picture and Box 3 the regulatory framework. This aimed at promoting competition and preventing the privatised state enterprises from abusing its market power.

### **Box 2**

#### **Telecommunications before Privatisation**

The telecommunications sector in the UK became a state activity in 1880 and later a state monopoly under the Post Office. The Post Office was a government department until the late 1960s, when it became a state corporation. From 1960 to 1980 there had been agreement on the need to commercialise the Post Office. First it was separated from the civil service, and then separate postal and telecommunications units were established. British Telecommunications (BT) was created from the telecommunications division in 1981 as a state corporation. Until liberalisation of the sector, the privately owned industry which manufactured domestic apparatus had effectively been operating as a cartel with BT.

The Post Office was given a statutory monopoly of inland postal business as far back as 1869 and eleven years later its remit was extended to telephone services. Under this remit the government was to run the industry according to public interest objectives rather than profit maximisation. Licences were given to private companies and municipal authorities but little real competition emerged. In 1913 telecommunications became a state monopoly. The monopoly of telecommunications suppliers remained intact, in terms of running the network, approving, supplying, installing and maintaining equipment until the 1981 British Telecommunications Act paved the way for the introduction of competition.

The Act liberalised the telecommunications sector by opening it up to competition. This policy shift derived in part from complaints from BT's customers about restrictive practices, but was also driven to a large extent by the ideological conviction of the new Conservative Thatcher government about the inefficiency of nationalised monopoly industry. Liberalisation of the apparatus market had been considered by the previous Labour government but had been dropped due to union opposition.

A duopoly policy was born in 1981 on the acceptance of a proposal by Cable and Wireless with British Petroleum and Barclays to lay the digital transmission network that became the basis of the Mercury project (BP and Barclays later withdrew from the project). Since then, Cable and Wireless has played a central role in policy on voice telephony. In addition to Mercury's licence to compete with BT, Racal was selected to develop a rival mobile network. Competition was also sought in cable TV, with hopes of an interactive and telecom capability, but this was not initially realised. The decision to privatise BT accelerated the liberalisation policy in order to strengthen competitors against potential abuse by BT of its monopoly position.

The decision to privatise was announced in July 1982, on the basis of the need to modernise the network while controlling government spending. Fifty-one per cent of BT's share were sold in a public stock issue in 1984, then a further 27 per cent in 1991 and the final 22 per cent in 1993. Demand for shares was generated in an international offer made by a syndicate of merchant banks. Since 1984 the government had not exercised the voting rights of its remaining shares, but even after 1993 it still retains a 'golden share' that entitles it to appoint two directors, and to block changes to the Articles of Association that limit any shareholder to a maximum 15 per cent holding.

With privatisation the telecommunications market was initially restricted to a duopoly (i.e. two competitors). This consisted of the privatised state-owned enterprise, British Telecommunications (BT) and the much smaller rival Mercury owned by Cable and Wireless. Mercury could develop its challenge to BT with a government assurance that no new competitors would be allowed into the market until 1990 at the earliest. A review of the duopoly policy in 1990 concluded that more was needed to speed up the pace of competition. The duopoly was abandoned in 1991 and the domestic market was substantially opened to competition. Cable TV companies (about 80 of them) now provide local telephone services in most towns in competition with BT and coverage has been extended to 50 per cent of the country. Four mobile phone operators are also well established at the national level, and are now subject to price regulation (see Box 4).

### **Box 3**

#### **Regulatory Regime for Telecommunications**

The Telecommunications Act of 1984 now governs the sector, with the aim of promoting competition and preventing BT from abusing its market power. The Act created the post of the Director General of Telecommunications and his office OFTEL, staffed by civil servants. It also defined the licensing system and the regulatory roles and duties of the Director General and the Secretary of State for Trade and Industry.

The Director General is mandated to advise the Secretary of State on the granting of licences, to enforce respect of the licence system, to modifying conditions of licences and to investigate consumer complaints. The Competition and Service (Utilities) Act 1992 later amended the Telecom Act 1984 by granting OFTEL the power to also set service standards and seek compensation for failure to meet them, and to approve operators' complaints handling procedures and resolve certain disputes. OFTEL has not set quality-of-service targets, but encourages BT to do so and to publish quality-of-service information.

Despite this, however, BT continues to have an effective natural monopoly position in the fixed-line network. The regulator's price review in 2001 extended the RPI-X controls on BT network charges until 2005. It was felt that insufficient network access was preventing effective competition in the retail call market. As a consequence the sector regulator OFTEL has expanded regulation by imposing a four year price cap in parallel with a new requirement on BT to market a wholesale line rental charge to its competitors. Wholesale line rental was deemed to be necessary to promote effective competition in the retail call market because it would increase access to BT's effective monopoly network.

#### **Box 4**

#### **Price Cap Regulation for Telecommunications**

A system of price-cap regulation is specified in the licence of BT, but does not apply to other providers. Maintaining price controls on BT is considered particularly important because its market share is so high. An RPI-X formula of price control regulates a basket of BT prices, weighted according to their contribution to BT revenues. Although the method allows some flexibility to BT in setting individual elements of tariffs, a separate limit is maintained for the residential rental charge. This regime is intended both to substitute for competition and stimulate new competitors to the sector.

The first cap of RPI-3 per cent, from 1984 to 1989, covered line rentals and local and national call charges. In 1989 the cap was tightened to RPI-4.5 per cent until 1991, when international charges were included and the cap was adjusted to RPI-6.25 per cent. A new cap of RPI-7.5 per cent came into effect for a four year period from August 1993, since when no individual price in the basket apart from line rentals can increase by more than the RPI. In 1997, a new limit of RPI-4 per cent was introduced until the year 2000 and with a more restricted coverage of BT's network services (40-45 per cent). In addition to the main price cap there has been, since 1990, a cap of RPI-0 on private circuit prices,  $RPI + 2$  on domestic line rentals and  $RPI + 5$  on business multi-line rentals. The 1993 price cap regime assumes a rate of return of 16.5-18.5 per cent.

BT has an incentive, as the owner of the telephone network, to restrict competition in the potentially competitive market by controlling the terms and conditions for access by rival enterprises. Competition can potentially be stifled by discriminatory practices but also potential competitors may be deterred from entry because they expect entry forestalling tactics to be used by BT.

#### **Box 5**

#### **Is a change in ownership necessary? The Case of Airport privatisation and Regulation**

The 1986 Airport Act paved the way for the commercialisation of airports in the UK. Previously, airports were operated by central or local government. The ownership structure that emerged from commercialisation and privatisation included:

- airports that were fully privatised transferring the state-owned British Airports Authority (BAA), a public corporation set up to own and manage the main international airports, into a private company listed on the stock exchange. The seven airports, including Heathrow, Gatwick, Stansted, Prestwick, Aberdeen, Edinburgh and Glasgow, were established as limited companies that were subsidiaries of the BAA plc
- airports that were partly privatised. these were regional airports and included Bristol, Birmingham and Liverpool who were financially self-sufficient profit making business, part owned by local authorities and private share ownership. They could fully privatise if they wanted to
- airports that remained under complete local authority ownership operating on a commercial basis: these included Manchester, Leeds, Blackpool and Newcastle.

Regulation of airport charges under a system of price cap on airport charges was introduced by the government and administered by the Civil Aviation Authority (CAA) in order to protect airlines from monopoly abuses by airport operators.

The main benefit of privatisation to a regional airport appears to be that those that were privately-owned had the potential to get access to funds from the private capital market to develop airports to their full potential at a faster rate than before privatisation. In contrast, airports remaining under local authority control and not privatised, were constrained from developing as they could not borrow funds with the same freedom as the private sector airports, and had to finance expansion from retained profits. After 1986 they could no longer borrow from government. In recognition of this difficulty, the government in June 1998, gave local authority controlled airports the freedom to borrow from the private market. This meant that state and privately-owned airports were able to compete for finance on equal terms, and in doing so, removed one of the major incentives for privatisation. Performance, in terms of passenger throughput and profitability, has improved for both state and privately-owned airports since the changes were introduced.

# **Railway Reform in the UK**

## **Background**

The railway system in the UK was developed in the 1800s. In 1921 nearly all railways were amalgamated into four companies. In 1948 nationalization consolidated those companies into a single publicly-owned entity known as the Railway Executive, a part of the British Transport Commission (BTC). In 1962 the BTC was abolished and replaced by the British Railways Board. Under public ownership, the Government provided grants for social services that were not self-supporting, and for the part of the commercial system that failed to cover their costs. Even by the end of the 1980s, when grants were declining as a result of cost-cutting, a quarter of British Rail's turnover continued to come from government grants.

## **The debate over privatisation**

Questions over competition and the low profitability of railways made privatisation potentially difficult. During the 1980s, many of the non-rail businesses, such as hotels, had already been sold off to the private sector. Similarly, freight was already being shipped on the rail network in private wagons.

In general, competition for the railway network was limited. The sector did face competition from bus and air transport but not directly on the railways. A significant hindrance to the introduction of competition was the high level of fixed and sunk costs involved in the industry. These refer to the sizeable infrastructural investments made in laying rail tracks and in building stations. Any duplication of this costly infrastructure would be wasteful.

There was little doubt, however, that there were inefficiencies in the operation of the railways, associated with the monopoly position over the infrastructure facilities and train operation. The greatest scope for competition appeared to be in running trains themselves, since operating costs of running trains were relatively small in comparison with the large sunk costs for infrastructure. There was potential for leasing rolling stock and paying fees or buying into access to railway routes.

## **Options for privatisation**

The options considered for privatisation were:

- a regional option (similar to the four regional companies that operated before state-ownership)
- a sector option (to base companies on the pre-privatisation sectors, i.e. Inter-City, regional, other passenger services, freight, parcels)
- an infrastructure option (separate rail track authority and private train companies)
- the British Rail PLC option (privatise British Rail as one company)

The infrastructure option was adopted.

## **New structure for railways**

The Government published its formal proposals for privatisation of British Rail in a White Paper in 1992. In summary, this provided for a restructured industry along the following lines:

- British Rail's track and infrastructure would become the responsibility of Railtrack, a newly established track authority
- passenger services would be managed and operated by the private sector through a newly-introduced system of 'franchising'
- rights of access to the rail network would be available to private operators without a franchise
- a Rail Regulator would be established to oversee access rights
- rail freight and parcels operations would be transferred entirely to the private sector
- the private sector would have the right to buy or lease stations.

The Railways Act was passed in November 1993. The Act prescribed a number of new industry participants.

### **Train Operating Companies (TOCs)**

Passenger rail services were operated by companies (Train Operating Companies), initially by becoming wholly-owned subsidiaries of British Rail, until they were franchised. All of the twenty-five passenger rail businesses have now been converted to TOCs. These TOCs obtain access to track through access agreements with Railtrack. TOCs also operate stations used by them under agreements, except those designated as special independent stations. These consist of the larger main city stations and are operated by Railtrack. TOCs own few fixed assets and are generally expected to have low capital requirements. Initially Railtrack operated the infrastructure.

### **Railtrack**

Railtrack was established in 1994 and privatised in May 1996. It operated the infrastructure as a monopoly and owns and operates track and signalling. It also owned most of the stations and depots. Railtrack was a commercial organization, obtaining revenue from charging for access to the rail infrastructure which it owned (referred to as track access payments). It had to review and maintain over 10,000 route miles of track, 2,500 stations and 40,000 bridges and tunnels.

### **ROSCOs**

These were rolling stock companies which owned or leased most of the domestic passenger rolling stock previously owned or leased by British Rail. All three of the ROSCOs were sold (Porterbrook Leasing Company Ltd, Angel Train Contracts Ltd and Eversholt Leasing Ltd). The 11,000 passenger coaches were evenly divided between ROSCOs to encourage competition. To facilitate their sale the government guaranteed 80 per cent of the lease income of the rolling stocks enterprise.

In addition to the above, six of British Rail's thirteen infrastructure and maintenance and track renewal units were sold, together with all seven of its design offices and related specialist engineering businesses.

## **Statutory bodies**

Initially, two new statutory offices, the Franchising Director and the Rail Regulator, were established. The Franchising Director, appointed by the Secretary of State for up to five years, had responsibility for negotiating and awarding passenger rail franchises on the basis of competitive tendering and monitoring their continued performance. In 1993, the Office of Passenger Rail Franchising (OPRAF) had a staff of twenty-eight and its budget was under £2 million.

The Rail Regulator's duties include the granting of licences to operators and enforcing compliance with their terms, regulating access to track, stations and depots and, finally, enforcing domestic competition law in relation to railway services (under the Competition Act 1989).

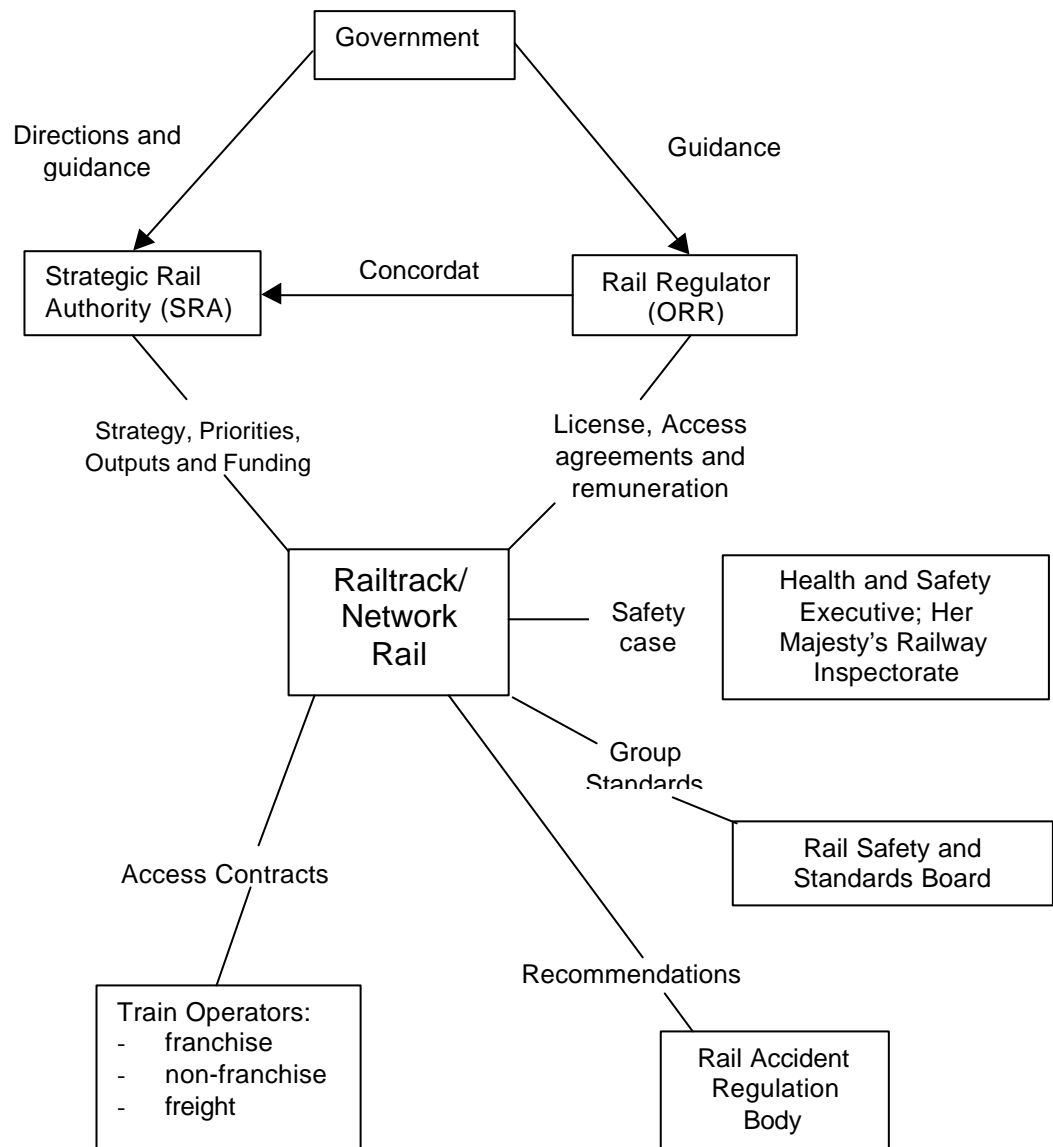
The policy for moderating competition among franchised passenger operators is initially provided by the document *Competition for Railway Passenger Services* published in December 1994 by the Office of the Rail Regulator. The document states that competition among passenger train operators would be restricted for an initial period because (1) the franchising process itself creates potential for increased competition, and (2) as the railway industry is at an early stage of restructuring it is not yet possible to predict the effects of allowing unrestricted competition.

## **Competition and Rail Industry Structure**

The 1993 Railways Act initially provided for an industry structure with more than 100 separate private companies operating within it. The current structure, which has evolved since privatisation, is presented in figure 1. The 25 TOC's held by 12 different franchises, are guaranteed the exclusive right to provide passenger services on the route for which they have successfully won bids. To win a bid, companies had to comply with various quality and investment criteria laid down by the then Office of Passenger Rail Franchising (OPRAF). This has since been replaced by the Strategic Rail Authority (SRA). Initially, the franchising bids requiring the lowest level of subsidies were preferred, although those with the most significant upgrading strategies were also selected.

**Figure 1**

**Framework for regulation and standard setting in rail**



The structure that was adopted was a vertical disintegration of the rail industry. Although there is competition in the maintenance and repair of rolling stock, the TOC's have monopolies for the lifetime of their franchises. This means that the bidding process provided the greatest scope for competition in the passenger service component of the industry. There has been some horizontal and vertical reintegration since privatisation, with Virgin and National Express creating a new maintenance company. In 1996 the rolling stock company Porterbrook was purchased by the train operator Stagecoach.

The purposes of rail privatisation included:

- increasing the quality of service
- raising investment
- improving efficiency
- reducing public subsidies

The actual performance on the rail network has not lived up to expectations. The House of Lords in 1993 indicated that privatisation would lead to increased competition, which would augment the quality of service and enhance the freedom of choice for customers. The rail industry's record on quality, measured by reliability and punctuality, has been disappointing. Most consumer complaints received by the Rail Users Consultative Committee have related to train performance service issues and station quality. The reasons cited for poor performance have related to the low level of performance target setting, contractual loopholes, poor and delayed investment in tracks, and failures to upgrade train coaches, as train operators claimed that their franchises were not long enough to provide them sufficient returns for any additional investment. The fall in quality has also been reflected in safety levels, although comparisons between the pre and post privatisation periods are subject to distortion owing to the changes introduced in 1996 with respect to new accident reporting regulations. According to a former boss of Railtrack, the privatised system was not a structure designed to optimise rail safety.

Despite the poor investment record, Railtrack initially had a good reputation in business circles. Since privatisation in 1996, Railtrack's shares on the stock market rose 250 per cent above the FTSE All-Share Index (Financial Times, 1999), with a total capitalisation of £17 billion by the end of 1999. All this was to change over the next two years following the Hatfield train disaster in October 2000.

The derailment at Hatfield, caused by a rail fracture, reinforced public concerns about rail safety and the state of investment in the industry, particularly with respect to the financing difficulties experienced over the West Coast main line Project. By late June 2001 Railtrack was in serious financial difficulties and attempted to raise money in the financial market. At the same time it approached government for funding, a move highly criticised by the Rail Regulator. With the fall in value of the

company and facing large debts, Railtrack PLC was placed in administration and eventually transferred to Network Rail, a company limited by guarantee, in October 2002. It was to operate as a not for profit company in the future, with profits being returned to the industry's infrastructure. It was provided with backstop equity loan facilities by the SRA.

The whole process threatened to undermine the independence of economic regulation in the rail sector as the government intervened to restructure the industry. The setting up of Network Rail and the rail recovery action group by government chaired by the Minister for Transport, with representatives from across the industry, led to a large scale re-railing programme and changes to the licensing framework for the infrastructure business, including the responsibilities of the Rail Regulator and the SRA. It also raised wider questions in the public's and the industry's minds concerning whether or not administration was the most cost effective way of refinancing regulated utilities that were not performing well and were to require new public money.

## **Competition Policy in the UK**

The UK has had a framework for competition policy since 1948. In the 1960s and the 1970s the concern was with industrial policy, initially with the reconstruction of industry in the aftermath of the Second World War, and later with restructuring it, largely as a consequence of oil crises and pressures from increased international competition. The 1980s and 1990s witnessed a shift from this interventionist industrial policy, in which the conduct of competition policy was not directly in the forefront, to a neo-liberal orthodoxy that provided greater scope for the regulation of competition, both in relation to the unique competition problems raised through the privatisation of previously state-owned industries that were considered to be natural monopolies, and in relation to the private sector as a whole. The way in which competition policy developed in the 1980s and 1990s, however, was not without criticism, and a challenge from those calling for reform. In response, significant changes in competition policy were introduced, with new legislation in the form of the 1998 Competition Act; followed by the 2002 Enterprise Act. Both measures were

strongly influenced by the desire on the part of the UK government to bring UK competition policy closer in line with European Union regulation on restrictive practices and abuse of a dominant position.

The UK has one of the largest bodies of anti-monopoly legislation in the world, except for the US. Table 4 summarises the evolution of competition legislation. The UK Monopolies and Restrictive Practices Commission (MRPC) was set up in 1948 to look into the problems associated with monopoly and restrictive practices exercised by business. It was established largely under pressure from the US to have a more competitive environment in Europe in the post war period. In practice, the Commission was asked to conduct only 28 inquiries in its first 17 years. In the early years its main achievement was to identify the need for a more formal and legally based procedure to deal with restrictive practices. This emerged in 1956 in the form of a separate institution, the Restrictive Practices Court. The scope of the Commission was expanded in 1965 with the added responsibility for advising on mergers; it was renamed as the Monopolies and Mergers Commission (MMC). In 1973 the Office of Fair Trading (OFT) was established with responsibilities for conducting investigations into monopolies and mergers, and where necessary referring cases to the MMC.

Between 1948 and the introduction of the Competition Act in 1998, the MMC was an advisory body, with members drawn from industry, public service, trade unions, and relevant professionals. The MMC had only a few full time staff, consisting of a few lawyers and six economists. Decisions on references to MMC, and on its reports, were in the hands of politicians, although it was unlikely that MMC recommendations would be overturned, leading to the view that politicians could be influenced by business interests.

**Table 4: Evolution of Competition Legislation**

Monopolies and Restrictive Practices Act	1948
Restrictive Trade Practices Act	1956
Resale Prices Act	1964
Monopolies and Mergers Act	1965
Restrictive Trade Practices Act	1968
Fair Trading Act	1973

Restrictive Trade Practices Act	1976
Restrictive Practices Court Act	1976
Resale Prices Act	1977
Restrictive Trade Practices Act	1977
Competition Act	1980
Companies Act	1989
Competition Act	1998
Enterprise Act	2002

There was increasing dissatisfaction with the earlier regime. Four main reasons have been cited

- the Restrictive Practices Court was increasingly seen as ineffective against business activities that resembled cartel type operations but the law was unable to prevent
- there was increasing awareness that some types of market power, for example predatory pricing and price discrimination, could not be adequately tackled
- there was a growing desire to bring UK competition policy in line with the European Union (EU) rules (previously Articles 85 and 86, now renamed Articles 81 and 82)
- it was increasingly recognised that decisions to deal with market power ought to rest with government

The UK competition regime was subsequently revised in two stages. The first stage was the introduction of the 1998 Competition Act, which was virtually identical to EU Article 81 prohibiting anti-competitive agreements, and EU Article 82 prohibiting the abuse of dominance.

The introduction of the 1998 legislation meant that the UK had cartel and dominance provisions that were compatible with the EU provisions in these areas. Further, like the US system, the UK also retained statutory provisions to conduct wider enquiries which could result in so-called behavioural remedies or more drastically structural

remedies. The 1998 Act also gave sector regulators (OFTEL, OFGEM, OFWAT, ORR etc.) concurrent powers with the Director General of the Office of Fair Trading (OFT).

**Box 6**

**1998 Competition Act**

The Act is composed of two main chapters.

Chapter I prohibitions apply to agreements between firms which prevent or distort trade in the UK. These could be oral or written agreements. Types of agreements falling under the Act include:

- agreement to fix buying or selling prices
- agreements to share markets
- agreements to limit production
- agreements relating to collusive tendering
- agreements involving the sharing of information

Chapter II deals with abuse of a dominant position. The investigation of a dominant position involves a two stage test which:

- assesses whether the enterprise is dominant in the relevant product or service market
- assesses whether, if dominant, the enterprise is abusing its position. Practices which constitute abuse includes situations where there are excessive prices being charged, price discrimination, predatory behaviour, vertical restraints and refusals to supply.

Nevertheless, the competition regime introduced in 1998 was felt to have three continuing flaws.

- the Competition Commission was still advisory, with government ministers potentially able to influence merger and monopoly decisions
- fines were not as effective as initially thought, as it is shareholders or consumers rather than managerial decision-makers who bear the brunt of the fines
- the wording of parts of the legislation was still complex and created a series of arduous legal hurdles to be overcome to reach a conclusion

To remedy these deficiencies the 2002 Enterprise Act came into force.

The combination of the Competition Act and the Enterprise Act is viewed as a significant strengthening of anti-trust policies in the UK. This regime prohibits cartels and abuse of a dominant position, with the threat of fines, and authorises investigations into mergers and markets with behavioural or structural remedies, and the potential criminalisation of cartels. This strict regime is implemented by the independent authorities of the OFT and the CC, with an independent appeal to CAT.

This reform paves the way for modernisation initiatives that the EU will be introducing in 2004, involving a substantial degree of delegation of EU competition powers to national authorities.

**Box 7**

**2002 Enterprise Act**

The Act which came into force in June 2003 modernises parts of the monopoly provisions in relation to how market investigations are to be conducted in the UK.

The act specifically:

- modernises, simplifies and clarifies provisions for complex monopolies
- removes government ministers from monopoly and merger decisions. When the OFT carries out an inquiry and refers a merger or a market to the Competition Commission, the decisions and remedies will rest with the Competition Commission and only be subject to judicial review by the CAT.

The only exceptions to this are through so-called public interest gateways. There are three gateways that relate to national security, the plurality of view in respect of the press and the media. Issues relating to employment, environment and social policy are not admissible as gateways unless a new gateway is created through a new statutory instrument approved by Parliament.

It is too early to judge the effectiveness of the new legislation, given the time it takes to investigate cases. Nevertheless, a number of large fines have already been imposed, indicating that in some respects the new competition policy is working.

## **SECTION THREE**

### **INTERNATIONAL EXPERIENCE WITH PRIVATISATION, REGULATION AND COMPETITION POLICY**

#### **Privatisation in Developing Countries**

Privatisation has been a major element of the economic reform programmes pursued by developing countries during the past two decades. Much of the privatisation revenue has come from infrastructure privatisation, mainly telecommunications and power, followed by the primary sector, including petroleum, mining, agriculture and forestry. In regional terms, Latin America accounts for the largest share of non-OECD privatisations, although Eastern Europe and Central Asia sold the largest number of enterprises. By comparison, privatisation activity has been modest in sub-Saharan Africa and the Middle East regions.

Has privatisation reduced the 'burden' of the public sector in developing countries? The evidence on the share of state enterprises in GDP shows no sign of a decline over the period 1978-91, when privatisation was being widely adopted. Public enterprises contributed about 11 per cent of GDP in developing countries throughout the period, with the highest share in sub-Saharan Africa (14 per cent), followed by 10 per cent in Latin America and 8 per cent in Asia. A similar pattern is observed for public enterprise employment, where the share in total employment remained unchanged at around 10 per cent. Regional variations are much greater for employment than for output, however, with the public enterprise sector in Africa accounting for perhaps 20 per cent of formal sector employment, compared to around 3 per cent in other developing country regions.

The case for privatisation is based in part on the assumption that an 'overextended' public enterprise sector lowers economic growth. However, the empirical evidence fails to show a significant relationship between the size of the state sector and economic growth performance. The literature on growth in developing countries suggests that a set of policy variables – particularly fiscal discipline, price and trade

liberalization and privatisation – are important in determining a country's growth performance, but, when taken individually, these variables have only a limited effect on growth.

Attempts to measure directly the relationship between privatisation and economic growth in developing countries have been few, and have provided conflicting results. Clearly the negative and positive findings between privatisation and economic growth do not rule out the possibility that the wider economic and sociopolitical environment may have important effects on economic growth, and on the success of privatisation. In any event the impact of privatisation on growth is likely to be linked to a change in investment levels. Privatisation has contributed to inflows of foreign investment to developing countries. Foreign direct investment and portfolio investment amounted to about 42 per cent of the total value of privatisation transactions in developing countries over the period 1988-94, with Latin America receiving much of the inflow. Enterprise-level data on capital expenditure showed a significant increase (as a proportion of sales) following privatisation. But privatisation-related foreign capital inflows are a small proportion of total inflows, and foreign capital, in turn, accounts for less than 10 per cent of total investments in most developing countries.

The fiscal impact of privatisation has been equally difficult to assess. While revenue from asset sales has been large, in many cases the net revenue gain has been significantly reduced by debt write-offs, costs of reconstruction, recapitalization and transaction costs. The contribution to the budget has also been found to be much less than sales proceeds, where privatisation revenues are treated as extrabudgetary funds. The fiscal impact of privatisation will depend on the amount, and the use made, of the proceeds and the subsequent changes in financial flows – taxes, transfers and dividends to and from the budget. There is substantial evidence to suggest that the objective of improving the fiscal balance through privatisation has not been achieved. The proceeds from privatisation have been too small and received too late to have a significant impact on the fiscal balance.

Micro-level evidence on the impact of privatisation is derived mainly from enterprise data on performance 'before and after' privatisation. The results from a wide range

of recent studies of enterprise level performance in developing countries have supported the notion that, on average, privatisation has led to an improvement in financial and economic performance. This holds for enterprises in both competitive industries and less competitive settings, although in the latter the evidence is less strong.

**Table 8: Summary of studies of firm-level impact of privatisation in developing countries, 1980s to early 1990s**

	<i>Mean before privatisation</i>	<i>Mean after privatisation</i>	<i>Share of firms with improved performance (%)</i>
Profitability (net income/sales)	0.05	0.11	63
Efficiency (real sales per employee)	1.92	1.17	80
Output (real sales)	0.97	1.22	76
Leverage (total debt/total assets)	0.55	0.50	63
Dividends (cash dividends/sales)	0.03	0.05	76

The evaluation of the experience of privatisation in developing countries over the past decade or so reveals a complex and sometimes contradictory picture, with major theoretical disagreements on the predicted outcomes and significant differences in the empirical evidence across sectors and countries, and over time. The experience with policy and performance has been diverse, making it difficult to identify common patterns of experience or to draw general lessons for policy.

What is apparent, however, is that improvements in public enterprise performance and in the contribution to economic development involve more than simply changing ownership from the public to the private sector. Privatisation can be an effective instrument for bringing about significant economic and developmental gains, but, besides ownership, it involves a set of interlinking issues which include corporate governance, institutional capacity, market competition and political economy.

The extent to which competition affects performance has important implications for the case of privatisation. Competition is viewed as a key determinant of economic performance, improving allocative and productive efficiency. If market competition is the only determinant of performance, and affects all enterprises equally, then the

focus for policy will be on increasing the level of competition in the market rather than changing the ownership of enterprises. In many developing countries, however, monopoly conditions are pervasive, and privatisation is likely simply to replace a public monopoly with a private one. In the absence of market competition, regulation of the privatised monopoly will be needed if post-privatisation economic (as distinct from financial) performance is to improve. However, if the previous arguments about the superiority of performance under private ownership are valid, the focus of policy should be on privatisation *and* increasing market competition, though this is not a policy option in cases of 'natural monopoly', where attempts to introduce competition would lead to economic inefficiency.

## **Regulation in Developing Countries**

In reality, it has been difficult for many developing countries to build sound regulatory systems with respect to competitive behaviour, service obligations and pricing policy. In contrast, it has been much quicker and easier to privatise utilities, with the result that monopolies and anti-competitive practices may have become entrenched in many countries. This is particularly the situation where responsibility for competition policy lies outside the regulatory system, and the administrative and judicial agencies are weak or underdeveloped. Even by the late 1980s only a handful of developing countries had implemented effective competition legislation.

In some network industries such as telecommunications, competition has been encouraged by issuing new licences to private network companies and regulating their connection to the public network. The obvious argument for greater competition is that it will encourage the telecommunications firms to improve service levels, expand networks, broaden the range of products available to consumers and, most significantly, lead to lower costs and prices. In some countries the continued use of locally wired services has protected economies of scale and made the introduction of competition more difficult.

Technological improvements have increased the scope for new forms of competition in relation to the supply and maintenance of consumer equipment and value added services. New radio-technologies, including cellular and mobile satellite systems,

despite being more expensive than wired telephones, have proved to be viable alternatives to the use of conventional lines.

With the privatisation of the telecommunications sector newer, sometimes less politically influenced, regulatory systems have been established. Most have concentrated on the need to improve economic efficiency and curb abuses of monopoly power. Forms of price-cap regulation have been established in Argentina, Mexico, Venezuela and Malaysia. Chile has adopted benchmark regulation while Jamaica and the Philippines have rate-of-return regulation.

Overall, in relation to the regulation of utilities in developing countries, a variety of solutions have been applied to try and reconcile the interests of major stakeholders – governments, consumers, producers, and investors. The industry structures and systems of regulation which have emerged have been shaped by political considerations, history, technology, resources and the development of the economy.

Clearly, in many developing countries privatisation has preceded the development of effective regulation and competition. In this situation, anti-competitive behaviour exists and is difficult to prevent when a state monopoly is privatised as a private monopoly without an accompanying regulatory system. The establishment of effective regulatory institutions and processes is therefore critical to the privatisation process in the utilities sector. Given that the interest of private investors in managing and operating newly privatised companies is likely to favour weak rather than strong regulation, then it is up to government to provide the political commitment to put in place effective regulatory and competition-inducing structures.

Experience has shown that the development of regulatory regimes is a continuous process and not a one-shot exercise. It has also been the case that, while the structures for regulation initially established have important implications for the evolution of the future system, political considerations often lead to compromise solutions that depart from those originally envisaged. Achieving an effective regulatory and competitive environment is a difficult and slow process, whereas privatisation is relatively easier to achieve. This is particularly the case where new

forms of regulation are being introduced and where there is little previous experience of regulation on which to draw.

Of the surveys of regulatory performance that have been conducted in recent years, most conclude that successful regulatory design has needed to address problems relating to information asymmetry and pricing. In the former case, attempts to overcome this have relied on the introduction of a more competitive environment although, in a large number of cases, countries operating telecommunications under private ownership have ended up with continuing monopolistic structures. Some telephone services have been split on a regional basis to create regional monopolies, as in the example of Argentina. As a result, forms of regulation have acted as surrogates for real competition. Sometimes the threat of competition has been introduced where private operators fail to live up to their licence agreements as, for example, in Argentina and Venezuela.

## **Competition Policy in Developing Countries**

The development of competition policy in developing countries is relatively new. Only a handful of countries had an effective competition regime prior to 1990. Two important sets of questions concern the development of competition policy in developing countries. First, what might be included in competition policy and at what cost? Should it focus on rules and procedures to prevent enterprises from engaging in anti-competitive behaviour? Should it be primarily aimed to reduce the barriers to entry and exit, and facilitate the conditions under which enterprises can compete? Second, how will the framework that is developed for domestic competition policy be shaped and impacted upon by global rules for competition?

In relation to the first question the debate has concerned the division between a behavioural and a market structure approach to competition policy, as well as the need to consider a wider range of factors other than those incorporated in an anti-trust approach to competition policy. An argument for a market structure approach, which tends to be more rules-oriented and more mechanistically applied, is that this suits the developing economy context, in which market institutions, capacity and

skills to implement policy are poorly developed. This mitigates against a behavioural approach, which is more skill intensive and potentially more costly to implement. This need for simple rules is also reinforced because the potential for collusion among enterprises is higher in developing economies, simply because monitoring technologies are less efficient, and enterprises have little to lose from colluding. There is danger, however, in pursuing a rules-based market structure approach to competition policy as opposed to a behavioural one, simply because it does rely on simplistic measures for market power, which raises the risk that enterprises may be unjustifiably penalised for perceived anti-competitive behaviour.

However, competition is not the automatic outcome of processes of deregulation, and effective competition policy does require the drafting of new competition laws and the creation of new institutions for their implementation and enforcement, which are costly to establish. The budgetary constraints facing many developing countries may inhibit the speed with which complex regulation and new institutions can be introduced. The recommendation that removing entry barriers to a market ought to form a central component of competition policy may also be problematic in developing countries, where barriers erected by government have been the most persistent, and difficult to eliminate. There may, therefore, be a potential conflict with the aims of government development policy (pursued through providing subsidies to uncompetitive enterprises which act as entry barriers to others) and competition policy, which demands a more level playing field and freer entry and exit conditions for enterprises.

The question of how international rules for competition are likely to affect domestic policy regimes is, of course, dependent on how far international rules are developed. One of the main arguments for international intervention is that anti-competitive practices in one area have spillover effects in others, as for example with import and export cartels and mergers involving foreign companies, and that domestic competition authorities are powerless to take action against them. There is mounting evidence that cross-border cartel activity has increased in recent years and is not being policed by international agencies. Further, most host country competition authorities are unwilling to do so. Even developing country governments that have competition laws in place have often been unable to gain evidence that

anticompetitive practices are being undertaken. It is generally recognised that the solution lies in greater cooperation between competition authorities across countries, although this is constrained by the fact that, at the present time, authorities in developed economies take into consideration the effects on their economies of actions taken elsewhere, but do not generally consider the effects of home-based cartel-like activities on others.

## Useful Websites

[ldpm.man.ac.uk/crc/](http://ldpm.man.ac.uk/crc/)

The Centre on Regulation and Competition (CRC) at the UK's University of Manchester, is one of the few research centres in developed countries devoted to the study of regulation and competition in developing economies, and is the institutional base for the contributions to this issue. CRC has produced a substantial number of working papers, which can be downloaded.

[www.worldbank.org/privatesector/ifur/](http://www.worldbank.org/privatesector/ifur/)

The International Forum for Utility Regulation has an online resource portal designed to facilitate the exchange of information on utility regulation. It also has a directory listing addresses and descriptions of nearly 800 regulatory institutions in over 180 countries.

[www.rru.worldbank.org/index.esp](http://www.rru.worldbank.org/index.esp)

The World Bank's Rapid Response Unit specialises in policy advice on investment climate and privatisation for developing countries and provides over 800 full-text documents and links on various aspects of private sector development including economic regulation. It also has downloadable indicators for benchmarking the performance of business regulations and toolkits for the privatisation and regulation of infrastructure services in sectors such as transport, telecommunications, water and sanitation.

[www.itu.int/home/index.html](http://www.itu.int/home/index.html)

The International Telecommunication Union is an international organisation within the UN system. Its website has a database of regulatory profiles of member states as well as information on the latest events, regulatory trends, case studies, reports and publications on different aspects of telecommunication regulation.

[www.cuts.org/](http://www.cuts.org/)

The Consumer Unity & Trust Society has research centres in India as well as in Zambia, Kenya and UK. It brings out newsletters that intend to highlight policy decisions in the field of regulation and competition in different countries. Its '7 Up'

project aims at doing a comparative study of competition regimes in seven developing countries.

[www.regulateonline.org/](http://www.regulateonline.org/)

The World Dialogue on Regulation for Network Economies generates and disseminates new knowledge in regulation and governance of network economies. It operates in both developing and developed countries through its involvement in research, dialogues, discussions, and widespread distribution of papers, reports, and other relevant information.

[www.aei.brookings.org/](http://www.aei.brookings.org/)

The AEI-Brookings Joint Center for Regulatory Studies aims to hold law-makers and regulators accountable for their decisions by providing thoughtful, objective analyses of existing regulatory programs and new regulatory proposals. It also has developed database to assess the quality of economic analysis and regulatory impacts.

[www.lse.ac.uk/collections/CARR](http://www.lse.ac.uk/collections/CARR)

The Centre for Analysis of Risk and Regulation focuses on the organisational and institutional settings for risk management and regulatory practices. The centre also hosts a searchable directory to locate up-to-date information on researchers working in the risk and regulation fields.

[www.bath.ac.uk/cri/home.htm](http://www.bath.ac.uk/cri/home.htm)

Centre for the Study of Regulated Industries investigates how regulation and competition are working in practice, both in the UK and abroad, with a focus on comparative analyses across the regulated industries.

[www.cabinet.gov.uk/regulation](http://www.cabinet.gov.uk/regulation)

This site carries information about the work of the UK Government's Regulatory Impact Unit, and the UK Better Regulation Task Force.