COMPETITIVE PUBLIC SERVICES – NEW CHALENGES FOR ROMANIAN ECONOMY

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Abstract: Over the last nineteen years public utility services have been transformed by the introduction of competition. Greater reliance on competition has been a key factor in improving the way these sectors are regulated, leading to improved efficiency, innovation and more attention to the needs of consumers. Introducing competition in different parts of public utility services is not simply a matter of removing legal barriers to entry. It is usually also necessary to introduce new regulation to ensure that new firms have access to any key inputs or services that can only be obtained from the incumbent monopoly firm. The incumbent firm may not willingly provide these inputs, especially where doing so means the potential loss of a profitable line of business to a rival. Incumbent firms can resist the growth of competition by refusing to supply essential inputs, supplying them at a lower quality, or at a higher price.

Key words: public services, competition, monopoly, restructuring public services

Regulators can and do try to prevent this behaviour, but the incentives on the incumbent firm to evade the regulation are strong, and developing a regulatory response takes time. Rather than trying to directly control the behaviour of the regulated firm, it often makes sense to instead change the incentives on the regulated firm to restrict competition. Often this can be achieved through various forms of restructuring of the regulated firm. For example, by carefully separating the regulated firm into its monopoly and competitive parts. Restructuring the regulated firm will not always be the right policy option. But certain forms of restructuring have proved effective in many industries and, as weaknesses in earlier reforms have become apparent, is being increasingly mandated in Romania now, particularly as a tool for facilitating the growth of competition.

1. Is competition possible in public utility services?

In the past it was common to treat "public utility" services (such as telecommunications, electricity, railroads, water supply and so on) as though they were monolithic natural monopolies. But the scope of the natural monopoly in these sectors is not fixed for all time – as technology develops the scope for competition changes. One of the biggest developments in regulatory thinking in the past nineteen years has been the recognition that these services are not monolithic but are made up of many separate parts. Many of these parts can, in fact, sustain competition. The following table lists, for a number of services, the parts that might be able to sustain competition (i.e., are "competitive") and the parts that are still a monopoly (i.e., are "non-competitive"). For example, in the electricity sector, the transportation of electricity over transmission lines is usually not competitive, while the generation of electricity is usually competitive. The introduction of competition into the competitive parts of these services has transformed the way they are regulated. Experience has shown that reliance on competition, where it is feasible, usually delivers better outcomes for end-users than reliance on regulation. Although regulation of the true monopoly parts of these services is essential, regulation seldom facilitates efficient production and has a tendency to hinder the development of new services and new ways of marketing those services to consumers. Greater reliance on competition has allowed the regulators to withdraw from regulating certain areas, facilitating innovation and efficiency in those sectors, while allowing the regulator to concentrate on the natural monopoly sectors that remain.

2. Restructuring public services

In most cases, introducing competition into the competitive parts of a regulated public utility industry is not simply a matter of removing legal or regulatory barriers to entry. It is usually also necessary to take steps to ensure that the new firms entering the market have non-discriminatory access to any essential inputs provided by the remaining monopoly parts of the industry. Access regulation of some kind is therefore one essential element in the process of introducing competition into a regulated industry. We focus here on the second possible element of this process – the possible restructuring of the regulated company.

There are many different ways in which restructuring could be used as a tool for promoting competition. Breaking a firm horizontally into competing pieces, for example, might be desirable to facilitate competition between the different pieces. In some countries, for example, a monolithic electricity generator has been separated into separate competing companies, to facilitate competition in electricity generation. It might also be useful to break up a regulated firm if doing so allowed the regulator to more precisely identify the costs of providing the regulated service, or to prevent the firm shifting its costs from unregulated to regulated activities. For example, in a case concerns were raised that Deutsche Post AG was able to cross-subsidise its competitive parcels service with revenue from its monopoly "reserved" services. To prevent this Deutsche Post was required to set up a separate legal entity for the provision of its non-universal and competitive parcel services. Separation of this kind facilitates the monitoring and control of anti-competitive cross-subsidisation.

These forms of restructuring are important but were not the direct focus of this study. Instead, it focused on restructuring to promote competition in those competitive markets which depend on access to the remaining monopoly for an essential input. To understand why restructuring is important in this context it is first important to understand the problems that can arise when a monopolist supplying essential inputs is itself allowed to operate in the competitive activities.

3. What is the basic problem in vertically-integrated industries?

When the owner of essential inputs also competes in a downstream competitive activity it typically has both the ability and the economic incentive to restrict competition in that downstream activity. It has the ability to restrict competition by restricting access to the essential input – by raising the price, lowering the quality or reducing the timeliness of the essential services it provides, relative to the services the regulated firm provides to its own downstream affiliate. For example, an integrated electricity generation and transmission company could limit competition from rival generators by raising the price that they must pay for access to the transmission network. An incumbent telecommunications operator can limit competition from rival long-distance operators by raising the price at which those rivals have access to the local loop, and so on. When the owner of the essential input also competes in the competitive activity it may also have the incentive to restrict competition. This would occur, for example, when the monopoly input was tightly regulated compared to the regulation on the retail services – e.g., if regulation of the transportation prices of a natural gas transmission pipeline was more tightly regulated than the price of delivered natural gas. In this circumstance the owner of the essential input has a strong incentive to itself provide the downstream services and, by restricting competition downstream, re-capture some of the monopoly rents that it would otherwise lose to regulation. For example, if the price of delivered gas was unregulated while the price of gas transportation services was tightly regulated, a gas pipeline could enter the market for delivered gas, exclude competing gas producers and sell delivered gas at the monopoly price – recapturing the monopoly profits on its pipeline transportation business that would otherwise be lost to regulation.

The regulated firm can use all the tools at its disposal, whether legal, technical or economic to delay, to lower the quality or raise the price of access. A well-resourced regulator, through persistence and vigilance, could hope to limit the anti-competitive activity of the incumbent, but the outcome is unlikely to be as much competition as would arise in the absence of the incentive to restrict competition. Potential entrants, fearing the effects of discrimination, despite the best efforts of the regulator, may hesitate to invest in new capacity

3. What are the alternative ways of addressing this problem?

There are at least four different ways of restructuring the regulated utility to address this incentive to resist the growth of competition:

The first possible approach is separation of the ownership of the competitive and non-competitive segments of the regulated utility, supplemented by a line of- business restraint which prevents the monopolist from re-entering the competitive activity. When the owner of the essential service is prevented from competing in the competitive sector, the incentive to restrict competition is eliminated. The owner of the essential input has no incentive to discriminate between any of the firms competing in the upstream or downstream competitive sector. The owner of the essential input no longer has any incentive to restrict competition. This simultaneously reduces the need for close regulatory oversight and enhances the scope for competition. *This is the primary benefit of vertical structural separation.*

A second possible approach is joint or club ownership of the natural monopoly facility by firms which compete in the competitive activity. Since all the competing firms are part owners of the natural monopoly facility they can ensure that they obtain access on non-discriminatory terms and conditions.

A third and related approach is allocating a share of the total capacity of the natural monopoly facility to each of the downstream competing firms.

A fourth approach is to separate the ownership and control of the natural monopoly facility – allowing the ownership to remain in the hands of a firm which may also compete in the competitive activity, but placing its control in the hands of a neutral body – such as a committee made up of representatives of the industry.

4. The costs of vertical separation

The previous section highlighted the primary benefit of vertical separation – by eliminating the incentive to restrict competition downstream, vertical separation makes the job of the regulator easier and facilitates the development of competition. What might be the costs of vertical separation? It is possible to identify many different costs that could be raised by separation:

1. Separation may increase transactions costs. After separation, operations that were previously carried out within a single firm must now be carried out at arms-length through contracting and market arrangements. In many instances, the full exploitation of the essential input by a downstream firm will require a specialised investment and therefore close co-ordination with the monopoly – this co-ordination is usually easier when carried out within a single firm;
2. Separation may force the monopolist to forego efficient ways of selling the monopoly services. For example, it is well-known that it is efficient for a monopolist to sell its goods at marginal cost whenever that is feasible. While it may be feasible for the monopolist to, in effect, sell to its own affiliate at marginal cost, if the monopolist sold to other firms at marginal cost it might not be able to recover its fixed costs;
3. Separation may also force the monopolist to forego efficient forms of price-discrimination. It is usually efficient for a regulated monopolist to sell at different prices to different consumers. By bringing the monopoly firm closer to the final consumer, integration can allow the monopolist to more finely differentiate its regulated prices, enhancing overall efficiency.

Some countries also consider that allowing a regulated utility to remain integrated may also facilitate the maintenance of a given level of universal service or service reliability.

5. Alternatives to full vertical ownership separation

Recognizing both the costs and benefits of vertical ownership separation, some countries have tried other controls which seek to achieve some of the effects of separation without actually requiring divestiture. These alternatives include: 1) Accounting separation, i.e., a requirement on the regulated firm to prepare separate accounts for its competitive and non-competitive businesses; 2) Management or functional separation – i.e., a requirement that separate activities be carried out within separate, distinct divisions of the regulated firm; Corporate separation – the requirement that separate activities be carried out by a separate corporate entity (wholly or partially owned by the regulated firm). These alternative forms of separation affect neither the incentives nor the ability of the regulated firm to act in an anti-competitive manner. They are often, however, an important supplement to other forms of separation, particularly as a supplement to access regulation. The information made available through accounting separation, for example, is typically used as a basis for determining access prices, for detecting cross-subsidies and for preventing discrimination.

6. Where has restructuring been tried and what was the outcome?

Public utility services differ widely, both in the degree to which competition has been introduced and the degree to which restructuring and vertical separation is required.

For example, in the air transport industry, it is now common to have many competing airlines. At the same time, vertical integration between airlines and airports is uncommon and is often strictly prevented.

The telecommunications industry was one of the first sectors to be liberalised and one of the first to be structurally separated

Conclusions

In the end I think that the separation has both potential benefits and potential costs. The text of the recommendation proposes that when member countries are considering policy towards a vertically-integrated natural monopoly, they should carefully balance the benefits and costs of structural measures (such as vertical ownership separation) against the benefits and costs of behavioural measures (such as the regulation of access to an integrated firm).

The recommendation explicitly mentions that this balancing should take into account a number of factors such as:

- the effect on competition;
- the impact on the quality and cost of regulation;
- the transition costs (*i.e.,* the one-off costs associated with a structural change); and
- the economic and public benefits of vertical integration.

The balancing should also take into account the economic characteristics of the industry in the country under review. The recommendation also explicitly notes that the benefits and costs to be balanced should be those recognised by the relevant agencies including the competition authority. This balancing should especially take place in the context of privatisation, liberalisation or regulatory reform.

The key points of this work on structural separation can be summarised as follows:

- Regulated utility services are not monolithic natural monopolies but consist of many parts, some of which can sustain competition and some of which remain monopolies. It is widely accepted that it is preferable to rely on competition in those components in which competition is possible, to facilitate innovation and efficiency in those sectors and to narrow the focus and scope of regulation.
- When a regulated firm also provides essential inputs to its competitors in a related competitive sector, the regulated firm may have both the ability and a strong incentive to restrict competition. Attempts to control the behaviour of the regulated firm to offset this incentive are difficult and regulators may face an uphill battle.
- There are a variety of ways that the regulated utility can be restructured to overcome this incentive to restrict competition. Perhaps the simplest way is to prevent the regulated firm from competing in the related competitive sector. Other approaches include club or joint ownership of the natural monopoly facility, sharing of the capacity of the essential facility or separation of the ownership and control of the essential facility.
- Separating the regulated utility into the competitive and non-competitive parts will likely involve certain costs. In particular, separation may raise transactions costs and may prevent more efficient forms of price discrimination. There will also be the one-off costs of the restructuring itself. These costs need to be balanced against the potential benefits to competition.
- Rather than full ownership separation, certain alternative forms of separation are often used which seek to enhance the level of competition without incurring the cost of ownership separation. These alternatives include accounting separation, management separation and corporate separation. These forms of separation have their uses but also their limits. Although these approaches reveal more information to the regulator and make anticompetitive practices easier to detect, the underlying incentive to restrict competition remains. Experience as to the weaknesses of these approaches has lead to calls for stronger forms of separation.

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