



International Summer School in Applied Environmental
and Regulatory Economics

THE REGULATION OF LOCAL PUBLIC SERVICES

**“Public property, political regulation and
independent regulation for the public
services”**

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**Public property, political regulation and independent
regulation for the public services**

- 1. public enterprise and regulation as
(alternative? complementary?)
instruments for the promotion of the
public interest in services**
- INTERMEZZO: What is “public
service”?
2. the case of network services

The general frame for public property and regulation

Economic policy in a market economy: main objectives

- (Re)distribution of income and wealth
- Correction for externalities (environmental policy)
- Guaranteed provision of common goods and public services
- What is needed for markets to work well (antitrust, regulation)

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The historic role of public enterprise (1)

- A public enterprise may be established as a substitute for lack of private enterprise
- A first or a second choice? A clash of ideologies leading to a gradual diffusion of a market economy based on private initiative
- Public enterprise as an engine for development: a pattern typical of the early stages of development
 - starting from the European continental countries in the 19th century
 - continuing with the developing countries of the 20th century
- particularly in the case of capital intensive sectors where the payback period is very long (steel, heavy industry, nuclear power)

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The historic role of public enterprise (2)

- At a later stage of development, a public enterprise may be established to correct the outcomes of a market economy
 - to provide infrastructures of general interest (railways)
 - to break monopolies (Italian oil and gas, cement)
 - to reduce dependence from foreign companies (military equipment)
 - to promote the diffusion of innovation and technology transfer (innovation, technology parks)

The crucial weakness of public enterprise

- The basic problem with public enterprise is its internal conflict between two goals of profit maximisation and pursuit of the general interest
- The awkward borderline between political and managerial responsibility
- The social function of profit maximisation is efficiency; alternative instruments for measurement, promotion and evaluation of efficiency are difficult to define and implement
- Growth of markets and global competition are making the behaviour of public companies very similar to the behaviour of private companies

**Is public enterprise (still) necessary?
(1) Look at the company**

- Supporters of public enterprise often rely on the idea that company decisions are in the absolute discretion of the owner (*patron, padrone*)
- Theory and practice indicate that company decisions result from interaction among many *stakeholders* (shareholders, workers, customers, providers of intermediate goods and services, public authorities)

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**Is public enterprise (still) necessary?
(2) from the viewpoint of the public authorities**

- Today public enterprise is almost never the only policy instrument for providing a necessary production or correcting the outcome of a market process
- There are other, alternative and powerful instruments:
 - legal constraints, regulation (technical, urban, health, consumer protection, environmental ...)
 - auctions for public procurement and for provision of public services
 - antitrust policy
 - taxes or subsidies to deal with externalities (innovation, environment)

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Is public enterprise (still) necessary? (3) state of the art

- Choice among instruments should be based on a comparison of advantages and disadvantages, but...
- ...an ownership structure inherited from the past has a great inertial power
- The European Union is neutral with respect to ownership of enterprises, but...
- ... it forbids state aid. Then what is state aid?
 - Is underwriting of new capital by a public owner to be considered state aid?
 - Official definition: it is state aid when a private investor would not underwrite.
 - In practice: negotiation between EC and MS through successive steps

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Regulation

- General purposes
 - set technical standards
 - set prices and tariffs in monopoly
- Specific market regulation
 - transparency and stability of financial markets
- Political regulation combines with self-regulation by market agents

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Independent regulation

- Regulation may be performed by a governmental office
- It is often entrusted to a specific body (agency, commission, authority)
- An independent regulator is appropriate
 - no implicit compromise among objectives
 - only exceptional, explicit political decisions
- Problems:
 - legitimacy
 - relations between regulator and government

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Public enterprise and regulation: alternative instruments for promotion of the public interest ?

- Regulation is necessary even in the case of public enterprise
 - Agency problem
- Regulation allows an easier distinction between the functions of government - parliament
 - To set objectives and main strategies (including those of a regulator)
 - To be shareholder of companies

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Public enterprises in recent practice

- Massive privatisation in the past 30 years, often dictated by ideology or financial necessity rather than a rational choice
- A rational choice requires credible alternative instruments in place: antitrust, capital markets, regulation
- Large companies in small markets have market power: solution is to enlarge the market, not to maintain state ownership
- Recent bank nationalisations do not represent a reversal trend but a temporary remedy

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Public property, political regulation and independent regulation for the public services

1. public enterprise and regulation as (alternative? complementary?) instruments for the promotion of the public interest in services
- **INTERMEZZO: What is “public service”?**
2. the case of network services

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What is “public service”?

definitions

- ***Traditional but inconsistent: All services supplied by public entities***
- ***In search of an economic rationale: services which***
 - are essential to life and are organized in a way as to be physically and financially accessible to all (help in reducing inequalities)
 - have “public good” characters (zero marginal cost for additional consumer, no exclusion is possible) or at least produce strong positive externalities, and consequently would not be supplied by private companies
 - help in strengthening social cohesion

Services of general interest: EU definitions

- **Services of general economic interest**
 - subject to internal market and competition rules of the EC Treaty
 - In the case of large network industries having a clear European-wide dimension, such as telecommunications, electricity, gas, transport and postal services, the services are regulated by a specific EU legislative framework
- **Non-economic services**
 - traditional state prerogatives such as police, justice and statutory social security schemes
 - not subject to specific EU legislation, nor covered by the internal market and competition rules of the Treaty
 - may be subject to other rules of the Treaty, such as the principle of non-discrimination.

“public service”: evolution of the notion

- traditional “public” services are increasingly similar to other services
 - produced by an industrial organization (*e.g.: evolution of water services and sanitation*)
 - in a variety of types (*e.g.: postal service and telecoms*), competing as and with substitutes
- aspects of public interest justify “public service obligations”
 - obligation to provide access, to connect, to supply
 - obligation to guarantee continuity and quality standards
 - obligation to provide low-cost options

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The economics of networks

- Physical networks: diminishing unit costs create natural monopolies
- Economic networks: customer utility depends on the number of utilisers, with the consequence of creating a similar feature
- Structural remedies to introduce competition (breakup of companies) are not available
- ... but unbundling and open access can be used wherever possible
- Where market power is inevitable, abuse must be prevented

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Regulation of network services: tasks (1)

- At an early stage: set tariffs for service provided under natural monopoly
- If unbundling is not feasible (water, urban transport):
 - Identify the provider of service (auction?)
 - Design and organize the contract
 - Monitor compliance (yardstick competition)

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Regulation of network services: tasks (2)

- If unbundling is feasible (electricity, gas, rail):
 - Set the basic rules for unbundling (accounting)
 - Regulate access (network codes)
 - Set tariffs for use of network
 - Regulate use of more than one network (compensation for transit)
 - Overlook the market structure
 - Set up an organized market (power, gas exchange)

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Regulation of network services: tasks (3)

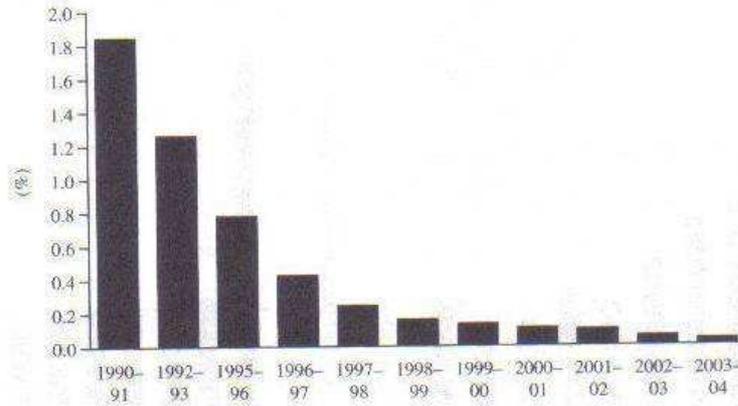
- Other tasks of a regulator:
 - Set and monitor quality standards
 - Enforce transparency rules
 - Ensure environmental protection
 - Protect small consumers
 - Identify characters of public service
 - Uniform tariffs?
 - Service to disadvantaged citizens

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Reliability of a water network ((England and Wales) - 1

Properties at risk of low pressure

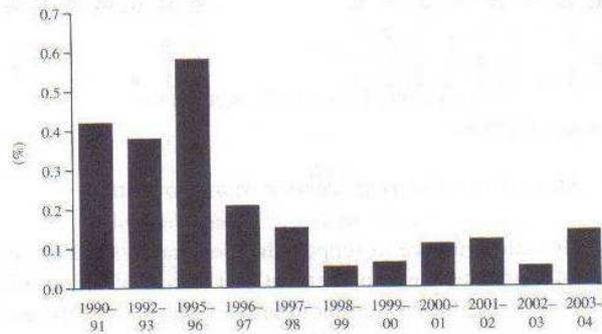


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Reliability of a water network (England and Wales) - 2

Properties subject to unplanned supply interruptions



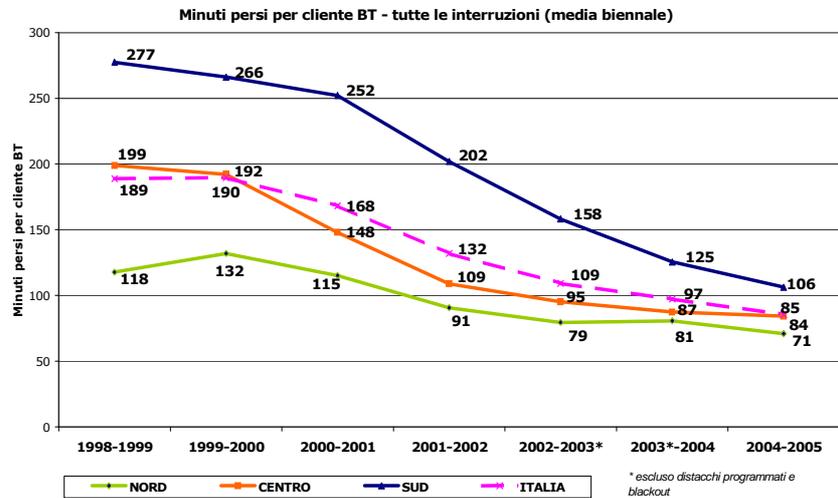
Source: Ofwat: Levels of Service for the Water Industry in England and Wales; 2003-2004 report.

Figure 4.4 Reliability of the water network

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Reliability of an electricity network (Italy) - 1



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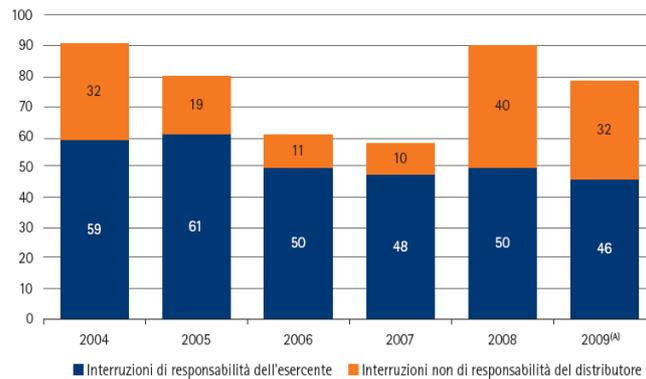
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Reliability of an electricity network (Italy) - 2

FIG. 3.1

Durata delle interruzioni per cliente BT, anni 2004-2009

Minuti persi per cliente all'anno (esclusi interventi dei sistemi di difesa e incidenti rilevanti sulla RTN)



(A) Il dato relativo alle interruzioni di responsabilità dell'esercente è provvisorio.

Fonte: Elaborazione AEEG su dichiarazioni degli esercenti.

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Privatisation of network companies

- A largely accepted solution for energy systems: energy companies go private, network companies stay public
 - Norway, Netherlands, Belgium, Italy
- Exceptions on either side:
 - British energy network companies (private)
 - French energy companies (state-owned)
 - Spanish electricity network: joint private ownership
 - German system: largely private with important public shareholdings

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How to limit market power of local network companies

- Regulation should be better understood and appreciated
- Systematic measurement of performance, yardstick competition
- Maintain a discovery process alive
- Competitive bidding, provided public administrators have knowledge, skills
- Partial privatisation and public-private partnerships often hide collusion

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