



## The Provision of Basic Services in Liberalized Markets (BASIC)

### Executive Summary

Project Website: [www.iccr-international.org/basic](http://www.iccr-international.org/basic)

**Co-ordinator:**

The Interdisciplinary Centre for Comparative Research in the Social Sciences, Vienna, Austria

**Partners:**

The Free University of Amsterdam, Economic and Social Institute, Amsterdam, The Netherlands

The Centre for European Economic Research (ZEW), Germany

Ecoplan, Bern, Switzerland

Jagiellonian University, Institute of Management, Poland

Sussex University, The Sussex European Institute, Sussex, The United Kingdom

Zentrum für soziale Innovation (ZSI), Vienna, Austria

Le Centre Interdisciplinaire pour la Recherche Comparative en Sciences Sociales, Paris, France

Institute of Studies for the Integration of Systems (ISIS), Rome, Italy

## **Executive Summary**

The BASIC project analyzed the provision of basic services or 'services of general interest' in the electricity, telecommunication, public transport and postal service sectors in eight European countries, namely, Austria, France, Germany, Italy, the Netherlands, Poland, Switzerland and the UK. It was funded by the European Commission under the 5<sup>th</sup> Framework Programme and carried out by an international and interdisciplinary consortium of nine partners. The overall aim of the project was to provide an analysis of the problems, shortcomings and strengths of basic service provision under different regimes of regulation and liberalization.

The study was carried out in the context of the ongoing changes in the electricity, telecommunication and postal service sectors, most notably the increasing tendencies towards liberalization. Two key characteristics render the liberalization of these industries somewhat atypical: first, their network properties and thus the problems associated with the regulation of natural monopolies; second the expectation that the services they provide represent, at least in part, a public good insofar as they are attached to social rights, and that they continue to do so even if privately managed or submitted to the rules of competition.

The results and conclusions of the BASIC project are drawn from many areas of study, ranging from a literature review and stakeholder analysis to the quantitative and qualitative analysis of different country and sectoral models.

### **The state of sectoral reforms**

Except for the UK, the development of the national legal frameworks in the electricity, telecommunication, postal service and railway sectors has largely been driven by EU regulatory. However, there remain some important differences between sectors and countries.

The sectoral differences reflect in part the different timelines of EU regulatory activity. For example, the liberalization of public transport services has not yet been agreed upon at the EU level. As a result considerable diversity in the types of regime in different member states remain. In contrast, full liberalization of the telecommunication sector has been in place for over seven years, and this has meant that the relevant directives are for the most part transposed at national level, even if the subsequent reforms have sometimes been slow to be implemented. Indeed the pace of implementation – in telecommunication, energy and postal services as well as with regard to some parts of the railway reforms – is the area where national differences are greatest.

**Telecommunication** was one of the first sectors to be liberalized during the 1990s (the UK introduced competition already in 1984). The sector is unique for its rapid technological changes during the last 15 years. In terms of the absolute quality, reliability and cost of basic service provision, the sector is performing reasonably well by most standards. The main problem is related to the formation of oligopolies and/or the misuse of power by former incumbents. In countries like Germany and Italy liberalization has greatly increased the number of operators but

has still not led to truly competitive markets. Thus the main challenge in the telecommunication sector is to set up regulatory regimes that lead to fair competition.

In most countries, **electricity** sector liberalization started after the EU Directive on partial liberalization in 1996 (UK 1989). The speed of implementation of EU legislation varies greatly across countries. While countries like Germany, the Netherlands and Italy proceeded rather quickly, other countries, like France, were slow to follow. An exception is the Non-EU Member Switzerland where liberalization has been put off until 2007. Even though liberalization is proceeding rapidly in the EU Member States this has not led to real competition. So far the market opening has failed to break up the oligopolistic or monopolistic structures of the national electricity sectors and, on a European scale, there is even an ongoing process of increasing concentration. Furthermore the current form of sector organization appears to be unable to tackle the emerging problem of the security of supply. Both in terms of grid capacity and in terms of generation capacity the current levels of investment do not appear to be adequate to ensure the long term sustainability of the system.

**Postal services** were separated from telecommunications in the mid to the late 1990s (UK 1980s). While the telecommunication sector was immediately liberalized, in the postal service sector a more gradual approach was taken. Following the first EU Directive on liberalization in 1997, the market was essentially divided in a reserved part that remained a monopoly and a non-reserved part with competition. Full liberalization on the basis of EU legislation will only be enforced from 2009 onwards. However, even the partial liberalization of the market has already led to significant changes in the provision of basic services. Even though the number of parcels and letters delivered by the postal service sector has remained largely constant over the past 15 years, the number of post offices (incl. postal partners such as small shops) was reduced dramatically in most countries. On the other hand changes in technology and lifestyle have altered the role of the postal service system in modern societies and thus justify the need of a modernization of the European postal service sector. What type of modernization is deemed desirable is first and foremost a political question but the current regime is certainly moving away from full territorial coverage with post offices and letter boxes.

The **public transport** sector differs from the other three sectors insofar as, and with the exception of railways, the EU has no competencies to influence its development. Only one of the eight countries in the BASIC project (the UK) has so far attempted a large scale liberalization of the public transport system. In recent years most other countries have slowly started to introduce tendering services for some local and regional bus services but in most cases there is still no effective competition. In the UK earlier liberalization and privatization policies are being partly reversed due to a wide range of problems in specific areas like a lack of infrastructure investment. The legislative frameworks in Austria, France, Germany, Italy, the Netherlands and Poland are showing an increasing tendency towards a more diverse organization of local public transport services. Prior to the year 1996 most services were owned, organized and operated directly by municipal or regional authorities. Since then, all the above mentioned countries have passed legislative acts allowing for some sort of private involvement through tendering procedures. In some cases like the Netherlands this has become obligatory but in most other countries it is at the discretion of the responsible public authorities to how to organize the services. In order to avoid problems with EU rules on state subsidies all laws contain provisions on the fulfillment of public service obligations. An attempt of the European

Commission to make public tendering mandatory for the payment of state subsidies in local public transport was turned down by the European Court of Justice in 2003.

In the **railway sector** the European Union started the creation of a common market for rail transport in 1991 with its first railway liberalization package. At first this was limited to freight transport but towards the end of the 1990s the legislative framework was extended to cover also passenger transport. The Member States have been slow to implement EU legislation on railway liberalization but within the next five years the process should be complete. Apart from the UK it is too early to assess the effects of passenger railway liberalization. One of the main failures in the UK, namely the privatization of rail infrastructure, will most likely not be attempted in the other seven countries in the near future. As for the other problems in the UK experience, most notably the coordination of schedules on different lines and integrated ticketing services, it remains to be seen how regulatory authorities in Continental Europe will address this problem.

### **Stakeholder perspectives**

The dominance, over the last couple of decades of the (regulated) deregulation paradigm is evidenced at the level of stakeholders such as political parties, business organizations, trade unions or consumer organizations and documented in the media. There are of course differences between these stakeholders depending on their perspective and the interests they represent; moreover, insofar as political parties and trade unions are concerned these differences run across the left-right cleavage. At the same time, most stakeholders accept the need of reform – many on ideological grounds, some as a result of pragmatism.

### **The impact of liberalization**

Liberalization is arguably the most important of many factors influencing the past and current development of the four sectors studied in the BASIC project. It has been advocated by the belief that competition would increase efficiency and service quality. However, the international literature on the effects of regulatory reform is inconclusive and controversial, especially concerning distributional effects. The success or failure of regulatory reforms depends on a variety of factors such as industry concentration, risk premiums, various types of transition costs, consumer and environmental protection and technological and organizational changes which influence industry structure.

Overall, the primarily economic analyses of regulatory reforms agree that some change in the existing arrangements was required. However, substantiating the extent or even the existence of benefits as a result of the reforms is not a particularly visible feature of the literature. While some account of price effects has been given on a general basis along with more limited range of in-depth analyses of reforms these accounts are often hedged by various qualifications which raise questions about the overall effect, particularly in distributional terms. The uncertainty regarding the overall effect of reforms reflects misgivings over the emerging structure of the liberalized markets and the effectiveness of the regulation overseeing their development.

The results of the BASIC project identify only two clear impacts of liberalization. First and foremost, in all countries and in all sectors the degree of liberalization tends to correlate with a **decrease of employment**. In the electricity, postal service and public transport sectors this has been equivalent to a decrease in the absolute number of employees. In the telecommunication sector the fast growth has mostly offset the reduction of employees and in many countries their absolute number has grown since the beginning of the liberalization process. In some cases the reduction of the number of employees leads to a corresponding loss of service quality (e.g. fewer post offices), in other cases it appears to be part of a process of rationalization without a loss of service quality. However, in both cases the lack of sufficient data on maintenance costs and investments raises questions about the impact of employment reduction on the **long term sustainability** of the system.

The second impact of liberalization is a **loss of transparency**. Contrary to a popular argument by which liberalization should increase transparency as compared with government provision, the BASIC project found that liberalization decreases transparency in many different ways. Regulators generally receive only a fraction of the information, especially regarding the internal cost structures of the companies, they would need to provide a fair and efficient regulatory framework (see section on regulation below). Governments have hardly any reliable information on private infrastructure investments and service quality. And last but not least, customers have to face uncoordinated public transport schedules and ticketing systems, price discrimination, etc.

Two impacts that are generally expected from liberalization could not be clearly identified by the BASIC project. Liberalization does not appear to always have a significant effect on **service quality** (with the exception of the postal service sector) and the effects on **prices** are mixed. Only in the telecommunication sector did prices drop significantly during the last ten years but it is unclear how much of this is due to liberalization and how much to changes in technology. In the electricity sector overall prices are currently somewhat lower than before liberalization (despite higher prices for fossil fuels) but in this case it is unclear whether this might correspond to lower levels of investments in electricity grids and generation capacities. It is interesting to note that there does not seem to be a relationship between the level of employment and electricity prices across different countries. Also electricity is the only sector with significant **regional price differentiation**. This is due to different charges for the publicly owned grids and not to price differences in the liberalized part of the market.

Particularly in the electricity sector but partly also in the telecommunication sector **market concentration** is a major concern. In most countries the market liberalization has not yet led to a competitive market for electricity for household consumers. Price data shows that high prices are (weakly) correlated to the degree of market concentration and currently there appears to be a tendency towards even more concentration rather than towards more competition.

### **Regulation of natural monopolies or oligopolistic markets**

The mixed results on price changes after liberalization may be due to oligopolistic market structures (or collusion) but they may also be due to the fact that large network services constitute typical "natural monopolies" in the economic sense. In both cases it would be

necessary to strengthen competition and anti-trust authorities as well as regulatory authorities both in terms of their legal possibilities as well as in terms of their resources.

However it is difficult to say how realistic it is to achieve truly effective regulation of network services and at what costs. Theoretically this requires perfect knowledge of the internal cost structures of all companies by the regulators. Without this knowledge economically correct decisions about adequate prices for the unbundling of lines or illegal practices such as cross subsidies within a company or the abuse of market power are very difficult to take. However, most data on internal cost structures is commercially sensitive and thus highly confidential. But even if this data were supplied to regulators it is not clear whether it would be technically and economically feasible to check the accuracy of the information.

### **Non-liberalization related factors for basic service provision**

Apart from liberalization, four factors stand out as the most important ones for the development of basic service provision; technology, demography, geography and history.

**Geography**, in combination with settlement structures, often determines the cost of providing network services. Mountainous areas, islands or sparsely populated parts of the continent constitute specific challenges for basic service provision and thus also for their regulation. The project's results show geographical differences in **service quality** for the postal service and public transport sectors but almost no differences in the telecommunication and electricity sectors. This is mostly due to the nature of the service infrastructure (virtual networks vs. fixed physical lines) but also differences in regulation that often do not specify a minimum service level (e.g. maximum distance to next bus station, minimum frequency of public transport). In terms of **prices** the only significant regional differences can be found in the electricity sector due to different public grid charges.

**Technology** is most important in the telecommunication sector. Due to technological changes the boundaries of speech telephony, internet, multimedia services, fixed line and mobile/wireless services are getting increasingly blurred. The scope of services which can be considered to be basic services is constantly changing and growing. Broadband internet, for example, used to be a luxury good only a few years ago but now it quickly becoming a necessity for access to certain private or public services. In the other three sectors, technology is not of such crucial importance but nonetheless efficient regulation of the sectors is dependent on keeping up to date with certain changes.

**Demographic changes** can have an important impact on basic service provision by changing the demand side in terms of the age of customers, their sociological structures, etc. Examples include the different demands for public transport in rural areas depending on the number of school children, commuters and pensioners, or the importance of local post offices depending on the percentage of the local population owning a private car.

**Historical factors** play a major role in terms of the economic structure of the sectors and differences in the understanding of the concept of basic services which is in turn reflected in the legislative and regulatory frameworks of different countries. The results of the BASIC project

show a number of such historical differences and their influence on the current situation. Most notable examples are the development of basic services in Poland during the 15 years since the end of Communism, the French model of state control and the British model of early liberalization.

## **Policy implications**

The BASIC project found a satisfactory level of basic **postal services** in all countries in terms of delivery times and prices. The single most important problem is the reduction of the number of post offices. According to the project's results the density of the postal service network decreases with liberalization. This is possible because the universal service obligations are usually very specific about issues such as delivery times and prices but they are vague (or do not cover at all) the issue of the maximum allowable distance to the next post office. Without changes in the regulatory and legislative framework explicitly determining the density or number of post offices this number will continue to be decreased.

Regional price differences in the **electricity** sector tend to be very high in some countries and almost non-existent in others. Since the price of electricity and the taxes are identical within each country the price differences are only due to different transport prices charged by the regional public electricity grids. Thus in order to tackle those regional differences transport prices would either have to be harmonized or – in certain cases with justifiably high costs – subsidized.

For the **public transport** sector the results of the BASIC project show that the introduction of competition does not have a significant impact on prices or on the quality of services. Thus, in terms of policy implications, it appears that the only promising advantage of liberalization may be a reduction of costs. The UK case, being the only long term example to study bus deregulation in Europe, suggests that deregulation may lead to a substantial decrease of costs. In the UK, however, after the initial period of intense competition between small bus companies the sector is now dominated by a handful of large companies giving raise to concerns that they may be able to exploit their growing market power.

In terms of basic service provision, the BASIC project found the **telecommunication** sector to be the least problematic. There is no significant problem with universal access and due to competition and technological advancement prices have been steadily falling over the last decade. The only policy implication arising from the BASIC project is related to the scope of basic services in the telecommunication sector. At the time the current legislative framework was designed, basic services encompassed fixed net services and, in some countries, also mobile phone services. Due to the pace of technological changes broad band internet and internet voice telephony are quickly becoming "basic services" and should be included in the scope of services for which universal access has to be granted.

## **EU basic service legislation?**

The general idea of what constitutes basic services or services of general economic interest is reasonably straightforward. The European Commission in its White Paper recently put forward an official definition and all Member States agree on the principle of specific consumer/citizen rights with regard to those services (such as universal access, minimum quality standards, etc.). On the European level there is an ongoing discussion whether a framework directive should be drafted to provide a basis for establishing an overall legal and regulatory framework in the Member States for all services of general economic interest.

The results of the BASIC project lead to the conclusion that the sectors in question differ from each other in so many important ways that an overarching operational concept for all basic services will hardly be suitable for achieving the goal of an effective, efficient and socially balanced service provision. Such a concept would only be useful for providing a general (methodological) framework and/or as a constitutional principle.

Rather than providing an inevitably incomplete and misdirected umbrella of general provisions it appears to be more promising to address basic service issues at the sectoral level. Many countries already have implicit or explicit sectoral provisions along the line of universal service obligations but they are usually defined in terms of maintaining a certain current, and thereby arbitrary, level of services. To make matters worse, many of the universal service obligations contain loopholes and are very weakly embedded in the legal system for enforcing sanctions if certain obligations are not met.

The results of the BASIC project suggest that it may be more effective to create a legal framework that defines for each relevant sector a certain minimum level of basic services for each citizen / consumer. Such a framework would have to include clear provisions on the quantity and quality of services, e.g. the maximum distance to the next post office or the minimum frequency of bus services. The detailed project results on service quantity and quality in different parts of the EU could be used as a starting point in a discussion about reasonable levels of basic services for each sector and for different regional characteristics.