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From the Private Secretary

MR. HATFIELD
CABINET OFFICE

STATE MONOPOLIES REPORT

The Prime Minister has agreed that there should be a discussion under her chairmanship at E(NI) of the CPRS State Monopolies Report.

The Prime Minister has also agreed that the paper attached to this note should form the basis for the discussion.

In circulating this note, you will no doubt bear in mind the need to remind recipients of the sensitive nature of the material and the need to restrict its circulation to the minimum.

I am sending a copy of this minute to John Sparrow (CPRS).

M. C. SCHOLAR

23 December 1982

N.B. Copies of CPRS report
27-35 to RTA'S
office 24/12/82

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Prime Minister

①

I understand that you agreed, during your meeting with Mr Sparrow on 30 November, that this could now be circulated and discussed.

We will need ^{all} the Ministers at X.

20 December 1982

E(N1), in fact, comprises these and no-one else. So it makes sense to take this at

State Monopolies Report

E(N1) under your chairmanship.

Qa 06192

To: MR SCHOLAR

From: JOHN SPARROW

1. - As requested in Mr Butler's record of my meeting with the Prime Minister on 30 November, I attach a covering note for the CPRS State Monopolies Report to form the basis for discussion in a small group of Ministers.

Agree?

MES 22/12

2. I suggest the Prime Minister invites to the meeting the Chancellor of the Exchequer, the Secretaries of State for the Environment, Scotland, Industry, Transport, Energy, Employment and Trade, and the Chief Secretary. I am therefore sending to you under separate cover sufficient copies of the Report and covering note for circulation to these Ministers.

x Yes no

3. In your note setting up the meeting you may consider it prudent to remind recipients of the sensitive nature of this material and hence the need to restrict its circulation to a minimum.

4. I am sending a copy of this minute and the attachment to Sir Robert Armstrong.

P.

Att

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CPRS Report on State Monopolies

1. Earlier this year the Prime Minister asked the CPRS to examine how to reduce the power of the state monopolies, introducing increased competition where possible, and to study systems of regulatory agencies.
2. The report is attached. The conclusions and recommendations are set out briefly in Section IV (paragraphs 80 - 89) which is attached separately for ease of reference.
3. The report identifies a number of problems associated with state monopolies; problems which arise partly because the industries are monopolies and partly because they are state owned. The report describes possible ways of reducing the power of the monopolies and thus the power of the associated unions.
4. The report puts forward various options for change. There is no single preferred solution. Not all of the options will be applicable to each monopoly.
5. The CPRS now recommends that Ministers consider the report's conclusions and the options it proposes, with a view to:
 - (i) deciding whether they agree with the general analysis of the report;
 - (ii) setting in hand, for each of the industries concerned, specific studies of how to reduce the monopoly power of that industry and its unions;
 - (iii) considering further the proposals in the report for removing Government guarantees against bankruptcy of state monopolies and for encouraging joint ventures between public and private enterprise.
6. Only Sponsor Departments and the Treasury have the knowledge and resources to carry out this work in appropriate detail but the CPRS would wish to be kept in contact with the studies as they progress.

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7. The CPRS report also provides a wider context for the current studies on privatisation and contracting out. Ministers may wish to ensure that future consideration of progress in all these areas is co-ordinated.

8. Finally, Ministers are invited to agree that the studies proposed in Paragraph 5 should be completed within six months for consideration by E(NI).

20 December 1982

IV - CONCLUSIONS AND RECOMMENDATIONS

80. We have examined in our study the development of state monopolies and shown that in many instances monopoly has been created and is not inevitable. The core of natural monopolies, where a second supplier would necessarily face prohibitively high costs, is narrower than is generally perceived. We have also examined the evidence available on the performance of the state monopolies, and have listed the adverse features which arise partly because they are monopolies and partly because they are in public ownership. The power of the unions stems mainly from the indispensable and monopoly nature of the products and services provided.

81. We suggest that the scope for change should be examined in detail for each industry. For various reasons the climate for change is right. The options discussed are not mutually exclusive; in many cases they are complementary. Not all are applicable to each industry. The overriding need is to break up the existing national monopolies.

A. Increase competition

82. The first objective should be to increase competition wherever possible. This means removing obstacles, and creating the right conditions for competition to develop -

a. remove the statutory bar on entry - necessary, but often not enough by itself;

b. regulate to ensure fair competition - we consider that an independent regulatory agency will provide the best assurance to potential competitors, against unreasonable pricing or regulatory actions by the state monopoly;

c. require industries to sell off parts where competition is possible - a quicker way to promote development of effective competition than waiting for new private sector entrants to appear;

d. as a step to privatisation under c, split industries into separate state companies, either by function (eg Sealink) or by region (eg regional electricity generating companies);

e. presumption against allowing state monopolies to expand - moving into new areas may sometimes increase efficiency or reduce dependence on another monopoly, and may increase competition short-term, but it increases market (and union) power.

B. Restructure and regulate

83. The process of stimulating effective competition will take time, and there will still be a core of natural monopolies. For the remaining monopolies, ways must be found to improve their performance. Last year's CPRS report made proposals within the existing framework of government/industry relations. This report reviews more radical options -

a. Privatise - this will remove the adverse features of state control, but not those of monopoly power (and union power); hence regulation and/or regionalisation should generally come first;

b. set up an independent regulatory agency - this should be an effective means of preventing monopoly abuse, but depends on Government willingness to hand over some of its powers to the agency (otherwise it merely adds another layer of supervision); hence we recommend that the experience of regulating British Telecom should be taken into account before regulatory agencies are established for other industries;

c. split the industry into regional corporations - in a natural monopoly these will not compete directly, but will enable management performance to be compared, so that a regulatory agency can be more effective; this will be strengthened if regional corporations borrow on their own credit without guarantee against bankruptcy, and if the possibility exists of a monopoly licence being withdrawn and the licence transferred ("competition for the field" as opposed to "competition in the field").

d. extend franchising and contracting out - much wider opportunities exist than have been considered so far, and should be pursued, even within the present framework, to promote efficiency by introducing private sector management and to reduce union power.

C. Reduce union power

84. There is a need to redress the imbalance of union power that currently exists. We believe that the options described above should all help to reduce monopoly power and therefore union power. Proposals for further general legislation on unions will be considered following a consultative period. The proposal for statutory cooling off periods may be useful in the state monopoly context. However we consider that other action might also be taken -

a. further studies should be undertaken where necessary to see how best to stand up to the ransom threat, for example by stockpiling;

b. union attitudes need to be changed; this should be tackled through management action;

c. where an industry is already structured on regional lines there may be advantages in developing decentralised wage bargaining;

d. linking wages more to performance will help to develop a relationship between effort and reward and hence lead to more responsible action.

D. Change the statutory and financial context

85. Other changes might also be made in order to change the context in which the state monopolies operate -

a. encourage private finance and joint ventures;

b. remove Government's guarantee against bankruptcy;

c. remove the statutory duty to supply;

d. make cross-subsidisation of classes of business including uneconomic social services more explicit.

Conclusions

86. The problems of monopoly power, and alternatives to state ownership, have baffled numbers of people for many years. We do not claim to have found any simple solution, for example in the model of a regionalised and regulated industry. In some industries or parts of industries where it proves impossible to introduce competition, the costs of splitting into regional organisations may turn out to be greater than the benefits, and Ministers may decide against handing over their powers to an independent regulatory agency. In such cases there may be no better course than the present system, with better business management along the lines proposed in last year's CPRS report. But we believe that the more radical options in this report need to be seriously and imaginatively examined in relation to the particular circumstances of each industry.

Recommendations

87. In order to effect changes wherever possible, we recommend that Sponsor Ministers should be invited to review the industries for which they are responsible and make detailed proposals, based on the general conclusions reached in this report and options put forward for change. Departments are already considering opportunities for privatisation and a separate exercise is being carried out to ascertain if nationalised industries could contract out more of their activities. A certain amount of ground will therefore already have been covered. We recommend that these efforts should now be extended to consider those more fundamental changes which might be made to break up the state monopolies and reduce their power.

88. We recommend that Treasury Ministers should be invited to consider the proposals for removing guarantees against bankruptcy and for encouraging joint ventures.

89. We further recommend that Sponsor Ministers should be invited to consider the proposals aimed at reducing the power of the unions in their industries.

21 October 1982

A STUDY OF THE STATE MONOPOLIES

Introduction

1. At the request of the Prime Minister, the CPRS has carried out a study of the nationalised industry monopolies, with a view to identifying ways in which their power could be reduced.

2. It was agreed that the study should examine how monopoly power has in practice been exploited, and how it could be curtailed through improved competition, privatisation, structural changes and regulatory pressure. It was further agreed that consideration should be given to ways of constraining union power in these key industries.

3. The CPRS began this study by carrying out brief reviews of the coal, electricity, water and telecommunications industries. These were based on discussions with officials in the Sponsor Departments and others, and a review of the published material and of the manner in which these industries are organised in other countries, notably the USA and Germany.

4. Last year the CPRS carried out a study of the relationship between Government and the nationalised industries, to review how they might be better controlled within the existing governmental framework. We have not sought in this study to duplicate any of this earlier work. Instead we have examined those more fundamental changes which might reduce the power of the state monopolies. We would like to re-emphasise however that the successful operation of any organisation depends on the quality of its management and we recommend that incentives should be improved to attract the best people to run these large corporations.

5. This report does not contain a blueprint for action in respect of the industries chosen for study, but rather general themes and principles which might be considered for application to each of the state monopolies. The CPRS recommends that as a next stage Sponsor Ministers should undertake a review of the industries for which they are responsible and make detailed proposals, based on the general conclusions reached in this report and options put forward for change.

6. We have structured this report as follows -

	Paragraphs
I The nature of state monopolies	7-12
II The problem and the rationale for change	13-20
III A review of possible remedies	21-79
IV Conclusions and recommendations	80-89

Findings following our review of regulatory agencies in the United States and also in the United Kingdom are set out in the annex.

I - The Nature of State Monopolies

Monopoly - Natural or Created?

7. Monopoly exists where there is a single supplier of a commodity or service. The extent of monopoly power depends on whether the entry of competitors into the market is restricted, either by economies of scale or by legislation, and whether there is any close substitute for the commodity.

8. In the United Kingdom many of the state monopolies supply products and services which are not strictly "natural monopoly" products, defined as those where a second supplier would face prohibitively high costs (including costs of entry), because of the nature of the market and technical economies of scale. Corporations have typically been established by statute as sole suppliers of certain products, and their monopoly position has thus been created. Examples of activities where competition has been prevented and monopoly situations created include -

- a. electricity generation;
- b. telecommunications services;
- c. coal production;
- d. local bus transport;
- e. collection of water;
- f. sewage treatment and disposal;
- g. postal services.

9. On the other hand nationalised industries also provide some services which it is less easy to envisage being duplicated by other suppliers. These natural monopoly activities include -

- a. transmission and distribution of water, gas and electricity;
- b. sewerage;
- c. possibly the provision and maintenance of railway tracks.

Thus the list of genuine "natural monopoly" activities is not a long one and it is shrinking. Services which were at one time thought to be necessarily provided by only one supplier are now being opened up to competition - for example long distance telecommunications services, electricity generation, gas supply and bus transport. This shows that the boundary is not absolute, and competition may become possible as perceptions change, technology develops and costs of entry decrease. Common carrier infrastructures are possibly the only operations of a strictly natural monopoly nature.

10. During the first half of this century, in many developed countries, monopolies were tolerated and even encouraged for certain activities. In such industries as electricity, water, gas, telecommunications, air and surface transportation, it was often considered that the "public interest" was best served by having a monopoly supplier. Competition was typically considered wasteful and monopoly rights were granted in return for a statutory duty to supply, sometimes in uneconomic circumstances.

Regulation of power

11. However the creation of a monopoly implies a concentration of power, particularly over pricing (and profits) and over the service provided. Governments appreciated the need to control this power and either set up a regulatory system where the industries remained in private hands, or alternatively brought them into public ownership.

Rationale for state ownership

12. In addition to the need to regulate monopoly industries, certain utilities were nationalised because -

- a. the provision of the product or service to the whole population was considered to be of vital importance to society;
- b. the industry was of special significance to the economy and to employment;
- c. public funds could more easily be provided to guarantee provision of services;
- d. the industry needed controlling for technical reasons, for example to control the hydrological cycle or to create a national grid for gas or electricity;
- e. the industry had not fared well under private ownership, for example the coal industry or the railways, and needed reorganising "in the public interest".

II - THE PROBLEM AND THE RATIONALE FOR CHANGE

The consequences of creating monopolies

13. There have been many benefits from the creation of monopolies. Duplication of facilities, for example the pipework, grid or common carrier infrastructure has been avoided and economies of scale have resulted. But there have also been disadvantages. Some of these arise from the creation of monopoly itself. Others arise through state ownership.

Adverse features of monopoly

14. Although some of the following features might apply to British industry generally, it appears to us that they are worse in those industries which are monopolies -

- a. failure to innovate, to respond to market signals, and to take account of consumer and local interests. Because monopolies do not face competition, they are less market-oriented;
- b. inefficiency of operations, deficiencies in management practices and inward-looking management. Monopolies have no incentive to remove inefficiencies because their additional costs can be passed on to the consumer in increased prices;
- c. cross-subsidisation of uncompetitive and loss-making operations. Monopolies often subsidise peripheral activities where they face direct competition or main activities where they are under threat from close substitutes (this may be necessary for a time, to shield new products, but is distorting and inefficient if it continues indefinitely);
- d. greater union power through threat of industrial action and disruption of monopoly (and often essential) supply. This power has long been latent, but since the early seventies unions have shown a greater willingness to use it. In the last few years there has been resistance to demanning in certain industries, and lack of flexibility in the use of labour to meet changing economic and technical conditions;
- e. a failure to encourage innovation and competitiveness in suppliers. As monopsony buyers, the industries have been inflexible in their requirements and have often overspecified the product in the interests of greater security of supply.

Adverse features of state ownership

15. The original Morrisonian concept was to appoint a board of directors who would ensure that the industry was being properly run in the nation's interest. However this concept of an arm's length relationship between Government and the nationalised industries has been difficult to maintain and Ministers have been drawn into intervening in industries' affairs. There are several reasons for this -

- a. Parliament has considered Ministers accountable for the well-being of these industries and their actions;
- b. it may appear to Ministers that national economic objectives can be achieved by influencing nationalised industries' behaviour;

c. the threat of labour disputes and union demands has led to intervention, in the short term interests of the public;

d. some industries have needed heavy external (state-guaranteed) borrowing for investment, and others have been judged to need Exchequer subsidies to maintain output and employment.

16. State ownership has had a number of adverse features -

a. prices have been artificially constrained, for example in the early seventies, resulting in inefficient pricing policies, customers receiving incorrect pricing signals, and incorrect forecasting and investment decisions;

b. investment has been artificially constrained at times as a means of deflating the economy;

c. there has been a failure to establish objectives and monitor the performance of the industries properly;

d. there has been a failure to deal with structural decline in certain industries, in particular the railways and (recently) the coal industry;

e. Government financial backing and the absence of the threat of bankruptcy has led to complacency and inefficiency as the industries have been protected from market disciplines;

f. hidden cross-subsidisation of services has been encouraged. This has exacerbated the supply-oriented approach of the industries by shielding them further from market forces. Hidden cross-subsidisation has made it difficult to identify those services the Government would wish to see continued and to determine whether it has been getting value for money.

17. A major problem has been the inevitable conflict which Government has faced in trying to reconcile the following responsibilities -

a. manager of the economy;

b. owner of the business;

c. banker to the business;

d. regulator of monopoly, including protector of the consumer;

e. provider/subsidiser of social services (rural telephone kiosks, railway lines etc)

18. State ownership has also sometimes enhanced union power, because the industries are interdependent (eg coal and electricity) and the Government as owner has presented a common target to union negotiators in the various industries.

Rationale for change

19. The existence of past and potential abuses of monopoly power and of state ownership, together with the real threat of union power, present cogent reasons for seeking to change the status quo. The climate for change is right: the traditional arguments in favour of large monopoly utilities and public ownership are being questioned; there is increasing criticism of the

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industries by consumers; what would have been considered unthinkable a few years ago is now happening, for example there are private sector refuse collectors and a rival telecommunications company is starting to develop. Above all there is a political will to change.

20. In the remainder of this report we consider options for change. These options are not mutually exclusive, and could be complementary. Not all of the options will be applicable to each industry.

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III - A REVIEW OF POSSIBLE REMEDIES

21. The distinction between "created" and natural monopolies, though not absolute, is useful in considering remedies. For those industries or parts of industries where cost structures are such that alternative suppliers could compete, the problem is to remove obstacles in their path. But for natural monopolies, other means have to be found to restrain and control monopoly power. In this section we first consider the manner in which competition can be encouraged in those industries where monopoly has been created; where natural monopolies will remain, we consider ways of restructuring and regulating these so that abuses are diminished. Finally we review ways of reducing union power and other steps to change the context in which state monopolies operate.

Increase Competition

Remove the statutory bar on entry

22. For those industries where monopoly has been created, it is necessary to provide a suitable environment for competitive and innovative enterprise. The first essential is the removal of the statutory bar on entry and this may be enough in some instances to allow competition to develop. Legislation has been introduced to encourage competition in the long distance bus transport, industrial gas and trunk telecommunications markets. Further legislative steps are to be taken to facilitate the private generation of electricity as a main business and its supply using the national grid as a common carrier. Only a few years ago competition in most of these industries would have been regarded as unthinkable.

23. However the practical difficulties facing potential new competitors are significant and there must be doubts about the willingness of the private sector to invest in industries where the costs of entry are likely to remain high. The decision to enter the market is bound to be a risky one, not least because of the political risk that the statutory role of the state industry as sole supplier might be reimposed. And any new competitor, facing the state monopoly's dominant position over a wide range of products, must be vulnerable at least for a time to cross-subsidisation and "predatory pricing" in his chosen markets. There may also be regulatory problems, for example over interconnect arrangements and equipment compatibility as in the BT case. Union pressure may prevent competition. The removal of the statutory bar on entry may not be enough on its own to achieve the objective of greater competition. At least protection, and perhaps even some forms of positive discrimination, may also be needed until new competitors are established.

Regulate the terms of competition

24. Regulation is primarily thought of as a way of controlling monopoly and this is comprehensively dealt with in paragraphs 49-56 below. However regulation is also necessary to protect emergent competition. The Government needs to provide some assurance to potential competitors that the competition will not be unfair. This means taking away the power of the state monopoly to impose unreasonable pricing or regulatory burdens. In principle the Sponsor Department may be in a good position to back Government assurances by detailed supervision of the state industry's behaviour. But in practice we consider that Sponsor Departments are likely to be less effective in this role than an independent regulatory agency.

Prevent the expansion of state monopolies

25. Any expansion of a state monopoly into a new area is bound to increase its market power. If successful, it will increase the scope for cross-subsidisation of other less profitable activities. We have also noted in our study that nationalised industries abuse their monopoly power when they become involved in activities that are not truly monopolistic. Inefficiencies and other malpractices are carried over into the non-monopolistic activities. Unprofitable and inefficient operations are typically subsidised by the monopoly activities and the industries compete unfairly. We are sceptical about the effectiveness of regulatory mechanisms to neutralise this power. In addition the extent of union power will be increased if the industry is permitted to expand its activities; this will be further enhanced if cross-subsidisation occurs and there is a lack of any threat of bankruptcy. It is arguable for example that the National Union of Seamen would have taken a less militant stance in the recent Sealink dispute if that company had not been owned by British Rail.

26. We start therefore with a strong presumption against allowing state monopolies to integrate vertically or to expand into other areas of business, except where this is to reduce their dependence on other monopolies. We recognise that in some instances it may be beneficial to a state (or private) monopoly to expand its operations but consider that the onus of proof must be on the industry itself. Thus we have a presumption against allowing British Telecom to manufacture its own products and to enter new markets involving cable systems and information technology, unless it can be demonstrated that these are essential to the efficient supply of a telecommunications service or to the preservation of competition. It could be argued that if an alternative telecommunications company could be found to enter the interactive cables market, this would create competition for British Telecom.

Require the industries to sell off parts where competition is possible

27. Reliance on new competitors entering the field in the case of many of the state monopolies will be a slow method of introducing competition. A faster method will be to break up the monopolies by selling off parts where competition is possible. The present Government has already taken some steps in this direction, but these have mainly been confined to peripheral activities. Over time this could be taken a good deal further, and extended to the main businesses, for example electricity generation, to reduce industries down to the core of natural monopoly activities. This will require clear political will, with a high priority for privatisation above other industrial objectives such as the preservation of particular jobs and activities. It will also require expertise to translate the objective into practical proposals for individual industries and parts of industries.

28. Confining the industries to their natural monopoly activities might result, for example, in -

- a. electricity generation being first regionalised and then sold, electricity showrooms being sold (or closed), and area boards transmitting and supplying electricity as monopoly suppliers. Consideration might also be given, as a second stage, to confining the state industry to a common carrier role;

b. British Gas Corporation being reduced to a pipeline carrier only. Its exploration and production activity, together with its consumer services, would be hived off;

c. splitting up British Telecom into area monopolies, a trunk telecommunications company and an international telecommunications company. BT Enterprises and Martlesham would be sold separately.

29. In cases where immediate privatisation is not possible, it may be worth considering the establishment of a separate state corporation (eg Sealink separate from British Rail) with its own separately accountable management, as a half-way house. Or regional corporations might be set up and allowed to compete. This is considered further in paragraph 43 below.

Restructure and regulate to improve efficiency

Privatise state monopolies

30. Efforts have been made by the present Government to return industries from the state to the private sector. To date no state monopoly has been privatised although plans have been announced to sell shares in British Telecom in the next Parliament.

31. The main advantage of privatisation appears to us to be the likelihood of removal of many of the adverse features of state ownership described in paragraph 16 above. We have sought to examine the evidence available on the relative performance of monopoly industries in private and state ownership. Many of the inefficiencies which occur in the water industry apply as much to the private water companies as to the water authorities; however the mechanism in this industry for regulating the companies is deficient and provides no incentive to efficiency. Some of the research in the United States and Australia indicates that monopolies in the private sector operate more commercially and efficiently than comparable state owned monopolies. In our view there is a general presumption that private ownership will lead to better results than state ownership.

32. Privatisation of state monopolies in their entirety will not however resolve the difficulties (referred to in paragraphs 15-18 above) which are inherent in any monopoly whether state or private. We consider that apart from selling off operations where competition is possible privatisation is likely to be more beneficial if the industry is fragmented into regional companies which are subjected to independent regulation, and later privatised.

33. It is difficult to privatise loss-making operations. However with few exceptions it should be possible for each of the state monopolies to be made profitable. It is likely that those parts of the rail system which are judged socially desirable will always require public financial support and remain in public ownership. The other large loss-maker, the National Coal Board, should be capable of being made profitable in the longer term, regionalised and then privatised.

Expand franchising and contracting out

34. Franchising and contracting out introduce "competition for the field" as opposed to "competition in the field". If parts of the industry's operations are franchised or contracted out, this will reduce the size of the state monopoly and thus its power; in particular union power will be fragmented. It

should also introduce benefits of private sector involvement. At one extreme a franchise could be granted for supply of the monopoly service. At the other there could merely be an extension of the present practice of contracting out. Thus where privatisation of activities is ruled out for any reason, franchising and contracting out may be adopted as "second best" solutions. An example of franchising is television where independent television companies are granted licences to broadcast for eight years; examples of contracting out include refuse collection and bureau computer services.

35. One of the criticisms of state monopolies is that the technical specifications for construction of plant and the supply of services are too high. In the case of franchising and contracting out, responsibility for ensuring that the services are provided to a given standard rests with the franchisor. However the franchisee is actually responsible for the service. Franchising activities to the private sector will create an incentive to reduce technical specifications to the extent that this is consistent with the standard of service required.

36. Franchising and contracting out are likely to be easier to introduce in labour intensive situations, where the initial investment is not high. However franchising in capital intensive industries should not be ruled out. Normally in order to make it attractive to a potential investor the length of the franchise would need to be sufficiently long for him to recover his investment. However if the franchise is too long, this could result in the franchisee developing all the adverse features of the monopoly industry in which he is operating. This could be avoided if franchising was widespread in an industry since there might be frequent competition for franchises which would provide an incentive to efficiency. Alternatively the management of operations only could be franchised for shorter periods with the assets continuing to be owned by the franchisor.

37. Franchises should be arranged to place the financial risk on the franchisee. It will also be necessary to provide safeguards when the activity remains a monopoly supply and the franchisee fails to perform adequately. The right to appoint an alternative franchisee or to acquire the assets and take over the operation should be retained in exceptional circumstances, which will need to be clearly spelled out in advance so as to avoid termination subject to political whim.

38. If industries are acting efficiently, they should be continually reviewing the relative costs of providing services themselves and of contracting them out. However there are pressures against this practice, for example from unions who see an erosion of their membership and power base, and from management because of the loss of status in a smaller organisation, and because of entrenched attitudes. Indeed over the years the industries have tended to take on themselves functions previously performed by others. This probably reflects a general tendency among large organisations in the UK, as opposed to Japan where contracting out is seen as a useful way of preserving flexibility and avoiding long-term commitments to employees. Where contracting out has been introduced it has mainly been confined to peripheral activities such as maintenance of vehicle fleets and catering. However we consider that the state monopolies should consider this more imaginatively and investigate the contracting out of mainline activities such as power station maintenance, the provision of postal services and meter reading - possibly jointly with other nationalised industries.

Regionalise state monopolies

39. By regionalisation, we mean the fragmentation of state monopolies into discrete independent companies based on geographic rather than functional lines. This is different from decentralisation, which is the devolution of decision-making and responsibility to subsidiary regional organisations, under central ownership and control.

40. Where it proves difficult to encourage new competitors to enter an industry and where an industry cannot easily be confined to a common carrier role, regionalisation may help. Apart from breaking up large national monopolies, regionalisation may also be a prelude to and facilitate privatisation.

41. Regionalisation of state monopolies appears to us to have the following advantages -

a. it brings the supplier closer to the customer and should result in greater attention to consumers' interests and complaints;

b. it facilitates comparison between monopolies and should therefore encourage competition between managers and greater consumer pressure for change;

c. it is more likely to lead to innovation in the industry because of the absence of centralised control and single culture, which are typical of national organisations;

d. it will facilitate regulation by a regulatory agency because of the comparisons available and reduced likelihood of "agency capture", referred to further below;

e. it will facilitate regional wage bargaining and local productivity schemes, referred to in more detail below;

f. it may reduce the likelihood of national disruption and therefore the bargaining power of the unions;

g. it may facilitate privatisation since it may be easier to sell smaller regional units;

h. it is less likely to lead to monopsony purchasing and uncompetitive suppliers;

i. smaller organisations are easier to manage.

42. Decentralisation on the other hand is unlikely in our view to result in the same benefits. Inevitably a large measure of control will remain with the central organisation and regional freedom of action will not be present to the same extent. We do not believe for example that decentralisation will result in the benefits identified under items c to h above being achieved.

43. Regionalisation of those industries where the monopoly position has been created could be used to facilitate competition. Examples of this are electricity generation and coal. However in the case of the coal industry any major change is difficult at the present time because of the strong militant union. In this industry we consider that decentralisation now may represent a step towards regionalisation at a later date when individual prosperity appears more relevant to miners than NUM unity.

44. Although the gas and electricity industries are decentralised in varying degrees, they are not structured into independent regional organisations. In addition it is generally accepted that the current structure of the electricity industry is unsatisfactory. The separation of a centralised generation authority from regional distribution and supply boards does distance the consumer from the dominant sector of the industry, the CEGB. In consequence, the potential for both inefficient and non-market oriented behaviour is inherent in the current organisation.

45. Our discussions in Germany have indicated that a regionalised electricity system, largely made up of separate power-boards, appears to allow a greater degree of market response and the potential for limited competition. There is evidence that the different approaches of the various authorities in Germany encourage more innovation and allow individual authorities to learn from others. This combination of innovation and imitation is more likely to lead to an efficient and responsive system than the approach of a single centralised organisation. We recommend that this model should be considered alongside proposals mentioned earlier for reducing the electricity monopoly to a common carrier role.

46. In the case of British Telecom, the lack of separate internal commercial relationships and adequate financial information makes regionalisation difficult at present. However we consider that the monopoly power of this corporation is more likely to be reduced by fragmentation into regional areas (with privatisation later) and by the separate sale of trunk, international and other activities rather than by privatisation as a whole.

47. One of the industries we studied, namely water, is already organised on a regional basis. However this has not produced the benefits we believe possible for several reasons. These include -

a. the regulatory function has traditionally not been adequately performed;

b. until recently the political will has not existed to remove inefficiencies in the structure of the industry.

48. We formed the view particularly following our visit to Germany that more could be done to stimulate competition between the management of different regions by means of inter-regional comparisons of price and performance. These comparisons could be made by a more effective form of regulation at national level.

Improve regulation

49. Whether monopolies remain in the public sector or become privately owned there is a need to regulate them to prevent monopoly abuse. In particular there is a need to ensure that -

- a. they do not charge unreasonable prices and so make monopoly profits;
- b. they act as efficiently as possible, in the absence of competition;
- c. they do not concede excessive wage increases, with a knock-on effect throughout the economy, and finance them by inflationary price increases;
- d. the consumer is protected, complaints are dealt with satisfactorily and the product or service is of a reasonable quality;
- e. they do not engage in anti-competitive practices;
- f. where they are dominant purchasers of other industries' products they encourage healthy competitive suppliers in the interest of the economy as a whole.

50. In addition to controlling monopolies better, there is also a need for regulation where competition is being introduced, in order to protect smaller operators from the dominant suppliers and ensure that competition is fair.

51. At one time it was believed that a board appointed by the Secretary of State could be relied on to see that state owned monopolies were properly run "in the public interest". Thus they were expected to ensure that the above adverse features would not occur. Last year's CPRS report recommended a key role for non-executive directors. However this will not be enough on its own, since -

- a. the industries cannot be properly directed and managed in the absence of strong boards with executive as well as non-executive directors;
- b. these directors have to resolve conflicts of interest between what is best for the corporation and what is judged to be in the public interest;
- c. it is difficult for non-executive directors alone, being part-time and reliant as they are on the organisation for information, to ensure the efficient running of the industry.

52. Other mechanisms have been introduced. The Sponsor Departments have increased the extent of their monitoring of the industries. Nationalised Industry Consumer Councils (NICCs) have been established to represent the consumer and advise on consumer policy. The Monopolies and Mergers Commission (MMC) is being used on a periodic basis to investigate instances of inefficiency, monopoly abuse and anti-competitive practices. However in our view these organisations in their present form are unlikely to fulfil the regulatory function defined above for the following reasons -

- a. Sponsor Departments will continue to have to attempt to resolve the conflict of interest described in paragraph 17 above. They are likely to go on giving low priority to regulatory responsibilities where these cut across political concerns and relations with the industries. In addition despite agreement to improve monitoring following the CPRS report on relationships with nationalised industries last year, it will be difficult for them to attract appropriate staff with business expertise to perform these tasks;

b. the NICCs rely heavily on voluntary support. They are often ignored by their industries. Without considerable expansion in their resources, rights and powers, their regulatory role will be limited. We consider that additional resources would be better employed elsewhere;

c. while the MMC is able to investigate subjects in depth, it remains an ad hoc review body visiting industries on a four to five year cycle. Sponsor Departments may not follow up recommendations with sufficient vigour for the reasons given above.

53. We have reviewed the experience of regulatory agencies in the United States and here. Our detailed findings are set out in the attached annex. Although these agencies have some adverse features, we are attracted by the benefits that could result from independent regulation of state monopolies. There is a need for continuous regulation of monopoly activities which we do not believe the present framework is capable of providing. A separate regulatory agency is likely to be more effective if -

a. the industry is first fragmented into regional operations. This will facilitate comparison, for example of prices and performance, and is less likely to lead to agency capture;

b. the agency is given wide powers of access to information and powers to ensure implementation;

c. it has a maximum degree of independence from Government thus making political decisions and actions affecting the industry more transparent;

d. there is complete or partial privatisation and there is provision for removal of monopoly rights. Where the regulatory agency has the ultimate sanction of withdrawing the monopoly licence, or at least recommending its withdrawal, there will be greater incentive for both public and private sector operations to refrain from monopoly abuses.

54. The appropriate mechanism for regulation will depend on the nature of each industry, and there are a number of issues needing to be examined, including -

a. the precise definition, in statutes or more informally, of the responsibilities of the agency, the Sponsor Minister and the Board of the industry itself;

b. the nature and funding of the agency;

c. which Secretary of State should be responsible for it;

d. whether there should be one agency for all the industries or one for each;

e. the relationship with MMC and the OFT.

55. We consider, in particular following our study of the German regulatory arrangements, that the scale of activities and degree of intervention should be less where there is competition for the field or an effective base for

regional comparison. We appreciate that the establishment of regulatory agencies will lead to additional expenditure although this could be offset to some extent by the abolition of the NICCs whose duties might be assumed by the agencies. However we consider that if the monopolies cannot be broken up by competition as advocated earlier in this report, then their power should be constrained by better regulation. It is arguable that this will produce expenditure savings which will more than offset the additional costs involved.

56. Accordingly we recommend that regulatory agencies should be established where the industry can be fragmented into independent regional organisations. Where regionalisation is not the best course, for example in the case of a common carrier role, and the monopoly remains in the public sector, then we recommend that rather than create an agency, regulation through Sponsor Departments should be improved. In order to achieve this, we consider that the recommendations in the 1981 CPRS report on the relationship between Government and the nationalised industries should be implemented. Where a monopoly is to be privatised, then we recommend that a regulatory agency is established to ensure regulation independent of Government and therefore as far removed from political pressures as possible.

57. The creation of regulatory agencies will involve a fundamental change in the relationship between Government and the state monopolies. Such a change is presently in hand in the case of British Telecom. We consider that the establishment and experience of the Office of Telecommunications will provide valuable lessons for regulation in other industries. A suitable candidate for early regulation would be the water industry.

Reduce union power

58. Union power in a monopoly industry stems from the following conditions -

- a. the service is indispensable;
- b. there is no close substitute;
- c. there is no possibility of the service being provided in some other way.

The trade unions are more conscious than they were of their power to demand excessive pay increases and job protection at the expense of their industries, the Government and the consumer. During the seventies the balance of power in the nationalised industries swung towards trade unions and away from management. In recent years wages in state monopolies have increased faster than average industrial wages, restrictive working practices have remained, no-redundancy agreements have spread, and in some cases union power has become more centralised and more co-ordinated. There has also been some evidence of increased militancy. If wages are too low and out of line with other industries, as had happened in the coal industry by the early seventies, this can cause problems.

59. We consider that union power can be reduced in a number of ways -

- a. by privatising potentially competitive activities. Privatisation directly introduces the threat of bankruptcy into those parts concerned, and at the same time reduces the size of the remaining organisation and therefore the power base;

- b. by introducing competition wherever possible. The existence of competition coupled with the possibility of bankruptcy and therefore loss of employment is likely to result in a more commercial environment;
- c. by expanding franchising and contracting out;
- d. by regionalising the organisation.

These options have been examined in the earlier part of this report.

60. Both the 1980 Employment Act and 1982 Employment Bill have sought to reduce union power by reducing unions' and individuals' immunities for unlawful acts. Further proposals for changing the legislative environment are being pursued by the Secretary of State for Employment following consideration in E Committee; we have not sought to duplicate this work by putting forward detailed proposals in this report. However, two legislative measures, the provision of statutory 'cooling off' periods and powers to make strikes unlawful, are particularly relevant to the reduction of union power in state monopolies. These measures were discussed in detail in the 1981 Green Paper "Trade Union Immunities" (Cmnd 8128). We believe that making strikes unlawful would be ineffective because of the difficulty of taking sanctions against strikers, but that the introduction of 'cooling off' periods may be a useful move at an appropriate time.

Standing up to union power

61. There is a growing realisation that it is possible to stand up to union power, at least in the short term. During postal strikes alternative methods of postal delivery develop. Even in telecommunications, where the chances of action are higher than in the past, it is likely to involve selective withdrawal of staff rather than an all-out strike and this would probably lead to a progressive deterioration of service in areas affected. Stockpiles of coal at power stations may be used to weaken the resolve of miners to strike. We consider that where studies have not already been carried out consideration should be given to ways in which union power can be reduced through self-sufficiency, including -

- a. reducing consumers' dependence on the state monopolies, for example by removing barriers to collection of water by private industry, generation of electricity and telecommunications;
- b. reducing the interdependence of state monopolies, for example by allowing the CEGB to develop its own water sources and by encouraging water authorities to develop stand-by generation of electricity;
- c. stockpiling and building in redundant capacity.

Above all, management needs to be persuaded to take a resolute line when dealing with unreasonable union demands.

Changing union attitudes

62. In many cases the unions are single industry unions so that union officials, as well as management, have been sheltered from external market forces. Trade union negotiators are often more militant than the members they represent. A strategy to increase the influence of moderate elements should be pursued, for example by better and more consistent management

communications both to union leaders and directly to members, and by introducing private sector management through joint ventures, competition and privatisation. This is likely to create new loyalties and break down existing prejudices.

Decentralising wage bargaining

63. It is claimed that decentralised bargaining exposes weak local management to militant union power. In addition one area can be played off against another by a strong cohesive union, with a consequent risk of wage settlements leapfrogging each other. While we recognise these risks, we consider that where an industry is regionalised then decentralisation of bargaining may be advantageous since -

- a. it should bring bargaining closer to local realities;
- b. it should lead to regional pay differentiations reflecting local conditions;
- c. it could reduce the power of the unions who will be stretched and less likely to be cohesive as a national group;
- d. it should lead to an increase in local productivity agreements.

Linking wages to performance

64. We consider that wages and salaries should be linked more closely to productivity and performance since this is more likely to lead to employees being less inclined to threaten disruptive action and sanction restrictive practices. Their livelihood and prosperity become more closely allied to the success of the organisation for which they work. Accordingly we recommend that efforts should be made to introduce more well-designed productivity and incentive arrangements where appropriate.

Change the financial and statutory environment

65. We have outlined above methods of reducing the respective powers of the state, the monopolies and the unions in trying to resolve the problems identified in Section II. All these involve significant changes to the operating environment. There are other changes which might be made which would help to create a new climate. These are described in the remainder of this section.

Encourage private finance and joint ventures

66. Private finance can make a contribution to the problem if it brings with it new pressures for greater efficiency. It is clearly irrelevant if private money is protected from loss. A recent development was the BT Bond, though this has been overtaken by plans for privatisation. The principle behind the proposed BT Bond was that its return was related to BT's performance: essentially it was a form of equity. The intention was that this form of financing would bring about pressure for improved performance, because the borrower would wish or need to raise further finance on a similar basis.

67. However the effectiveness of this option should not be exaggerated. Investors have no sanction against the Board if performance is inadequate and if the Board has other sources of future finance. Thus the holders of the London Transport Passenger Board's C Stock in the 1930s became defenceless victims of that Board's inadequate return.

68. Alternatively the private sector can play a role in a particular activity within a corporation. This may either be simply a financial involvement, or it may be a joint venture. We believe that such joint financial frameworks introduce private commercial practices and disciplines, and that, provided they are reasonably free-standing, they should be encouraged, even in cases where it is hard to demonstrate immediate and tangible benefits. We consider that, even where the public stake exceeds 50 per cent, Government should make it clear that it accepts no implied commitment to guarantee the finance.

Remove the guarantee against bankruptcy

69. It is at present considered unthinkable that a utility monopoly should be permitted to become insolvent. Even where private monopolies exist, for example in the water industry, there is no ultimate sanction against inefficient management and unions contemplating extremist action. This has created the cosy and complacent thinking that currently exists in these industries. There is an absence of commercial disciplines.

70. Morrison's original conception for nationalised industries was that they should stand on their own without a guarantee of Government funding. However, Ministers would find it difficult not to support state industries and the legislation has often been interpreted accordingly.

71. We regard the guarantee against bankruptcy as part of the framework which encourages the abuse of monopoly power and inhibits the pursuit of efficiency. We therefore consider that removing the guarantee against bankruptcy may have benefits, in changing attitudes within monopolies and also in eliminating loss-making activities where restructuring has proved difficult by other means. This would be best achieved by creating Companies Act companies, to emphasise that the Government sees them as businesses specifically with limited liability and not as distinct public corporations. It might for example be easier to close down excess capacity or to introduce new manning practices by taking the drastic step of appointing a receiver rather than operating through the existing or even a reconstituted board. The receiver would restructure the business and dispose of those parts which are viable or for which the state is prepared to make explicit subsidies. At some stage in the future restructuring of the coal industry involving closure of uneconomic mines might be capable of being carried out more easily through the appointment of a receiver.

72. It is less easy to envisage decisive advantages from removing the guarantee of bankruptcy in the case of activities where the business is a national natural monopoly, since insolvency could be avoided by price increases unless a regulatory authority or Government prevented this. Within a regional framework insolvency could lead to another regional company taking over the operation.

73. We recognise that without Government backing, external loans to nationalised industries would cost more. In addition we accept that the first large public bankruptcy may have adverse knock-on effects on future trading arrangements by the monopolies and on the financial markets. However the decision to appoint a receiver for one of the state monopolies would not be taken lightly and would not happen often. We consider that when it did occur it would have major implications in "encouraging the others" to maintain commercial disciplines despite the monopoly power. As a result, we see net advantages in removing the guarantee of Government funding.

Remove the statutory duty to supply

74. We have referred to the supply-oriented approach of most of the nationalised industries. Employees in the state monopolies typically consider themselves as providing a public service rather than carrying on a business and selling a product. To some extent this attitude has acted as a brake on abuse of union power. The threat of termination of a public service was until recently unacceptable to many employees. However in the last decade, as employees have become more conscious of their ability to achieve objectives by holding the public to ransom, the beneficial effects of the "public service" attitude have diminished.

75. The dominant consideration has been to supply, not necessarily at least cost, rather than to ascertain what the customer wants. This has typically been used as an excuse, for example in the electricity industry, for excessive planning margins.

76. Now that the bulk of the population is connected to essential public services, we consider that the statutory duty to supply may be an anachronism and also irrelevant. It has diminished the importance of consumer choice and led to surplus capacity. Its removal could encourage a change in attitude.

Make cross-subsidisation explicit

77. Many of the state monopolies have a statutory duty not to discriminate between customers. Initially this was designed to prevent monopoly profit and result in "fair" pricing. However the industries have taken this to mean standard pricing for consumers regardless of cost. Thus many services are provided at uneconomic prices and subsidised by more profitable activities. Typically rural consumers are subsidised by urban consumers.

78. Hidden cross-subsidisation of this nature may achieve social objectives, as well as being politically convenient, but it has many adverse features -

- a. it increases the ability of the monopoly to hide inefficiency;
- b. it makes the prices of profitable services higher, thus restricting demand, and confusing market signals;
- c. it results in the funding of loss-making services being questioned only on an irregular basis, if at all.

79. We recommend that the monopoly industries should be required to cost separately their services and products so that cross-subsidisation is not hidden but either explicit between consumers or eliminated by separate subsidy of social loss-making activities. The latter course would add to public expenditure, but it is the only way of avoiding economic distortions while meeting social objectives.

IV - CONCLUSIONS AND RECOMMENDATIONS

80. We have examined in our study the development of state monopolies and shown that in many instances monopoly has been created and is not inevitable. The core of natural monopolies, where a second supplier would necessarily face prohibitively high costs, is narrower than is generally perceived. We have also examined the evidence available on the performance of the state monopolies, and have listed the adverse features which arise partly because they are monopolies and partly because they are in public ownership. The power of the unions stems mainly from the indispensable and monopoly nature of the products and services provided.

81. We suggest that the scope for change should be examined in detail for each industry. For various reasons the climate for change is right. The options discussed are not mutually exclusive; in many cases they are complementary. Not all are applicable to each industry. The overriding need is to break up the existing national monopolies.

A. Increase competition

82. The first objective should be to increase competition wherever possible. This means removing obstacles, and creating the right conditions for competition to develop -

a. remove the statutory bar on entry - necessary, but often not enough by itself;

b. regulate to ensure fair competition - we consider that an independent regulatory agency will provide the best assurance to potential competitors, against unreasonable pricing or regulatory actions by the state monopoly;

c. require industries to sell off parts where competition is possible - a quicker way to promote development of effective competition than waiting for new private sector entrants to appear;

d. as a step to privatisation under c, split industries into separate state companies, either by function (eg Sealink) or by region (eg regional electricity generating companies);

e. presumption against allowing state monopolies to expand - moving into new areas may sometimes increase efficiency or reduce dependence on another monopoly, and may increase competition short-term, but it increases market (and union) power.

B. Restructure and regulate

83. The process of stimulating effective competition will take time, and there will still be a core of natural monopolies. For the remaining monopolies, ways must be found to improve their performance. Last year's CPRS report made proposals within the existing framework of government/industry relations. This report reviews more radical options -

a. Privatise - this will remove the adverse features of state control, but not those of monopoly power (and union power); hence regulation and/or regionalisation should generally come first;

b. set up an independent regulatory agency - this should be an effective means of preventing monopoly abuse, but depends on Government willingness to hand over some of its powers to the agency (otherwise it merely adds another layer of supervision); hence we recommend that the experience of regulating British Telecom should be taken into account before regulatory agencies are established for other industries;

c. split the industry into regional corporations - in a natural monopoly these will not compete directly, but will enable management performance to be compared, so that a regulatory agency can be more effective; this will be strengthened if regional corporations borrow on their own credit without guarantee against bankruptcy, and if the possibility exists of a monopoly licence being withdrawn and the licence transferred ("competition for the field" as opposed to "competition in the field").

d. extend franchising and contracting out - much wider opportunities exist than have been considered so far, and should be pursued, even within the present framework, to promote efficiency by introducing private sector management and to reduce union power.

C. Reduce union power

84. There is a need to redress the imbalance of union power that currently exists. We believe that the options described above should all help to reduce monopoly power and therefore union power. Proposals for further general legislation on unions will be considered following a consultative period. The proposal for statutory cooling off periods may be useful in the state monopoly context. However we consider that other action might also be taken -

a. further studies should be undertaken where necessary to see how best to stand up to the ransom threat, for example by stockpiling;

b. union attitudes need to be changed; this should be tackled through management action;

c. where an industry is already structured on regional lines there may be advantages in developing decentralised wage bargaining;

d. linking wages more to performance will help to develop a relationship between effort and reward and hence lead to more responsible action.

D. Change the statutory and financial context

85. Other changes might also be made in order to change the context in which the state monopolies operate -

a. encourage private finance and joint ventures;

b. remove Government's guarantee against bankruptcy;

c. remove the statutory duty to supply;

d. make cross-subsidisation of classes of business including uneconomic social services more explicit.

Conclusions

86. The problems of monopoly power, and alternatives to state ownership, have baffled numbers of people for many years. We do not claim to have found any simple solution, for example in the model of a regionalised and regulated industry. In some industries or parts of industries where it proves impossible to introduce competition, the costs of splitting into regional organisations may turn out to be greater than the benefits, and Ministers may decide against handing over their powers to an independent regulatory agency. In such cases there may be no better course than the present system, with better business management along the lines proposed in last year's CPRS report. But we believe that the more radical options in this report need to be seriously and imaginatively examined in relation to the particular circumstances of each industry.

Recommendations

87. In order to effect changes wherever possible, we recommend that Sponsor Ministers should be invited to review the industries for which they are responsible and make detailed proposals, based on the general conclusions reached in this report and options put forward for change. Departments are already considering opportunities for privatisation and a separate exercise is being carried out to ascertain if nationalised industries could contract out more of their activities. A certain amount of ground will therefore already have been covered. We recommend that these efforts should now be extended to consider those more fundamental changes which might be made to break up the state monopolies and reduce their power.

88. We recommend that Treasury Ministers should be invited to consider the proposals for removing guarantees against bankruptcy and for encouraging joint ventures.

89. We further recommend that Sponsor Ministers should be invited to consider the proposals aimed at reducing the power of the unions in their industries.

A REVIEW OF REGULATORY AGENCIES

1. As part of our study we have considered the experience of regulatory agencies in the United States where there is a long history of private sector ownership of monopoly industries and also of regulation. We have also examined regulation in the United Kingdom of broadcasting, air transport, local stage carriage bus services, private water companies and pharmaceutical companies. Where a monopoly exists, there is a need to regulate its activities in the interests of consumers, primarily in order to prevent excessive prices and therefore monopoly profits or excessive costs.

2. However in the United States in particular in the past it is competition as much as monopoly that has been restricted and regulated. In certain industries, mainly transport, monopolies and limited competition have been tolerated on the grounds that this best serves the public interest. A period of de-regulation of potentially competitive industries began under the Ford administration with some resistance from the operators who had previously been protected from competitive forces and effectively guaranteed a steady stream of profits. Experience has shown that regulation has had many unsatisfactory features, referred to further below, and we therefore recommend that regulatory agencies are only established where necessary. We consider that regulation is essential -

a. where, despite the introduction of competition, a created monopoly will exist for some time and there is a need to ensure that the monopolist competes fairly with new entrants to the market;

b. where natural monopoly cannot be avoided.

3. Regulation in the United States dates from the last quarter of the 19th Century where it was thought necessary in order to protect customers from exploitation by private monopolists. Regulators have been mainly concerned with ensuring a secure supply, at a fair price, and partly as a result of these and other considerations, mentioned below, regulatory agencies have suffered from the following defects -

a. they are too bureaucratic and legalistic. This is partly a reflection of the relative dominance of lawyers in United States commercial life and also of the difficulty the regulators and regulated have experienced in agreeing a "fair price" and "fair rate of return";

b. hearings are too formal and applications for price increases too burdensome;

c. the commissions have been too slow to respond. There have been delays in granting price increases, in periods of inflation. Such delays are referred to as the "regulatory lag";

d. many agencies have developed a cosy relationship with their industries and have failed to be sufficiently questioning and investigative in their approach. This is referred to as "agency capture".

e. economic efficiency has not been encouraged. Agencies have been more concerned with ensuring that a rate increase is reasonable;

- f. they have responded too much to local political pressures and have tended to favour short term interests, and present rather than future consumers;
- g. some commissions are underfunded and understaffed and lack good quality staff;
- h. in order to increase their return, utilities have artificially expanded their "rate base" or capital employed;
- i. agencies have condoned and even fostered unimaginative tariff structures and pricing policies.

Perhaps the most damaging effect has been the regulatory lag which, coupled with adherence to historic cost accounting, has resulted in low rates of return. This has affected bond and credit ratings. As a result regulated industries have had difficulty in expanding their funding at economic rates and have been loath to make new investments.

4. Despite these defects, the clamour for de-regulation has not extended to the monopoly industries such as telecommunications and electricity. Indeed in the former, the United States can claim, under the regulation of the Federal Communications Commission (FCC), to have developed one of the world's better telephone systems. The FCC has to some extent stimulated competition to AT and T and required that company to make interconnection facilities available. More recently it has been agreed with AT and T that it should divest itself of its local regional telephone operations in return for permitting it to retain its interests in telephone equipment.

5. Experience in the United Kingdom of regulation of private sector monopolies has not been encouraging. However as in the United States, this has mainly been the result of the methods of regulation used. Thus -

a. it is claimed that the Independent Broadcasting Authority (IBA) has failed to make the independent television companies operate more efficiently and economically. However the IBA has no direct responsibility for efficiency and the companies have little incentive to reduce costs, because monopoly profits are constrained by a levy which results in a marginal tax rate of 82 per cent above a certain level;

b. private water companies have had no incentive to improve their performance, other than from the threat of nationalisation, because profits earned in excess of a maximum rate of dividend must be ploughed back into the business or returned to water ratepayers.

6. Regulatory agencies can however claim certain advantages -

a. they act as a surrogate for market forces and aim to prevent abuse of monopoly power;

b. they are a better method of regulation than a Government Sponsor Department since they will not have the other conflicting responsibilities of manager of the economy, owner of the business, banker and subsidiser of social services;

c. they are likely to be more professional and can present a better method of highlighting inefficiency and promoting efficiency. Staffing is less likely to be constrained by Civil Service terms of employment and remuneration - they can more easily employ staff with expertise and knowledge of the industry concerned, accountants and economists;

d. there is greater transparency of decision making. The pricing mechanism will be divorced from Government and subsidies for loss-making and "social" activities are likely to become more explicit;

e. there is increased public accountability on the part of the industry being regulated;

f. they are essential if the monopoly is to be privatised, in order to reduce uncertainty and potential interference which would exist under Government regulation;

g. they will be able to assume the responsibility of the NICCs whose duties they will be able to carry out more effectively;

h. they offer the prospect of continuous regulation of monopoly.

7. We consider that regulatory agencies can be an effective method of reducing monopoly power and are essential if state monopolies are to be privatised and remain monopolies. They are likely to be most effective if accompanied by regionalisation, since this will facilitate comparison and is less likely to lead to agency capture. The deficiencies noted above are less likely to arise if the following conditions exist -

a. the agency should be divorced from Government in order to reduce the possibility of political intervention;

b. the agency should be managed by a small number of members who are full-time appointees of the Government. Terms of office should be at least 5 years, with cyclical rotation in order to minimise political interference. The members should be properly remunerated;

c. the agency should have statutory investigative and judicial powers. These will include rights of access to information and premises, to subpoena directors and staff, to conduct audits and reviews and to request the MMC to investigate the monopoly;

d. care should be taken to ensure that appellate arrangements will not result in political interference; we consider that the MMC should be able to fulfill this appellate function, with its experience of examining "public interest" questions;

e. uncertainties are created in the US system of regulation because agencies attempt to determine each year when approving price increases a fair rate of return based on the monopoly's relative efficiency. Major reviews of rates of return and of efficiency should only take place periodically, for example every 4 or 5 years. The results of efficiency reviews should represent a major input to the determination of permitted maximum rates of return, so that past effort and achievement are rewarded. However some flexibility should also be permitted to the agency in the intervening period as an added stimulus to efficiency;

f. permitted rates of return should be established by the agency (or the MMC as the appellate) rather than by Ministers, in order to reduce the possibility of political interference;

g. the agency should have powers to ensure that the monopoly is constrained and abuses are remedied. In the longer term the permitted maximum rate of return can be varied to meet this need. In the short term, price restraint could be used where maximum rates of return are likely to be exceeded;

h. the agency should be adequately funded and should be permitted to recruit those staff appropriate for the task, from outside the Civil Service where appropriate, at market rates of remuneration;

i. the agency should be permitted to examine all aspects of the business, including profits, efficiency, pricing, extent of market and services provided, standards of service, consumer protection, investment and possible abuses of monopoly power such as cross-subsidisation to keep out competitors and pressure on suppliers;

j. current cost accounts should be used primarily as the financial basis for regulation. However we would point out that for many industries there is a high degree of subjectivity involved in the preparation of CCA accounts. As a result we consider that for the time being at least it will be necessary for agencies to have regard to and even regulate by reference to historic cost accounts, as well as CCA accounts.