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## Evaluating network services in Europe

– a critique of the EC Evaluation of the Performance of Network Industries'

by

David Hall

[d.j.hall@gre.ac.uk](mailto:d.j.hall@gre.ac.uk)

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**PSIRU, Business School, University of Greenwich, Park Row, London SE10 9LS, U.K.**

Website: [www.psiru.org](http://www.psiru.org) Email: [psiru@psiru.org](mailto:psiru@psiru.org) Tel: +44-(0)208-331-9933 Fax: +44 (0)208-331-8665

Director: David Hall Researchers: Robin de la Motte, Jane Lethbridge, Emanuele Lobina, Steve Thomas, Violeta Corral

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## Preface

This is the second critique by the European Federation of Public Service Unions (EPSU) on the European Commission's evaluation of the performance of network industries (EPNI). It has been written by the Public Services International Research Unit (PSIRU), with input from an expert meeting organised by EPSU on 22 February 2006.<sup>1</sup>

As with the first critique, the aim is to challenge the EPNI process itself - both in terms of how it is carried out and in the conclusions it draws - and to argue for an alternative approach. The critique makes a number of concrete demands for change, including:

- The need for an independent, participative, and democratic process: the European Commission should not provide the defence, jury and judge for its own policies. Rather, this should be a task of a European observatory on Services of General Interest/Services of General Economic Interest (SGI).
- the definition of broader objectives for the evaluation; i.e.
  - To assess the objectives of liberalisation - e.g. efficiency, productivity, price levels etc - against the actual evidence of developments;
  - assess the impact of the liberalisation directives, internal market rules, state aid rules and other EU level frameworks on the development of SGI in Member States (at national, regional and local level);
  - assess the extent to which SGI in Member States contribute to public policy objectives;
  - provide comparative information to assist Member States in improving their own services, and to support collaborative arrangements between them.
- The need for active follow-up. What responses should follow the evaluation? The EC and Member States should be prepared to re-assess policies on liberalisation of SGI, and to respond to the results of the evaluation with comments and proposals for action to address the issues identified.

We hope that our critique contributes to the development of a more rigorous evaluation process for the EU liberalisation policies, and also to an alternative (positive) policy agenda for SGI. Such an alternative policy would be based on the following elements:

- The cost of 'non-public' as illustrated in segregation and social exclusion, but also long-term financial implications;
- Sustainable development based on quality SGI and jobs through investment into public administrations and infrastructures in areas, such as education, environment, health and social services;
- Democratic control of service delivery and accountability;
- Regulation of private companies providing SGI;
- Equal rights and opportunities for all and fairer taxation and distribution of wealth.

Feedback and comments on the critique are welcome.

Jan Willem Goudriaan  
EPSU Deputy General Secretary  
[epsu@epsu.org](mailto:epsu@epsu.org)

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## 1. INTRODUCTION<sup>1</sup>

The 2005 report ‘Evaluation Of The Performance Of Network Industries’ (EPNI) was published by the European Commission on 22nd December 2005.<sup>2</sup> It consists of a 16 page report<sup>3</sup> and a 55-page annexe<sup>4</sup> which presents some data in more detail. It refers frequently to other reports which are in effect ‘remote annexes’ to the EPNI: a report by Copenhagen Economics (CE) on ‘Market Opening in Network Industries’ (September 2005)<sup>5</sup>; and consumer surveys from Eurobarometre, one on services of general interest in the EU (July 2005)<sup>6</sup>, and one on perceptions of service of general economic industries in new member states (September 2005)<sup>7</sup>. All these are available from [http://europa.eu.int/comm/internal\\_market/economic-reports/index\\_en.htm](http://europa.eu.int/comm/internal_market/economic-reports/index_en.htm)

The EPNI is the second formal report on this subject, following the previous evaluation report published in June 2004<sup>8</sup>; which was preceded by a report on methodology published in June 2002<sup>9</sup>. These previous reports were also the subject of critiques by PSIRU.<sup>10</sup>

This critique is divided into four main sections:

- a critique of the process by which the EPNI was conducted and produced.
  - o This lacks a democratic framework, and fails to meet the original expectations of a public process
- a critique of the main EPNI report and annexe, following the structure of the report itself
  - o the report ignores much evidence concerning productivity, employment, prices and consumer satisfaction which does not fit its overall picture of satisfactory results.
- a critique of the Copenhagen Economics (CE) report on which many of the claims are based
  - o The report uses a model, based on some highly implausible indicators and very little data, to produce results which are contradictory and unrealistic (including the possibility that liberalisation could result in electricity prices falling to zero).
- a set of proposals for improving future evaluations

## 2. A defective process

The process of the EPNI lacks a public and democratic framework, contrary to its original remit. For the third time in succession, no attempt has been made to involve citizens and others. Like its predecessor, the document is not addressed to any of the EU’s democratic institutions, but simply designated as a ‘Commission Staff working document’. The EPNI says only that it aims to “contribute to an open and transparent debate” but does nothing to provide the framework or conditions for that debate. No actors outside the Commission were involved in the production of the EPNI; no process is created for assessment of the issues through the democratic institutions of the EU and its member states. The EPNI was published only in English, indicating that democratic debate was neither expected nor desired.

This is contrary to the specific requests of the European parliament, the promises of the Commission’s own 2002 methodology paper, and the white paper on European governance of 2001. The request from the European Parliament in October 2001 specified that public debate should form part of the process and proposed to “organise the debate within the various existing forums (Economic and Social Committee, Committee of the Regions, consultative bodies, associations involved in services of general interest initiatives and consumer associations)”. The 2002 paper promised “*a permanent mechanism for the monitoring of citizens’ opinion and their evolution*”, including the consultation of stakeholders, including the social partners, and a great expansion of public participation; it agreed with the Parliament that “*public participation could be greatly expanded ... The results of this debate should be taken into account and provide guidance for the annual horizontal evaluation, and the evaluation should itself be the subject of debate*”.<sup>11</sup>

The White Paper on European Governance in 2001 proposed: “opening up the policy-making process to get more people and organisations involved in shaping and delivering EU policy. It promotes greater openness, accountability and responsibility for all those involved. The quality, relevance and effectiveness of EU policies depend on ensuring wide participation throughout the policy chain – from conception to

implementation. The Union will no longer be judged solely by its ability to remove barriers to trade or to complete an internal market; its legitimacy today depends on involvement and participation. . . . . Five principles underpin good governance and the changes proposed in this White Paper: openness, participation, accountability, effectiveness and coherence.”<sup>12</sup> The preparation of this report seems to take the contrary position, being entirely concerned with the completion of the internal market with no interest in participation.

It is not even clear if the EPNI involved any discussion between different directorates of the Commission itself. It is described as a “Working paper of the Services of Mr Almunia [Economic and Monetary Affairs] and Mr McCreevy [Internal Market] in cooperation with the services of Mr Kyprianou [Health and Consumer protection]” . There is no indication of any input from the Commission directorates for Employment – although employment is discussed in some detail by the report; or from Regional Policy – although the specific impact on new member states is an important section in the report; or from Transport and Energy – which covers most of the liberalised sectors discussed by the report; or from research, which funds a large amount of research on the subjects covered by the report.

Secondly, the EPNI remains as part of the Cardiff process, concerned with the development and performance of the internal market. It thus focuses on the performance and impact of the liberalised sectors rather than on the wider question of how these sectors could be best organised to achieve a range of public policy objectives. It is true that, compared with the previous report, this paper shows greater consciousness of critiques than before e.g. concerning the impact on prices, investment, employment and environment (and, although it states it will ignore distributional issues, it does in fact address issues of impact on poorer households and the relative impact in new member states).

However, the exercise remains focussed on the single public policy objective of extending the internal market, as epitomised by its conclusion that “*Significant milestones have been achieved in opening up network industries supplying services of general economic interest to competition. However, there remain many obstacles to competition and to completing the internal market, which the Commission is taking steps to address.*” This monolithic perspective leaves no room for public service objectives, implies that public services are of no concern to the EU. Even regulation, which is often assumed to be an instrument for achieving public policy objectives, is only another way of developing the market: “*An appropriate regulatory framework is also important for competition and to ensure adequate incentives for investment.*”<sup>13</sup> The accompanying press release shares the same exclusive focus, with Commissioner McCreevy quoted as saying that “*This report shows that EU rules enabling more competition are having a positive effect on the essential services that Europeans use every day. The results for new Member States are particularly encouraging. But there is no room for complacency – overall progress could be much quicker and many market barriers still remain.*”<sup>14</sup>

In doing so the Commission chooses to ignore other objectives of the EU treaty. Article 3 of the treaty refers to “the strengthening of economic and social cohesion”, “a policy in the sphere of the environment”, “the establishment and development of transEuropean networks”, “the attainment of a high level of health protection”, “education and training of quality and . . . the flowering of the cultures of the Member States”, “consumer protection”, “promote jointly [in developing countries] economic and social development”; and “the Community shall aim to eliminate inequalities, and to promote equality, between men and women”.<sup>15</sup>

As a result of these factors, the EPNI once again consists of the Commission evaluating its own policies, against the single criterion of developing the internal market, and declaring itself reasonably satisfied. This again demonstrates the need for an independent, and public, evaluation process. The EC cannot itself carry out an evaluation of a policy which it is committed to presenting as favourably as possible in order to counter public opinions on the subject. The EC’s opinion should become an important input into the evaluation process, not an outcome.

### 3. A critique of the EPNI

#### 3.1. Policy and legislative developments

The survey of legislative developments is a useful reminder of the various dimensions of EU policy which now bear on the structure of public services in the EU, not only SGEI. It covers most of the relevant current

initiatives and policies, including: the future of the white paper on SGI; the proposed Services Directive (and other possible extensions of the internal market); new rules on state aid (arising out of the Altmark ruling); and the Commission's forthcoming proposals for new rules on public-private partnerships (PPPs) and concessions, which affect public procurement rules.

These and further developments under EU law create considerable uncertainty and stress for the structures of Europe's public services. The ECJ rulings in the cases of Halle and Parking-Brixen, force European public authorities further towards compulsory tendering of work instead of being able to decide to provide it through a 100% owned but corporatised entity. Long-standing national laws, for example French laws on mixed economy companies, have been thrown into confusion by such developments. And many such entities were corporatised in response to the fiscal limits of the EU stability pact, in particular the rules on general government borrowing, under which the borrowing of corporatised trading services was exempt. The EPNI appears ignorant of, or indifferent to, the institutional consequences of these developments.<sup>16</sup>

The report also fails to note that the influence of EU policies on the structure of public services is now consciously extended beyond the boundaries of the EU itself. It is an element of the European Neighbourhood Policy, covering 17 countries in North Africa, the Middle East and former Soviet Union which are not even expected to become member states in the future: the action plans include requirements for these 17 countries to implement policies of liberalisation of services, reduction of state aid and even privatisation.<sup>17</sup> Bilateral trading agreements with specific countries (BITs) also include encouragements to liberalise public services. In the context of the WTO, the EU's negotiating position under the GATS have also attracted major criticisms for seeking liberalisation in a number of public services – indeed, in the Green paper on Services of General Interest of 2003 the Commission suggested that the GATS liberalisation rules should be one of the guiding principles for public services in Europe.<sup>18</sup>

The report correctly notes that there is support for the principle of a framework directive on public services. It should however add that the advocates of a framework directive see it as establishing a set of principles to protect public services from further liberalisation, whereas the Commission's idea of a framework directive on public services, as outlined in the green paper, is for a set of guiding principles for liberalising sectors.

## **3.2. Market performance**

### **3.2.1. Evolution of market structure**

The EPNI's discussion of market structure repeatedly refers to the problem of progress with liberalisation, and the problem of 'incumbents', by which is meant the state-owned companies which typically had monopolies in many of these sectors. The report continues to see these former monopolies as the problem, even where they no longer exist: in rail, the UK is amongst 5 countries mentioned where the market share of the incumbent remains high, but again there has been no incumbent in the UK for 10 years.

One aspect of the concentration in most sectors is the international nature of horizontal concentration, with the same companies owning significant stakes in many different countries. This is acknowledged by the report, but the only remedy offered is that of scrutiny of merger proposals (p.6). The report should also recognise that this international concentration has only been possible because of liberalisation – not despite it. National monopolies are being replaced by a European oligopoly, whose growth is hard to control, as evidenced by the takeover bids for electricity companies in early 2006. This Europeanisation of company power has not been matched by any corresponding development of democratic control mechanisms.

Commercial operators may not find it worthwhile to engage in the kind of idealised competition that the EPNI dreams about, but will seek to adopt various risk-reducing strategies. In each sector, or any essential service where there is a public interest in ensuring universal access, both producers and consumers have a shared interest in eliminating uncertainty from the system, and this shared interest is of greater benefit than any possible savings gained from competition. In electricity, this can be seen in the systematic use of vertical integration by the commercial operators. But the same structure that provides security enables commercial profit-maximising to extract monopoly profits: which is why the case for public sector control of these services has been so widely accepted.

The EPNI treats competition as though it was not only a certain good, but also a free good. This ignores the transaction costs involved in enforcing liberalisation and competition, which can be seen recurrently throughout the document. There is significant expenditure on bureaucracy to create and regulate markets, and significant public expenditure in infrastructure to make competition possible. The unbundling of rail operations and the creation of new rules for tendering, calculating access fees and subsidies, for example, create significant new transaction costs (Annex p. 7). In electricity, the cost of creating wholesale markets represents a huge effort and expenditure by public authorities: in the UK this cost was around €1 billion, which means that the system would have to deliver significant efficiency savings even to be neutral: but only 1% of all electricity sold in the UK passes through that market. Public authorities including the Commission, and regulators, devote public resources to encouraging consumers and producers to engage in more competitive activity, it suggests that the market is more a creation of public policy than an automatic consequence of liberalisation.

Thus market opening does not lead inevitably to something close to perfect competition, and can rather result in oligopoly. In these situations the expenditure of public money in trying to create an artificial market it is not the best way to increase efficiency: once suppliers are in a position to alter both the probability and volume of demand for their services, incentives become perverse. Hence dulling the effects of market incentives via employment in the public sector, with public finance and production, becomes an attractive option.<sup>19</sup> Where there is monopoly or oligopoly of any kind, which requires public interest regulation, it is not certain that the joint effect of privatisation or liberalisation and regulation is higher efficiency than under public ownership.<sup>20</sup> Political control through public ownership can be expected to produce better results in oligopolistic markets where competition is weak and so there is no justification for the presumption that competition makes for greater efficiency.<sup>21</sup>

Costs are also ignored because the EPNI fails to distinguish adequately between competition in the product market from competition for contracts, licenses, monopolies or concessions from public authorities. For example, rail, gas and electricity transmission networks are natural monopolies. In mobile telephony competition takes place between licensed oligopolies, in passenger rail services companies compete for monopoly licenses. The prices consumers pay for these services reflect the cost of acquiring these oligopolistic or monopoly positions.

Finally, the EPNI treats the issue of opening to competition as simply a matter of unenlightened resistance to the only correct way forward. But in sectors such as rail, for example, public authorities may be reluctant to change their systems because of the severe problems of investment, safety and performance that have been observed in the UK: this may explain why Estonia considers renationalising its railways, for example.

Some parts of the process of EC intervention in these sectors, for example the harmonisation of safety rules and practices (Annex. p.9 – not mentioned in the main report), are useful cooperative approaches facilitated by the EC as a European-wide public authority. These initiatives do not require competitive markets however.

### **3.3. Prices, Productivity and Employment**

#### **3.3.1. Prices**

The EPNI claims that there has been a wide variation in price trends between sectors and countries, and emphasises that there are many factors affecting prices in these sectors (p.7). The graph on the trends in retail prices in the liberalised sectors over the last 9 years (A p. 10, Figure 1) shows a fairly general trend, however: in all these sectors, prices have either exceeded or been close to the general trend, except for telecom and electricity. But telecom prices have not fallen for the last 5 years, and electricity prices are only just below the general price index (and will very probably have caught up by the end of 2006). This is not much to show for the impact of liberalisation. The EPNI's analysis of trends in PPP prices in different sectors does not alter this basic fact.

The EPNI then prefers to concentrate on the question of convergence, because “economic integration of network industries in Europe should bring some price convergence” – and so this is some kind of indicator of success – and also refers to it as “a long-term goal”. (A p.13) But the liberalisation directives do not in fact create ‘economic integration’ of the sectors. They force member states to operate a series of national

markets. They enable multinational companies to buy dominant stakes in these markets, but otherwise there is no integration. As the EPNI notes, there may be a number of good reasons of public policy for integrating these services in some respects, but liberalisation has not done that: public authorities including the EC are doing it (see below). Nor is there a good reason to treat price convergence as a long-term goal, or short-term. As the experience of the new member states, and the expectations of their citizens, demonstrate, increasing prices of essential services to EU15 levels is a bad thing, not a good thing. (see later section)

The EPNI here relies heavily on the forecasts from the Copenhagen Economics study to find some link between liberalisation and price changes. A detailed critique of that study is attached as an annexe. It is worth emphasising here, however, that the results are not observations of what has happened, but figures calculated by creating a model of the relationship between liberalisation and prices and productivity, and then using this model to forecast what effect they think it should have had, according to their own constructed index of the progress of liberalisation. The figures are therefore retrospective forecasts, whose value depends entirely on the value of the model and index constructed – and both the model and the index have serious defects.

The EPNI chooses to ignore other evidence on prices. For example, industrial consumers of electricity, as represented by IFIEC Europe, are profoundly dissatisfied with the effects of liberalisation on prices, and states that the current regime allows electricity companies to inflate their margins – ‘a significant and undue transfer of wealth’ – and creates an unstable environment, which ‘gravely destructs industrial asset value’. A study by KEMA for Eurelectric shows overall price reductions for industrial consumers between 1995 and 2004, but with differences over time and between countries: the sharp fall in industrial prices in the UK from 1999, when retail prices for domestic consumers were deregulated, is most probably explained by companies taking the opportunity to shift a greater burden of costs onto domestic consumers. So the gain to industrial customers was at the expense of households, and the result of deregulation and the operation of the market. The KEMA data on household prices shows an overall fall, but this conceals a significant rise in prices in the Nordic countries – with an open market over the whole period – and a significant decline in Greece, Portugal, France, Italy and Belgium, which remained monopolies for residential consumers in this period.<sup>22</sup>

### 3.3.1.1. Different impacts on different groups of users

The EPNI does address the question of whether poorer and smaller consumers have lost out either in absolute terms or relative to larger consumers (despite declaring at the start that it would not address distributional issues). The report itself acknowledges the well-established data showing that while international and national phone calls have more than halved since 1997, the price of local calls – the major item for small users – has remained unchanged. The EPNI’s response is to describe this regressive change in pricing policy as ‘tariff rebalancing’, but apparently to accept it as an unfortunate consequence of competition – “some categories of users may in theory face higher prices in some countries” A p.16). The report claims that this is less of a problem because in other sectors the poor might do better, on the basis of data on comparative changes in electricity costs for large and small domestic consumers, and thus argues that “the categories which might benefit differ from sector to sector”. (p.7) There is however no attempt to offer a way of rectifying the problem indicated by the data, that the poor have been made worse off relative to the rich. The Commission here seems more concerned with constructing a defence of their ideological position rather than addressing a real European social policy question.

In any case, the data on electricity however shows almost nothing about the effects of competition. Despite listing all 25 countries, the great majority of these had not opened the household sector to retail competition at all by 2004 (as can be seen from Table 13 on p.48 of the annexes), and so no data in the graph is of any relevance to liberalization except that for the UK – the other 24 countries could have been omitted altogether with no loss of information. The chosen indicator also compares only different segments of household consumers: if the comparison is made between household users and industrial consumers, then the UK experience has been rather different: between 1999 and 2002, the prices paid by industrial users fell sharply, while prices for household consumers rose slightly – as was observed by Power UK and the National Audit Office.

The EPNI also ignores the evidence set out in a report for DG Regio in 2004<sup>23</sup> which set out clear evidence that poorer consumers were at risk from liberalization, not only in terms of prices but in their vulnerability to

being cut off or subject to pre-payment meters if they face problems of payment. Specifically on electricity, the report showed that “in those countries where competition for large consumers was introduced but residential consumers remained a monopoly (Italy, Spain, Portugal, France) the ratio [between households and industrial users] remained reasonably stable, suggesting that regulation was protecting small consumers ..... In the countries where residential competition existed, Germany and UK, the relative position of small consumers got worse...”<sup>24</sup>

The EPNI thus fails to convince that the experience of the poor losing out is peculiar to the telecom sector. Indeed, almost any analysis of commercial behaviour would expect companies to offer the best prices to the biggest purchasers, and so it would be surprising if commercial markets did not produce this result. From the perspective of public policy, however, it is unacceptable that the poor should pay more for such essential services.

### 3.3.2. Employment and productivity

The EPNI notes the fall in employment in these sectors, and the sectoral variations, including a 16% fall in electricity gas and water from 1996-2002, and the rise of 24%, followed by a fall of 6%, in telecom over the period 1995-2003. They also note the variations across countries, within sectors. There is no attempt to analyse the causes of these changes: for example, in 1999 many gas and electricity companies reduced jobs on the grounds that they were facing competition. It would be interesting to know whether competition materialised or not, and what companies have said about the reasons for reducing their workforce since that time. An annual public observatory would facilitate gathering evidence to analyse these processes.

There is a need to understand the employment policies by companies operating in liberalised sectors because they affect performance and delivery. For example, the problem of a reduction in training and labour quality, as a result of outsourcing, recurs across a number of sectors (as noted in last year’s critique). It has been a key factor in the deterioration of capital maintenance of rail infrastructure in the UK (see below under maintenance). It also recurs on other sectors, including electricity and water. Issues of training and working conditions and the value of a committed and respected workforce receive no attention from the report: employment levels are treated as a consequence of the operation of a liberalised system, but labour is a vital input to the production of these services.

There is now extensive evidence on this subject. A report by FORBA has documented the widespread casualisation that has arisen in privatised and liberalised sectors, with damaging impacts on workers’ security and income.<sup>25</sup> A study for the UK government showed that training of workers in electricity and water had declined sharply due to widespread use of outsourcing.<sup>26</sup> Across the entire EU, there is evidence of widespread outsourcing in the electricity sector, mainly by monopoly distribution companies not subject to competitive pressures, and consequent problems for training, as documented by a study for the social partners in the sector.<sup>27</sup>

The EPNI’s comments on productivity, employment consequences and long-term effects of liberalisation, are based entirely the Copenhagen Economics model, a critique of which is in the annexe.

### 3.4. Investment

The EPNI addresses the criticisms that liberalisation leads to underinvestment. It seems ambivalent about whether liberalisation has in itself made it more difficult to obtain the required investment. The annexe (A p.22) argues that the problems are not “caused by liberalisation per se, they have been caused by defects in the regulatory environment” The main report however refers to the need for cohesion policies in respect of “investments in transport, energy and telecommunications infrastructure – all areas where the market has difficulties in supplying services at an affordable cost and an adequate level, especially in the new Member States and in remote and rural areas” (p.11).

The cohesion policies are good examples of international solidarity financing of investment through the EU level public sector. Much of the €38billion public investment by the EC in road, rail, sea and ICT networks (A p.25) redistributes wealth on a European scale in support of common public policies. The role of the EC in coordinating and financing such public investment is essentially a valuable contribution to economic and social development. The report nevertheless insists that member states have to carry the responsibility for investment (p.10-11), and that competition is a system which will certainly lead to greater production and

investment, so that member states should simply “create the right framework for price signals to foster investment” (A p.26).

When EC policies on investment are driven exclusively by the perspective of extending markets, however, rather than by public interests in cohesion or economic developments, it can become a problem. For example, the repeated commitment to invest in greater capacity for cross-border electricity transmission, in order to make international trading in electricity easier (e.g. p.11, A p.25), ignores the public interests which are adversely affected by such expenditure, notably the environmental costs of building such transmission lines, the potential efficiency gains of an alternative policy to encourage more generating capacity is closer to the source of demand, and the value of demand management policies.

The EPNI seeks to avoid the conclusion that the blackouts and problems in the USA and Europe do not really indicate a serious problem with liberalization in the sector (A p.24), but they acknowledge that the blackouts of 2003 in both USA and Europe were caused directly by the transmission systems being unable to cope with the increased volume of trading that had resulted from liberalization. The EPNI argues that the solution is more public expenditure on regulation and/or transmission lines: an alternative would of course be to change the system by discouraging such volumes of international trading. The EPNI also claims that the 2003 blackouts were not caused by shortage of capacity, which is true: but the California blackouts of 2000 were certainly the result of capacity shortage, which was created by deliberate cartel actions to withdraw generators and push up prices – as admitted by an Enron executive, who has pleaded guilty to conspiracy for orchestrating schemes to manipulate California's energy markets during the state's power crisis in 2000-01.  
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The EPNI also seems to be unaware of the massive problems experienced with investment spending and drastic write-offs of capital in the US electricity sector under deregulation since 2000. A presentation at the World Bank in 2005 by the corporate investment banking division of Societe Generale (SGCIB)<sup>29</sup> described the experience as “the collapse of the US power sector”. SGCIB acknowledged that previous complacency about the market was ill-founded “We thought the rules of deregulation and competition in the power industry in the U.S. were well understood and that deregulation could serve as the profitable foundation for a merchant power business... what actually happened was that power prices collapsed in the U.S., major industry players that invested heavily in merchant power and trading have collapsed or struggled to survive, and investors have abandoned major portions of the infrastructure business... The result is the loss of several hundred billion dollars for equity and debt investors: more money lost by investors than the total cost of all the merchant power facilities built in the U.S.” Thus although new capacity was added to the system, it was at the cost of destroying huge amounts of capital. SG offered as a final conclusion: “Immediate and perfect deregulation may not be necessary, however a clear public policy approach is needed”. The EC should surely take note of this extremely costly, destructive and unproductive experience in the USA.

The report seeks to argue (A p.24) that the problems of rail in the UK are due to underinvestment before privatisation, and that the infrastructure problems require a change in access pricing regime. But the lethal state of the UK rail network, which led to two fatal crashes at Hatfield and St Albans, was the result of a failure of track maintenance standards, partly as a consequence of cost-minimising sub-contracting by the private companies responsible for the track, whose incentive to enhance their returns in this way would not have been eliminated by re-calculation of operators' fees to the network company.<sup>30</sup>

### **3.5. New Member States compared with EU15**

#### **3.5.1. Market dominance**

This section is a welcome addition to the EPNI. The internal market policies and the liberalisation directives of the SGEI were all developed by the EU before accession by the new member states. The effects of applying these requirements to countries with much lower levels of industrial and economic development could have a regressive social impact by introducing market pricing mechanisms which adversely affect poorer household consumers.

On market structure, the EPNI notes that it appears more concentrated in the EU-10, based on data in the annexe about the telecom and energy sectors (A p.28), and offers the comment that “markets in those countries are smaller than in many EU15 Member States. But only a certain market size allows companies to

profit from potential economies of scale. Countries with an overall smaller market size might therefore be less attractive for new competitors. As a result, the market shares of incumbents remain high.” (p.12).

One conclusion from this should be that liberalisation of these sectors is not appropriate in smaller or poorer countries, as it does not even achieve the first step of creating competition, the effect is simply to create private (or at least commercialised) monopolies or oligopolies, which is a worse result for consumers than the retention of a public monopoly. At the very least, therefore, the directives should provide for the possibility of exemption for smaller and poorer states, either by a centrally determined threshold for GDP or GDP per capita, or by enabling member states to assess for themselves the relative benefits of liberalisation.

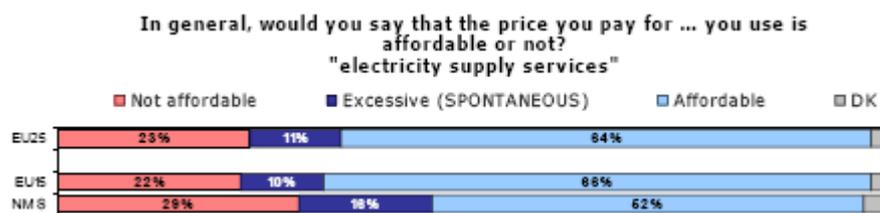
The concentration in new member states, at least in electricity and gas, is not a result of incumbent state monopolies, but of takeovers by companies from the EU-10 which have purchased the operations of the former state companies – in the case of Hungary, this happened as long ago as 1995. The electricity and gas industries of Hungary and Slovakia are now predominantly owned by the same multinationals which dominate in the rest of the EU – RWE, E.on, EdF/GdF. This has further negative effects. Firstly, it has a negative effect on the national economies of these countries: sectors with domestic markets but negligible export potential are taken over by companies from richer states. Secondly, it further reduces effective competition throughout the EU, as the takeovers eliminate potential competitors – there is now no Slovak electricity or gas company which can compete anywhere in Europe (or its neighbourhood) with the west European oligopoly. Rather, the multinationals can construct a new regional dominance, including transnational concentration: for example, RWE now owns electricity distributors, which are still monopoly suppliers, in adjacent regions of Slovakia and Hungary: “Our Slovakian subsidiary, the electricity utility VSE a.s., is based in Košice, the country's second largest city. Since the supply area of VSE borders on the supply area of the Hungarian company ÉMÁSZ Rt., both companies cooperate closely”<sup>31</sup>.

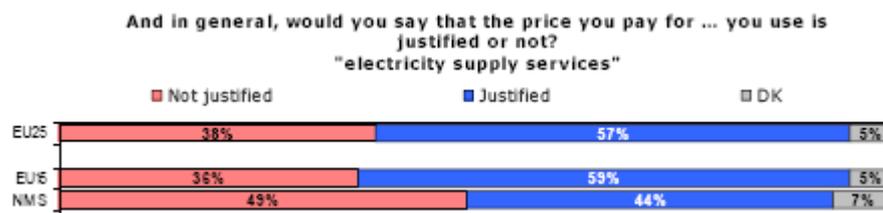
Ironically, the strength of the west European companies is derived from their dominance of their home markets which was established over the long post-war period based on state-owned monopolies, as in France and most other states, or private monopolies, or the gradual agglomeration of municipal monopolies which resulted in RWE and E.on in Germany. The new member states have been encouraged to throw away this historic home market advantage by breakup and/or privatisation of the sector (following the UK model) – the one case of a new member state resisting this breakup is the Czech republic, which reversed its original plans to unbundle state electricity company CEZ and retained a state majority holding.

### 3.5.2. Prices and affordability

The EPNI acknowledges the difference in affordability of services for citizens in new member states, where electricity, for example, costs on average around 2% of household income, compared with about 0.9% in the EU15. The EPNI fails to add that consumers in the new member states strongly resent the level of prices and do not believe that this is necessary. The 2005 Eurobarometer survey shows a significantly greater degree of dissatisfaction with electricity prices on the part of consumers in the new member states: 46% considered the price of electricity to be not affordable or excessive, compared with 34% in the EU15 states.<sup>32</sup> Even higher proportions, 49% in new member states and 36% in the EU15 states, thought that the prices were not justified. Similar disparities exist in respect of the prices for gas and fixed telecom.

Chart A. Consumer perception of affordability/value for money of electricity





The EPNI offers the observation that “However, affordability of services in the new Member States continues to improve more dramatically than in the old EU15.” (p.12). This however is misleading, because affordability has not improved in the EU15 at all between 2002 and 2004: the annexe shows for the EU15 no change in affordability of electricity and a worsening of affordability in gas, with a slight improvement in affordability of electricity in new member states, and a significant improvement in gas (A figures 13 and 15, pp. 29-30).

It is nevertheless true that the percentage of income spent on electricity and gas by the poorest 10% has fallen more in recent years in new member states than in others (A figures 14 and 16, pp. 30-31), which is what would be expected with relatively higher economic growth rates in new member states.

The EPNI annexe (but not the main report) offers the conclusion that increased competition will help counter inflationary tendencies arising from price convergence which, according to the EPNI, results from economic integration (p. 31). This fails to address the greatest transitional impact on affordability in new member states, which is the result of changes to subsidies or cross-subsidies. For all transition countries state subsidies have been rapidly reduced, and the process has been politically highly sensitive, to the extent that key regulatory decisions on prices have been postponed or seriously affected by elections in Hungary, for example; in Bulgaria, the reduction of energy subsidies has been repeatedly insisted upon by international bodies including the IMF, but has been strongly resisted within the country. The importance of subsidies and cross-subsidies in policies to support cohesion should be clearly recognised.

The EPNI does at least note the problem. In other publications, the Commission simply ignores the affordability of liberalised SGEI completely from its approach to questions of social cohesion. The 2005 joint report on social protection and social inclusion lists seven policy priorities, including “Improving access to quality services”: this mentions transport, but has nothing to say about improving affordability of electricity or telecom or post.<sup>33</sup> The report encourages member states “to develop integrated and co-ordinated strategies at local and regional levels and especially in those urban and rural communities facing multiple disadvantages. Such strategies should adapt policies to the local situation and involve all relevant actors”, but this is impossible to do in respect of these services covered by the liberalisation directives, which insist on a single approach throughout the continent.<sup>34</sup> The 2005 report on sustainable financing of social policies does not mention the issue of affordability of essential services, or the potential role of subsidies<sup>35</sup>; the 2005 progress report on economic and social cohesion does not mention the issue of affordability or price of essential services<sup>36</sup>; the 2004 interim report on territorial cohesion does not mention the question of affordability or prices of essential services such as electricity, except once as a possible minor factor influencing firm’s location decisions.<sup>37</sup>

### 3.5.3. Quality of service: renewable energy

On the question of renewables, the EPNI annexe shows that the lack of progress in the new member states is a real problem, with new member states using renewables for only 5.6% of electricity consumed, compared with 13.5% in the EU15 (A p.35): the proportion has not improved since 1995 in either new member states or the EU15. Current targets require the new member states to double the proportion generated from renewables by 2010, but since much renewable energy is not commercially competitive, subsidies are necessary to achieve the policy goal.

The EPNI again avoids all mention of subsidies in this context, so has nothing useful to say on the problem. Such subsidies are treated as a form of state aid by the Commission, which engages in lengthy annual scrutiny of such payments to ensure that they do not distort competition: the 2005 report included a lengthy and complex discussion of the circumstances in which such aid is or is not anti-competitive and therefore illegal.<sup>38</sup> That report shows that the level of subsidies in new member states for any environmental or

energy saving measures is far lower than that of the EU15. It is clear that it is necessary to encourage and provide support for new member states to subsidise renewables if the EU targets are to have any hope of being achieved.

**Table 13: State aid for environmental and energy saving purposes**

	Aid for environmental and energy saving (in million €, 2004)	Share of environmental and energy saving aid in total aid less agriculture, fisheries and transport, annual average 2002-2004	% point difference in this share (2000-2002 and 2002-2004)
EU-25	11384,1	19,1	5,6
BE	16,9	1,1	-0,4
CZ	3,2	2,2	0,6
DK	541,5	51,4	1,1
DE	6844,8	33,8	9,5
EE	0,1	0,4	-18,9
GR	25,9	3,9	3,8
ES	100,0	2,0	0,9
FR	137,5	3,7	-1,3
IE	6,6	1,0	0,7
IT	34,9	2,1	1,7
CY	1,7	1,0	0,4
LV	0,0	0,0	-0,4
LT	-	-	-
LU	0,0	0,1	-1,2
HU	2,3	3,0	-1,3
MT	-	-	-
NL	446,6	41,8	6,1
AT	94,8	20,5	4,3
PL	10,6	1,5	-2,2
PT	1,7	0,1	-0,1
SI	26,2	23,5	9,2
SK	0,0	0,0	-1,9
FI	215,4	35,1	16,2
SE	1956,9	78,4	40,6
UK	1116,6	21,9	14,5

Source: DG Competition

### 3.6. CONSUMER SATISFACTION

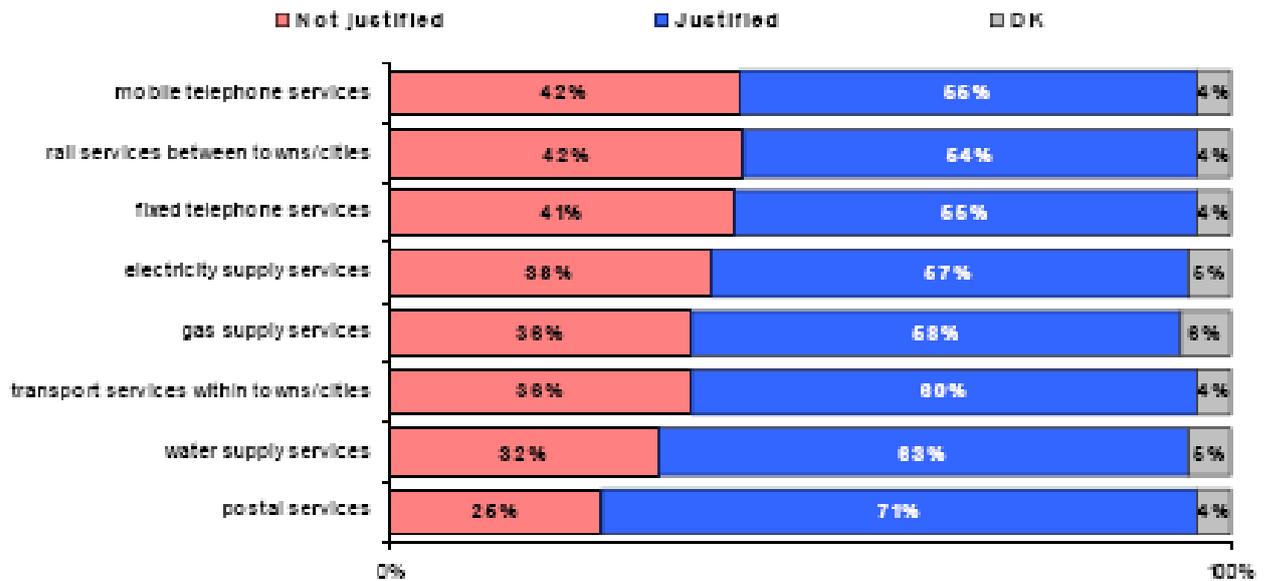
#### 3.6.1. Survey results

The EPNI refers to the summary report of the latest Eurobarometer survey<sup>39</sup> carried out on consumer satisfaction with SG EI, and states that these confirm previous results that satisfaction with these services is relatively high (p.13). A corresponding table is given in the annexe showing satisfaction rates ranging from 77% in postal services, down to 66% for rail services between cities and towns: for all services the rates are similar for new member states and the EU15. (A p.45).

These figures are derived from the summary report. They are calculated from simple arithmetical averages of consumer responses to questions concerning 6 aspects of each service: affordability, value for money, quality, information, terms of contract, and customer service. The overall figures mask the impact of the responses on value for money, where substantial minorities think that the prices of services are not justified.

#### Chart B. Consumers perception of value for money

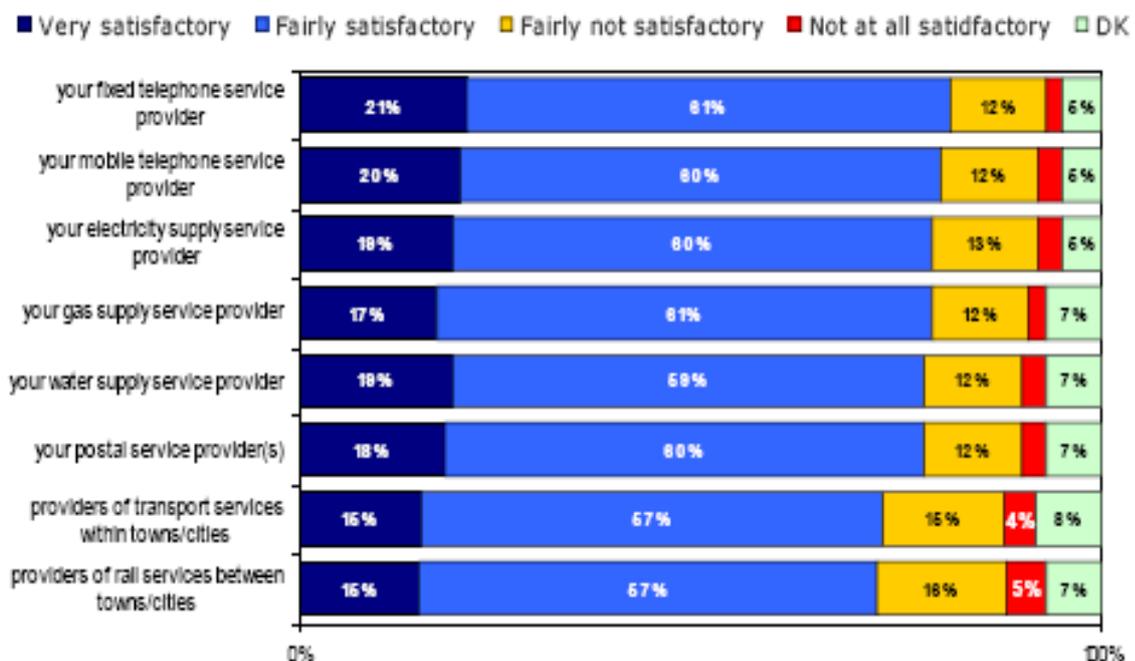
**To users : In general, would you say that the price you pay for ... you use is justified or not?**



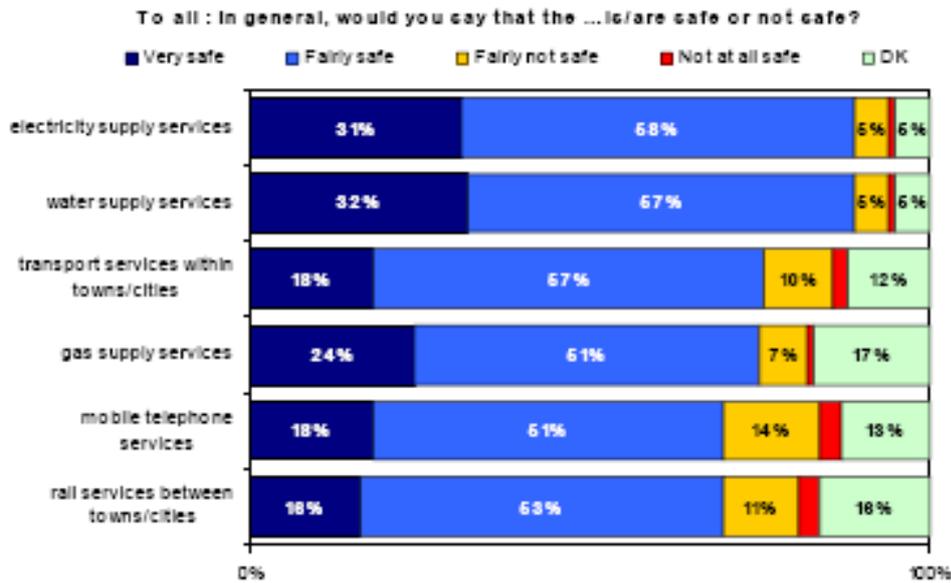
The overall figures also conceal another dimension of the results. The proportion classed as ‘satisfied’ includes both those who are ‘very satisfied’ and those who are ‘fairly satisfied’. However, as the 2003 qualitative survey pointed out, “scores that are by and large high, but include a dominant proportion of “fairly good” answers alongside a low number of “very good” replies, may in fact indicate only qualified satisfaction, accompanied by at times significant and serious elements of dissatisfaction”; and “failure to understand [abstract evaluation criteria], or difficulty in understanding them, may lead ... respondents to give favourable answers stemming from mere assumptions rather than enlightened opinions.”<sup>40</sup> Bearing this in mind, it is worth noting the very large proportion of responses classified in the summary as ‘satisfied’, which are in fact only ‘fairly satisfied’. The results on information, safety and customer service, shown in the charts below, thus suggest a significant and widespread dissatisfaction.

**Chart C. Consumer perceptions of information provided**

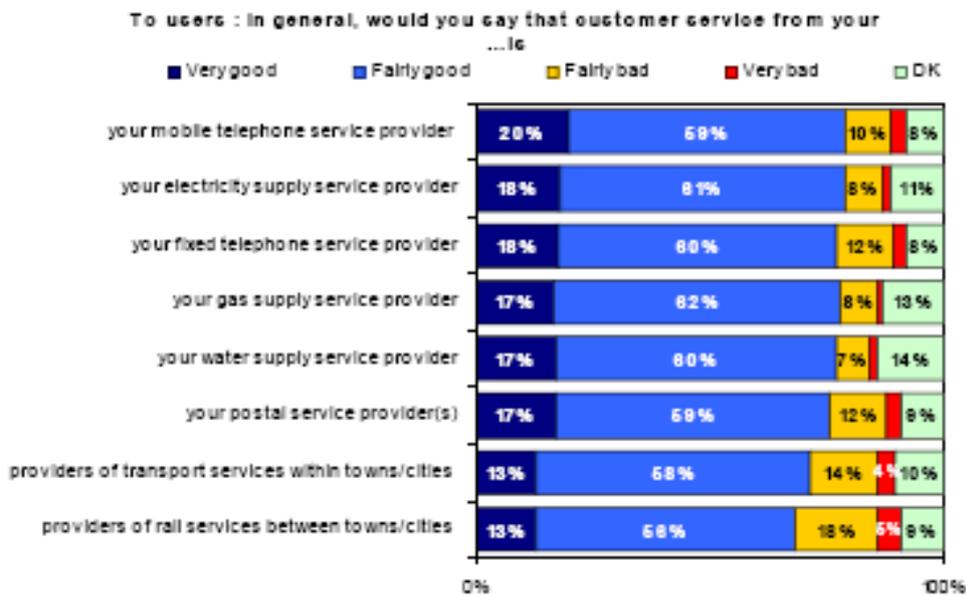
**To users : In general, would you say the information (bills, contracts, advertising, tickets, leaflets, etc.) you receive from ... is ...**



**Chart D. Consumer perceptions of safety**



**Chart E. Consumer perceptions of customer service**



**3.6.2. Specific Issues in the New Member States**

The EPNI refers to a specific 2005 Eurobarometer survey on attitudes in new member states. The EPNI notes that 49% believed that the main effect of EU membership would be to increase prices in these services, but that a large majority believed competition would drive down prices.

## 4. Critique of Copenhagen Economics "Market Opening in Network Industries"

### 4.1. The CE study

This part of the report focuses on the impact of market opening on price and productivity performance, based entirely on the results of studies by Copenhagen Economics (CE) on "["Market Opening in Network Industries"](http://europa.eu.int/comm/internal_market/economic-reports/index_en.htm)", available at [http://europa.eu.int/comm/internal\\_market/economic-reports/index\\_en.htm](http://europa.eu.int/comm/internal_market/economic-reports/index_en.htm). The EPNI itself makes a number of claims for the results of this study: "real-term price reductions of 8% in the electricity sector due to opening markets to competition...After controlling for factors such as technological change in telecommunications, market opening led to price reductions of 22%....Price reductions of 25% in rail freight transport and productivity improvements of 47%, both as a result of market opening....Accumulated productivity improvements of 93% can be attributed to market opening in mobile telecommunications....At the macroeconomic level, important benefits were estimated as a result of market opening. The econometric simulation has shown that market opening resulted in a permanent increase in welfare (consumption) of 1.9% (€98 billion per year) and an economy-wide employment increase of about 500 000 jobs (0.3% of total EU employment)." (p.10)

The following examination of the CE study argues that its methodology and data are too weak to support the conclusions advanced in the EPNI.

### 4.2. Divergent results

The EPNI annex includes a table from the survey which highlights some of the weaknesses of the CE study. (The version here is the original table from the CE study). It shows a range of figures for 'the impact of market opening' on prices and productivity, in the short- and long-term, for the various sectors. It includes figures which suggest that market opening mostly improves productivity and reduces prices, though by widely varying amounts, but that it:

- **worsens** productivity in rail passenger transport, short and long term – although it is also claimed to **massively improve** productivity in freight rail – but delivers equally impressive **price reductions** in both services
- **increases** postal prices, short and long term – despite a big **improvement** in productivity
- **increases** urban transport prices, short and long term

These inconsistencies are striking and raise questions about the value of the results. Since there are no proposals to repeal the Postal Directives, presumably the European Commission is also sceptical.

#### Chart F. Size and sign of impact of market opening, CE study

Table 4.3 Impact from market opening, EU15 average.

EU15	Productivity impact			Price impact		
	1990-2001 (short run)	1990-Long run (long run)		1990-2001 (short run)	1990-Long run (long run)	
Sector	Percent					
		Min	Max		Min	Max
Air	13.2	15	17	-2.3	-2	-2
Electricity	2.3	7	8	-7.6	-28	-60
Gas	-	-		-1.0	-4	-5
Postal services	28.1	36	37	4.2	7	8
Rail, freight	46.7	83	261	-24.9	-26	-26
Rail, pass.	-6.6	-9	-12	-21.9	-26	-27
Telecom, total	23.8	57	75	-22.2	-34	-35
Telecom, mobile	93.2	153	383	-20.5	-39	-43
Urban	1,0	2	6	2.2	4	6

Note: The table presents the estimated impacts of market opening in all seven network industries. The column 1990-2001 reflects market opening from 1990-2000 since the econometric models include market opening with a one period lag, whereby market opening in 2000 affects prices and productivity in 2001. The column

### 4.3. Forecasts, not observations

The CE methodology involved firstly using various indicators to create, for each sector in each country, an index of market opening over the period 1990-2001; then data on prices, productivity etc over the period was related to the market opening indices, and statistical calculations were used to derive factors which were significantly linked to the changes in prices or productivity; these results were then used to build a model, which was itself used to forecast, on the basis of the pattern of market opening, the contribution made by market opening to prices and productivity changes. Finally, the impact of this on the whole economy was calculated. In addition, countries were grouped according to the speed of market opening, and various data on prices and performance were then plotted for each group to see what patterns emerged.

The presentation of the above table in the EPNI fails to make this clear. The EPNI title describes the data as “Quantification of the impact of market opening on performance” - but CE title the relevant section of their report “Results of the forecast analysis” (CE1 p.45). CE emphasise that they: “forecast the economic impact on prices and productivity that has been caused by the market opening that has occurred during the past 10-15 years in EU15 network industries.” (CE1 p.44). Even the short-run effects in each sector are calculated as forecasts by CE using their model. The only role of observations is as inputs to generate the model.

The data generated by the CE study are thus forecasts of the contribution made by market opening (to be more precise, selected elements of CE’s indices of market opening), according to the assumptions built into their economic model. They are **not** actual observations of price and productivity changes caused by market opening.

### 4.4. Market opening and performance:

The EPNI claims that the CE study “shows that countries with more market opening tend to perform better than the rest. This is illustrated by looking at the performance of countries grouped in three categories” (EPNI-A p.41). The EPNI then goes on to show two selected graphs from the study which appear to be consistent with this assertion.

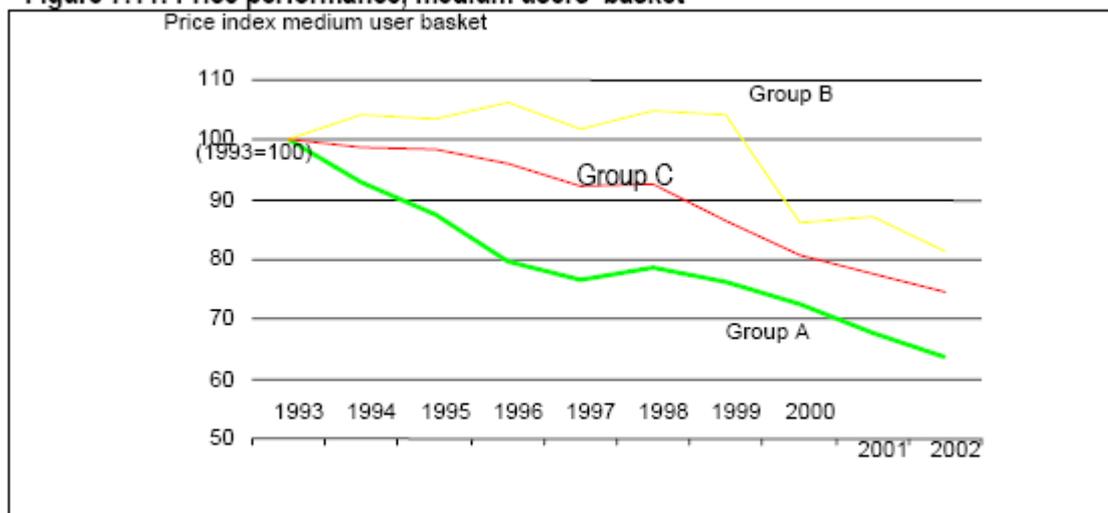
However, the actual data in the CE study is not strong or consistent enough to support the conclusions. It is based on limited data; uses indicators and groupings of market opening which may be considered arbitrary or inappropriate; and presents data which shows inconsistent results in relation to market opening and prices, productivity, employment and quality. The following section examines the CE data in telecom, one of the two most important sectors in the study. A similar critique could be applied to any of the other sectors.

#### 4.4.1. Telecom: inconsistent relations between market opening and performance

In Telecom the market opening index (MOI) generated by CE has no distinction between market opening in fixed and mobile sectors – just a single index. It shows that most countries had reached much the same level of market opening by 2003, but at differing rates. Three of the five elements however are relevant only to fixed telecom - third party access, pricing of third party access, and unbundling of local loop - which limits the relevance of this index to mobile telecom. CE then split the EU15 countries into three groups of high, average and low market opening, with the distinction between the groups established by intuition: “The splitting of the countries in these three groups is not based on “tough” objective criteria but rather on the natural grouping that seems to follow a graphical illustration” (CE2 ). CE then correlate these ‘natural’ groupings with performance on price and productivity. The same process, but with different indicators of market opening and different groupings, is repeated for other sectors.

These ‘natural’ groups, however, do not show consistent relationships to fairly important data. For example, the groups with high market opening have lower market concentration in fixed telecom – but higher concentration in mobile telecom. (CE2, tables 7.7 and 7.8). The data on price shows the group with most market opening doing best – but the group with lowest market opening doing better than the group with average opening (CE2, table 7.11). In general “prices tend to go down with the level of market opening..... However, the bi-variate relationship is not strong, indicating that other explanatory variables quite sensibly have a role”. (CE2 p.128).

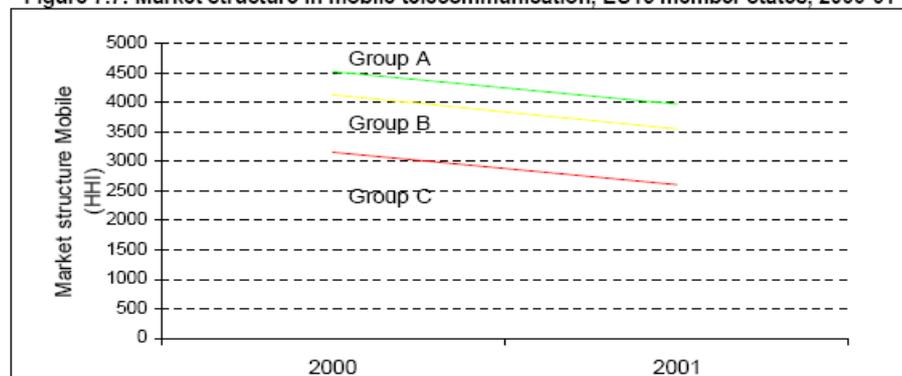
**Figure 7.11: Price performance, medium users' basket**



Note: Prices shown here are based on standard tariffs in real prices, Euro per year, including VAT. Deflators are based on 1990 price level. Calls to mobile are included from 1998. The baskets also include fixed costs, i.e. the annual rental plus part of the nonrecurring cost. Group A is green, Group B is yellow, and Group C is red.  
 Source: DG INFO-SOC/Teligen and Copenhagen Economics, Market Opening Milestone Database

There is only one set of data presented which is specific to the mobile telecom sector. That data is extremely limited – it concerns two years only - 2000 and 2001 – and shows the degree of concentration measured by the HHI, which shows a very high level of concentration (3100-4500: equivalent to market domination by 2 or 3 operators) falling in the following year, in all three groups, to a level which is still equivalent to market domination by 2.5-4 operators (2500-4000). The order of the three groups is the *reverse* of what CE expect - the faster opening countries have higher concentrations; and the fall is the same for all three groups. (CE2 p.124). CE’s only direct data on mobile telecom thus shows very high concentration, which is higher in countries which have opened markets more, and which changes regardless of the degree of market opening. This does not support generalisations about more market opening leading to better performance.

**Figure 7.7: Market structure in mobile telecommunication, EU15 member states, 2000-01**



Note: Group A (green) will tend to represent the countries with high levels of market opening compared to EU15 average and with many years above EU15 average. Group B (yellow) will tend to represent the countries with MOIs close to the EU15 average and with a medium number of years above EU15 average. Group C (red) will tend to represent the countries with MOIs lower than the EU15 average and therefore also with a small number of years above the EU15 average.

The relations between the groups and productivity (table 7.13) are also improbable and unresponsive of CE’s expectations. They show that the group with highest market opening (A) displayed productivity growth of about 25% over 5 years, double the rate of the group with lowest market opening (C) – but far behind the performance of the average group (B) which recorded a remarkable productivity growth of over 90% in the same 5 years. CE acknowledge the problem, if not the scale of it: “However, a bit unintuitively, Group B performs better than Group A”. (CE2 p.128). This is surely inadequate. Unless the intuition is preferred to the data, this result does not support generalisations about the performance benefits of market opening.

Figure 7.13: Productivity performance in telecommunications, EU15 member states, 1996-2001

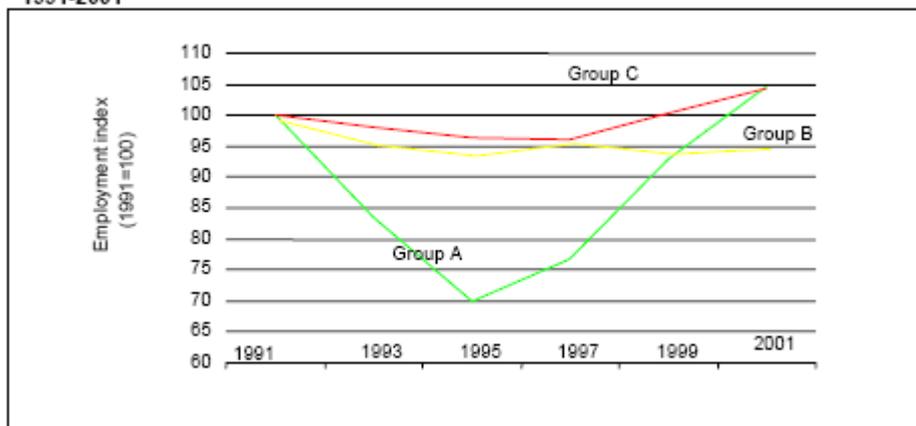


Note: Interpolation on employees has been done in 1996 and 1998 in order to create a coherent time series suitable for this figure. Group A is green, Group B is yellow, and Group C is red.

Source: Own calculations on OECD Communications Outlook and Copenhagen Economics Market Opening Milestones database

The data on employment is also curious: CE use data showing that in Group A countries – with highest market opening – employment fell by 30% in just 4 years to 1995, and then rose by 50% over the next 5 years: ending up at the same point as the countries with least market opening, who had arrived there by more modest fluctuations, both slightly above the employment level of the average, which has declined slightly and then remained very stable for 8 years (table 7.15). CE do not consider the possibility that the data, or their grouping of it, may be flawed (nor do they indicate which of these three paths they regard as optimal).

Figure 7.15: Employment performance in telecommunications, EU15 member states, 1991-2001



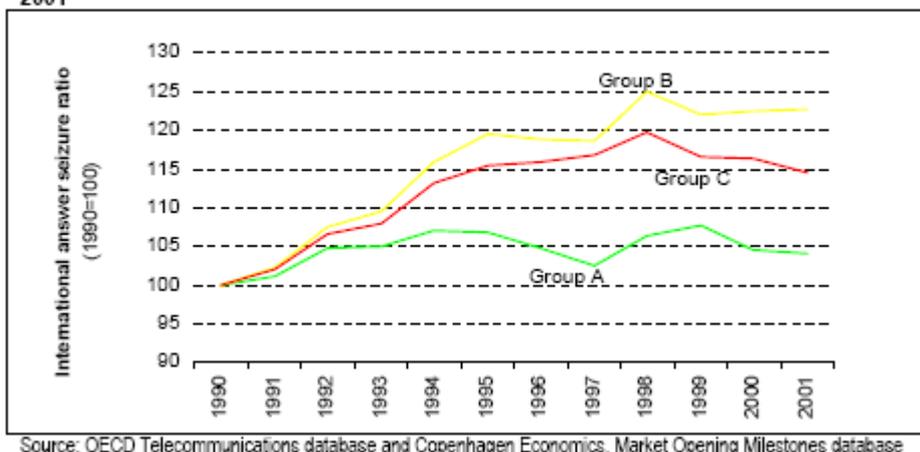
Note: Group A is green, Group B is yellow, and Group C is red.

Source: OECD Communications Outlook and Copenhagen Economics Market Opening Milestones database

On the question of quality, CE find that the cost of directory enquiries is correlated with the degree of market opening of their natural groupings: but the other measure of successful completion of international calls appears to show the opposite, with the least open group (C) improving their performance by 15% in 11 years – more than three times the improvement of the most open group (A) – whilst the average group did even better (Table 7.17). CE's comments are understated: "We have no evidence that Group A achieves better results than Group B and Group C. On the contrary, there are some indications that the quality is lower for Group A member states, cf. figure 7.17. One interpretation could be that market opening tends to lower quality in this area. Another interpretation could be that quality initially was "artificially" high due to government dictating amounts and effort spend on this particular dimension of quality. So now, in a more open market, this quality might previously have been too expensive to uphold and is now coming down in Group A as telecommunication companies adjust to a more competitive market." In this case CE do consider

the possible limitations of the data: “Finally, it must be recognised that the success of international calls depends on both the calling and receiving member state, which may indeed distort the picture.”

Figure 7.17: Quality performance in telecommunications, EU15 member states, 1990-2001



#### 4.4.2. Mobile telecom: thin data, inappropriate indicators, and implausible mechanisms

Telecom, especially mobile telecom, is an important success story of the benefits of market opening for the EPNI. The EPNI announces that ‘Accumulated productivity improvements of 93% can be attributed to market opening in mobile telecommunications’. (p.10). It also emerges in the EPNI (annexe Table 9) with a forecast of long-run productivity gains of between 153% and 383%. This impact in telecom is also responsible for a significant part of the spillover effects of employment and growth in the rest of the economy. But the basis of the forecasts made by CE is not robust enough to support such massive claims.

The models for mobile telecom are derived from an econometric analysis of the relationship between CE’s market opening indicators and prices and productivity – first in mobile telecom, then in fixed telecom. It is the results of this analysis which are used to construct the model which forecasts the price improvements, productivity gains, and economic benefits on which their conclusions – and those in the EPNI – are based.

For the effect on prices in mobile telecom, the data used by CE is very thin: “We have observations from all 15 member states but the time series varies between three and six observations (out of ideally 14).” The model is constructed using this data, processed until: “In the final model we see positive and highly significant estimates on the cost of inputs capital and labour. Meaning that higher costs imply higher prices.” (CE2 p.136) In addition to this interesting result, they find that there is a significant contribution from their market opening index (MOI), although at an earlier stage, step 2, the MOI was “insignificant”. Using this final model – “chosen because it has the best statistical and economic interpretable properties” - CE then extrapolate long-run estimates.

The MOI which emerges as the significant variable here is CE’s single index covering fixed and mobile telecom. It includes five elements: Ownership, Pricing of third party access, Third party access, Unbundling of the local loop, and Choice (p.120, figures 7.2 and 7.3). As noted earlier, three of these have no relevance at all for mobile telecom - third party access, pricing of third party access, and unbundling of local loop: it is therefore hard to think of an explanatory mechanism connecting these factors to changes in mobile prices. Of the remaining two, the level of choice, according to CE’s index, is identical in all 15 states (except Ireland). The remaining element, ownership, covers the extent of privatisation of both fixed and mobile sectors. It is not credible that this compound can be used to explain price changes in mobile telecom.

The calculation of the relations with productivity in mobile telecom is based on a similarly small data set (82 observations over 15 countries and 14 years). It arrives through a similar process at a final model which identifies not the MOI, but ownership alone, as the significant factor. CE say this is: “in accordance with expectations where private owners focus on profitability and increasing the productivity, whereas public

owners might have many other incentives as well.” (CE2 p.138). This is a surprising comment, as the result is at odds with other studies which suggest that privatisation by itself makes no significant contribution to improving efficiency or productivity.<sup>41</sup> In any case, ‘ownership’, which refers to privatisation, is a very poor indicator to use for liberalisation or market opening: as the UK showed in 1984, it is possible to completely privatise the whole telecom sector, without any market opening. And, again, this ownership variable is based on the ownership in the sector as a whole, not only mobile telecom: but it is hard to find a plausible mechanism that could make the degree of privatisation of fixed telecom should have any bearing on the growth of productivity in mobile telecom.

**This may be summarised as an unimpressive attempt to use a very small amount of data, a single, inappropriate indicator, and a generally discredited belief about privatisation, to make a claim about the impact of a different category, market opening. Yet it is this result on mobile telecom which features prominently in the EPNI’s summaries of the results.**

The results for fixed telecom are different, but also include surprises. The factors of unbundling, third party access, and choice are identified as significant in reducing prices – but changes in market structure are apparently have a small impact in the opposite direction: “that higher market shares to new entrants raises prices. ... The result could mean that significant changes in market structure is not necessarily a precondition for market opening to lower prices.” (p.141). This should be a significant result for the Commission, which pays a lot of attention to such changes in market structure: if this CE result is taken seriously, in at least one sector it appears not to matter now many competitors are entering the market.

For productivity (based on just 45 observations for 15 countries across 14 years) , all the elements of the market opening index turn out to be significant, in contrast to mobile telecom where only ownership mattered. There is no discussion of why this result should be so different between the sectors.

The scale of the long-run effects are also quite different between the two sub-sectors. In fixed telecom the long run impact is about twice as large as the short term impact: “due to the dynamic adjustment in prices as a response to changes in the explanatory variables, e.g. market opening. Each shock carries around 50 percent over to the next period and so forth” (p.141). However, in mobile telecom, the long run effect is only slightly larger than the short-run effect “Due to the fast adjustment of shocks to a new equilibrium” (p.136). There is no discussion of why one market should behave so differently from the other.

The results for other sectors show the same pattern of variable and contradictory results, based on similarly limited data: for example, rail passenger transport, where the results imply that market opening will reduce productivity, but will reduce prices because of the impact of public service obligations.

For rail passenger transport, the analysis of the impact on prices shows, at the first stage, a significant *negative* correlation between the cost of capital and labour and prices: “indicating, unintuitively, that higher cost of capital and labour reduces prices.” (CE2 p.186). The final results then show that the single most important factor is the basis for compensation for the public service obligation, in other words the formula for government subsidy. CE interpret this as evidence that competitive tendering, on the basis of awarding the contract to the company seeking the lowest subsidy, has the effect of driving down prices. The results also show that “increased market share of the incumbent may in fact lead to lower prices.” (CE2 p.186), for which CE offer the inventive explanation that “countries with high market share of the incumbent often go hand in hand with efforts to increase competition whereby the incumbent is facing competitive pressure from other railway undertakings not on the market, but with the possibility to enter the market.”. As for the speed at which markets are opened, CE have the interesting result that “the country that introduce market opening at a slower pace will experience a larger decrease in prices” (CE2 p.190). This also falsifies some of the inaccurate generalisations in the EPNI e.g. “those Member States that initiated market opening early and that have opened markets more have gained the most.” (p.10)

On productivity, the analysis generates the interesting finding that the impact of labour input on productivity “is insignificant in the short run” (p.189). The use of a formal public service obligation significantly improves productivity, which CE interpret as “confirming the expectation that introduction of legal contracts for provision of public service obligation may have a positive impact on productivity”. However, the formula for government subsidy for the public service obligation – which was the only factor with a major impact in

reducing prices – emerges as having the effect of *reducing* productivity, on which CE comment that “This pattern could perhaps be the result of insufficient incentives for railway undertakings operating under tendered contracts.” (p.189). The final model also finds that “more international competition lowers productivity”. (p.189) Overall the result is that market opening has a *negative* impact on productivity.

#### 4.5. Short-run and long-run impact and benefits to the whole economy

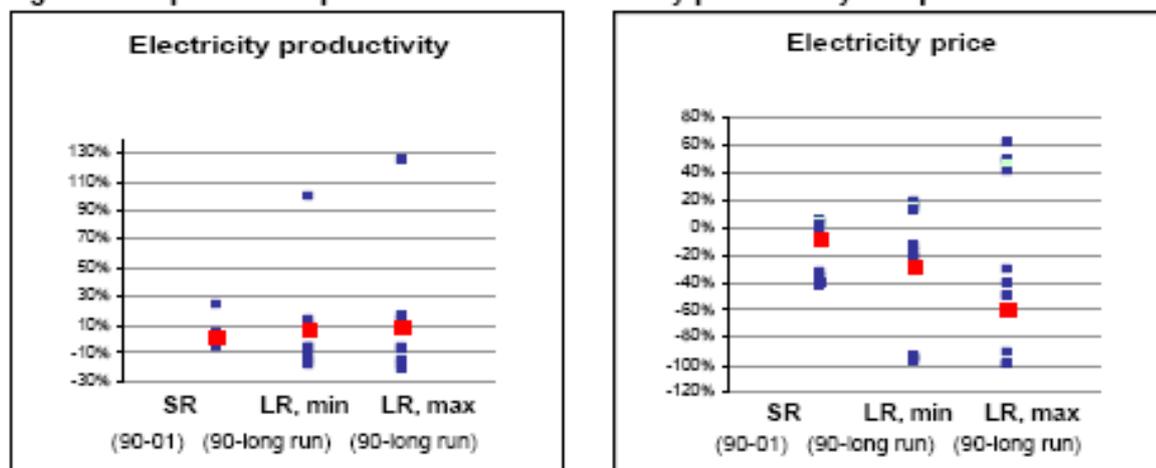
The EPNI claims that the benefits to the general EU economy are already established, arguing that “it is important to note that the analysis is essentially an ex-post assessment as market opening has already taken place” and further insists in a footnote that “when the effects of market opening are fully realised, there will be 500,000 more jobs in the EU economy than if market opening had not taken place. But since market opening has already taken place, many of these new jobs already exist in the EU economy.” (EPNI-Ap.43)

This sounds as though the CE study is reporting observed, actual improvements in performance. However, this is not so. Even the figures which refer to the past are forecasts, not observations.

Copenhagen Economics are more cautious than the EPNI: “we shall strongly emphasise that the longer term gains are considerably more uncertain than the gains already achieved and reported above.” (CE1 p. 8-9). This is partly because CE’s models are based on data up to 2001, a period with little market opening for most countries in a number of sectors, including electricity and telecom. The estimates of long-run impacts use this model, based on limited market opening, to forecast large future gains from the observed extension of market opening in 2000-2003, and CE note that: “Especially for telecommunications and electricity, market opening increased dramatically in the years 2000-2003 which leads to predictions of strong impacts on performance in the future years (long-run). But data for the econometric models often ends in 2000/2001 meaning that the dramatic increase in market opening is not reflected in the econometric model. Had it been, the estimated long-run impact from LR market opening might very well have been smaller.” (CE1 p.45).

The uncertainty of the forecasts can be seen from the graphics in CE’s report, which show the great scattering of estimates. Even for the short-run impact, the estimates range between a 20% increase in productivity and a 10% reduction, and between a 10% increase in prices and a 40% reduction. The long-term estimates cover an even wider range - the long-run impacts on electricity productivity range from a reduction of 25% to an increase of 130%, for the long-run impact on prices the spreads are even greater, from a 65% increase in prices to a 100% reduction. The extent of these spreads indicate great uncertainty. The estimates on prices suggest that there may be a serious flaw, since a 100% reduction in electricity prices appears as one possible result of the impact of market opening. Even the most passionate believer in liberalisation has never previously suggested it could lead to zero prices.

Figure 4.2. Spread of impact estimates in Electricity productivity and price.



Note: The figures show the spread of estimated impacts in electricity productivity and prices. The complete set of estimates comes from the numerous econometric specifications made to assess the stability of results. The highlighted, red dots are the point estimates singled out from this array of estimations to represent the impact from 1990-2001 (short run) and 1990-long run minimum and maximum values (long run). For both price and productivity

#### 4.6. Benefits to the whole economy

The EPNI also implies that the CE estimates of the spillover effects on the whole economy are based on actual data: **“The econometric simulation has shown that market opening resulted in a permanent increase in welfare (consumption) of 1.9% (€98 billion per year) and an economy-wide employment increase of about 500 000 jobs (0.3% of total EU employment)”** (p.10). The estimates for the impact on the whole economy are, however, entirely derived from the forecasts made by CE’s model, modified by the relationship between the sectors and the EU economy as a whole. The results of these calculations have no more credibility than the forecasts on which they are based.

Again, the EPNI emphasises the apparently huge contribution made by market opening (or, to be more precise, forecast by CE to occur as a result of one of CE’s indicators of market opening). This needs to be put in context however. Even CE’s forecasts only assign a minor role to market opening in productivity growth: productivity growth in telecommunications amounted to 114% over the period 1990-2001, but only 22% points are attributed to market opening by CE’s forecast; the same picture emerges for electricity, with overall productivity growth of 10%, to which CE forecast a 2% contribution from market opening. On prices, CE forecast for market opening effects represents two-thirds or more of the observed fall in prices.

Any fall in prices and/or improvement in productivity in these sectors has the same impact on the economy, regardless of the cause. The size of the sectors themselves will shrink, but the fall in prices will stimulate increased demand in other sectors.

As for the long-term effect, CE rightly warn that **“The large uncertainty regarding the long-run effects means that no reliable conclusions can be drawn regarding the economy-wide effects of market opening.”** (CE1 p.70). Unfortunately they then ignore their own advice and print a table with just such estimates.

Figure 5.1 from CE1 report: Blue is actual changes, red is CE forecasts of effect of market opening indicators

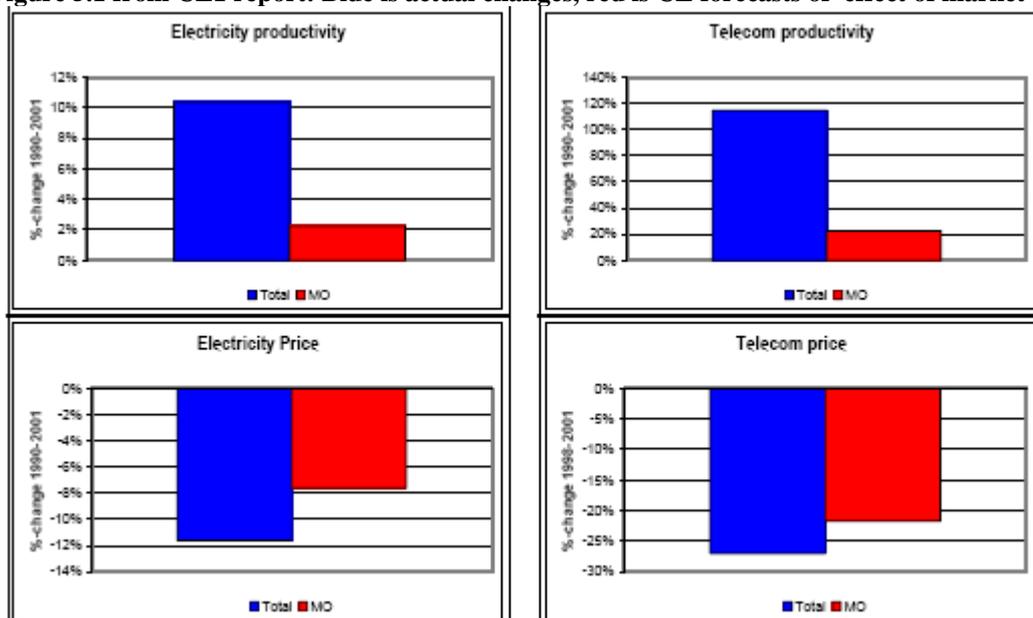


Figure 5.2. Change in share of total economy, 1990-2001.



## 5. Conclusions

The EPNI and the CE study fail to support the defence that is offered for liberalisation. Without the CE study, the report has very little to offer in support of the benefits of liberalisation. The CE results do not stand up to much examination, and certainly do not support the claims made for them by the Commission in the EPNI.

A different process should be adopted in future, along the lines indicated in previous critiques:

- A democratic process should be created as a public vehicle for future evaluations. Such a democratic process could be built on consultation of stakeholders, organised public meetings in member states, structured debates in the European parliament.
- Future evaluation should be conducted by a body independent of the Commission. It could be based on a European observatory on Services of General Interest/Services of General Economic Interest, consisting of experts at national and European level, producing an annual report, a website, and ad hoc reports, all open to all stakeholders and citizens - including public authorities, operators, consumers/users, unions, etc –to provide inputs to and take feedback from the meetings and consultations
- The evaluation should include at least four objectives:
  - assess the expected impact of liberalisation on EU level objectives - e.g. efficiency, productivity, price levels etc - against evidence of the actual developments under liberalisation;
  - assess the impact of the liberalisation directives, internal market rules, state aid rules and other EU level frameworks on the ability of Member States to organise Services of General Interest according to policies and structures determined locally and reflecting national and local conditions and histories.
  - assess the extent to which Services of General Interest in member states contribute to numerous public policy objectives;
  - provide sets of comparative information which can assist member states in improving their own services, and also consider collaborative arrangements which might
- A clear framework of objectives also makes clear what responses should follow the evaluation. The EC should be prepared to re-assess its policies on liberalisation in the Services of General Economic Interest, and to respond to the results of the evaluation with comments and proposals for action to address the issues identified; member states can use the results for internal review of services, and develop collaboration between member states where appropriate. This cooperative model for improving public service performance is already being used within member states, for example in water services in Netherlands and Austria

Beyond the evaluation itself, there remains a need for a framework for European support and development of public services. This needs to be based on a 'bottom-up' approach, with democratic mechanisms determining the agenda, and directed at improving the effectiveness of services in achieving public policy objectives. There is a clear positive role for the EU to perform in many public services, both by facilitating and encouraging cooperation and mutual evaluation of policies and practices, and by developing its role of funding and supporting measures to improve cohesion between different regions, states, and groups of people.

## 6. Notes

- <sup>1</sup> The author wishes to acknowledge very helpful comments and suggestions by Pierre Bauby, Barbara Sak, Christelle Pezon, Werner Raza, Jorg Huffschmid, Markus Krajewski, Andres Sanz, Andres Caballero, Penny Clarke, and Jan-Willem Goudriaan. Any faults that remain are the author's.
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- <sup>17</sup> For a detailed critique of the policy and action plans see [www.psiru.org/reports/2006-01-EU-ENP.doc](http://www.psiru.org/reports/2006-01-EU-ENP.doc)
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