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Competitive Neutrality
and State-Owned
Enterprises: Challenges and
Policy Options

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Abstract

COMPETITIVE NEUTRALITY AND STATE-OWNED ENTERPRISES: CHALLENGES AND POLICY OPTIONS

By Antonio Capobianco and Hans Christiansen*

Competitive neutrality implies that no business entity is advantaged (or disadvantaged) solely because of its ownership. The Paper argues that far from all SOEs have the opportunity or the incentives to act in an anti-competitive way, and a trend in recent decades toward more fully corporatised and commercially operating SOEs has no doubt improved overall efficiency. However, problems remain, not least in the network industries where many remaining SOEs are market incumbents that continue to enjoy monopolies in part of their value chains or government subsidies, purportedly in compensation for public service obligations. Renewed concerns about competitive neutrality have also arisen from the market entry of SOEs domiciled in countries where the process of corporatisation has yet to run its full course.

To counter these problems some OECD countries as well as the European Union have established specific competitive neutrality frameworks. These frameworks go beyond addressing the anti-competitive behaviour of SOEs, to also establish mechanisms to identify and eliminate such competitive advantages as they may have, including with respect to taxation, financing costs and regulatory neutrality. The experience so far with such formal arrangements is generally encouraging. Jurisdictions that have them have generally been successful in rolling back state subsidies and, on the evidence to date, have obtained significant economic efficiency gains.

The Working Paper concludes that a full implementation of the OECD Guidelines on Corporate Governance of State-Owned Enterprises would go a long way in ensuring competitive neutrality. The business activities of currently unincorporated segments of the government sector would become much more competitive and accountable if they were made subject to the Guidelines. For incorporated SOEs the Guidelines also include a portmanteau recommendation of a “level playing field”. However, they offer only limited concrete recommendations on how governments are expected to obtain this outcome in practice. The Guidelines are moreover weakly implemented in a number of countries.

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COMPETITIVE NEUTRALITY AND STATE-OWNED ENTERPRISES: CHALLENGES AND POLICY OPTIONS

This report was prepared as a first step in the OECD Working Party on State Ownership and Privatisation Practice's ongoing project on competitive neutrality. It is part of an effort to provide a comprehensive empirical overview of the significance of state-owned enterprises worldwide; their role in markets and their impact on economic activity. The paper was considered by the Working Party in October 2010 and approved for publication.

The report was developed jointly by the Secretariats of the Working Party and the Competition Committee. It is partly based on earlier discussions of the corporate neutrality of SOEs by OECD Competition Committee's Working Party 3 on Co-operation and Enforcement in October 2009 and by the Committee itself in February 2010. Some of the central parts of the paper draw on background documents developed for these earlier events.

The report has four main parts. First, the main sources of competitive advantages, and incentives for SOE managers, boards and government owners to use them, are discussed. Second, some national approaches to countering these advantages and incentives (establish "competitive neutrality frameworks") are described. Third, approaches available to competition agencies to counter anti-competitive practices by SOEs are reviewed. Finally, options to help enhance competitive neutrality are discussed, including through further developing and strengthening the implementation of the SOE Guidelines.

1. A stocktaking of concerns about competitive neutrality

Across the OECD area many public sector businesses are providing services (throughout the document this term is used synonymously with state-owned enterprises – SOEs), in competition with private sector businesses, or in areas where private sector businesses could potentially compete. The experience of OECD countries illustrates that in these competitive or potentially competitive markets, several possible sources of competitive distortions can arise because of advantages some public sector businesses have due to their government ownership. Governments may create an uneven-playing field in markets where an SOE competes with private firms, as they have a vested interest in ensuring that state-owned firms succeed. Accordingly, despite its role as regulator the government may, in fact, restrict competition through granting SOEs various benefits not offered to private firms. While in some areas this preferential treatment will be direct and obvious, there may also be indirect preferential treatment through other means.

A good, comprehensive definition of what is implied by "competitive neutrality" is provided by the Australian Government, whose standing Productivity Commission includes a "Competitive Neutrality Complaints Office"¹. An excerpt of the definition is provided in Box 1.

¹See "Competitive Neutrality Policy Statement" available at www.treasury.gov.au/documents/275/PDF/cnps.pdf.

Box 1. An Australian definition of competitive neutrality

Competitive neutrality requires that government business activities should not enjoy net competitive advantages over their private sector competitors simply by virtue of public sector ownership.

The implementation of competitive neutrality policy arrangements is intended to remove resource allocation distortions arising out of public ownership of significant business activities and to improve competitive processes. Where competitive neutrality arrangements are not in place, resource allocation distortions occur because prices charged by significant government businesses need not fully reflect resource costs. Consequently, this can distort decisions on production and consumption, for example where to purchase goods and services, and the mix of goods and services provided by the government sector. It can also distort investment and other decisions of private sector competitors.

Competitive neutrality requires that governments should not use their legislative or fiscal powers to advantage their own businesses over the private sector. If governments do advantage their businesses in this way, it will distort the competitive process and reduce efficiency, the more so if the government businesses are technically less efficient than their private sector competitors.

Competitive neutrality is supported by the OECD Guidelines on Corporate Governance of State-Owned Enterprises (the “SOE Guidelines”). The overarching recommendation in Chapter I of the SOE Guidelines states that “[t]he legal and regulatory framework for state-owned enterprises should ensure a level-playing field in markets where state-owned enterprises and private sector companies compete in order to avoid market distortions. The framework should build on, and be fully compatible with, the OECD Principles of Corporate Governance”. The recommendation of a “level playing field” is fully consistent with common definitions of competitive neutrality. The second sentence of the citation takes on an importance of its own because the corresponding Chapter of the Principles recommends frameworks to be “developed with a view to its impact on overall economic performance, market integrity and the incentives it creates...” In other words, whereas governments are free to set rules and objectives for their SOEs consistent with overall political priorities, an ultimate goal should be to enhance economic performance and market integrity.

1.1 Basic competitive advantages of some SOEs

In most instances, SOEs enjoy privileges and immunities that are not available to their privately-owned competitors. These privileges give SOEs a competitive advantage over their rivals. Such advantages are not necessarily based on better performance, superior efficiency, better technology or superior management skills but are merely government-created and can distort competition in the market. For example (a concrete case is presented in Box 2):

- *Outright subsidisation.* Some SOEs receive direct subsidies from their government or benefit from other public forms of financial assistance to sustain their commercial operations. For example, the favourable tax regimes or exemptions from certain taxes that are enjoyed by SOEs are tantamount to selective government subsidies. Another form of subsidisation is in-kind benefits, for instance where state-owned operators in the network industries receive benefits such as land usage and rights of way at a price significantly below what private competitors would have had to pay in like circumstance. These exemptions artificially lower the SOEs’ costs and enhance their ability to price more efficiently than competitors subject to a full tax regime.

- *Concessionary financing and guarantees.* SOEs may enjoy credits directly from governments, or provided via state-controlled financial institutions, at below-market interest rates². A related area is explicit or implicit state guarantees for SOEs, which reduce their cost of borrowing and enhance their competitiveness vis-à-vis their privately-owned rivals. This anti-competitive effect may be somewhat more “accidental”, in that it is perfectly rational for commercial lenders to lower their rates when the debtor is perceived as enjoying state backing, and it may in practice be difficult for the state to convince markets that a given enterprise is not subject to such guarantees³. Conversely, the presence in OECD countries of a number of SOEs with negative book equity values may serve as an illustration of the continued importance of government guarantees. Moreover, SOEs of some sectors and/or some corporate forms may enjoy outright exemptions from bankruptcy rules.
- *Other preferential treatment by government.* In some cases, SOEs are not subject to the same costly regulatory regimes as private firms, lowering their operating costs. According to the national context, these exemptions may, for example, include compliance with disclosure requirements and exemptions from antitrust enforcement, building permit regulations or from zoning regulations. Moreover, notwithstanding the relatively stringent public procurement rules of most OECD countries, some SOEs may in practice continue to benefit from preference in public procurement. This may not necessarily reflect onerous practices at the level of general government – merely an accumulated competitive or informational advantage allowing SOEs to tailor their offers more closely to government requirements. SOEs may also benefit from more general information asymmetries, by having access to government information or data which are not available to their private competitors or only available to a limited extent.
- *Monopolies and advantages of incumbency.* In many cases, governments entrust SOEs with exclusive or monopoly rights over some of the activities that they are mandated to pursue. This can be seen, for example, in postal services, utilities and other universal services that the state decided to pursue through state-controlled entities. Where SOEs continue to benefit from a legal or natural monopoly this may be of little practical consequence for the competitive landscape, but a number of SOEs in the network industries operate as vertically integrated structures with incipient monopolies in parts of their value chains. This can have a direct effect on relative competitiveness, and it may also allow them to influence the entry conditions of would-be competitors across a number of commercial activities.
- *Captive equity.* SOEs’ equity is generally “locked in”, i.e. in other words control of an SOE cannot be transferred as easily as in privately-owned firms. The inability to transfer ownership rights will result in a number of advantages for SOEs, such as: (i) some SOEs are generally absolved from paying dividends or indeed any expected return to shareholders⁴; (ii) SOEs will be more inclined to engage in anti-competitive (and rarely

² This has been expressed repeatedly as a concern regarding some countries’ sovereign wealth funds. The allegation has been made that some of these entities had a central role the provision of subsidised credit in support of governments’ industrial policy objectives.

³ For example, the US government in the 1990s on some occasions tried to raise the funding costs of the “government sponsored entities” Fannie Mae and Freddie Mac by publicly declaring that these institutions would not be subject to a government bail-out in case of failure.

⁴ However, this contrasts sharply with certain other SOEs which are effectively used as “cash cows” by their national treasuries. Such enterprises may be expected to convert the monopolies they enjoy into a stream of fiscal revenues.

profitable) exclusionary pricing strategies, such as predation, without fear of falling stock prices when losses are incurred due to the below-cost pricing; and (iii) SOEs' management will have less incentives to operate the company efficiently as it is not subject to the threat of takeovers and generally impervious to the disciplining effects of capital markets.

- *Exemption from bankruptcy rules and information advantages.* SOEs often enjoy exemptions from bankruptcy rules. Because equity capital is locked, SOEs can generate losses for a long period of time without fear of going bankrupt. In addition, SOEs may also benefit from information asymmetries. Information asymmetries occur when SOEs have access to data and information which are not available to their private competitors or only available to a limited extent.

Box 2. The example of the US Postal Service

In the United States for example, the federal government grants the US Postal Service (USPS) a number of the advantages that are listed above. For example, USPS is granted an exclusive monopoly over both the delivery of letters and the use of customers' mailboxes. It is allowed to borrow directly from the Federal Financing Bank which guarantees public bonds at interest charges which are lower than the market rates for private companies of comparable risk. The federal government also guarantees the USPS debt. Finally, the USPS has the power of eminent domain; it is immune from paying parking tickets for its vehicles and from paying the vehicle registration fee; it can purchase fuel tax free and it does not have to apply for building permits or conform to local zoning regulations. In addition, for many years USPS enjoyed an express immunity from antitrust liability for conduct undertaken at Congress' command under the Postal Reorganization Act of 1970. The Postal Reorganization act of 2007, however, explicitly allows for the application of antitrust law to the US Postal Service where competitive services are concerned*.

Note.

* This development followed the Supreme Court decision in the United States Postal Service Industries.

1.2 Are SOEs anticompetitive by error or design?

1.2.1 Why governments may decide to depart from competitive neutrality

As a starting point it must be recognised that the notion of state-owned enterprises operated according to totally commercial principles is in most cases “a pie in the sky”. Even privately owned companies may pursue objectives that are not wholly commercial. In the case of SOEs the reason the state has decided to remain as (majority) owner is logically that those enterprises are expected to behave differently from what private entities might. The question, then, is whether the state's objectives can be pursued in a manner that does not impair the competitive landscape. According to “textbook economics” this is mostly possible when the state intervenes in the economy with the purpose of remedying market failure. In practice this argument is most convincingly brought forward in favour of SOEs in sectors with a strong element of natural monopoly, the potential abuse of which by private operators would be difficult to address through regulation⁵. A variation of the externalities argument, which is particularly relevant in the light of the many commercially operating SOEs in emerging economies, relates to the use of SOEs as agents of developmental policies. The use of SOEs to develop certain economic activities for

⁵ Market failure also occur where business activities create “externalities” – e.g. widespread societal benefits for which no market price can be charged – which may arguably be corrected by reserving the activities for SOEs. However, in this case governments retain the alternative option of correcting the market failure through remedial payments to private operators.

which, at the outset, there is no market in order to nurture private commercial activities can also be portrayed as an effort to correct externalities.

Recent evidence from OECD economies suggests at least three main reasons why governments may sometimes make a conscious decision to depart from competitive neutrality in their SOE sectors. These are briefly suggested below:

- *Maintaining public service obligations.* The most commonly heard rationale for protecting SOEs from “excessive” competition occurs in the network industries and relates to these companies public service obligations – such as maintaining postal and telecommunication services in outlying areas, providing essential utilities at affordable rates, etc. From a strictly economic perspective this does not imply that these companies must remain in the public domain as these objectives could be similarly met through targeted subsidies. (In effect the SOE Guidelines says that they should be, if the company remains in public ownership.) However, it is often seen by public planners as easier to continue providing public services through fully controlled entities. On a slightly more onerous note, continued state ownership also provides an opportunity for cross-subsidisation areas – e.g. by charging excessive revenues in certain “lucrative” areas in order to be able to fund the public service obligations elsewhere. In addition to their effects on the competitive landscape such practices also fall short of commonly agreed standards of transparency. However, they appear to be quite widespread. On numerous occasions, the first opening of segments of any given network industry to market competition has given rise to accusations of unfair “cherry picking” by the entrant. Taken literally this does seem to indicate that the activities concerned were previously used to generate extraordinary profits that could be used to cross-subsidise other activities.
- *SOEs as a tool for industrial policy.* Relatively few OECD countries these days appear to be assigning a pro-active industrial policy role to their SOEs sectors – such as, for example, obligations to develop certain capabilities or pursue knowledge and technologies in the broader national interest. Conversely, the practice has remained commonplace in some emerging economies. Many OECD countries do, however, seem to attach “defensive qualities” to their state ownership, aiming to maintain companies alive and in state hands because of fears of no longer having a national champion in certain economic sectors. Some of the considerations motivating the internationalisation of SOEs point in that direction. Several governments encourage foreign operations of state-owned incumbents in the network industries “to protect their revenue streams” faced with increasing domestic competition. This motivation makes sense only in a context where the state attaches societal value to the maintenance of a state-owned company in the respective sectors. Governments may differ in respect of whether state-ownership is a goal in itself or a tool for preventing a foreign takeover.
- *Protecting fiscal revenues.* Some SOEs provide consistently large profits (or in some cases revenues) on which the national treasury comes to depend. This has most frequently been the case in the extractive industries⁶, but is also not uncommon in the utilities sectors. From a competition viewpoint this may be particularly problematic, because not only does it imply that the government has a strong incentive to shield of

⁶ Another frequently heard argument for governments to own SOEs that control natural resources is that they want to control the time preference in the rate of exploitation. According to context this may be construed as an effort to correct externalities.

such SOEs from competition, the high revenue stream itself may depend on monopoly rents.

- *The political economy of SOEs.* Policy makers sometimes feel they need to protect SOEs because of pressures from interest groups or the general public. For instance, SOEs remain a major source of employment in many OECD countries. Also, SOEs are often seen as offering civil service status or higher paid jobs – especially for blue collar employees – and in some countries have more generous retirement arrangements than the private sector. Any failure of the State to shield its enterprises from competition from companies decried as “low-wage” or “not maintaining adequate standards of corporate responsibility” could expose politicians to strong public pressures. Whilst formally related to democratic accountability, such mechanisms have the potential to be used by rent-seeking insiders to stifle competition.

1.2.2 *Corporate governance weaknesses as a source of anticompetitive behaviour*

Some of the points listed above serve as an illustration of an issue that has attracted increasing attention in recent corporate governance literature⁷, namely a “third agency problem” between the general public ultimately owning SOEs and the public officials supposedly acting on their behalf. In the words of one academic observer of the SOE sector “the only way the SOE shareholder equivalents can ‘vote with their feet’ is indirectly through national elections”⁸. By this logic – as of yet not strongly reflected by the SOE Guidelines – a failure of politicians and civil servants to deal with state-owned enterprises as fiduciary agents of the general public could in itself be cast as a shortcoming of corporate governance. Not all the rationale for anti-competitive behaviour suggested above qualify equally to fall in this category. For example, politicians might successfully argue that the protection of public service obligations as well as a prudent industrial policy is in the general public interest. However, the final discussion about the political economy of SOEs does touch upon a number of areas where high officials may make decisions in their own, as much as the general public’s, interest.

Moreover, when discussing corporate governance in a more traditional sense of the word it needs to be kept in mind that the corporate shape of SOEs differs markedly across countries and sectors. There has also been a development over time. For example, listed enterprises with the State as their majority owner have (reflecting, among other things, fiduciary duties as well as listing requirements) less scope for pursuing non-commercial objectives than wholly-owned unlisted stock companies. The latter, for their part, are constrained by corporate law from engaging in some of the practices regularly ascribed to corporate activities operated out of government departments or statutory corporations operating solely under their own legal framework. In that sense, the trend toward increasing corporatisation (and in many cases stock-market listing) of SOEs in OECD countries over recent decades has in itself contributed to greater competitive neutrality, while not removing the problem entirely.

Among the corporate governance problems, classically defined, that could contribute to anti-competitive practices, the incentives facing SOE top management figure prominently. In SOEs that are un-corporatized or otherwise subject to weak corporate governance arrangements these incentives, as suggested above, include sometimes very soft budget constraints. Freed from

⁷ A recent standard reference is L. Caprio, M. Faccio and J.J. McConnell (2008), “Sheltering Corporate Assets from Political Extraction”, AFA 2009 San Francisco Meetings Paper. The topic has also been come up in numerous studies of the reform process in post-communist economies.

⁸ D. Daniel Sokol *op. cit.*

concerns about corporate failures, managers may feel freer to pursue “aggressive” strategies. Even for commercially-oriented SOEs, the presence of actual or perceived government guarantees may have qualitatively similar effects.

The degree to which a market for SOE managers exists varies according to country and context. At one extreme, fully commercial SOEs listed on stock exchanges are in principle free to recruit managers from private competitors, and vice versa, although in some countries the government owners of such enterprises continue to rely on “internal” recruitment from within companies themselves or civil service. In many other SOEs incumbent management may feel their position protected by a lack of alternatives⁹. Additional factors that have sometimes led to SOE managerial entrenchment are some cases of cronyism within the general government as well as the formation of coalitions between management and employee interest groups. Regarding the latter point, labour unions are in many OECD countries guaranteed seats on SOE boards, and whether or not this is the case, they wield a non-trivial political influence. By placating these groups managers may further secure their own position.

Moreover, many governments are limited in their ability to incentivise SOE managements – whether entrenched or not – to pursue purely profit maximising strategies. Most SOE sectors operate subject to formal rules on compensation that do not allow for the kind, or at any rate level, of incentivisation (e.g. a share of the profit; equity based pay) that is commonly used in the private sector.

The outcome of a combination of incentives that effectively limits both the upside and the downside for SOE managers has in practice often been a “civil service attitude” of protecting one’s company turf by competing for revenue and market shares rather than profitability. In the words of a representative of the state ownership agency of an OECD country, the managers of SOEs have strong incentives to try and expand the scope of business because “especially in medium-sized or monopolistic SOEs they are often bored and perceiving an unfulfilled potential”¹⁰.

The government bodies charged with the ownership function and regulation of SOEs are obviously responsible for countering any adverse managerial incentives through the imposition of company objectives and boardroom oversight. The degree to which they have been effective in doing so is to some extent discussed in the following sections. Suffice to mention here that the government ownership functions (and to some extent SOE board members) are themselves subject to shifting incentives. Having limited time and resources they naturally focus on SOEs that are, for either economic or political reasons, perceived as “problem companies”. SOE managers that provide a steady stream of income consistent with the objectives set for their enterprises, may in practice be subject to either weak or benevolent oversight. Recent experience in some OECD countries even points to some examples where a strong reliance by the national treasury on the high revenues generated by a few SOEs has to some extent shielded these enterprises’ management from scrutiny of their aggressive overseas expansion plans¹¹.

⁹ Relative to private companies the absence of a “market for corporate control” may have a similar effect on managerial incentives.

¹⁰ The remark was made specifically concerning overseas expansion, but can be assumed to apply equally in other contexts.

¹¹ Op. cit.

2. Competitive neutrality frameworks

Competitive neutrality frameworks (CNFs) focus on reforming the environment that public and private entities compete in. Introducing a CNF involves a systematic review of the legislative and administrative landscape in which SOE's operate, and a reform of that landscape so that the conditions in which SOE's operate are as closely matched to those faced by private sector competitors as possible. CNFs also improve transparency and accountability of government business's activities by presenting their costs in a comparable manner to the private sector. In other words, competitive neutrality aims to promote efficient competition by minimising competitive advantages government business activities may enjoy over their private sector competitors simply because they are government owned.

An explicit targeted CNF draws together those components of competition laws, other rules and regulation and governance reforms that redress competitive neutrality problems and extend the reform program to cover smaller government business activities and any remaining competitive advantages. CNFs also include ex post mechanisms to monitor the implementation and effectiveness of the competitive neutrality framework and rectify any remaining issues. CNF's are not, as yet, the common procedure in many countries.

Competitive neutrality reforms provide an alternative for dealing with an SOE's competitive advantages. They form part of the interim strategy for preparing the market for competition by levelling the playing field between state-owned and privately-owned enterprises, that is to eliminate the advantages that SOEs enjoy because of their government ownership. Countries have developed a range of options for dealing with competitive neutrality issues, influenced by their circumstances and policy priorities.

The source of the competitive neutrality problem must be considered. If the competitive distortions arise from a deliberate decision by a government to favour its businesses, then "advocacy" may be the most effective approach. Most competition agencies have the right, at their own discretion, to alert policy makers to the likely impact of their decisions on the competitive landscape. This process can also be used to generate a broader public awareness of a problem.

Alternatively, if the competition distortions are the unintended consequences of other government policies, then transparency rules and specific competitive neutrality policies may be more effective. Nearly all countries use advocacy, to some extent, to encourage efficient and fair competition between public and private sector businesses. As we have seen above, some countries are using remedies that deal with competitive neutrality problems ex post, for example applying competition law to require public sector businesses to cease actions that have a detrimental impact on competition. The use of competition law can help address competitive neutrality problems where the government businesses fall within the scope of competition law because they are of sufficient size, have sufficient impact on the market and are not covered by any specific exclusions. Such competition law-based approaches can stimulate a competitively neutral environment, but can only deal with specific problems after they have occurred.

Other countries deal with competitive neutrality issues ex ante, through policies that change the governance arrangements or industrial organisation of public sector businesses to reduce the scope of the advantages these businesses have, changing and enforcing procurement policy in a way that equalises competition between the public and private sectors, or reforming the approach to subsidising public services to ensure that these subsidies do not advantage public sector businesses over private sector businesses. The effectiveness of these policies depends on

whether they cover all government organisations providing commercial services in competitive or potentially competitive markets, whether the policies address all the sources of competitive advantages and disadvantages, and how the policies are implemented and enforced.

2.1 The scope of competitive neutrality policies

There is no universal definition of a government business activity and therefore identifying the different types of government activities covered by CNF's can be complicated. Issues to consider include:

- *Levels of government.* It should be considered whether all levels of government, i.e. national, regional and local, should be included in the CNF. While larger national and regional SOE's may appear the most potent threat to competitive neutrality, the economic significance of local government has become increasingly clear. Local government often competes with the private sector in key industries such as recreational activities, childcare, education, health care, housing and transport. Therefore CNF's that do not, for example, encompass local level government could exclude a significant amount of government business activity.
- *Commercial nature of activity.* For a CNF to apply the activity of the SOE must be commercial, i.e. the entity needs to be organised in accordance with commercial principles and be commercial in character. However, it is important to distinguish between non-profit and unprofitable activities. Due to social objectives an SOE may be required to provide certain services at zero profit, or even at a loss. These types of non-profit services should be left outside the CNF.
- *Actual/potential competitors.* There must be competitors in the market for a CNF to be effective, i.e. there should not be any legislation prohibiting competition. However, the competitors do not have to be 'actual' as the existing advantages afforded to a SOE may have prevented 'potential' competitors from entering.
- *Cost/benefit analysis.* A CNF is beneficial if the benefits of the reforms are greater than the costs. Therefore it may be necessary to subject each individual SOE to a costs/benefit analysis. While in theory a CNF may be suitable for smaller SOE's in practice this may not be cost effective if there is little potential competition on the market, and a requirement for substantial changes to the administration.

After identifying the scope of competitive neutrality reforms, the next step is the removal of any competitive advantages of SOEs. A government business activity could obtain an advantage in competing with the private sector from any aspect of its regulation, management or the method of pricing its products and services. Governments that implement competitive neutrality policies need to address these advantages. The competitive advantages may include any or all of the ones suggested in Section 1.1.

2.2 *Monitoring and enforcement*

Any competitive neutrality reform requires ongoing monitoring and enforcement to be effective. The most appropriate approach will differ from country to country depending on existing institutions and their roles, the extent of the reforms being introduced, the type of business activities subject to those reforms and the provisions available for education and training programs.

Monitoring involves the formal process of reporting on the progress and success of new reforms, ensuring adherence to the original rules decided upon, and amending any areas that may need adjusting to ensure the continued effectiveness of the reform. Monitoring can be conducted in a variety of ways including:

- Through a *regulator*, who would be given responsibility for researching and reporting on the implementation and success of the reform.
- Through *government departments* or *Ministers*, who would be given responsibility for reporting on reform within their area of responsibility.
- Through the *SOE itself*, who could be required to report on its progress.
- Through *periodic reports*, which could be commissioned to review the implementation and success of the reform.

Enforcement involves the mechanisms used to impose obligations on SOE's to implement the competitive neutrality reforms. Enforcement measures will vary from country to country in both type and level of severity, but commonly would include:

- *Legislation*. Specifying how SOE activities must be conducted when and SOE is competing with the private sector.
- *Administrative mechanisms*. Requiring SOE's to comply with their competitive neutrality obligations.
- *A formal complaints handling body*. Responsible for investigating claims from competing businesses that an SOE is not complying with its obligations, and with the power to take remedial action.
- *Existing country specific mechanisms*. Most governments have existing mechanisms under which agencies are accountable for their compliance with government policies. These could be adapted to accommodate competitive neutrality obligations.

2.3 *Competitive neutrality in the European Union*¹²

Some countries have special competition-law rules to deal with the effects of distortions in competition between government and private entities. Countries that are members of the European Union or use the EU model often have a provision like Article 106 EC (formerly Article 86 – see Box 3), setting the rules for entities that perform services of general economic interest or are granted special or exclusive rights. Broadly, Article 106 EC provides that the services performed by government entities, or private entities on behalf of the government, should be subject to the competition provisions of the EC Treaty unless the application of such rules obstructs the performance of the particular tasks assigned to them under the law.

Box 3. European Union Model Provision: Article 106 EC

1. In the case of public undertakings and undertakings to which Member States grant special or exclusive rights, Member States shall neither enact nor maintain in force any measure contrary to the rules contained in this Treaty, in particular to those rules provided for in Article 18 and Articles 101 to 109.
2. Undertakings entrusted with the operation of services of general economic interest or having the character of a revenue-producing monopoly shall be subject to the rules contained in this Treaty, in particular to the rules on competition, in so far as the application of such rules does not obstruct the performance, in law or in fact, of the particular tasks assigned to them. The development of trade must not be affected to such an extent as would be contrary to the interests of the Community.
3. The Commission shall ensure the application of the provisions of this Article and shall, where necessary, address appropriate directives or decisions to Member States.

The first characteristic of the EU approach is that the principle of neutrality was recognised in the Treaty of the European Union for more than 50 years. Article 106 of the Treaty clearly establishes that public companies fall under the scope of competition law, and that member states of the EU are not entitled to do anything contrary to this rule. Public companies are also subject to rules on monopolisation and state aids (subsidies). The second characteristic of the system is that the Treaty empowers the European Commission with the tools to tackle problems concerning the economic activities of public sector companies. The Commission can require the member states to apply competition rules to public companies. And, if a public company infringes competition rules, the Commission itself can issue a decision against that company requiring it to stop the conduct, and can impose fines. If the public company infringes competition law with the assistance of the government, or due to governmental influence (for example the government requiring the company to charge abusive prices), the Commission can address a directive or a decision to the member state, requiring it to stop these practices.

In addition to Article 106 EC, the European rules on state aid and subsidies apply to all subsidies and state aids that member states or other public bodies provide to any company, public or private. They are particularly important in the context of public companies, given the specific relationship public bodies have with public companies. State aids cover not only capital injections or grants, but also tax reductions or tax holidays, reductions in the social security costs and warranties. State aids are generally forbidden, though there are exceptions. The member states are obliged to notify the Commission if they plan to grant state aid to any company. The

¹² See the paper submitted by European Commission to the OECD Competition Committee Roundtable on Regulating Market Activities by the Public Sector (2004) www.oecd.org/competition/roundtables.

Commission then scrutinises the planned measure and decides whether to authorise it. Another tool used by the Commission to achieve competitive neutrality between public and private firms is the transparency directive,¹³ which concerns the financial relationships between public bodies and public companies. The transparency directive requires separate accountability. Public companies that have both commercial and non-commercial activities need to separate their accounts to demonstrate how their budget is divided between commercial and non-commercial activities. These tools have been used in many sectors, including the postal, energy and transport sectors¹⁴.

2.4 Competitive neutrality in Australia

Australia has a specific competitive neutrality policy but it is less integrated with competition policy than in Europe. Australia's competitive neutrality policy is based on the principle that government businesses operating in competitive or potentially competitive markets should not enjoy net competitive advantages over the private sector because of their public ownership. The competition authority, the Australian Competition and Consumer Commission (ACCC), does not play a major role in implementing the competitive neutrality principle. The National Competition Council and the Productivity Commission are in charge of implementation.

Australia had already begun corporatizing government businesses by the time of a 1993 review of competition policy – the Hilmer Report. That review found that while subjecting government business activities to the provisions of competition law was important, this would not address all concerns about the cost advantages and pricing policies of government businesses. For example, market distortions would still arise where government businesses were exempted from certain taxes or received subsidies. It also found that where problems arose from within governments, it was appropriate to address them through ex-ante policy measures. Therefore, the governmental agreement in 1995, signed by all Australian governments, introduced competitive neutrality policy.

The responsibility for implementing this policy rests with government policy agencies for several reasons. Firstly, competitive neutrality is not based in competition law; rather it has been developed and implemented within government. At the national level, the policy is the responsibility of the Australian Treasury. Secondly, it seeks to encourage policy implementation. It takes an educative approach such that competitive neutrality policy and enforcement bodies work with governments to achieve implementation. It also recognises that individual governments may retain some flexibility, for example where they are at different stages of reform, while competition law is applied uniformly across all jurisdictions. Thirdly, sanctions are provided for through a system of financial penalties upon recommendation by an independent body, the National Competition Council.

Compliance measures at the federal level are consistent with state arrangements. A Complaints Unit was established in the independent Productivity Commission, which is the

¹³ Commission Directive 80/723/EEC of 25 June 1980 on the transparency of financial relations between Member States and public undertakings (OJ L 195, 29.7.1980, p. 35). This Directive has been amended several times, most recently by Directive 2005/81/EC (OJ L 312, 29.11.2005, p. 47) and codified by Commission Directive 2006/111/EC of 16 November 2006 (OJ L 318, 17.11.2006, p. 17-25).

¹⁴ For example, in order to increase transparency and avoid cross-subsidies, public service operators which are subject to public transport service obligations but also engage in other activities, must have separate accounts corresponding to each of these activities (See Regulation (EC) No 1370/2007 of the European Parliament and of the Council of 23 October 2007 on public passenger transport services by rail and by road, and repealing Council Regulations (EEC) No 1191/69 and (EEC) No 1107/70)

primary advisor to the Australian Government on microeconomic reform issues. There have been relatively few formal complaints. These arrangements do not restrict the power of the ACCC to take action under competition law.

The goal in Australia is to remove any distortions in a market that arise because a business is publicly owned. The policy applies: where there is a market; to significant government business activities (this is where the gains are greatest); to all levels of governments; and only to the extent that the benefits outweigh the costs of the implementation. It does not apply to non-business, non-profit activities. The key principles under competitive neutrality are:

- 1) taxation neutrality, which requires that a government business is not advantaged by taxation exemptions or advantages not available to its competitors;
- 2) debt neutrality, which requires that a government business is subject to similar borrowing costs to its competitors;
- 3) regulatory neutrality, which requires that a government business is not advantaged by operating in a different regulatory environment to its competitors;
- 4) commercial rate of return, entities are required to earn a return sufficient to justify a long-term retention of assets in the business and pay commercial dividends; and
- 5) prices reflect costs, which requires agencies undertaking significant business activities as part of a broader range of functions to set prices to reflect full cost attribution for their business activities, in part to ensure that public funds provided for non-business, non-profit activities are not used to subsidise business activities.

Australia's approach also addresses where governments seek to subsidise non-commercial service obligations. Such subsidies may enable government businesses to achieve a competitive advantage, for example cross-subsidise other activities. In Australia, non-commercial service obligations must be clearly identified and funded so that prices reflect full cost attribution. The National Competition Council assesses whether commercial service obligations have been clearly specified and funded appropriately.

Australia's competitive neutrality policy has apparently worked well for the following reasons: (1) it deepened the reform of public enterprises in Australia; (2) it has been implemented by large governmental businesses, which led to significant efficiency gains; and (3) it substantially eliminated the advantages of government ownership.

3. Remedies available to competition agencies

The issue of whether or not SOEs aim to maximise profits or pursue other long-term objectives has been central to much of the recent debate about the use of competition to safeguard competitive neutrality. Competition law is focused on preventing dominant companies or cartels from restricting competition and raising prices. Many of the traditional regulatory remedies have shown themselves to be perhaps less suited to address a situation where the anti-competitive practice includes cross-subsidisation and lowering of prices. Moreover, some national jurisdictions have been wary of taking steps in this direction out of concerns that competition enforcement actions might inadvertently discourage price reductions.

In practice many of the tests habitually applied to establish whether a certain practice is anti-competitive assume that firms pursue a long-term profit maximisation objective. This, in turn,

makes them less applicable to state-owned enterprises which, as discussed above, face strong incentives to engage in non-profit maximising strategies. The challenges that this poses for competition regulators are described below.

3.1 A “catalogue” of anti-competitive practices

The advantages that SOEs may enjoy, where they exist, can in themselves affect competition by either providing a competitive edge to the state-owned entities or allowing them to remain in business despite more efficient competitors. In addition SOEs may leverage some of these advantages through deliberately anti-competitive practices. Most or all of these have also been employed by private companies, but the possible combination of market incumbency, preferential treatment and cheap finance makes anti-competitive strategies by SOEs particularly burdensome. Some of the main concerns in the past have surfaced in the network industries, and generally focused on predatory pricing, cross-subsidisation, efforts to raise competitors’ costs and strategic choice of technologies. These issues are briefly discussed in the following sub-sections. Some of the text is quite “technical”, in the vernacular of competition economists. An explanation of some of the most commonly used terms is provided in Box 4.

3.1.1 Predation

Government support of SOEs through government created immunities and privileges allow SOEs to price below marginal cost.¹⁵ This creates a situation where they are free to engage in predatory strategies – essentially lowering process in order to knock out competition. A successful antitrust predation case normally hinges on whether a company lowering prices has a realistic chance of “recoupment” (the clawing-back of lost revenues through subsequent price increases).¹⁶ However, SOEs enjoying significant subsidies and not necessarily aiming to maximise their long-term profits may engage in predation without recoupment. When SOEs operate at the same time in reserved and non-reserved markets, the concern is that the SOE can exclude competitors by pricing below costs and cross-subsidise to the competitive sector from the reserved sector without the need to recoup its losses in the post-predation period.

¹⁵ Lott, Are Predatory Commitments Credible?: Who Should the Courts Believe? 77 (1999) (arguing “government enterprises also face higher returns from below-cost pricing since they benefit not only from the long-term reduction in competition, but also from the short term increase in their output required to undertake the below-cost pricing strategy.”).

¹⁶ Sappington and Sidak, Competition Law for State-Owned Enterprises, 71 Antitrust L.J., 2003. An increasing economic literature notes that predatory pricing may be rational in other settings for profit maximising firms as well. See Bolton, Brodley and Riordan, Predatory Pricing: Strategic Theory and Legal Policy, 88 GEO. L. J., 2000 (describing that “modern economic analysis has developed coherent theories of predation that contravene earlier economic writing claiming that predatory pricing conduct is irrational” and thus that “the consensus view in modern economics [is] that predatory pricing can be a successful and fully rational business strategy.”).

Box 4. A mini-glossary of terms from competition economics

Predatory pricing: A strategy, usually by a dominant firm, of driving competitors out of the market by setting very low prices or selling below the firm's incremental costs of producing the output. Once the predator has successfully driven out existing competitors and deterred entry of new firms, it can raise prices and earn higher profits.

Recoupment: Reclaiming losses incurred during the predatory period through subsequent raising of prices above the marginal costs.

Variable costs: That part of cost which varies with the level of output. This is in contrast to fixed costs, which must be incurred for output to be possible at all, and do not depend on its level

Avoidable costs: The part of the cost of any output that could be saved by not producing it. Differs from variable cost mostly because certain variable costs may, in the short-term, not be avoidable if for example part of the costs are stipulated by long-term contracts

Marginal costs: The overall change that a company experiences by increasing production fractionally. Closely related to "incremental costs" which means essentially the same, but is expressed in terms of standards units of production.

Long-term variable costs: The variable costs when the time perspective is so long that capacity-determining decisions such as long-term contracts, staffing and capital investment are part of the variable element.

In some jurisdictions predatory behaviour does not violate the law unless the predator could recoup its losses,¹⁷ the principle being if loss recoupment is not possible then competition has not been harmed. However, public enterprises do not always aim to maximise profits and therefore do not recover losses in the same way as private companies. Therefore, the ability of SOEs to engage in non-recoupment predatory pricing raises important issues as to whether there is any consumer harm if prices do not go up as a result of the predation and if there should be a different legal standard for SOE's predatory strategies. The supporters of enforcement of antitrust laws against non-recoupment predatory pricing by SOEs argue that when an SOE can pursue a successful predation strategy, this reduces the resources of a competitor to innovate or operate. The "but for" case is that there might have been even lower prices and more innovation. Successful predation also may have reputational effects if a firm competes in multiple product markets. This reputational effect creates a credible threat that allows firms to reap the benefits of predation even in markets in which they did not predate. This in turn negatively affects the overall market.¹⁸

3.1.2 *Raising rivals' costs and raising barriers to entry*

Predation must be distinguished from raising a rival's costs.¹⁹ An assessment of whether or not predation takes place requires antitrust laws to balance short-term losses against long-term benefits. In raising rival's costs, the goal is to increase the price of output for rivals rather than decrease price. A successful costs raising strategy would enable the dominant firm to ensure its

¹⁷ OECD Report, Predatory Foreclosure, 2005.

¹⁸ Milgrom, Predatory Pricing, in The New Palgrave Dictionary of Economics, Eatwell, Murray Milgate and Newman eds., 1987.

¹⁹ Cope, Regulating Market Activities in the Public Sector, 7 OECD J. Comp. L. & Pol'y, 2005; Sappington and Sidak, Competition Law for State-Owned Enterprises, 71 Antitrust L.J., 2003.

average costs increased less than the “incremental costs” (the cost of embarking on a new activity) of a rival. This allows a dominant firm to create an asymmetric impact on costs relative to its rival and to induce competitors to reduce their output or increase their prices.²⁰ In this way, the SOE will see the demand for its product increase leading to broader economies of scale for its operations.

The ultimate goal of raising rivals’ cost differs from predation. A successful costs raising strategy does not require the firm with higher costs to exit the market, merely to allow the dominant firm to raise its price above the competitive level.²¹ As Sappington and Sidak suggest, “[c]onsequently, even though an SOE may value the profit that its anti-competitive activities can generate less highly than does a private profit-maximising firm, the SOE may still find it optimal to pursue aggressively anti-competitive activities that expand its own output and revenue.”²²

Given that an SOE may have revenue rather than profit objectives, it can more effectively absorb higher costs than its privately-owned rivals.²³ When an SOE can pursue an effective strategy for raising a rival’s costs, it can expand the scope of its operations. Predation or raising rivals’ cost takes away the ability for competitors to invest in increased research and development and limits their ability to roll out new products and services and processes that increase dynamic gains from innovation.²⁴ SOEs may have particular incentives to raise the costs of their rivals. As the rivals’ marginal cost increases, it may be costly to the SOE but it simultaneously increases the demand for the SOE’s product or service. Since the SOE’s main objective is to maximise revenues, the SOE benefits from the increased demand.²⁵

Strategies to raise rivals’ costs can take a variety of dimensions. For example: incumbent can attempt to prevent rivals from gaining access to essential infrastructures or inputs or increase the market price of those inputs by purchasing excessive amounts of the input;²⁶ confronted with new environmental regulations, incumbent companies can lobby hard to obtain grandfather clauses;²⁷ incumbents may lobby the government to adopt restrictive regulation that would make entry into the market more costly, unprofitable or even impossible for new entrants; incumbents can tailor their product or service such that consumers cannot easily switch to a rival’s product;²⁸ or companies can vigorously pursue patent extension applications and one of the objectives of this behaviour could be to impose additional (litigation and other) costs on rivals to delay or thwart their entry.

²⁰ Martin, *Advanced Industrial Economics*, 2d ed., 2002.

²¹ Krattenmaker and Salop, *Anticompetitive Exclusion: Raising Rivals’ Costs to Achieve Power over Price*, 96 *Yale L.J.*, 1986.

²² Sappington and Sidak, *Competition Law for State-Owned Enterprises*, 71 *Antitrust L.J.*, 2003.

²³ Scheffman and Higgins, *20 Years of Raising Rivals’ Costs: History, Assessment, and Future*, 12 *Geo. Mason L. Rev.*, 2003.

²⁴ Fox, *US and European Merger Policy--fault Lines and Bridges: Mergers That Create Incentives for Exclusionary Practices*, 10 *Geo. Mason L. Rev.*, 2002 (citing *United States v. Microsoft Corp.*, 253 F.3d 34, 50-53 (D.C. Cir. 2001)).

²⁵ Sappington and Sidak, *Incentives for Anticompetitive Behavior by Public Enterprises*, 22 *Rev. Indus. Org.*, 2003.

²⁶ Sappington and Sidak, *Competition Law for State-Owned Enterprises*, 71 *Antitrust L.J.*, 2003.

²⁷ These clauses allow the incumbent businesses to continue to operate under the older rules for a length of time while forcing any new business to meet the standards immediately. This can create significant cost asymmetries between incumbents and entrants with considerable harm to competition.

²⁸ Such restrictive contracts, with lock-in periods, have been found in industries such as telecommunications, natural gas, electricity generation and banking.

3.1.3 *Cross-subsidisation*

Many SOEs are active in both a monopolised market and in one or more competitive markets where the SOE competes with privately-owned rivals. In this case, the SOE is in a position to exploit any economies of scope and cost complementarities between the two markets. One of the most straightforward ways for an SOE to use its privileges in order to exclude rivals is to shift costs away from the competitive activities and charge them to the monopolised activities.²⁹ If an SOE is allowed to cross-subsidise, it can price below costs and reduce its competitors' share of the market or force them out of business or deter the entry of new competitors.

This is the case even if the competitors may be more efficient than the SOE. Moreover, a statutory monopoly prevents an efficient entrant in the second competitive market from achieving the same economies of scope as the SOE, thus increasing its marginal cost for supplying the competitive product. In addition to the economies of scope, the SOE may also indirectly benefit through economies of scale. If the SOE can set prices below cost by cross-subsidising between competitive and monopolised activities, the SOE output of the competitive product may increase. If that happens, the SOE will experience economies of scale that its rivals cannot achieve. The increased output will result in a decline in the SOE's unit cost of operation in the competitive market and will cause a further shift in sales from the rivals to the SOE's product.

3.1.4 *Strategic choice of inefficient technology*

If an SOE is in a position to strategically choose the technology, e.g. it has a choice among various production technologies that it can implement, it may use this opportunity to operate with an inefficient technology that secures a relatively low marginal cost at the expense of a particularly high overhead (fixed) costs.³⁰ The reason for pursuing such a strategy would be to secure an abnormally low level of marginal costs in order to relax a binding prohibition on pricing below costs.³¹ The less profit-oriented the SOE is, the higher its incentive to over invest in capital because the higher it values revenue relative to profit, the more it will benefit from an expanded output and revenues that can be achieved with a lower price. Hence, the greater is the technological inefficiency the lower its pricing will be.

Countries have developed a range of options for dealing with competitive neutrality issues, influenced by their circumstances and policy priorities. The source of the competitive neutrality problem is also relevant. If the competitive distortions arise from a deliberate decision by government to favour its businesses, then advocacy may be the most effective approach. Alternatively, if the competition distortions are the unintended consequences of other government policies, then transparency rules and specific competitive neutrality policies may be more effective. Competition authorities can and do play a role in ensuring a level playing field between public and private competitors. Some of the options available to competition authorities, and their limits, are discussed below.

²⁹ OECD Report on Non-Commercial Service Obligations and Liberalisation, 2003.

³⁰ Sappington and Sidak, Incentives for Anticompetitive behaviours by Public Enterprises, Review of Industrial Organization, 22, 2003.

³¹ See also Baseman, Open Entry Costs and Cross-Subsidization in Regulated Markets, in Gary Fromm eds., Studies in Public Regulation, Cambridge MA, The MIT Press, 1981; Brennan, Cross-Subsidization and Cost Misallocation by Regulated Monopolies, Journal of Regulatory Economics, Vol. 2, 1990.

3.2 Antitrust responses to competitive neutrality issues of SOEs

3.2.1 Ex post enforcement of competition rules on unilateral conduct

Some countries are using remedies that deal with competitive neutrality problems ex post, for example using competition law to require public sector businesses to cease actions that have a detrimental impact on competition. In general, the enforcement of competition law is neutral as to ownership of companies. Competition law applies to conduct of both private and public economic entities. Most OECD countries do not exclude public sector businesses from competition law (except a few specific enterprises that are exempted in some countries). However, there may be partial exemptions that protect some types of public sector businesses or some aspects of their business activities. Commercial activity by non-corporatised government-related entities in competition with the private sector is often enough to make those entities “undertakings” or otherwise subject them to competition law jurisdiction.

Box 5. Regulatory practices in predatory pricing cases

a) Cost benchmarks

There is no consensus on the best cost benchmark to use in predatory pricing cases, or even on whether an ideal measure exists, although the average avoidable cost test is gaining support among scholars and practitioners. Practices vary widely among jurisdictions concerning the cost measures used to analyse predatory pricing. Traditional tests such as the average variable cost (AVC) and average total cost (ATC) tests have long been criticised but continue to be used because they often have the virtue of being easier to apply than other cost tests. In some industries, including many of those where network effects are present, it makes little sense even to try to approximate marginal cost because it is close to zero, whereas fixed costs are relatively high. In other industries, it may be hard to distinguish variable from fixed costs in the first place. ATC, on the other hand, is usually difficult to apply without introducing a degree of arbitrariness into the process. Furthermore, both measures may be too lenient in predatory capacity expansion cases where costs tend to increase in large increments, rather than gradually over specific portions of output. That problem has led several jurisdictions to consider and/or apply the average avoidable cost test, which focuses solely on the range of a firm’s output that is allegedly predatory. It also takes fixed costs into account when they are specifically associated with the capacity expansion that accompanies a predatory campaign.

b) The recoupment test

The recoupment test aims to determine whether a company’s allegedly predatory pricing strategy would be likely to eliminate and deter competition, and whether it is likely that the predator would then be able to collect at least enough profit to recover the losses it sustained during its predatory attack. In other words, it does not focus on whether a predatory campaign was actually undertaken, but rather it assumes that one was and asks whether it matters. The recoupment test’s primary value is its ability to help competition agencies ensure that they are targeting behaviour likely to harm consumer welfare, and that they do not inadvertently reduce that welfare. The test accomplishes this by screening out cases in which the characteristics of the incumbent firm and the market make recoupment implausible, even if the firm sustained losses with the intent of eliminating competition and gaining the ability to charge supracompetitive prices. Such conditions may exist, for example, when entry barriers are low or when rivals are well-funded and determined to survive a price war. When recoupment is implausible, consumers are at low risk of long term harm. In fact, they are made better off by the dominant firm’s price cutting while it lasts, which is why it could be harmful if a competition agency nevertheless intervenes.

In a number of OECD countries, competition rules on abuse of dominance and monopolisation have provided the basis for investigating and sanctioning business conduct by SOEs. These cases, mostly related to pricing abuses, have shown the complexity of enforcing competition law against public entities. All OECD countries have rules on predation which establish that it is abusive, and therefore illegal, for a dominant firm to price below a certain level of its costs. The standard applied by OECD countries, however, varies as countries take different level of costs as benchmark for predation (average variable cost, average avoidable cost, long run average incremental costs) , and some countries require recoupment of losses for a successful predation case while other do not (further details in Box 5).

This poses issues when applying dominance rules to SOEs. In particular, two issues have emerged in the literature³²:

- *SOEs can engage in non-recoupment predation.* Because of the soft budget constraint, SOEs may have goals other than profit maximization such as revenue maximization. This, together with government support through government created advantages (such as, for example, explicit and implicit subsidies), allow SOEs to price below marginal cost. This creates a situation which does not require recoupment for successful SOE predation. The ability of SOEs to engage in non-recoupment predatory pricing raises important issues as to whether there is any consumer harm if prices do not go up as a result of the predation and if there should be a different legal standard for SOE's predatory strategies. The supporters of enforcement of antitrust laws against non-recoupment predatory pricing by SOEs argue that when an SOE can pursue a successful predation strategy, this reduces the resources of a competitor to innovate or operate. The “but for” case is that there might have been even lower prices and more innovation. Successful predation also may have reputational effects if a firm competes in multiple product markets. This reputational effect creates a credible threat that allows firms to reap the benefits of predation even in markets in which they did not predate. This in turn negatively affects the overall market.
- *Cost-based predation tests may not be suited to SOEs.* The difficulty in calculating the appropriate measure of costs of public business entities and to benchmark these costs against similar private firms can be daunting, particularly when the governance arrangements for the government businesses lack transparency or their accounting practices are poor. These difficulties combined with conflicting incentives between SOEs and privately-owned firms, can result in a variance in the application of antitrust standards between private companies and SOEs.

However, the use of competition law and particularly of competition rules on abuse of dominance can help address competitive neutrality problems only where the government businesses fall within the scope of competition law because they are of sufficient size, have sufficient impact on the market and are not covered by any specific exclusions. Such competition law-based approaches can encourage an environment for competitive neutrality but can only deal with specific problems after they have occurred. Concrete examples of predation cases are provided in Box 6.

³² For example, D.E.M. Sappington and J.G. Sidak (2003), “Competition Law for State-Owned Enterprises, *Antitrust Law Journal*, Vol. 71, No. 2.

3.2.2 Using merger control rules to level the playing field

In all OECD member countries, large investments which allow the investor to acquire a controlling share in a company must be approved by the competition authority ex-ante, so that a successful approval process becomes a condition for the deal. In most OECD countries merger control rules are ownership neutral and equally apply to private as well as state-controlled investors. When states or state-controlled entities operate in the marketplace as commercial operators, their activities are not immune from merger enforcement. Acquisitions by foreign government-controlled entities are routinely subject to merger review.

The purpose of merger control is to identify and investigate competition-related concerns arising from M&A activities. Competition concerns may arise if a transaction is expected to increase market power resulting in higher prices (or in lower quality or less choice) for consumers (unilateral effects); or if the transaction changes the nature of competition in such a way that firms will be significantly more likely to coordinate and raise prices or otherwise harm effective competition after the merger in terms of lower product quality or less innovation (coordinated effects).

Box 6. Examples of SOE predatory cases

Deutsche Post. On March 2001, the European Commission issued its first Article 82 EC decision in the postal sector, finding that the German postal operator, Deutsche Post AG (DPAG), had abused its dominant position in the market for business parcel services by granting fidelity rebates and engaging in predatory pricing.¹ DPAG was fined EUR 24 million in respect of the foreclosure resulting from its long-standing scheme of fidelity rebates. No fine was imposed in relation to predatory pricing given that the economic cost concepts used to identify predation were not sufficiently developed at the time.² From the investigation, it transpired that DPAG was using revenues from the letter delivery monopoly to finance below-cost selling in the open market for business parcel services.

The Commission decided that any service provided by the beneficiary of a monopoly in open competition has to cover at least the additional or incremental cost incurred in branching out into the competitive sector. Any cost coverage below this level is to be considered predatory pricing. The investigation revealed that DPAG, for a period of five years, did not cover the incremental costs for providing the mail-order delivery service. This decision was of a particular interest, as the European Commission considered that a derogation under the EC competition rules was not applicable because termination of the fidelity rebates and an increase in DPAG's price to cover at least the incremental cost of providing mail-order parcel services would not prevent DPAG from complying with its statutory obligation to perform a service of general economic interest ('carrier of last resort').

US Postal Service. In the United States Postal Service v. Flamingo Industries,³ the Supreme Court of the United States was called to decide if the US Postal Service (USPS) enjoyed antitrust immunity. When the USPS decided to terminate a contract with Flamingo Industries, a supplier of mail-sacks, Flamingo sued in U.S. district court claiming that the Postal Service declared a "fake emergency in the supply of mail sacks" so it could give no-bid contracts to cheaper foreign manufacturers without allowing U.S. companies to compete for them. Flamingo claimed that with its behavior the USPS had sought to suppress competition and created a monopoly in mail sack production and that this violated federal antitrust laws (among other charges). The district court dismissed the antitrust claim reasoning that the federal government is protected by sovereign immunity. The Ninth Circuit Court of Appeals reversed on the antitrust immunity count. It ruled that the 1970 Postal Reorganization Act (PRA) waived the Postal Service's sovereign immunity and that it could be sued under federal antitrust laws as a "person". The Supreme Court ruled that USPS was not subject to antitrust liability. According to the Court, in both form and function, the USPS is not a separate antitrust person from the United States but is part of the government, and as such it is not controlled by the antitrust laws.

Hence the Supreme Court concluded that, absent an express congressional statement that the Postal Service can be sued for antitrust violations despite its status as an independent establishment of the government, the PRA does not subject the Postal Service to antitrust liability. The Court found this conclusion consistent with the nationwide, public responsibilities of the Postal Service, which has different goals from private corporations, the most important being that it does not seek profits. It also has broader obligations, including the provision of universal mail delivery and free mail delivery to certain classes of persons, and increased public responsibilities related to national

security. Finally, the Court found that the Postal Service has powers and characteristics which makes it more like a government than a private enterprise, including its state-conferred monopoly on mail delivery, the powers of eminent domain and the power to conclude international postal agreements.

Japan Post. The Japanese postal service has also been investigated for predatory pricing claims. In a private suit,⁴ both the Tokyo District Court and Tokyo High Court rejected the plaintiff's predatory pricing claim against Japan Post. The resolution of the case turned around the question of whether the plaintiff had brought sufficient evidence to prove its predatory pricing claim. As the Japan Federal Trade Commission ("JFTC") had not bought a case of its own first, the plaintiff could not obtain the necessary cost data from the defendant to prove its claim that Japan Post had priced its services below cost. This case is, however, interesting because the High Court argued that Japan Post's cost in commercial parcel delivery should not be calculated on a "stand-alone" basis (i.e., separately from the cost incurred for the provision of the regulated postal delivery). The Court argued that it is economically rational for an enterprise, when it enters into new business, to make use of its resources in its existing business. In 2006, the JFTC published an opinion on the case as a study group report, arguing that a "standalone" approach should be used for allocating common fixed costs when a monopolist in market A entered market B.⁵ The Tokyo High Court in Yamato rejected the "standalone" cost method because it was not sufficiently established as a legal test.

Notes.

- 1 Case COMP/35.141 (OJ L 125, 5.5.2001).
- 2 To address the concerns raised by the Commission during the investigation, DPAG undertook to create a separate company to supply business parcel services which would be free to procure the 'inputs' necessary for its services either from DPAG (at market prices) or from third parties or to produce these inputs itself. In addition, DPAG undertook that all inputs it supplies to the new company would be supplied to its competitors at the same price and under the same conditions. This development followed the Supreme Court decision in the United States Postal Service Industries.
- 3 See further in Box 7.
- 4 540 U.S. 736 (2004).
- 5 Yamato v. Japan Post, Tokyo High Court decision, 2006 (Ne) No. 1078, LEX/DB Legal Database No. 28140088 (28 November 2007).

Should any of these concerns be identified, the competition authority can block the transaction unless the parties can offer sufficient remedies to the competition concerns. The ability to impose remedies allows competition authorities to affect the structure of competition of the markets affected by the transaction to ensure that effective competition is not significantly impeded. Remedies can be structural or behavioural. To the first type belong divestiture commitments which allow for the creation of a new competitive entity in the market. To the second type belong remedies foreseeing the granting of access to key infrastructure, networks, key technology, including patents, know-how or other IP rights, and essential inputs³³. When applied to SOEs, these remedies can reinstate a level playing field on markets where SOEs enjoy competitive advantages over privately owned competitors. An example of a concrete case involving the merger of an SOE is provided in Box 7.

³³ Normally, the parties grant such access to third parties on a non-discriminatory and transparent basis.

Box 7. The merger between Gaz de France and Suez

In November 2006, the European Commission approved under the EU Merger Regulation the merger of Gaz de France (GDF) and the Suez group.* After an in-depth investigation, the Commission initially found that the deal would have anticompetitive effects in the gas and electricity wholesale and retail markets in Belgium and in the gas markets in France. The Commission's concerns related mainly to the removal of the increasing competitive pressure that GDF and Suez had so far exerted (and would have exerted in the foreseeable future) on each other in both Belgium and France.

Given the conditions on the markets, including the very high barriers to entry, their respective dominant positions would have been considerably strengthened by the merger. In response to these concerns, approval of the merger was subject to extensive remedies including the divestiture of Distrigaz (the strongest competitor of GDF in Belgium) and Suez relinquishing its control of Belgian network operator Fluxys. In light of these structural remedies, the Commission concluded that the merger would not significantly impede competition in the European Economic Area (EEA) or any substantial part of it.

Note.

* Case No COMP/M.4180 – Gaz de France/Suez.

The use of merger rules to re-establish a level playing field, however, can help address competitive neutrality problems only where there is an event that qualifies as a concentration, that this event is likely to limit effective competition in the market and that there is a link between the remedies and the likely anticompetitive effects of the proposed transaction.

Box 8. State Action Defence

a) *In the United States*

The Supreme Court of the United States first addressed antitrust liability for conduct directed by the government in 1947 in *Parker v. Brown*. In *Parker*, a group of raisin producers agreed on output restrictions, an agreement subsequently ratified by a state department of agriculture. The Supreme Court held that anti-competitive conduct is immunised from antitrust enforcement if two cumulative conditions are met: (i) The conduct "must flow from a clearly articulated and affirmatively expressed state policy"; and (ii) Be subject to "active state supervision". Under *Parker*, therefore, a conduct that follows the direction of clearly articulated and affirmatively expressed state policy and is subject to active state supervision, is protected from antitrust liability. The state action defence has been applied in a number of cases after *Parker*, including trade association cases, in which US courts have refined and clarified the interpretation of the two *Parker* conditions. In particular, courts have applied close scrutiny to the meaning of 'clear articulation of a state policy', refusing to extend the defence to every governmental activity; courts have also closely scrutinised the application of the 'active supervision' criteria, objecting to the defence where such supervision is de facto rarely or never exercised.¹ For example, in *Retail Liquor Dealers Association v. Midcal Aluminium Co.*,² the defence was denied to a trade association's 'price posting' system because, although the system was established by law, it was not properly supervised as prices continued to be left to the discretion of the participating dealers.

b) *In the European Union*

In Europe, the European Court of Justice (ECJ) has considered the issue of state measures with anti-competitive effects and their relationship with the competition provisions in the EC Treaty since the seventies³. Most cases, however, discuss the state action doctrine, which outlaws state measures hampering the effectiveness of the EC competition rules applicable to undertakings, rather than the state action defence, which immunises private behaviour fully determined by lawful public measures from the competition rules. As early as 1977, the ECJ concluded that: "while it is true that Article [82] is directed at undertakings, nonetheless it is also true that the Treaty imposes a duty on Member States not to adopt or maintain in force any measure which could deprive that provision of its effectiveness",⁴ that is, a wide obligation to abstain from depriving

Article 82 of its effectiveness. Likewise, continued the Court, “Member States may not enact measures enabling private undertakings to escape from the constraints imposed by Articles [81] to [89] of the Treaty”.⁵

The scope of the duty of Member States not to enact or maintain state measures which may affect the application of the competition rules of the Treaty was clarified over the years by the European courts in a number of cases. In *Eycke*,⁶ the ECJ re-stated the principle established in *GB-Inno-BM* that the EC Treaty requires the Member States not to introduce or maintain in force measures, even of a legislative nature, which may render ineffective the competition rules and clarified that “such would be the case, [...], if a Member State were to require or favour the adoption of agreements, decisions or concerted practices contrary to Article [81] or to reinforce their effects, or to deprive its own legislation of its official character by delegating to private traders responsibility for taking decisions affecting the economic sphere”.⁷

As for the state action defence, which is the natural complement to the state action doctrine, the Court held that the Member states’ obligations under the Treaty are distinct from the antitrust liability of the private entities under the EC competition rules.⁸ According to the Court, the state action defence is very narrow and it does not exempt private entities from antitrust liability as such. Under EC law, companies are not responsible if their anti-competitive behaviour is required by a public measure and companies had no space for ‘autonomous conduct’. The ECJ held that such defence is based on “the general Community-law principle of legal certainty”.⁹ However, the undertakings are responsible under the EC competition rules and may incur fines if the public measure “merely encourages, or makes it easier for undertakings to engage in autonomous anti-competitive conduct”. In such cases, antitrust liability can be established but the national legal framework may be taken into account as a ‘mitigating factor’ to reduce the fine imposed.¹⁰

Notes.

1 *FTC v. Tior Tiles Inc.*, 504 US 621 (1992), cert. denied, 114 S.Ct. 1292 (1994).

2 445 US 97 (1980).

3 Cruz, *The State Action Doctrine*, in Amato & Ehlermann, *EC Competition Law – A Critical Assessment*, Hart Publishing, 2007.

4 *Case 13/77, GB-Inno-BM*, [1977] ECR 2115, para 31.

5 *Id.* at para 33.

6 *Case 267/86, Van Eycke*, [1988] ECR 4769.

7 See para 16. The meaning of terms such as ‘requiring’ or ‘favouring’ an illegal conduct and ‘reinforcing’ the effects of such conduct or ‘delegating’ to private entities public regulatory functions was clarified in a number of cases: *Case C-2/91, Meng*, [1993] ECR I-5751; *Case C-245/91, Ohra*, [1993] ECR I-5851; *Case C-185/91, Reiff*, [1993] ECR I-5801.

8 *Case C-198/01, Consorzio Industrie Fiammiferi*, [2003] ECR I-8055, para 51.

9 *Id.* at para 54.

10 *Id.* at para 56-57.

3.2.3 Exemptions from antitrust liability for SOEs

In some countries public sector businesses may be able to engage in anticompetitive practices because they are de facto or de jure exempt from competition law. While most countries do not exclude public sector businesses for coverage under competition law there may be partial exemptions that protect some types of public sector businesses or some aspects of their business activities. In the United States, for example, the US Postal Service enjoyed an express immunity from antitrust liability for conduct undertaken at Congress’ command under the Postal Reorganisation Act of 1970. The new Postal Reorganization Act of 2007, however, explicitly allows for the application of antitrust law to the US Postal Service for competitive services.

In addition, there are some actions by public sector businesses that could distort competition in a market but would fall outside the scope of traditional competition law. Many activities of state-owned enterprises are established by law or find their justification in public policies. Public entities may give SOEs the power to set prices or other terms and conditions in their commercial

activities. The question is whether such activities, which can entail serious price or output restrictions, should be subject to antitrust scrutiny although they are compelled or authorised by law. Under the state action defence there is no antitrust liability if the challenged business conduct (by both privately-owned and state-owned firms) is determined by lawful public measures.³⁴ In practice, jurisprudence appears to be shifting in the direction of imposing ever stricter limits on when the state-action defence can be invoked (Box 8).

4. Would a full implementation of the SOE Guidelines take care of the rest?

Over the last decade SOE governance reform in itself has no doubt contributed to reduce problems with competitive neutrality. The reform trends in almost all OECD countries have been toward a more complete corporatisation of SOEs. A number of commercial activities previously operating out of government departments or as statutory corporations with boards full of ex-officio directors have in the course of this process been subjected to the disciplines of corporate law and in some cases stock market listing. This has limited their scope for anti-competitive practices and non-commercial objectives more generally. Similar benefits will have arisen from a separation of ownership from regulatory functions in a number of jurisdictions. The self-regulating monopoly operators (especially in the network industries) of an earlier era have in many cases been replaced by corporations overseen by independent sectoral and competition regulators.

However, it does not automatically follow from this that the concerns about competitive neutrality have necessarily abated. The first reason for this is that, whereas public sector monopolies have become rarer, the boundaries between the private, public and non-profit sectors in many OECD economies have become more blurred. For instance, market mechanisms are increasingly used to improve public sector efficiency, including an increasing reliance on public procurement, licensing, concessions and delegated management contracts. In consequence, outright competition or competing activities between private and public enterprises occurs in a number of new areas, effectively multiplying the scope for commercial disputes.

Another new development is the increasing internationalisation of OECD countries' SOEs as well as the appearance of a number of SOEs owned by non-OECD governments in the global market place. Whether or not non-OECD countries are less likely to adhere to good practices for competitive neutrality is of course an open question, but it is fair to say that many of their SOEs are at an earlier stage of corporatisation than the current state of affairs in most OECD economies. Similarly, it is not always obvious that governments necessarily remain unwavering in their commitment to a level playing field for SOEs when the said "playing field" is located in a foreign economy. Issues of competition between countries as well as between enterprises may enter the calculation.

³⁴ Muris, State Intervention/State Action - A U.S. Perspective, October 2003, George Mason Law & Economics Research Paper No. 04-18; Delacourt, and Zywicki, The FTC and State Action: Evolving Views on the Proper Role of Government, *Antitrust Law Journal*, Vol. 72, No. 3, 2005.

Box 9. US anti-trust authorities' view on the corporate governance of SOEs

The 2005 *OECD Guidelines on Corporate Governance of State-Owned Enterprises* are an important source of guidance for government corporations, and are consistent with much of our experience relating to federal government corporations. For purposes of the WP3 discussion of this topic, we suggest the following notional principles, based on the *OECD Guidelines* and the U.S. experience, to guide policymakers in this area.

First, an SOE's legal status, as established by its corporate charter or statutory authorization, should clearly identify its relationship to the government, any exemptions from suit or regulatory frameworks, and any special privileges, for the benefit of other economic actors with which it interacts. In particular, any public service responsibilities assigned to an SOE should be clearly and transparently mandated by laws or regulations. For example, costs related to an SOE's public service responsibilities should be covered in a transparent manner, enabling a ready determination as to whether public service activities are subsidizing the costs of any operations in markets where the SOE competes with private sector companies.

Second, governments should seek to ensure an equitable competitive environment in markets where SOEs compete with private sector companies, so as to avoid unnecessary market distortions and inefficiencies that reduce consumer welfare. In the same way, to the maximum extent consistent with an SOE's public service responsibilities, governments should minimize favorable financial terms bestowed on the SOE.

Third, there should be a clear separation between the state's ownership function and other state functions that influence market conditions, particularly with regard to market regulation. To the maximum extent consistent with an SOE's public service responsibilities, government regulatory authorities should treat SOEs and their private sector competitors equally and the overall business framework (including antitrust laws) should apply equally as well. To that end, the government's ownership rights should be clearly identifiable, separated from any regulatory authority, divorced from day-to-day management of the SOE, and should not intrude on the SOE board's independent exercise of authority. To evaluate compliance with such principles, SOEs should be subject to an annual independent external audit and should be subject to the same accounting and auditing standards as publicly traded companies.*

Note.

* Consistent with this principle, Congress enacted the Government Corporation Control Act (GCCA) in 1945. 31 U.S.C. § 9101. The GCCA required that specified corporations, both wholly owned and partially owned by the Government, be audited by the Comptroller General. Additionally, the wholly owned corporations were required to submit budgets that would be included in the budget submitted annually to Congress by the President. The GCCA also ordered the dissolution or liquidation of all government corporations created under state law, except for those that Congress chose to reincorporate, and prohibited creation of new Government corporations without specific congressional authorization.

4.1 What the SOE Guidelines recommend

A widely held view among anti-trust officials seems to be that SOEs operating entirely according to the SOE Guidelines should not give rise to concerns about competitive neutrality. During the Workshop of the Competition Committee's Working Party in October 2009, several national delegates made this point. In documents submitted for the meeting, the authorities of Spain informed that "...the very recent Royal Decree 1373/2009... introduces the necessary precisions on the actual public enterprises' organizational model in order to align it with the OECD Guidelines on Corporate Governance of State-Owned Enterprises". The Brazilian authorities highlighted the formation of an inter-ministerial committee on federal SOEs and told that "the committee has aimed to establish strategies and directives that are in line with those promoted by the OECD Guidelines on Corporate Governance of State-Owned Enterprises". Finally, the point about the importance of the SOE Guidelines, and SOE governance reform more generally, in the context of competitive neutrality was made most eloquently by the US authorities (Box 9).

There can be little doubt that a full implementation of the SOE Guidelines would be sufficient to address the problems of anti-competitive behaviour due to self-serving SOE managers, which

was discussed in Section 1. Assuming an SOE, on top of being fully corporatized, also has an independent and well-resourced board (Chapter VI of the SOE Guidelines) and operates under the oversight of a state ownership function that abstains from day-to-day intervention, communicates clear and verifiable objectives to the board of directors and undertakes regular performance monitoring (Chapter 2 of the SOE Guidelines as well as the new “TrAc Guide”³⁵), then corporate managers will have no more scope for acting outside the company’s interest than their colleagues in a well-run private enterprise.

Another important issue raised in Section 1 is that governments may have incentives to instruct, or at least allow, their SOEs to act in an anti-competitive way. As also mentioned this is discouraged on principle by the SOE Guidelines recommendation that governments maintain “a level playing field in markets where state-owned enterprises and private sector companies compete”. In practice, this recommendation may, however, have less “teeth” that appears at first glance. First and foremost, nothing is said about markets where SOEs and private sector companies do not compete. If this state of affairs reflects legal monopolies then there is no direct problem with competitive neutrality, but if it reflects the fact that incumbent SOEs are so heavily favoured that no private enterprise perceives a market opportunity then it is a distortion of competition which not covered by the SOE Guidelines.

Secondly, individual recommendations in the SOE Guidelines about competitive conditions in access to finance, non-exemption of SOEs from rules and regulations and full disclosure and cost-coverage of SOE objectives beyond generally accepted norms would go a long way toward establishing competitive neutrality. However, it is less clear whether they may not in effect condone departures from a level playing field. The tacit acceptance of non-commercial objectives by SOEs could be taken to indicate this, because departures from generally accepted commercial norms may in practice be fully consistent with competitive neutrality only if they are motivated by a need to address market failure.

Governments can seek to compensate for this by “broadening” the recommendation that SOEs be compensated for undertaking public objectives to also making the SOEs pay for any benefits that they receive in consequence of their ownership. One example of this being done in practice are the fees that some OECD governments levy on their SOEs in compensation of their cheaper access to market financing. Some Australian states even have developed a pioneering approach to the financing costs of SOEs benefiting from no explicit guarantees. Rating agencies were asked how they would, in the absence of state ownership, rate the debt of these enterprises and what this would imply for funding costs. The SOEs were subsequently asked to reimburse the state treasury for the difference between theoretical and actual funding costs.

4.2 The challenges ahead

The SOE Guidelines are generally implemented across OECD countries in a less consistent way than the OECD Principles of Corporate Governance. The SOE Guidelines have as one of their main purposes the extension of the good practices recommended by the Principles to the SOE sector, but, unlike the Principles, the implementation of the SOE Guidelines is generally not backed by pressure from regulators, investors and stock exchanges. The distance between ideals and actual practice was clear already when the Guidelines were developed. The stocktaking of national practices that accompanied the work³⁶, made it clear that in many OECD countries for years to come the SOE Guidelines would continue to be considered as

³⁵ OECD (2010), *Accountability and Transparency: A Guide for State Ownership*, Corporate Governance Series.

³⁶ OECD (2005) as cited above.

recommendations at a high aspirational level. Notwithstanding recent progress in corporatisation and commercialisation of SOEs this apparently still holds true³⁷.

Among the unresolved “pure” governance issues (as opposed to the regulatory framework more generally) within the SOE sector that could have an impact on competitive neutrality, the one most frequently cited by market participants is a continued use in many countries of SOEs for purposes of patronage and nepotism. Politicians and top civil servants may insert their associates into the boards and management of SOEs purely as a reward for past services. Whatever the initial intent, this effectively creates backward linkages from these SOE insiders to the highest levels of state. This, on the one hand, may allow managers to avoid accountability by surpassing oversight bodies and, on the other, may create channels through which the SOEs can lobby politicians to intervene in the markets on their behalf. An earlier exercise by the Working Party on SOEs operating across borders further established that, even in some of the countries thought to have most fully implemented the SOE Guidelines, SOE managers with a solid record of success in their job may for extended periods of time have been able to operate subject to minimal levels of oversight and control. Finally, close personal links between SOE management and the state heighten the risk that SOEs will be able to benefit from informational advantages in their competition with private enterprises.

More generally, the most commonly heard concerns from businesses within the OECD areas regarding competitive neutrality and SOEs fall in two categories, namely those directed at their domestic competition and those directed at foreign SOEs. The first of these relates closely to what was said above about the increasing commercialisation of SOEs that still have either monopoly elements in their value chains or receive compensation from the state for public service obligations. Private businesses often consider even at the outset that such SOEs are over-compensated by the state, or have excessive scope for cross-subsidisation – but when the SOEs expand into purely competitive market segments at home and abroad the complaints from the private competition tend to multiply.

Concerns about a level playing field tend to grow considerably when the SOEs concerned are owned by foreign governments. The nub of the controversy is closely related to the discussion about protection of national champions and may in practice have more to do with the SOEs’ foreignness than their ownership since a number of governments also extend preferential treatment to privately owned “champions”. Among the most commonly heard objections from private competitors have been the perception that foreign SOEs in some countries benefit from concessionary finance, allowing them not only to compete stronger but also to embark on series of corporate takeovers abroad. Secondly, governments have sometimes been accused of raising regulatory barriers unfounded in genuine public-interest objectives with the purpose of protection their own enterprises. Thirdly, while public procurement procedures are subject to rigorously enforced laws and regulations in virtually all OECD countries, SOEs are mostly found in sectors where complex contracts and multiple bidding criteria are common. Governments have been accused of benefiting from the complexities and gray zones to effectively giving preferential

³⁷ An example of this surfaced during the work toward the Working Party’s unrelated effort to collect data on the SOE sectors in member countries. Amid the SOE Guidelines’ relatively uncontroversial recommendations about coordination of the ownership function and consolidated disclosure, several national Delegations told the Secretariat that they had no information about, and in some cases no knowledge of, the enterprises owned by other parts of the government.

treatment to their national champions³⁸. Any of these, apparently not uncommon, practices go against the letter of Chapter I of the SOE Guidelines.

The entry of non-OECD countries with large SOE sectors in the global market place has amplified many of these concerns. Non-members are not party to the OECD consensus on good practices, although from a competition perspective it is important that most of them are subject to WTO disciplines as well as a number of other trade and investment agreements. In practice, business sector allegations of departure from competitive neutrality through overt subsidisation of SOEs (including through soft loans from state-owned financial institutions) is most frequently made against the governments of emerging economies.

³⁸ Again, this is by no means limited to SOEs. This allegation is for example one of the recurrent themes in public debate concerning the competition between Boeing and EADS – only one of which is, partly, state-owned.

www.oecd.org/daf/corporateaffairs/wp

