# Regulatory Reform in Finland

## MARKETISATION OF GOVERNMENT SERVICES – STATE-OWNED ENTERPRISES

OECD

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# FOREWORD

Regulatory reform has emerged as an important policy area in OECD and non-OECD countries. For regulatory reforms to be beneficial, the regulatory regimes need to be transparent, coherent, and comprehensive, spanning from establishing the appropriate institutional framework to liberalising network industries, advocating and enforcing competition policy and law and opening external and internal markets to trade and investment.

This report on *Marketisation of Government Services – State-owned Enterprises* analyses the institutional set-up and use of policy instruments in Finland. It also includes the country-specific policy recommendations developed by the OECD during the review process.

The report was prepared for *The OECD Review of Regulatory Reform in Finland* published in 2003. The Review is one of a series of country reports carried out under the OECD's Regulatory Reform Programme, in response to the 1997 mandate by OECD Ministers.

Since then, the OECD has assessed regulatory policies in 18 member countries as part of its Regulatory Reform programme. The Programme aims at assisting governments to improve regulatory quality — that is, to reform regulations to foster competition, innovation, economic growth and important social objectives. It assesses country's progresses relative to the principles endorsed by member countries in the 1997 *OECD Report on Regulatory Reform*.

The country reviews follow a multi-disciplinary approach and focus on the government's capacity to manage regulatory reform, on competition policy and enforcement, on market openness, specific sectors such as electricity and telecommunications, and on the domestic macroeconomic context.

This report was principally prepared by David Parker in the Competition Division of the OECD. It benefited from extensive comments provided by colleagues throughout the OECD Secretariat, as well as close consultations with a wide range of government officials, parliamentarians, business and trade union representatives, consumer groups, and academic experts in Finland. The report was peer-reviewed by the 30 member countries of the OECD. It is published under the authority of the OECD Secretary General.

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## Executive Summary

The provision of public services at national government level have been significantly commercialised in Finland over the past decade through the formation of state enterprises. Most of these entities have now been transformed into companies and some have been privatised. Overall this reform has been very successful: efficiency, effectiveness and quality of service have improved, competition has increased, profitability has improved and real prices have gone down. These reforms were sensitive in the context of the welfare state arrangements because of concerns about service provision and loss of employment and job security in liberalised markets. In the event there were only isolated instances of significant problems with the implementation of reforms.

It is essential for successful reform in these areas to observe a number of key policy underpinnings, including the need for separation of regulatory and business functions, that competitive neutrality apply between private and public business entities and that governance systems are “fit for purpose”. These requirements were broadly observed in the Finish reforms, but inevitably there is scope for improvement. Regulatory and ownership functions are separated but are exercised within sectoral Ministries - there remains the potential for tension in this arrangement and further separation would be desirable. Following the example of other countries this could involve the collection of ownership responsibilities in a single place within the government. Some violations of competitive neutrality remain and should be addressed, particularly an income tax exemption. At a more conceptual level is a question of the merits of grouping of commercial functions and public duties within some state enterprises. There can be some synergies in grouping commercial and public functions, but the necessary political steerage for the public function then detracts from the environment for operation of the commercial activities. A possible way forward would be to do away with the state enterprise model, now that it has served its transitional reform purpose, and move to a situation where all state commercial activity in liberalised sectors is done via a corporate vehicle.

One challenge in commencing the reform was achieving consensus about the necessary degree of political control over remaining public functions within these commercialised entities and the governance structures needed to achieve this. These tensions still exist and caused delays in a further reform of the law.

An end point for these reforms is privatisation - Finland explicitly does not have a privatisation policy but has a quite highly developed ownership policy. Privatisation has been careful, staged, and done on a case by case basis according to the pragmatic circumstances of the moment. The extent of privatisation is limited by Parliament mandates that are significantly influenced by a unionised labour view that significant ongoing government ownership in commercial entities is a form of insurance against job loss in adverse circumstances. This insurance is not costless. Privatisation has proceeded furthest in sectors which are purely commercial and do not have significant public policy elements. This is implicitly consistent with a well principled privatisation policy but ultimately the policy position about what the government should and should not own, and thus what it should or should not privatise, is fragmented. It would be desirable to take forward privatisation more broadly, according to a principled policy if that would assist, as ultimately this will help the fiscal sustainability of the welfare state.

This study looks in detail at the liberalisation of the postal sector as a particular example of the commercialisation process. Finland has liberalised its market completely on a de jure basis but prospective entry proved highly controversial and raised fears of the postal operator not being able to deliver its universal service obligations. A special tax was enacted to forestall entry that was limited to population dense areas. In retrospect that tax was overkill and has forestalled all competition in the letter post market. A number of other barriers to entry remain – in the form of incomplete regulatory arrangements. The postal sector is one where there are large natural barriers to entry and additional regulatory barriers are not needed. The experience in other countries that have liberalised and seen competition emerge has been strongly positive and fears of major negative consequences for the sustainability postal systems have not been realised.

# 1. STATE-OWNED ENTERPRISES

## *1.1. Overview of the Study and Main Issues*

The state has a very significant direct involvement in the Finnish economy through its ownership of separate commercial entities and through direct production at the municipal level of government. Partly, this reflects the fact that Finland is a "Nordic welfare state", where the government directly provides most social and welfare services, such as heath and education. It also reflects the historical fact that the State was significantly involved in the industrial and commercial development of the economy. Over the past decade significant commercialisation of formerly public services has occurred at the national level and there has been some privatisation. However, commercialisation in the municipal sector is still at a relatively early stage[1].

The overall economic context of these developments and the surrounding circumstances was discussed in Chapter 1. We can summarise by noting that policies that have driven commercialisation in government economic activity are motivated and constrained by the following critical factors:

- The welfare state enjoys fundamental political support at all levels and such a state structure necessarily implies a significant tax burden. Nevertheless constraints exist on the size of the tax burden that is feasible or sustainable, both because of the incentive implications of high average and marginal tax rates and because of international tax competition.

- Efficiency is not and should not be the only objective of the state but, given increased constraints on taxes, the weighting on efficiency among the state's objectives has had to increase[2].

- There was and is scope to significantly improve productivity, including in the government sector, as productivity levels are significantly lower than the high performing OECD countries.

- Improving the efficiency of the state is also possible through a privatisation of assets that can be used more productively in the private sector and for which there is not an over-riding public policy purpose in keeping a function directly within state control. The overall the level of state involvement in of economic activity through ownership is relatively high in Finland[3].

- Consequently, to maintain and prolong the welfare state, it has been and is necessary to pursue policies that enhance efficiency in the public sector to produce public services with lower resource demands that are consistent with sustainable tax rates.

- But such reforms raise a policy tension because mechanisms to enhance productivity – such as contracting out, commercialisation and privatisation – can alter the way the welfare state functions. Given the political choice in favour of the welfare state, the policy challenge is thus to manage the reform process carefully and without disruption of services so that efficiency is enhanced through private participation and a more commercialised orientation is applied to ongoing direct state production, while the role of government shifts progressively in favour of steering and procuring services rather than producing them. As noted, this process of change is already very well advanced in the national level and can be rated as a very strong policy success. At the municipal level the constraints on change which arise from the nature of the welfare state and the production of public services are more apparent.

This chapter focuses on one element of this reform process, where the creation of state enterprises has been undertaken to marketise services formerly produced directly by government agencies. The chapter does not cover local government (municipality) enterprises. This can be seen as a first stage in a large process as most state enterprises have been further transformed into incorporated companies and some of the have been subsequently privatised. The basic questions addressed in the study include: What types of activities are suitable for this process? How successful has it been? Have competitive markets been created? What policy lessons have been learned? What is the scope for further commercialisation/privatisation? The chapter is laid out as follows. Firstly, the scope of public sector commercial activity is set out followed by a brief discussion of a number of policy themes that have arisen in the reforms. Secondly, a conceptual framework to consider the issues of competition, regulation, privatisation and corporate governance is set out. Then these issues are examined in more depth in the context of the existing framework for regulation of state enterprises and state ownership. Some possible policy options are then developed. The final part of the chapter looks in more detail at the regulation of the postal sector, which has been through this reform process.

## *1.2. State Participation in Economic Activity and Commercialisation of State Enterprises*

### *The Extent of State Ownership*

The high level of State ownership of commercial entities in Finland has occurred through two main channels. The first channel has a long history and involves the State being directly involved in the industrial and commercial development of the economy. In essence, private capital was relatively scarce and the State directly intervened to accumulate real capital through state-owned companies which were established in a range of sectors including pulp and paper, metals, mining and chemicals, finance, etc. Some of these entities have been subsequently partly or wholly privatised over the past decade.

The second channel involves the creation of state enterprises and is a more recent development. From 1989 to 2001, 14 state enterprises were created out of former budget funded government agencies. State enterprises were created in the areas including transport and communications, support services for the State, asset holding and forestry. A state enterprise is “hybrid” form of economic entity. It is created by statute, so it is not a company. Yet it has some governance structures that resemble a company in the form of a Board and Management that are independent from day-to-day intervention by the Government. Nevertheless, the Government sets down a robust framework to publicly steer the strategic direction of the enterprise. Of the 14 state enterprises, 9 have been subsequently incorporated into a company form, and 4 of these have been wholly or partially privatised. Consequently, in some cases the state enterprise form can be seen as an interim step in commercialisation/privatisation, while in others the entities have remained as state enterprises. The entities involved, timing and outcomes of this state enterprise process is illustrated in Figure 1. Appendix 1 sets out some brief entity specific details on state enterprises and some and “strategic” govt owned companies.

The most significant example of this state enterprise process was in the communications sector where the post and telecommunications functions where transformed from a state agency under the Ministry into a state enterprise entitled Post and Telecommunications Finland. Then in 1993 the post and telecommunications functions were further separated into different companies of Finland Post Corporation and Telecom Finland Ltd. (now Sonera). Until 1998, these companies were managed jointly as part of PT Finland Group at which point the group was de-merged and Sonera was partly privatised. Finland Post remains wholly government owned. The regulatory arrangements applicable to the post sector are discussed in more detail in the second part of this chapter.

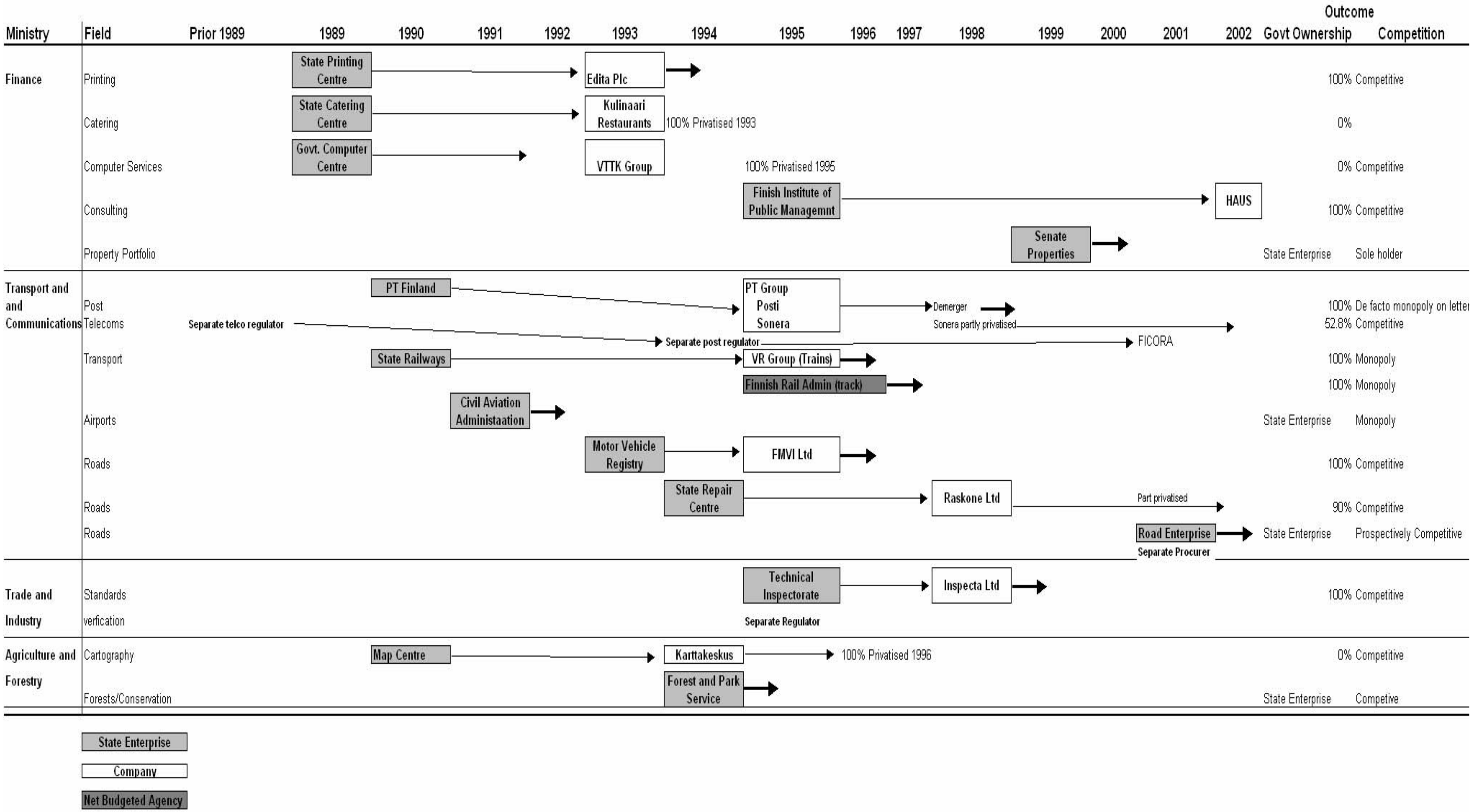
The largest remaining state enterprises are the Civil Aviation Administration and the Forest and Park Service. The remaining state enterprises currently employ around 8,000 persons, which is around 1/10 of the personnel of all current and former state enterprises. The major remaining state enterprises have significant administrative or regulatory functions, such as responsibility for air safety remaining in the CAA and the guardianship of wilderness areas remaining in the Forest and Park Service. Consequently, further commercialisation/privatisation has been seen as inappropriate. The other remaining state enterprises are relatively recent creations and their transformation into a likely final corporate stage is incomplete. The most recent creation of a state enterprise in 2001 is the Road Enterprise, which was carved out of the Ministry of Transport and Communications. The Road Enterprise will construct road infrastructure under contract from the Road Administration and there is scheduled to be a transition to competition over a period of 4 years.

The authorities do not expect further significant marketisation of remaining national level production activities via the state enterprise model. This reflects the view that reform in this area is mostly complete and that few potentially commercial activities remain directly within the State. One possible new state enterprise which is being contemplated is in the maritime sector where the Finnish Maritime Administration is already operating as a net budgeted agency (it charges for its services) and further commercialisation of some functions (ice breaking, pilotage, and ferry traffic) is being considered. Major remaining production activities – such as education or health – raise more complex issues for commercialisation due to their more significant public policy dimensions and involvement of the municipal level of government.

In a small number of other instances, corporate entities have been directly carved out of government agencies without the intervening step of a state enterprise. This has occurred in the case of government acquisition activities (Trading House Hansel), grain storage (Avena), construction and real estate management (Engel) and the Mint of Finland. Broadly speaking, these entities were created in fields where there was already an operative private sector.

It can been seen that, with the exception of the identified on-going state enterprises there is a convergence of the two channels though which the state has attained large interests in commercial companies. As will be discussed later there is also a convergence of governance and ownership issues.

## Figure 1 Creation and evolution of state enterprises



State shareholdings in the main government owned companies, including those that were formerly state enterprises, is illustrated in Table 1. At the end of 2001 the market value of the State's holdings in listed companies amounted to € 12 billion and the total value of all State shareholdings, including listed companies, was estimated to be above €20 billion. This represents a decline in the value of listed holdings over the previous year of €4 billion due to a significant decline in market valuations. Receipts from privatisation in 2001 were small and were substantially exceeded by a capital injection into Sonera. However, the mandate for privatisation approved by Parliament was widened and this is to be welcomed. Since 1992 the State has fully privatised 13 companies. Of the remaining companies, 27 are fully owned, 4 are majority owned and 8 are minority owned (<1/3 interest). State owned or associated companies employ around 200 000 persons, which is approximately 12% of total private sector employment.

Table 1. **Main state-owned companies**[1]

| | Sector | Persons employed in 2001 (thousands) | In December 2002 (% share) | | Ministry |
|---|---|---|---|---|---|
| | | | Ownership | Minimum[2] | |
| **Company** | | | | | |
| Alko | Alcoholic beverages | 2.2 | 100 | 100 | Social Affairs/Health |
| Altia | Production and wholesale of alcoholic beverages | 0.7 | 100 | 50.1 | Trade and Industry |
| Edita** | Printing and publishing | 1.6 | 100 | 0 | Finance |
| Engel*** | Property management and cleaning | 5.7 | 43 | 0 | Finance |
| Finnair* | Airline | 10.8 | 58.4 | 50.1 | Transport and Comms. |
| FMVI** | Technical inspection motor vehicles | 1.0 | 100 | 0 | Transport and Comms |
| Fortum* | Energy | 14.8 | 60.8 | 50.1 | Trade and Industry |
| Inspecta** | Technical inspection | 0.2 | 100 | 100 | Trade and Industry |
| Kapiteeli | Real Estate | 0.1 | 100 | 100 | Finance |
| Kemijoki | Energy | 0.4 | 67.0 | 51.0 | Trade and Industry |
| Kemira* | Chemical industry | 10.2 | 56.2 | 15.0 | Trade and Industry |
| Metso | Machinery | 25.6 | 11.5 | 0 | Trade and Industry |
| Mint*** | Metals | 0.1 | 100 | 100 | Finance |
| Outokumpu | Metal | 19.0 | 39.7 | 10.0 | Trade and Industry |
| Partek | Vehicles and machinery | 13.1 | 30.2 | 0 | Trade and Industry |
| Patria Industries | Defence | 2.3 | 73.2 | 50.1 | Trade and Industry |
| Posti** | Postal services | 23.3 | 100 | 100 | Transport and Comms |
| Raskone** | Heavy duty machinery service/repair | 0.3 | 86 | 82 | Transport and Comms |
| Rautaruukki | Metal | 13.6 | 40.1 | 20.0 | Trade and Industry |
| Sampo | Banking and insurance | 10.2 | 40.3 | 0 | Finance |
| Sponda* | Real Estate | 0.1 | 47.7 | 0 | |
| StoraEnso | Pulp and paper | 44.3 | 10.8[3] | 0 | Trade and Industry |
| Suomen Siilot*** | Grain handling and storage | 0.4 | 100 | 100 | Agriculture and Forestry |
| TeliaSonera*[4] ** | Telecommunications | 10.5 | 19 | 0 | Transport and Comms |
| Trading House Hansel*** | Procurement | 0.1 | 100 | 100 | Trade and Industry |
| Vapo | Wood and peat | 1.2 | 66.7 | 50.1 | Trade and Industry |
| Veikkaus | Lottery and football pools | 0.3 | 100 | 100 | Education |
| VR Group** | Railways | 14.9 | 100 | 100 | Transport and Comms |
| Yleisradio | TV and radio broadcasting | 3.7 | 100 | 70[5] | Transport and Comms |

* Publicly quoted companies
** Former State Enterprises
*** Directly Created company from a government agency

1. In the above table 25 smaller companies have been omitted – these are active in the fields of finance and investment, insurance, property and share management, energy efficiency, telecommunications, clothing, hazardous wastes, energy transmission and trading, tourism, personnel services, computing, plant breeding and seed potato production.
2. Minimum means the limit set by Parliament for possible privatisation.
3. Government share in votes is 24.8 per cent.
4. In December 2002 Sonera merged with Telia, the incumbent Swedish telephone company.
5. A statutory requirement form the Act on Yleisradio (1380/1993).

*Source*: Ministry of Finance, Ministry of Trade and Industry, Ministry of Transport and Communication and OECD Secretariat.

### *1.3. Description of State Enterprise Reforms and Performance Consequences*

There is no single model by which different countries have chosen to marketise public services – either as to the way it is has been done nor its extent, but there are a range of common threads, in terms of the objectives and outcomes and consequential policy issues – see Box 1. The following addresses the Finish experience in terms of these policy issues.

*Objectives and Mechanisms of Reform*

Commercialisation through state enterprises involves the creation by statute of an entity that is functionally separate from the state, with its own management structure (subject to governance mechanisms) and operating according to "business principles", i.e. along commercial lines. Consequently, state enterprises sell their products and services to customers, including the non-government private sector, in markets that are in most cases at least potentially competitive[4]. State enterprises must fund their operational expenses (including interest) from sales income so that their operating budget is outside of the state budget.[5] Capital expense for investment can be funded by retained earnings (after payment of a dividend to the State), debt capital (normally from the private sector) and equity capital (which is sourced from the state by definition). A state enterprise is primarily responsible for its financial obligations. However, there is no limited liability as for a corporate form. In fact, the state enterprise is not a legally separate identity from the state in so far as liabilities and asset ownership are concerned, so that the state ultimately bears any residual obligation to repay the debts of the state enterprise.

Broadly, it can be seen that there are two related objectives in these state enterprise reforms. The first relates to improving the operational performance (productivity and quality) of state economic activity through commercialisation[6]. The second relates to establishing a robust but more flexible governance structure for activities that are still seen as having "public" characteristics (notwithstanding their commercialisation), but one in which the government has a less direct operational role with respect to "day-to-day" decisions[7]. Consequently, such enterprises have more operational or day-to-day independence from government to deliver their objectives than would a state agency. The governance mechanism is considered in detail in section 1.5.

**Box .1 International Experience with Reforming Public Enterprises**

The OECD undertook a study on "Reforming Public Enterprises"[8] in 1998 by examining the reform experience in Australia, Netherlands, Norway, Spain, Switzerland and the UK. The following draws out some issues that are reflected in the Finnish experience.

**In Norway**, the commercialisation process started in earnest through the 1990s, triggered by a 1989 study "A Better Organised State". This led to a formalised policy position in Guidelines from the Ministry of Government Administration in 1994 that the state would commercialise using one of two vehicles, being a limited company and a state enterprise. A company would be used where corporate governance arrangements were seen as sufficient to exert a relatively low degree of government control, while a state enterprise would be used when the needed government control was significant. In the event, however, this "neat" outcome was not achieved, with major companies operating in monopoly infrastructure sectors in a form of hybrid closely controlled government company. The push to form companies in these sectors was to give them greater flexibility to respond to the commercial environment, yet special legislative limitations were imposed on the flexibility of the companies in the rail and postal sector to reorganise and shed labour. Privatisation has not been on the agenda. Consequently, reform is described as a pragmatic incrementalism: a step-by-step consensual process rather than driven by fundamental principles.

- Similar pressures for commercial flexibility underlie the transition from a state enterprise to corporate form in Finland. But limitations on restructuring/labour shedding in Finland are less explicit. The union movement hold to the view that "insurance" against excessive restructuring exists through the ownership/control channel and consequently resists full privatisation.

**In the Netherlands**, privatisation has been launched through extensive consultation processes that must address mandated questions about the rationale for initial government involvement in an activity and whether that rationale still exists. While this has aided coherence of the program actual implementation has been hampered by a slow legislative process and other technical requirements. Employees are protected by a right of transfer to a continuing civil service function.

**In Spain**, non-strategic government companies were privatised in the later 1980s. This was followed by a period of commercialisation of state entities aimed at efficiency until 1996 when a new government was politically committed to privatisation leading to a very significant reduction in state ownership of commercial activities

**In Australia,** commercialisation and privatisation progressed on a case by case basis but were in some respects hampered by the federal structure where the distribution of tax powers was different to the ownership of government enterprises. One unique element of the reform program was the adoption in 1995 by all Australian government of the National Competition Policy Reform. NCP had the effect of coordinating further reform by laying out a blueprint of principles for competition related reforms (including reform of public enterprises), an implementation timetable and a system of "competition payments" designed to share the benefits of reform among the different governments. These "competition payments" were made contingent upon actual implementation of the required reforms.

**In the UK**, all state enterprises have been corporatised and most privatised. Reform started earlier in the UK than most countries. One of the early lessons was the need to give considerable weight to competition conditions in privatisation so as not to create industry structures with significant market power.

A parallel policy objective in the formation of state enterprises has been to liberalise these areas of commercial activity to permit private participation and develop competitive markets in these services. This competition objective has been more obvious in respect of some areas (such as telecommunications) than others (such as airport infrastructure) but it is fair to say that the overall emphasis upon competition has increased over time. The commercialisation and competition objectives are mutually related and reinforcing. Clearly, private competition reinforces the pressure for efficiency gains within state enterprises/companies and commercialisation increases the potential for management action that can release efficiencies. And, reform of state economic activity into a form where there is broad competitive neutrality with potential private entrants is important for fostering private entry and competition – clearly, if state enterprises/companies retain significant competitive advantages over private companies then private entry is not likely.

A key advantage in the state enterprise or company arrangements is greater flexibility to respond to changes in the business environment. This is because activities which are undertaken "on budget" inevitably brings with it the constraints on flexibility inherent in Government budgeting and where there is an overall fiscal constraint – which is in almost all countries – there are constraints on capital investment that are not necessarily aligned with the needs and return on capital in particular sectors or projects.

The state enterprise form provides for a greater degree of more transparent direction from government about the activities of the enterprise than is appropriate with the corporate form. Conceptually, such steering for a 100% owned government company could take place through ownership/governance channels, i.e. shareholder meetings and board decisions. But, this would not be as transparent, nor as robust, as the arrangements that are written into statutory form in the Act on State Enterprises.

Marketisation inherently separates the roles of governance or procurement and production and reduces political influence on the latter so that production of services becomes more orientated to the demands of consumers. Similarly, focussing of the state on its public objectives should clarify these objectives because if they are to remain they can no longer be left as implicit objectives that are pursued through direct control or ownership channels. In the case of privatisation any public objectives need to be pursued through regulation or contract. This range of mechanisms is summarised in the following table.

| Organisation Form | Government Agency | State Enterprise | State Owned Company | Private Company |
|---|---|---|---|---|
| Public Objective Mechanism | Direct Control | Legislative Steering Governance | General Regulation Governance | General Regulation Governance |

Consequently, it can be seen that the state enterprise form is a mid way point between a budget agency and a company and is suitable either because of the nature of the task that the entity performs or as a transitional stage to a company form.

Transition through State enterprise has been useful where the degree of change involved for the personnel or the scope of functions in moving directly to corporation would have been very large, or where there was initially no operative competition. Moreover, where the state enterprise model is used it is feasible to initially include administrative or regulatory functions where this would not be possible or feasible of a company model was adopted immediately. A company cannot perform a state regulatory function and a profit maximising company generally will not perform uneconomic activities unless it is provided for by legislation or funded in some way. Thus if further commercialisation into a corporate form is subsequently pursed it is necessary to have public functions performed by a new state body. This approach was followed in the separation of the VR Group and the Rail Administration, the Finnish Motor Vehicle Inspection and the Vehicle Administration Center, and Senate Properties and the Engel Group.

Further marketisation is conceptually feasible in areas where the government "sells" services and where there is not an uncorrectable market failure from private provision. In essence this includes any "excludable[9]" good where consumption of a service can be excluded and where there is not some other form of market failure that cannot be remedied by some regulatory device. Further marketisation is being considered in the maritime sector as already been noted. A possible further area which has been marketised in some other countries and which could be considered in Finland are job placement and labour market services. Policy choices here necessarily go beyond the question of feasibility. For example, it might be conceptually feasible to marketise education, as attempts have been made through proposed voucher programs in some regions of the USA, but there are obviously significant political constraints on such reforms.

Salminen and Viinämaki (2001)[10] conducted an extensive study of the process and consequences of government service marketisation in Finland, including through state enterprises and concluded that overall efficiency, effectiveness and quality of service has improved, competition has increased, profitability has improved and prices have gone down. Where specific problems have arisen it has been because of an isolated failure or problem in labour arrangements or in the regulatory design, such as where the boundary between public and commercial activities has been left un-defined. In general the degree of competition has proved to be less than envisaged. Over time, commercialisation has become much less controversial and is accepted by representative unions, so long as it is done with due regard to the interest of workers.

*Combination of commercial and regulatory or public functions*

A standard feature of these reforms in Finland, as elsewhere, has been the separation of commercial and regulatory functions that were previously combined within state agencies. This is particularly important in cases where actual competition exists, as otherwise a commercial enterprise would be able to selectively use regulatory powers to disadvantage its competitors.

There is one special exception to such separation in Finland in respect of the Civil Aviation Administration. The CAA has the duty to own and run the airport network, but it also includes the Flight Safety Authority (FSA) which is the safety regulator[11]. The inclusion of the FSA within the CAA is one of the prime reasons why the CAA is a state enterprise with additional political steering rather than a company. Within the CAA the FSA is an autonomous unit. FSA is the regulator of safety aspects of CAA's activities, including infrastructure provision and air traffic control, and those of the airlines. There is no significant competition in the provision of airport services since the CAA is effectively a monopoly provider. Consequently, there is not a risk of regulatory bias as between public and private providers. However, in most countries the regulator is not part of the airport enterprise as it raises potential conflicts within the enterprise regulatory and commercial objectives. For so long as the CAA remains as a state enterprise, there should not be major risks of conflicts between the commercial activities and regulatory decisions, since the CAA as a whole is tasked under the steering system with operating in a safe manner and a public memorandum sets out the terms of their relationship. The CAA believes that there are certain cost and competency synergies which are captured by locating the FSA within the CAA and some staff rotation occurs. Similarly the Forest and Park Service sees some synergies in rotating staff though forestry and conservation functions and in the internalisation of land use tradeoffs. A further consideration which bears on this issue which is whether the additional steering which needs to be applied to the CAA due to its regulatory functions makes it more difficult to perform its commercial functions – this issue is examined subsequently after governance arrangements are considered in more depth.

The costs of performing regulatory or other social functions are either reimbursed from the State budget or allowance is made in setting a lower required profit target. Part of the costs of the FSA within the CAA are financed by a transfer from the CAA. The other non-commercial function performed by the CAA is to maintain a network of regional airports that considered alone are non-economic. There are some network effects from operating these airports but the substantive justification is a regional policy objective that is specified in the CAA's objectives as set by the Parliament/Government. The costs of meeting this regional policy objective is in effect the losses made on the regional airports and this is funded by a cross subsidy from profits from Helsinki airport and related commercial operations. Consequently, the return on invested capital in the CAA Group has ranged between 2.6 and 3.0% over the last four years. Conversely, in the case of the Forest and Park Service, the nature conservation and recreational service functions are mainly financed by a direct transfer from the State budget. As a general observation it is preferable from the perspective of transparency that such activities be directly financed.

*Personnel Issues*

State enterprises are part of the state sector, nevertheless almost all personnel of state enterprises are "employees" under the generally applicable labour legislation rather than being "civil servants"[12]. This is essential as any entity that is run along business lines must have at least some flexibility to increase and decrease its labour inputs in line with demand otherwise it cannot adjust to market developments and its financial sustainability is at risk. This risk is clearly amplified if there is actual competition in the sector with private firms staffed by employees. Therefore, in order not to have a competitive disadvantage vis a vis private firms, it is appropriate that the personnel of state enterprises also be employees with broadly similar terms of employment as comparable private sector firms.

In fact employees of state enterprises receive slightly better conditions then their private sector counterparts, in the form of better leave and sick pay, which correspond to conditions in the State sector, and pension premiums which are a "few percentage points" higher than corresponding private sector employees. In part these better conditions represent a continuation of the former position when civil servants transferred into newly formed state enterprises.

A small number of the personnel of state enterprises perform public administrative or regulatory duties. These personnel remain as civil servants, which is appropriate given the function they perform. Certain other offices retain their civil service status having not transferred to employee status when the state enterprise was formed. As noted this occurred mainly in respect of the CAA, where some 350+ persons remain as civil servants performing business functions out of a total business function staff of around 1800 staff. Some 70 civil service staff perform public administrative duties within the Flight Safety Authority that operates independently within the CAA.

While the use of employee status personnel reduces risk for the enterprise, it clearly increases risk for the personnel involved. And, there is a perception that additional risk is involved in the event of privatisation. Concerns about these risks is the key constraint in Finland - as in many other countries – on the pace and extent of marketisation and privatisation. Most state enterprises and state owned companies have shed staff but this has generally occurred without significant dispute[13]. While unions have accepted the need to achieve efficiencies, they remain wary of labour shedding from further commercialisation and privatisation, in particular. Consequently, the unions prefer the government to retain a significant minority interest in privatised companies, even where these have no other social objectives, as "insurance" should influence need to be bought to bear on an "unreasonable management"[14]. Apparently this insurance has never been actually called but it is regarded as real by the unions and could be seen to operate if ever the state were to bail out one of its firms rather than let it fail.

It should not be imagined that the insurance benefit is necessarily costless. The actual cost is difficult to quantify, but the opportunity cost will be a function of the capitalised value of the loss in efficiency that is attributable to ongoing state ownership[15] and the carrying cost of that ongoing ownership. Ultimately this must result in an increase in the level of taxes that is needed for fiscal sustainability so that, in one sense, the insurance benefit seen as a transfer from the general population to the particular employees of residually government owned firms.

*Emergence of Competition*

Competition has emerged strongly in some cases, such as telecoms, but less strongly than expected or initially hoped in others. A special part of this chapter focuses on the reform in the postal sector where competition has failed to develop in the traditional letter post market due to regulatory barriers. In the case of rail, the VR Group had sole right to track access until 1999 and, more recently, a government decision limited the potential for above rail competition by following the minimum mandated liberalisation in EU directives (which requires access only for co-operative international rail consortiums). International interconnection is made more complex by gauge differences with the EU but domestic rail competition could have been encouraged more.

Staged reform is also evident in the Finnish National Road Administration where an internal separation of administrative and production was implemented within the state agency in 1994 prior to the creation of the state enterprise for production activities in 2001. The internal arrangement where purchaser and provider were separated but within the umbrella of a state agency were seen as problematic for neutrality of competition. Consequently, further separation has now been undertaken into the Finnish Road Administration which is responsible for road planning and procurement and the Finnish Road Enterprise which will construct and maintain roads under contract. The latter is a potentially competitive market and it is expected to be fully competitive after completion of transitional arrangements which reserve a progressively smaller proportion of road contracts to the Road Enterprise over four yeas. This transitional arrangement is intended to allow a smoother adjustment of current overstaffing of the Enterprise. Competitive neutrality issues as discussed below are likely to prove a point of tension in this market.

*Competitive Neutrality Issues and the Application of Competition Law*

Competitive neutrality is a theme that runs through the state enterprise commercialisation process. Particular elements of the state enterprise governance arrangements, such are requiring the businesses to be run in a commercial manner and to earn a profit, have a justification in competitive neutrality concerns as much as they do in efficiency objectives. An example of this is that the formation of Finnish Institute of Public Management (HAUS), which provides management and personnel training and consulting services, was partly spurred by perceived problems of state support for HAUS which were not available for private competitors. However, as is analysed below, there are significant remaining non-neutralities in the state enterprise model. This has been one reason why state enterprises have been further transformed into companies. Apparently, concerns about Finnish railways not having a tight budget constraint led to criticism of it "dumping" transport services and distorting competition in the road transport market. The FCA examined this case and was involved in advocacy and negotiations for reform that resolved the competitive neutrality problem through structural change that. Consequently, no legal enforcement action for abuse of dominance was taken by the FCA.

The creation of state enterprises, which involves the "transfer" of assets from the State to the enterprise and the creation of a liability structure (debt and residual "equity") establishes the balance sheet of the enterprise[16]. This has a significant influence on the basic cost structure of the enterprise, which flows through to prices, and thus determines a starting point for the potential for competition to emerge through private entry. If assets are taken onto the books at a substantial undervalue, and if debt and equity positions are not broadly in accord with private sector norms for the sector then the state enterprise may have "built in" competitive advantages over its potential private sector rivals. The authorities state that their aim has been to assign asset values at the going market price and leave enterprises with a balance sheet that corresponds with private entities of the same size and in the same sector, i.e. of a comparable private sector competitor. It is difficult to independently evaluate the implementation of this aim ex post, including because of the obvious fact that state enterprise have generally not had comparable private sector competitors from the start[17]. Under the new State Enterprise Act it will be required that an auditor certify that such transfers were at proper (current) value. This would help to ensure competitive neutrality in potential markets.

Taxation is another significant aspect of competitive neutrality. Value added and transaction taxes are applied to state enterprises in the same way as for corporate entities[18]. However, State enterprises are *not* subject to income tax on any net income from their business operations if their operations are *mainly* (more than half) directed at serving other state agencies. The exemption in these circumstances applies to all income including any derived from sales to the private sector. Due to this exemption, state enterprises paid tax at an average rate of 11.0258% of net income in 2000, compared with the corporation income tax rate of 29 %.

The partial exemption from income tax has the potential to be a very significant non-neutrality in competition between state enterprise and private competitors. It is a *potential* distortion because the effect on the prices charged by state enterprises, *vis a vis* those charged by private competitors will depend also upon the performance steering applied to the enterprise.

- If a state enterprise is set and achieves a performance target that is expressed as an <u>after tax</u> rate of return on assets employed, which that is comparable to its private competitors, then that state enterprise will have a significant competitive advantage if its business is mainly directed at sales to state agencies. Assuming its costs were comparable to private sector competitors the state enterprise could charge lower prices and still achieve the after tax performance target since it would not pay tax. The after tax nature of the performance target makes taxation payments a cost of doing business so far as calculating the performance target is concerned.

- Alternatively, if the same state enterprise were set a before tax performance target comparable to its private sector competitors, then the tax exemption should not flow through to lower prices. In this event, tax is not a cost of doing business so far as calculating the performance target is concerned – tax is then simply one mechanism by which a return is made to the state.

Competitive neutrality requires that state enterprises should fully recover their costs and these costs should include an appropriate return on capital. For a discussion of the practical issues involved in measuring and setting rate of return targets, including through the use of benchmarks see Productivity Commission (1998)[19]. In Finland the principles applied and actual means of setting performance targets is not highly transparent. The Act requires that a profit target be set and that it should be achievable. Consequently profit targets are set in terms of the specific level of profits to be achieved in each year. It is not clear to what extent rate of return objectives or other consideration enter into setting this target.

State enterprises generally raise debt finance directly from private financial markets – although there is provision within the legal framework for the state to lend debt capital to a state enterprise, this is an exception to the general procedure.

State enterprises are ultimately guaranteed by the State since state enterprises are not separate legal entities with limited liability. Should a state enterprise not be able to meet its debts the state would be directly liable. Consequently, the risk attaching to borrowings by a state enterprise is essentially that attaching to state borrowings (which can be taken as default risk free for domestic debt). This confers a competitive advantage on state enterprises compared with private sector competitors for which private financial markets will attach some default risk. The Ministry of Finance estimates that the benefit accruing to state enterprises amounts to about a 0.5 percentage points reduction in applicable loan interest rates. A corresponding benefit also applies when a state enterprise grants a guarantee in respect of a loan made to one of its subsidiaries.

Statutory insurance applicable to labour accidents is self insured within a State system where the State enterprise pays to the Treasury for any amounts paid out by the Treasury in treatments, benefits, compensation or pensions. The Treasury does not levy a fee on state enterprises for administering this scheme.

Non-statutory insurance (which covers the assets of an enterprise, damage to business operations and consequential lost profit, and external liability to third parties) can be obtained from insurance markets or under a state indemnity scheme set up under the old Act on State Enterprises. All state enterprises opted for the indemnity scheme, which operated as follows:

- No periodic insurance premiums were paid.

- An annual “excess” was determined by the Ministry of Finance, which was intended to measure the independent ability of an enterprise to survive economic loss due to unforeseen damage each year. Case specific excesses were also set.

- The state enterprise bears the loss in respect of any actual damage less than the excess and is compensated for any damage beyond the excess by the State. The Ministry of Finance determines maximum amounts of damages and periods of payments etc.

In fact all cases of actual damage were less that the case specific and annual excess limits so that the State has not had to compensate a state enterprise under the indemnity system.

This indemnity system clearly introduced a competitive non-neutrality with respect to (potential) private participants in these markets. Such a private participant has the option of self insuring and bearing any damage, in which case the private participant would not have the risk protection enjoyed by state enterprises for damage beyond the excess that applies in the state indemnity system. Alternatively, the private participant could choose to purchase insurance cover, which would involve a cost commensurate with contingencies covered and excesses (and the insurance market's periodic appetite for risk). This cost would put them at a competitive disadvantage relative to a state enterprise. In effect state enterprises enjoyed an advantage which is equivalent to the economic value of the insurance offered under the state indemnity system.

Many of these competitive neutrality issues are dealt with in the new Act on State Enterprises (1185/2002), but not all – see section 5.1.5 for a discussion. Moreover, the competitive neutrality effects of performance steering decisions (such as if the rate of return required of an enterprise were to be set too low compared with private competitors) can only be addressed as they arise. It is therefore appropriate to examine broader mechanisms to ensure competitive neutrality and this potentially includes the operation of competition law[20]. For present purposes it can be noted that the competition law applies without exception to publicly owned or managed enterprises were these are carrying out a business undertaking. The concept of business undertaking extends to commercial activities carried out directly within state agencies as well as through separate entities such as a state enterprise or company.

Most competition laws can apply to adverse competitive neutrality problems if it gives rise to a situation that comes under the applicable abuse of dominance (or equivalent) provisions. Generally, these set relatively high thresholds either in terms of the requisite market power required to attract jurisdiction or the severity of the conduct. This is the case in Finland and it is recognised by the authorities that a public entity which enjoys a built in competitive advantage can do considerable damage to competition even though it could not be said to be dominant or could never recoup losses from predatory conduct (because of a soft budget constraint it might never have to). In Finland a special article which was carried over from the original competition law is potentially applicable in these circumstances:

> ARTICLE 9: A competition restriction which is not forbidden under Articles 4-7[21] shall be deemed to have harmful effects, if it, in a manner inappropriate for sound and effective competition, decreases or is likely to decrease efficiency within the economy, or prevents or hinders the conducting of business by another.

The FCA has never formally applied article 9 to public sector entities that could be seen not to meet desirable standards of competitive neutrality, but is has been particularly active in an advocacy role to address competition problems which have competitive neutrality causes. Article 9 has been the basis for advocacy in these instances. This was one of the major elements of the *Government and the Markets* project in 1998. In part this was motivated by government business entities moving into the domain of formerly private sector activities when as a result of a recession the public entities found themselves with resource slack. As part of this exercise the FCA investigated the activities of some government offices, departments and companies. The targets of investigation included the occupational health service provider Medivire**,** the Finnish Institute of Public Management providing training and consulting services, the Finnish grain trader Avena**,** the materials management and public procurement house Kauppatalo Hansel**,** the Finnish Meteorological Institute and the Finnish National Road Administration.

In March 1999, the FCA made a proposal to separate road production (which is a competitive industry) from road procurement (which is not). It was proposed that the separation be in the form of a company, but the FCA has later supported the plan of the Ministry of Transport and Communications to establish a state enterprise of road production. The competitive neutrality problems that still remain in this instance (notably the tax exemption) has already been noted. The four year transitional arrangement under which the Road Enterprise has a guaranteed share of the market might also give rise to competitive neutrality problems. In the circumstances the transition is reasonable to allow the Enterprise to adjust and provide scope for entry. However, some care will be required in its implementation to avoid possible cross subsidisation of between guaranteed projects and potentially competitive projects which might be used to foreclose entry.

These efforts are all restricted to starting conditions but have not addressed competitive neutrality problems arising from the way state entities are run, particularly the possibility of setting low profit targets. Some other countries have more developed and explicit competitive neutrality frameworks which are designed specifically to deal with neutrality problems that arise within the threshold of potential application of the competition law. A brief description of some of these is set out in Box 2. It is notable that an important motivation for these frameworks is one of equity rather than efficiency and that they deal with cases where lax steering imparts an advantage to a pubic enterprise because it does not earn a reasonable rate of return on the capital employed. It is also notable that these frameworks provide the possibility for private parties to seek to resolve neutrality problems that are adversely affecting them. Although the FCA has been active in advocacy about such problems, more could feasibly be done if the Finnish law gave it or another agency more specific tools and resources to enforce them. If this function was given to an entity other than the FCA care would need to be taken to avoid possible conflicts. For example, it would generally not be appropriate to vest a competitive neutrality enforcement role of this kind in a Ministry that performed ownership functions.

### Box 2: Competitive Neutrality Mechanisms: A Survey of OECD Practices

Competitive neutrality policies are intended to remove resource allocation distortions arising out of public ownership of business activities and to improve competitive processes. A key feature is that prices charged government businesses need to fully reflect resource costs, otherwise there will be distortions of decisions on production, consumption and investment. A number of countries have implemented explicit competitive neutrality frameworks that operate at a lower threshold of distortion than would general competition law prohibitions on abuse of dominance. In part this reflects a policy view that it is simply unfair for a government to use the coercive powers of the state to selectively advantage its own business operations over those of private citizens.

**Netherlands**

A set of "*Instructions for the performance of commercial activities by central government organisations*" came into effect in 1998. But these were found to be inadequate to address the full range of competition issues since private companies complained of unfair competition from the commercial activities of government organisations. Competitive advantages of government entities can include lower risk, public subsidies or tax advantages or access and privileged relationships with policy makers. Following experience with these *Instructions* and further policy development, the Government proposed in 2001 to legislate a framework of formal rules for government commercial activities involving the supply of goods or services to third parties in actual competition with private providers so as to create more equal competitive conditions. Consequently, the Market and Government Bill if enacted would impose obligations on government organisations (State, provincial and municipal) and organisations with exclusive and special market rights[22] (OEMs), as follows:

- Rules for ***market access*** by government organisations – commercial activities undertaken by government entities must have a specific statutory basis and result from a decision that has been underpinned by a thorough and transparent, prior assessment of the desirability of the commercial activities by a government organisation. This access rule also applies to the participation of the government in an incorporated company involved in commercial activities where the company is controlled by the government[23]. The benefits of serving the pubic interest (not merely to generate income) through the activity must outweigh any negative consequences for private providers. Interested private businesses can provide input to this assessment, before the government organisation decides to engage in commercial activities, and have recourse to administrative law remedies if they believe the decision was not properly considered. The decision must be reassessed every 5 years[24]. A Government and Market Commission will be an expert, non-binding advisory body for government organisations undertaking this analysis and making the decision. This Commission can also advise any private entity and its advice can enter into any administrative law complaint proceedings and act as an expert witness.

- Rules for ***conduct*** by government organisations and OEMs that aim to prevent unfair competition. Policy functions must be segregated from production functions and policy areas must not grant preferences to production areas. Specific conduct rules include a requirement that all costs attributable to the commercial activity are included in the price for the good or service (intended to prevent cross subsidies) and rules concerning accounting for such costs. OEMs may not use government funds provided to them to perform their function for any other purposes (also intended to prevent cross subsidies to non-exclusive activities). Confidential government data cannot be used in government commercial activities and non-commercial data cannot be used unless it generally available to all commercial entities. Administrative law remedies are available in the case of misapplication of these rules as they related to internal administrative functions of the government entity while the Netherlands Competition Authority (NMa) applies the rules of conduct. The NMa may issue a decision of violation in respect of government organisations and may also penalise OEMs.

An administrative law finding against a government entity could form the basis of an action for a civil penalty for damages by a private entity that had been adversely affected by competition from the government.

Preexisting commercial activities and liberalisation programs are treated under transitional provisions that provide for continuation of existing contractual activities. Existing specific competitive neutrality frameworks – such as in respect of post and energy activities - will continue and after liberalisation be reviewed for compatibility with the Government and Markets Bill.

**Australia**

Part of the National Competition Policy Reform implemented in the mid-1990s involved the formulation of competitive neutrality principles and the establishment of special complaints mechanisms to ensure that the principles were applied effectively and the private entities could seek a solution if they have been damaged by unfair competition from a public entity with an inappropriate competitive advantage. The competitive neutrality principles required that significant government business activities should not enjoy net competitive advantages over their private sector competitors simply by virtue of public sector ownership. Consequently, governments committed not to use their legislative or fiscal powers to advantage their own businesses over the private sector. The motivations behind this policy were efficiency and equity concerns. Thus:

"In the public sector, increased attention has been given to the core role of government and how government services can be best delivered in an environment of resource constraint. This imperative has driven reforms ranging from privatisation, deregulation of public monopolies, competitive tendering and contracting to various management reforms, including devolution and accountability frameworks. Competitive neutrality requires that where governments choose to provide services through market based mechanisms that allow actual or potential competition from a private sector provider, that competition should be fair. In this sense, competitive neutrality will operate to ensure the integrity of other reforms to improve the operation of government businesses."

Competitive neutrality requirements are applied essentially commercial activities, i.e. significant government business activities that charge for their services in an actual or potentially competitive environment where the business managers have some discretion in price setting. The requirements do no apply to non-profit, non-business activities.

The principles were elaborated in the following areas:

- Corporatisation: The legal and governance structures of businesses were reviewed.

- Taxation: All tax exemptions were removed or tax equivalent regimes were developed for entities not legally separate from government.

- Finance: Advantages from implicit guarantees could be addressed by a neutrality charge.

- Rate of return requirements: Businesses were required to fully recover costs and earn appropriate rates of return on capital.

- Regulatory neutrality: Special exemptions from regulatory arrangements (eg safety or reporting requirements) were removed.

The complaints mechanism is an administrative procedure undertaken by specially established complaints bodies in each jurisdiction that can assess whether the competitive neutrality requirements are being complied with. If the complaint is found to be verified, including by means of a public enquiry, and the matter is not then remedied the complaints body makes a public report with recommendations to the Treasurer who must determine the matter. Investigations have been implemented at the national level in a range of areas including airport services, meteorological services, post, television, security services, railways and job placement services.

**Other Countries**

In other countries competitive neutrality issues can be partly addressed to the extent that competition law is applicable to state enterprises and that the neutrality problem is caused through conduct. The applicability of competition law in these circumstances will be limited to cases where relevant thresholds (dominance, substantial market power) are met and, broadly speaking where the conduct can be shown to be predatory. The limits on state aids in the EU are also potentially relevant. Less serious conduct and structural competitive non-neutralities (e.g. tax and regulatory exemptions) are often subject to advocacy efforts by competition authorities.

### *1.4. Corporate Governance, State Ownership and Privatisation – General Principles*

*Corporate Governance and State Ownership*

There is a long history of development of corporate governance models in the private sector that have a basic objective to deal with a "principal-agent problem", irrespective of differences between approaches in different countries. The principal-agent problem arises from the separation of ownership and control of a corporation. When a firm is managed professionally by managers (agents) they may have different objectives to the shareholders or other stakeholders (principals), so that the managers may make different decisions affecting the company than would be made if shareholders/stakeholders were taking the decision[25]. For example, while shareholders own the profits of a firm, its managers can take decisions that divert profits to satisfy the managers' interests – i.e. manager's prestige, perks and financial rewards – rather than maximise profits and dividends. A further dimension of this problem is the potential for managers to accept or avoid risks that do not reflect the risk preferences of shareholders.

There are several market-based mechanisms and regulatory frameworks that limit the discretion of managers. The market for corporate control translates a company's performance into the share price and so poor performance (or bankruptcy) and a consequently low share price relative to comparable firms is likely to lead to take over and dismissal of the management. Equally, these mechanisms sharpen the incentives that shareholders have to monitor management. Securities law sets up a monitoring and information flow mechanism that assists capital markets to perform these functions. Similarly, the market for managerial talent translates reputation, which is affected by performance, into financial rewards for managers. Consequently, behaviour which is at variance with shareholder interests and which thus increases agency costs will be born to some extent by errant managers. Audit mechanisms are a further market related process which limits the discretion of managers. Audit is intended to certify that accounts have been prepared in accordance with specified standards and this guarantee influences financing costs and the attitude of shareholders to management. Lenders to a company have an incentive to monitor performance and measure and price risk in a way that should be taken into account by managers. Corporate and criminal law also operate to discipline management in cases of fraud and other misbehaviour. But, all of these mechanisms are partial and work imperfectly, so that considerable importance attaches to corporate governance systems that are intended to provide for shareholders to exercise influence over management.

In the narrowest sense "corporate governance" is about control of the managers by the shareholders, so as to set the objectives of a company, the means to attain them and performance monitoring. Some broader concepts of corporate governance incorporate the interest of other stakeholders – financiers, suppliers, employees and (even) customers. Different countries place varying emphasis on the interests of different groups. As such, corporate governance systems are designed to improve on market mechanisms to provide an institutional framework to formulate and monitor contracts that provide the management agents with incentives that are aligned to shareholder and stakeholder interests and which punish unsatisfactory behaviour. Box 3 provides a brief summary of the main elements of private sector corporate governance systems.

Corporate governance systems address the principal-agent problem through a number of related channels. Firstly, they determine the rights that shareholders (and stakeholders) can exercise in the control of the firm. Secondly, it provides shareholders/stakeholders with a flow of information necessary to make control decisions. Thirdly, it sets up a mechanism where an interposed entity (the board) that represents the interests of shareholders/stakeholders and which has more direct influence over management than is feasible directly by (dispersed) shareholders/stakeholders. Shareholders can also try to better align the interest of managers with their own. This is the objective of performance remuneration systems, some of which build on the market mechanisms noted above, by giving managers a stake in the value of the company, such as through option schemes.

Corporate governance systems are not costless and they can also fail. This is because complete contracts that specify the consequences for managers in all contingencies over which they might have influence cannot be written. Also, information flow to shareholders is necessarily imperfect. And, diverse shareholdings can increase the transaction cost of imposing shareholder control over management. Myopic shareholder behaviour and fads can mean that market valuations can diverge from fundamentals and highly regarded companies and managers can, with the benefit of hindsight, be seen as abject failures. A number of high profile corporate failures (not in Finland) have underlined that existing systems of market surveillance, including audit mechanisms, and corporate governance arrangements have not keep pace with the need for improved surveillance and standards in complex, liberalised and globalising markets. Consequently, a global policy challenge is the need to strengthening present models of corporate governance and the coherence of regulatory and prudential oversight.

There are several factors that make the governance task more complicated in the state sector. Firstly, for fully state owned firms[2627] or state enterprises there is no market for the ownership of the firm, so the market based mechanisms that allow the monitoring of performance and which partially align managerial incentives with performance do not operate. Secondly, even where there is a market value in the case of partly privatised entities, governments are constrained in their exit options as owner. Thirdly, lenders to a firm and possibly private shareholders have smaller incentives to monitor performance if it is perceived as government guaranteed. Fourthly, public sector managers are generally less likely to be dismissed for poor performance and their remuneration is less often directly or indirectly related to performance. As a result, public sector managers may have less financial incentive to pursue performance and may have more discretion *vis a vis* performance than their private sector counterparts. A priori, one might expect the performance of government owned firms to be lower than comparable private firms and this appears to be born out by empirical evidence[28]. So, in the absence of the market surveillance mechanisms, administrative governance structures become effectively the sole means to address the principle-agent problem in publicly owned companies and enterprises.

However, the larger task for corporate governance in the public sector is not easily achieved even if it is a 100% owned firm. This is because the owner (state) also is likely to have a richer set of objectives than simply profit maximisation. It is conceptually possible to deal with other objectives through arms length regulation but governments may choose to use their ownership leverage to achieve these aims. For example, in some industries a government may have objectives relating to universal service delivery and quality standards, employment or regional issues. Alternatively, ownership could be used instead of regulated private ownership to control monopoly problems. These objectives may also change over time, may not be clearly defined and may partly conflict – such as efficiency and USO delivery. Consequently, it may be difficult to measure the extent to which objectives are achieved. It is harder to write a performance related contract with managers in these circumstances and the informational advantage enjoyed by managers will be higher. This adds to the complexity of the governance problem.

Moreover, even where a government 100% owns a firm, the governance and monitoring mechanisms may not be as direct as for the private sector. This is because there is range of participants within the structure of the government (voters, parliament, executive, civil servants) which adds to the chain of principles and agents in the governance structure. The consequences of this will depend upon the constitutional makeup and political norms that apply in particular countries and influence the relationship between these different levels in the government and the way the government functions. Therefore, it is not feasible to say that there is a best single governance structure that will apply in all countries and all situations.

**Box 3 Principles of Corporate Governance**

The OECD Principles on Corporate Governance were approved by Ministers in 1999 as a common basis that Member Countries consider essential for the development of good governance practice. While they were primarily developed for publicly traded companies they are also to the extent deemed applicable a useful tool for non-traded companies and state owned enterprises. Further specific development of this work in respect of state enterprises is proposed. The Principles include guidelines under five headings:

- The Rights of Shareholders: The corporate governance framework should protect shareholder rights to transfer shares, obtain information, vote, elect the board and share in profits.

- The Equitable Treatment of Shareholder: The corporate governance framework should ensure the equitable treatment of all shareholders and the right of redress for violation of shareholder rights.

- The Role of Stakeholders Corporate Governance: The corporate governance framework should recognise the rights of stakeholders as established by law and encourage active co-operation between corporations and stakeholders in creating wealth, jobs and the sustainability of financially sound enterprises.

- Disclosure and Transparency: The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.

- Responsibilities of the Board: The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of the management by the board and the board’s accountability to the company and the shareholders.

Although governance arrangements between governments and state owned entities are necessarily varied and complex, there are several general principles that can be adopted that are likely to assist the attainment of the government’s objectives, whatever they might be. Broadly, these are better definition of the objectives, better measurement of performance and better alignment of managerial incentives to efficient achievement of these objectives. Moreover, as governments have allowed competition in formally government controlled sectors, they have been more explicit about their regulatory objectives. As a result, governance arrangements of firms which remain government-owned have been focussed more on efficiency based performance criteria. Consequently, it is possible to pose a number of “solutions” to the governance problems in the state commercial sector as follows:

- If it is possible to define the objectives of the government clearly and these do not vary over time then governance forms like that of a company will be feasible and are likely to reap at least some efficiency benefits from more commercially orientated management. Essential to achieving this is adherence to the state objectives and to buffer commercial decisions from day-to-day political interference.

- Where governments are competing with private companies, efficiency and equity demand that there be competitive neutrality between them and, so far as governance in concerned, this requires a separation of ownership and governance functions within the government.

- Formulate regulatory objectives through transparent and explicit regulation, including where necessary an independent regulator to enforce it. For natural monopoly industries further governance structures, in the form of independent regulators, are likely to be preferable to government ownership[29].

- Better emulating private sector incentives can be done through corporatising into a private law company and creating a transparent relationship between the state, Board of Directors and the company. This should include clear rules for the appointment of independent directors, clear corporate goals, a defined governance role for the Board and regular disclosure of relevant information. Where the company remains state owned some private surveillance mechanisms can operate if its debt is held privately. Nevertheless, to ensure appropriate incentives, the state should not be seen as guarantor for these companies.

- Performance contracts between SOEs and the state can be especially useful when there is relatively little competition which would otherwise guide the evolution of services provided by the enterprise. Over time, these performance contracts have tended to rely less on production targets, and give additional commercial flexibility and more clarity in the financial relationships.

- Privatise commercial companies where there is not an overriding policy reason to retain a commercial function in state ownership as discussed below[30]. This is all the more appropriate for companies that are operating in a competitive environment.

*Privatisation Principles and Evidence*

Privatisation has often been motivated by a view that private firms would be more efficient that continuing public ownership[31] and that the government could reap some of this efficiency gap in the form of a capitalised value in privatisation proceeds. However, government objectives are not limited to efficiency concerns alone. Consequently, any discussion of what are the appropriate conceptual boundaries of the state, and thus what should the government sell and not sell, must go beyond efficiency concerns[32]. This is a complex area which in practice is heavily influenced by political processes and interest groups, the fiscal needs of a government, present market valuation and so on. However, at a conceptual level, the desirable boundaries of the state can be framed around the key determinants that are summarised in Table 5.2 and discussed below[33]:

Table 2: **Key Determinants of the Merits of Private and Public Production and Ownership**

| | **Private** | **Public** |
|---|---|---|
| Contractable | Feasible | Difficult |
| Innovation/Flexibility | Important | Unimportant |
| Agency Costs | Low | High |
| Rent Seeking Potential | Low | High |
| Regulatory Framework | Developed | Undeveloped |
| Competition | Strong | Weak |
| Reputation | Strong | Weak |
| Corporate Governance | Developed | Undeveloped |
| Capital Market | Developed | Undeveloped |

- ***Contractability***: Where some element of a transaction cannot be defined in advance or monitored ex post it is difficult to write a reliable contract, so it is then it is said to be non-contractable. The private sector is not very good at delivering non-contractable things because they involve risks that are difficult to price. For example, governments tend to supply a substantial part of their demand for policy advice and implementation internally by employing civil servants. This is because the government cannot specify in advance what those demands will be in any particular period so the government contracts for inputs rather than undefinable outputs. Work by external policy consultants tends to be time limited and focussed on identifiable tasks. Non-contractable issues are can also give rise to hold up problems.

- ***Innovation/Flexibility:*** If rapid decision making and innovation are important to the ongoing economic viability of a production functions (such as if the market is risky or changing rapidly) it is better suited to the private sector

- ***Agency costs:*** If large consequences attach to privately motivated action by agents that might diverge from the interests of the steering entity then it may be better to undertake a function directly within the control of the public sector. For example, governments tend to wage war (or own nuclear power plants) directly.

- ***Rent Seeking Potential*:** Funding the state is least distortive and thus least costly to the economy if that funding comes from pure rents. In part this is one reason behind traditional state monopolies (such as salt monopolies) prior to the development of more sophisticated tax systems which could effectively tax private activities of this sort. Technical progress has also eliminate many such rents.

- ***Regulatory Framework:*** Private production works best if the regulatory framework for the control of risks and promotion of factors deemed to be in the social interest are well developed. Failures in liberalisation have often been due to inadequate regulatory frameworks.

- ***Competition***: Competitive markets perform better than private monopolies, with the exception of natural monopolies. The balance between public and private monopolies depends upon a range of circumstances and is not clear cut a priori.

- ***Reputation:*** Reputation effects can strongly discipline behaviour to socially beneficial norms. If these are operative then risks associated with private provision are reduced. Consumers have a higher level of trust in branded products.

- ***Corporate Governance:*** If developed it reduces agency costs and makes corporate forms less risky than otherwise.

- ***Capital Market:*** If undeveloped then private firms have difficulty raising capital.

All of the above points apply on an “other things equal” basis and should be assessed against the background that efficiency objectives would tend to promote private ownership where those factors do not provide an over-riding reason for public ownership. The key determinants will change in an economy over time and this may change the scope of activities that are better placed in the private sector. For example, development of capital markets, or growing sophistication of tax and regulatory systems, or improved technology that enhances the potential to measure and monitor outcomes are all likely to promote the scope for privatisation.

This survey does not address privatisation in detail; specifically, it does not address issues concerned with privatisation methods[34] and we only very briefly examine empirical evidence on the consequences of privatisation.

There is now a large empirical and analytic literature on the actual effects of privatisation. These effects are difficult to isolate empirically from the effects of broader regulatory reform because, in most instances, privatisation has been accompanied by significant regulatory or structural change. And, there is a complex sequencing of cause and effects where the implementation of a policy is staged over a period of time and is also anticipated by participants. A survey of 61 empirical studies by Megginson and Netter (2001) concluded that privately owned firms are more efficient and profitable than otherwise comparable state-owned firms, enterprises; that privatisation works in that divested firms almost always become more efficient, more profitable, financially healthier and increase their capital investment spending; most studies show a fall in employment as a result of privatisation, except where sale increase substantially; and privatisation helps to develop and deepen capital markets and thus improve the general business environment. A substantial collection of work on these issues can be found in OECD(2000)[35] which includes the following points:

- Labour productivity and, in some cases, total factor productivity increases with privatisation.
- Consumers reap part of these gains in the form of lower real prices[36], and this effect is strongest where there is competition. Regulation of post privatisation monopolies is less successful than competition – regulation is hard.
- Service quality and range improves, often beyond minimum regulated levels set by the state – the important exception to this outcome is where the reform fails due to partial, incomplete or inconsistent reform design.
- Privatisation makes a significant positive contribution to public finances – the pre-privatisation earnings yield from the entities is usually less than the yield the government pays on its debt. The private sector investors recognise the efficiency gains and consequently higher earnings that are possible from more commercial management and this efficiency gain is partly capitalised into the privatisation price. The state also captures part of any efficiency gain in the form of taxes on increased corporate profits of the privatised firm

The issue of whether privatisation or competition is more important for performance improvement is vexed and no attempt to resolve this issue is made here. It is reasonable to expect that the effect is cumulative, i.e. liberalisation and privatisation are more effective than either privatisation of firm with continuing market power or continued government ownership in a liberalised sector. The latter result is what would be expected given the additional challenges of governance of commercial activities with continued state ownership.

It is very important when undertaking privatisation that appropriate weight be given to competition issues in assessing the worth of particular bids. It is a bad policy mistake to give undue weight to maximising the sales revenue if that occurs through the creation of private market power as set out in Box 4.

Box 4. **Privatisation: Revenue and Competition Objectives**

Among other objectives, governments desire to maximise the revenues from privatisation of former government owned firms. This can be influenced by the way that an entity is privatised, including whether the resulting privatised firm will have market power. For example, traditional utilities (gas and electricity) can be sold either in the form of a pre-existing vertically integrated monopoly or, alternatively, the monopoly may be restructured vertically along functional lines and horizontally in potentially competitive segments and sold to yield a competitive structure. Similarly, an industrial firm may be privatised to a private entity that already has a large share in the relevant market or it may be privatised in a way that maintains competition.

There are grounds for predicting that firms being privatised in a way that maintains or increases market power will command a higher market value than will the sale of a more competitive structure. This is because a private sector owner should be prepared to pay a capitalised premium for the flow of rents arising from the market power to the extent that this is used to raise the price of goods in the market. Consequently, there is commonly perceived to be a policy conflict here between maximising sales revenues and the degree of competition in the resulting industry structure.

There is certainly a policy trade off involved, but the view that fostering competition should be subordinated to maximising sales revenue is poor policy choice. In fact, there are good reasons to expect that the government will get "poor money for value" from such a deal, which sells rents in return for higher privatisation revenue.

- First, part of the role of a competition authority or a regulator is to reduce rents. To the extent that they are expected to perform that job (their credibility), the expected degree of rent is reduced and consequently, the sales premium is reduced.

- Second, after the sale is complete the government has an incentive to erode the rent and ensure the best economic performance and this introduces a time inconsistency and hence policy or regulatory uncertainty. Any regulatory uncertainty will reduce the certainty attached to any expected rents and increase the discount rate applied to those expected rents and consequently further reduce the premium.

- Third, in normal circumstances private agents bidding for the firm are likely to have a higher discount rate than the government. Hence, private sector agents are likely to value the rent stream at a lower capitalised value than it is worth to the government.

- Fourth, an equivalent outcome on final prices could be achieved by privatising a competitive structure and imposing a special excise tax on the goods in the subject market. This would yield more revenue in net present value terms for the government than privatising a monopoly because there would be no uncertainty and the government would have a lower discount rate. It can also be questioned whether the implicit tax imposed on the goods in that market by privatising a firm with market power is the least distortive way of raising tax revenue.

- Fifth, the competitiveness of all industries which use the subject goods as an important input will be reduced and their profits and tax payments lowered to the extent that their final selling prices are constrained.

A dynamic perspective should also be taken on this question. An important precursor to strong economic growth over an extended period on the supply side of the economy is an economic framework that fosters competition across a broad front. It is evident that economies that are able to achieve such dynamic growth are in the best position to achieve strong fiscal performance. Consequently, while privatisation of monopolies might improve the fiscal performance of a government in the short run (even though it is a bad "deal"), it is also likely to reduce the growth potential of the economy and hence its revenue generating potential. It is not difficult to conceive of circumstances where the privatisation of intact dominant firms may be counter-productive to a government's fiscal objectives beyond the very short term.

### *1.5. Regulatory framework for governance of SOEs in Finland*

The Act on State Enterprises (185/2002) and the prior Act on State Enterprises (627/1987) lay out the general framework for commercialisation of state production through the state enterprise model – they set out basic principles of the operations, finances and management. Each state enterprise is then created by a further Act of Parliament that is specific to each state enterprise. This specific Act sets out the business functions and any "derogation" from the general business principles as set out in the general Act, such as any continuing administrative functions of the enterprise or special governance arrangements.

Preparation of the first Act on State Enterprises and its passage through Parliament took several years to complete. This relatively long time period reflects several factors. Firstly, there was a need to ensure compatibility with the Constitution, where amendment was required to permit state enterprise accounts to be accounted for outside of the overall state budget. Secondly, at the time there were significant political sensitivities and resistance to the prospect of commercialisation of state economic activity and expected employment loss and insecurity. Overtime, this element of sensitivity has declined as discussed in the section discussion the process and outcomes of the reforms. A third cause for delay was the need to find consensus about the governance role to be exercised by the respective entities (Parliament, Government, competent Ministry, enterprise board, management and labour). Partly as a result, the governance structure in the first Act contains considerable areas of overlap and some ambiguities. This sensitivity about the distribution of governance roles remains in large measure and is the reason why the enactment of the second Act took a number of years to complete.

It is instructive to examine how the governance structures have evolved between these two Acts. Under the first Act, the formal governance structure for state enterprises formally "cascades down" with decisions from Parliament, to the Government, the Ministry of Finance and the responsible Ministry, and then to the board and managing director of the state enterprise. As a matter of practice preparation of proposals for these decisions cascades up (as is normal in state structures) broadly as follows:

- In the annual State budget, Parliament determines the ***central service and other operating targets, major investments, maximum short and long-term borrowings*** and budget allocations for loans and compensation for specified services of each state enterprise.

- Based on a preliminary financial plan submitted by the enterprise, the Government approves the service and other operating targets (loans investments etc) of the enterprise and decides on its ***financial and performance targets***. In effect, the government may supplement but not over-ride the targets set in the parliamentary budget process. The Government appoints the Board and Managing Director. Board members are appointed for a three-year period and at least one must represent the personnel of the enterprise. The Government can also decide on the operating and financial (OFP) which guides the enterprise over the period beyond the current budget year. The Government approves the annual accounts of each enterprise and decides upon the distribution of its profit. These roles can be delegated from the Government to the responsible Ministry, and have been done so in some cases[37] and progressively more so such that the competent Ministry plays a more direct role in performance steering. Where the government is dealing with these matters, most are dealt with in the first instance by the Finance Committee of Cabinet, prior to being formalised by full Cabinet consideration. The government appoints the auditors, including the State Audit Office, but the Act does not specify the responsibilities of the auditors. In practice the auditors follow private sector practice and certify that the accounts are prepared in accordance with applicable accounting principles.

- The Ministry of Finance has a co-ordinating role in the budget preparation process, accounting financial planning principles and financial directions.

- The responsible Ministry acts as a conduit for and participant in the preparation of draft budget and operating and financial plans from a state enterprise and any delegated tasks from the government. If the service and other operating targets and performance targets set for the enterprise have not been attained without a justifiable reason then the competent Ministry shall consider the position of the Board and the Managing Director.

- The enterprise itself decides on issues of "its operations, economy and administration" other than those that have been set in the above governance structure. This general decision making power does not formally distinguish between the Board and the Managing Director. Nevertheless, the Board is given a specified control and supervision functions with respect to business principles, administration and management, the annual financial plan, investments and expenses, balancing the accounts and other matters specifically assigned to it under the specific enterprise act or statutory orders. The managing director has responsibility to follow and enforce the decisions and directions of the Board and the MD also has a general duty to conduct and develop the operations of the state enterprise. The MD must inform the "Board of all measures and activities of great significance to the enterprise." Consequently, there is a degree of ambiguity about formal differences in responsibilities of management, the board of directors. The enterprise must make an annual report.

- State enterprises are generally responsible for setting their prices based on business principles (Act on State Enterprises - section 7) and so as to achieve their operational targets, unless otherwise provided for in enterprise specific acts. The specific acts that establish the Civil Aviation Administration and the Forest and Park Service reserves to the Government the possibility to decide prices for these entities. It is notable that these state enterprises are the ones that have the most significant residual administrative functions. In fact this pricing power was used in the early years of these enterprises but has now "lapsed" to a reserve power. This is appropriate.

The essential feature of this governance structure compared to functions carried out in a corporate form is the political level steering by Parliament. The multi-layered framework brings with it transparency and political level steering in decision making, which is appropriate in respect of public services or where the state enterprise is performing public administrative duties. The multi-layered framework also it necessarily brought with it a slowness that is inherent in government budget processes which is not well suited to enterprises operating in truly competitive situations where there is the potential for substantive loss of market share by customers voting with feet for more flexible services.

So, if there are no public duties performed by state enterprise, then a company format would be more suitable since this would lessen the potential for political intervention in commercial matters and improve the potential for rapid decision making. This is the apparent policy practice of the authorities in further transforming state enterprise into the corporate form. For example, in telecommunications the state enterprise framework was seen as insufficiently flexible and a corporate form was preferred.

Where a state enterprise is performing both commercial and public functions there was clearly a tension in these governance arrangements. Political steering is appropriate for the public functions but it brings with it constraints that are not ideal for the commercial functions. Improving on this position is possible but brings with it important practical questions. Conceptually, it would be possible to separate the commercial functions into a company and the regulatory duties would be performed by a government agency – this would do away with the state enterprise. The company could still perform non-commercial duties such as custody and management of conservation areas or operation of the airport network but this would be steered through a different mechanism than that used at present. If there remained complete government ownership, with a supervisory board, and the company was appropriately governed (see next section) it could be feasible that the company could perform public duties through transparent contractual arrangements. This would allow the synergies or economies of scope between the commercial and public functions of the CAA and the Forest and Park Service to be retained. On the other hand, the airport functions of the CAA are a de facto monopoly, and steering through a state enterprise has been used in effect as a substitute for regulation of a private monopoly. This will have some attractions for a government – since it is easy to implement and is thus flexible. It may however be a less open or transparent, neutral and robust form of regulatory governance than might be involved in regulation through the creation of generally applicable law. The policy choice here involves a complex balance.

It can also be observed that while the formal multi-layer governance framework (Parliament/Government/Ministry) provides for additional detail to be added at each layer, in practice there has not been substantive additional detail added at subsequent levels. Often the wording of subordinate decisions is identically the same as the higher level. This is to be expected in a system where preparation of material for decisions cascades up the governance hierarchy while formal decisions cascade down and where there is significant overlap of decision-making functions (e.g. the government endorses the steering decision made by the Parliament). There is clear scope here to improve this process by better defining the respective responsibilities of the different participants in the governance chain. This is not simply a question of tidiness but also of clarity and efficiency since it would mean that relatively minor matters would not have to be "taken to the top" for a decision.

A further issue with these governance arrangements lies in the corporate governance practices, where government ownership functions can be exercised through board representation, including by the relevant Ministry. There is some concern about differences in governance by the different ministries, particularly with respect to the treatment of confidential business information which has been requested by private competitors under the Openness Of Government Activities Act (621/1999) which applies to state enterprises but under which confidential business information is protected by an exception. Apparently, interpretation of this exception has varied between different Ministries concerned. Accordingly, the Ministry of Finance has applied corporate governance principles in a set of guidelines and it would be desirable that these be applied by all Ministries. There is also potential for increased attention to be paid to transparency and reporting, particularly where ownership functions are being exercised to pursue regulatory or public administrative duties.

Under the first Act the executives of a state enterprise do not bear the same liabilities that attach to directors of a corporate form, e.g. in respect of continuing to trade and further borrowings while a corporation is insolvent. Ministry of Justice has recommended (see Opinion No. 2169/43/97) as part of intergovernmental consideration on corporate governance issues initiated by Ministry of Finance that the liabilities of directors of state enterprises should at least be made to correspond to those of the Limited Companies Act as soon as possible. Two other points noted by the Ministry of Finance are the ability of a state enterprise to grant loans and subsidies – there are no regulations in force here so it is technically possible for a state enterprise to grant a subsidy or loan on non-commercial terms to a subsidiary, which might distort competition.

The intention of the authorities is that state enterprises operate financially independently from the state budget other than in respect of specified non-economic duties which could include the performance of regulatory functions or provision of other public services. The state can pay for any shortfall in net charges for such activities either in the form of a specific appropriation or a reduced required rate of return which implies a cross subsidy from any surplus accumulated from commercial activities. Nevertheless the first Act legally permitted the state to make an appropriation in more general circumstances so the law was not as strict as the practice of the authorities. It can be accepted that the authorities' intention is honoured. Nevertheless, it can be noted that in the implementation of this intention the framework is not sufficiently transparent as neither the law nor policy sets out the basis on which such activities should be funded. For example, should such funding be on an incremental or average cost basis? If a payment is made from the budget should it be on a cost recovery basis or should it allow a rate of return equivalent to the overall set performance target – the latter approach would assist the implementation of competitive neutrality objectives as otherwise the rate of return for the whole entity is necessarily affected by the performance of the public duties.

The State Audit Office, which is responsible to Parliament, carried out an audit of the functioning of the performance management and owner control of state enterprises in 2001[38]. This audit focussed on the CAA, Senate Properties and the Finnish Forest and Park Service. Overall the audit concluded that, “Although there is room for improvement, the State Audit Office notes that control as a whole cannot be viewed as working poorly in any of the state enterprises included in the audit”. This is a view that is endorsed by the present review. In summary, the main conclusions of the State Audit office were:

- Overlap and Multistage Control: Participation of multiple organs (Parliament, Government, Ministries etc) sometimes slows down and complicates control without adding value, but it seldom causes significant problems.

- Service and Other Operational Targets: Objectives which are set in the state budget do not meet effectiveness criteria in terms of essentiality, correctness and measurability as specified in Ministry of Finance Guidelines and do not give Parliament sufficient possibilities to influence control with regard to the level of services. Targets are too broad and are in any event often equivalent to the scope of activities of a state enterprise stipulated in its enabling legislation.

- Performance Information: Information provided by state enterprises on performance is not standardised in accordance with Ministry of Finance Guidelines issued in 1994. Guidelines need to be updated and complied with.

- Control of Investments and Borrowings: Ceilings set for investments and long-term borrowings are insufficiently flexible. It would be preferable to use control based on indicators that apply to profitability, capital structure and level of financing that would allow the Board/management to direct operations within overall limits.

- Group Structure: The steering process does not adequately recognise the group structure of state enterprises (where significant functions can be carried out by corporate “subsidiaries” of a state enterprise). Information and objectives should be presented on a group basis.

- Board of Directors: Greater attention should be paid to business and management skills and previous experience in the field in selecting potential board members. Finding suitable candidates should be arranged more systematically and actively than at present and should include a wider range of candidates. The liability position of board member should be clarified.

- Role of the Managing Director and Board: Respective responsibilities should be clarified. The role of the Board should be to support and back the managing director but also to oversee and critically evaluate the effectiveness of management. The managing director’s role is to manage the enterprise. Consequently the managing director should not be an actual board member but should participate in board meetings unless the board decides otherwise for the consideration of a particular matter.

- State as Purchaser of Official Tasks and Social Services: From the viewpoint of competitive neutrality and transparency as well as control, the state should do more to promote a buyer-supplier model in relation to state enterprises.

- Long Term Planning: The state should prepare a long-term ownership and performance policy for each state enterprise and should note in the budget the average return expected on state assets and average percentage “dividend” to be paid from profits to the state budget. The state would guide the preparation of preliminary performance plans of state enterprises in the multistage control process.

- Reform of Legislation: Delay in reforming this legislation has complicated state enterprises' decision making and reflects poorly on the state's ability to control state enterprises effectively.

On issues of governance through ownership control the State Audit Office set out a number of general considerations, reflecting the relatively undeveloped position on ownership governance, as follows:

1. Ownership Authority: The control exercised by the state and the use of ownership authority should be channelled clearly so that everyone's role and the tasks are clear to the owner's representatives and the state enterprise.

2. Trust and Responsibility: The management of each state enterprise must enjoy the owner's trust. Supervising organs must be aware of their position, authority and responsibility.

3. Objectives and Means: The owner must present its own objectives and the management must be committed to them. Objectives must be based on well-grounded strategic choices and resources must be made available for their achievement.

4. Monitoring and Reporting: Risk-taking and its consequences are always ultimately the responsibility of the owner. The state should be able to evaluate and control risks through monitoring.

5. Owner Control and Management: Balance must be achieved in the division of labour between paid management and the representatives of the state as owner, and control and management should not become entangled.

A new Act on State Enterprises involves a complete re-write of the Act to a number of points raised above in respect of governance mechanisms and competencies of the various actors. The new Act came into effect in February 2003. In summary it is proposed that:

- The Parliament sets service level and other operating targets. (Compared with the prior Act this position is broadly unchanged).

- The Government determines the assignment of assets to a state enterprise which must be at market value, determines its opening balance sheet, confirms its annual accounts and appoints and discharges its Board of Directors. (A reduced and clarified role).

- The relevant Ministry handles all other steering matters, including performance steering, although matters of economic importance or other significance could be referred to the Cabinet Finance Committee. (An enhanced role, consistent with potential for delegation under present Act.)

- The Board of Directors appoints and discharges the Managing Director. The Board and Managing director are liable for damage caused to the enterprise with intent or through negligence (Aligned with incorporated company governance structures and responsibilities).

- Responsibility of auditors would be defined. An auditor would evaluate the neutrality of commencing balance sheets in terms of asset values and assigned debts. (Aligned with incorporated company requirements for annual audits but otherwise a new function.

- Consolidated accounts of a state enterprise and any subsidiaries are required.

- Services acquired by the State must be under a budget appropriation and subject to the government procurement arrangements.
- A implicit guarantee fee is to be collected from state enterprises in respect of borrowings from capital markets with the intent of placing them on a neutral footing with private competitors
- A service fee is to be levied on state enterprises for services provided to them by the State.
- The state indemnity system is discontinued with any insurance for property damage and third party liability obtained from private insurance markets, subject to a transition period.
- Enterprise specific Acts can no longer derogate from the principle that prices must be based on business principles. Subject to a transition period of 1 year (2 years in the case of the CAA) enterprise specific Acts will be amended to comply with the general principle.

These proposed reforms address many but not all issues identified as possible areas for improvement in this survey. Specifically, many of the outstanding competitive neutrality problems are addressed, but not all. In addressing competitive neutrality issues the revised Act would set a better starting point, but it still does not address the important gap in the policy framework where there is no means for private competitors to seek some remedy when the entity is not steered in a neutral way, such as if a performance target is demonstrably too low. It is also unfortunate that the income tax exemption for state enterprises mainly providing services to government customers has been continued. It is most likely that this exemption has the effect of reducing the budget appropriation necessary to secure services for state purchasers[39], but from a government wide perspective such a benefit is an accounting fiction as it would be offset by a commensurately lower level of tax receipts. This exemption violates competitive neutrality and also complicates determination of appropriate financial performance targets for state enterprises in competitive industries, where the results of comparable private competitors could act as a reasonable benchmark.

The proposed reforms also address overlaps and uncertainties about the role of the respective parties in the governance chain and moves the overall governance arrangements towards private sector norms. It is also possible that these revised arrangements would assist to lift the burden of political steerage from the truly commercial elements of continuing state enterprise activities since steering functions are devolved downwards away from the inherently cumbersome political and budget processes. Whether this occurs or not will depend importantly on the degree of caution that is taken to the task by responsible ministries and in particular whether they might seek endorsement of their decisions further up the chain.

### *1.6. State Ownership Policy and Corporate Governance Practices*

A full examination of state ownership policy in the industrial sector, past privatisation and corporate governance of state owned companies is outside of the scope of this study. Nevertheless, a number of general policy themes in the area state ownership are relevant to the process of commercialisation of public services and the liberalisation of markets as entities involved have become state owned companies.

State shareholdings are regulated by the Act on the Use of State Shareholder Power in Certain Limited Companies Carrying on Economic Activity (740/1991). This requires a specific consent of Parliament for the sale of share in a company in each case where the state would lose a qualified majority interest (2/3rds voting rights), majority control (1/2 interest) or a qualified minority (1/3 voting interest) in the company. Parliamentary authority has given the Government scope to pursue privatisation, within the limits of the parliamentary authority, at its discretion taking into account market conditions and other considerations.

The State's shareholding in a company is managed by the ministry covering the sector in which the company operates. Nine ministries[40] are currently involved in managing the stakes of the state. So, for example, the Ministry of Transport and Communications exercises ownership functions for Sonera, Posti, Finnair, Yleisradio and the VR Group among others. These functions include Board appointments and a senior officer of the Ministry is a board appointee, with the exception of Sonera after the Board was completely re-appointed in 2001 following significant financial losses. The Ministry of Trade and Industry plays a co-ordinating role that encompasses formulation of broad ownership policy and assists with implementation of privatisation, but it does not exercise direct ownership functions other than in respect of companies directly within its ministerial ambit. The Ministry of Trade and Industry also publishes an annual report on overall state shareholdings. This spread of ownership functions between ministries means that regulation of a sector and ownership of the major firm in a sector are collected within a single Ministry. The objective of regulation is to further the interests of the community at large, including by neutral treatment of participants in an industry. At least one of the objectives of ownership is to earn profits and maximise the value of a firm, which might be contrary to the interests of the community at large or other participants in the industry. Consequently, there is the potential under present arrangements for conflicts of interest to arise within a Ministry.

Within Ministries there is a strict separation of regulatory and ownership functions by means of "Chinese walls". So, for example, in the Ministry of Transport and Communications significant regulatory functions are conducted in statutorily separate entities, being FICORA for communications and the CAA for air safety[41]. It has *not* been suggested anywhere in the collection of material for this survey that these Chinese walls have been breached or that the exercise of regulatory functions *within the existing statutory frameworks* has been biased in any way. Consequently, possible conflicts between regulatory and ownership interests only come together in the person of the Minister who is responsible both for the regulator and the area of the Ministry carrying out the ownership function. It has not been suggested that this has proved actually problematic. However, there is a recognition among private industry participants that there is a possible tension in these arrangements. Such tensions would be particularly evident when a Minister is considering a *change in the regulatory framework.* For example, a pro-competitive regulatory change to further liberalise a sector might adversely affect the profitability of a state owned company in that sector.

These potential conflicts must be resolved *somewhere* in a government, so long as the state maintains ownership interests in commercial entities. If ownership and regulatory functions were separated in different Ministries then the potential conflicts would come together at the Cabinet or Prime Ministerial level. Absent complete privatisation, the relevant policy question is, therefore, "Where should the conflict of interest between ownership and regulation come together?" There is a trend in other countries to separate these functions into different Ministries precisely so that the conflict does not come together in the person of a single Minister – this is evident in recent reforms in Norway. Collecting ownership responsibility in a single place also has the advantage that it would be easier to deal with ownership issues in a more consistent way than is possible under the present arrangement where the Ministry of Trade and Industry plays a policy co-ordinating role.

There has been a debate about this matter in Finland, and the Government submitted a policy statement on the matter to the Parliament in September 2002. (In part this debate and statement have been in response to the large losses incurred by Sonera on its UMTS licence investment in Germany and the consequent need for recapitalisation in which the Government participated.) The policy statement indicates that shareholder management of market driven-companies will be centralised in one government body. Market-driven companies are those that pursue a profit and operate in competitive markets. Companies which carry out specific functions of government will stay under the management of the Ministry that regulates or performs public functions in the sector concerned. This move will enhance the separation of shareholder and regulatory functions of market orientated companies. However, it has not yet been decided where this centralised body will be located. Consensus on this matter has proved difficult largely because of the coalition nature of successive governments and the stability in the assignment of particular ministerial responsibilities to particular political parties. Consequently, a shift in ownership responsibilities among Ministries translates into a shift in the balance of political responsibilities that has proved difficult to resolve. This matter is under continuing discussion.

The annual publication on state shareholdings by the Ministry of Trade and Enterprise summarises the ownership policy of the state. This publication notes that:

> *"The State carries out an active and pragmatic corporate ownership, aiming to achieve good dividend yield and rise in value of the investment. The state as an owner seeks to develop its companies so that they would be interesting investment objects for private investors. The State does not have a company privatisation programme, but the possible gradual extension of the ownership base is based on company-specific deliberation with the goal of strengthening the company's operating conditions."*

There has been a significant "sharpening" of ownership policy over the last 5 years, with increased attention focussed on the economic objectives and improved governance. In Kaisanlahti (2001), a study published by the Ministry of Trade and Industry, the central aim of the corporate governance of the state owned companies sector is defined as "production of economic profit[42] in companies belonging to the State's portfolio of investments. In the production of this economic profit, the legitimate interests of the personnel and other stakeholders are taken into account". This definition is broadly consistent with the OECD guidelines. Implementation of the role of the State as shareholder in the governance framework is set out, as for other shareholders, in the general company law, and also in a number of Government Decisions-in-Principle and other published memoranda.

One of these Decisions-in Principle (16 September 1999) and a Cabinet Memorandum (11 January 2000) identifies the board as the principal governance agent for the pursuit of the state's interest as owner. Boards have been comprised as the company managing director, external directors and direct representation from the Ministry that has policy competence. Between 2000 and 2002 ministries adopted a policy that the managing director and other executives will not be members of the board of companies within its ministerial responsibility. Some larger companies have adopted a committee structure for the board to deal with areas with potential conflicts of interest such as audit, remuneration and appointments. The larger state owned companies have a two-tier board structure incorporating a supervisory board of Parliamentary appointees that oversight the board.

The above Decision-in-Principle and a subsequent one (31 May 2001) makes an important delineation about the governance of specified different types of companies and the consequential interests of the State. The state is identified as having two separate interests, firstly as owner and secondly a special interest which flows from the Government's role to order society.

- For some companies, the state's interest as owner predominates – essentially those companies producing "ordinary goods and services". For these companies, a supervisory board is not considered appropriate, nor is it necessary for the State to maintain a majority holding. Indeed, Kaisanlahti (2001) notes that when such companies are operating in a competitive environment it may be feasible for the state to dispose of its entire interest.

- In other companies where the state has a societal interest a supervisory board may remain appropriate. The greater is that societal interest, relative to the interest as owner, the more appropriate it will be to have a supervisory board and the greater will be the range of the supervisory functions.

If a state decides to pursue non-economic objectives through ownership and governance channels then, in a perfectly informed market, this will reduce the share price to reflect the lower rate of return implicit in these objectives. So the state "pays" for these objectives irrespective of whether that is in the form of a lower dividend yield or lower price on partial privatisation. It is clearly good policy that potential investors are informed of these objectives and that they are pursued consistently. If that is not the case, there is the potential for arbitrary transfers of wealth from (to) investors to (from) the State after privatisation if further non-economic objectives are imposed (removed). The internationalisation of capital markets has seen more emphasis placed on sound corporate governance practices that are consistent with international norms. Consequently the state has a strong interest in ensuring good practice so as to make its assets attractive privatisation propositions as well as aligning the interest of actors within corporations to the ongoing objectives of the state as an owner.

The supervisory boards of the major government owned companies are mostly comprised of elected representatives to Parliament. Given the role of supervisory boards in companies with societal interests this can be seen as appropriate. There is scope to debate just what is a "societal interest" in this context, and clearly there is a link here to the perceived "insurance" role of ongoing government ownership that is perceived by organised labour. Related to this there is a question about the possible conflicts in the role of Parliamentarians participating in Parliament decisions on general privatisation policy, or the privatisation mandates of specific companies, when they are a member of a supervisory board.

As noted at the outset, it is not within the scope of this study to examine the status and functions of the supervisory boards of particular state owned companies[43]. For our purposes it is sufficient to note that on the one hand, as the economy liberalises and competition extends into formerly government dominated sectors, it is conceivable that the role of political level supervisory boards might diminish. On the other hand, it can be noted that an incorporated company, *with* a supervisory board and ongoing government ownership, is a possible evolution point for existing SOEs that are further liberalised yet nevertheless retain important societal functions. It is part of state ownership policy that once the State disposes of a majority interest in a company that the supervisory board would be abolished.

It is government policy as set out in the Decision-in-Principle (16 September 1999) that state owned companies be exemplary employers. This includes compliance with labour agreements, the pursuit of sustainable and sound personnel policies. State owned companies must inform a responsible Ministry of impending major layoffs or dismissals well in advance. Employee representative(s) are appointed to the supervisory board or board of state owned companies.

Incentive based remuneration of management and personnel is contemplated in the 16 September 1999 Decision-in-Principle, and Cabinet Memorandum, for decision by each company board (or supervisory board in some cases), where possible aimed at management acquiring an equity interest in the company so as to motivate management to have a long term interest in the company. However, cash bonuses for top management are ordinarily capped at 40% of standard remuneration (unless competitive conditions dictate otherwise). Options arrangements and share purchase requirements should have minimum vesting periods before executives are free to sell their interest and should be linked accountably to the achievement of performance benchmarks. All listed state owned companies use options-based incentive remuneration schemes for senior management but, according to an evaluation prepared for the MTI by consultants, these are more limited in scope and have more challenging performance requirements than other listed companies privately owned companies[44]. Many, but not all, state owned companies also have mechanisms for employees to participate in equity ownership in form of personnel funds or with share linked bonds.

### *1.7. Summary and Policy Options for Consideration*

The structure of the Finnish economy has undergone marked change as the Finnish state has progressively shifted from being a direct participant/owner of substantial parts of the economy to place more emphasis on governance and explicit regulation. This has involved liberalisation of markets and introduction of competition, restructuring of state commercial entities and partial privatisation. The objective is not to abandon the welfare state, which has fundamental political support, but to make it more sustainable through reducing resource demands and increasing its responsiveness to the needs of the citizens.

The state enterprise model has been used as a mechanism to commercialise key infrastructure and service industries. Most of these entities have now been transformed into companies which provide greater business flexibility and a reduced role for political level steering. The recently created Finnish Road Enterprise for the time being is a state enterprise but it could be expected that a further transformation could be made in due course to a corporate form since road construction is an inherently competitive activity.

There are two major entities that remain as state enterprises as they include some functions that have a public character – ether regulatory functions and non-commercial functions in the aviation sector or non-commercial functions in natural heritage and conservation. It would be possible to further commercialise these into a corporate form but this would requires further structural change. Firstly, it would be necessary to form a separate Flight Safety Authority – conceptually this has some attractions since presently the FSA performs some regulatory oversight of the CAA, but equally it may increase costs to some degree. Secondly, both the CAA and Forest and Park Service perform non-commercial functions that reflect explicit policy choices by the Parliament/Government. Respectively these are operation of regional airport networks and natural heritage conservation. Maintaining these arrangements under a corporate form would involve different steering arrangements through corporate governance and contracts. This would have the advantage of enhancing the flexibility of the truly commercial functions of these entities, as it would remove the slow governance arrangements that are implicit in the present parliamentary steering mechanism. On the other hand it would involve steering of these non-commercial functions that was possibly slightly less transparent than present arrangements. Given the various practical trade-offs noted here assessing the right balance within the confines of this exercise is not possible**. But a thorough consideration of these matters by the Government would be appropriate after the impact of the reform to the Act on State Enterprises can be assessed.**

The state enterprise model has been very successful because it has been underpinned by sound policy principles, including the need for competitive neutrality between private and public business entities. Nevertheless, the new law still conflicts with competitive neutrality in certain respects.

- **It would be highly desirable if the present income tax exemption for a state enterprise that earns most of its income from sales to the state was repealed**. This has significant practical potential to distort competition. It is feasible to neutralise the advantage by setting performance targets on a before tax basis but this is an extra layer of complication and is not ensured to work well. An argument that the exception is justified because it is the State that is paying for the services, so that removing the exception would simply increase costs to the State, rests on an accounting fiction. And the present 50% rule is arbitrary.

- **Consideration could be given to implementing an explicit competitive neutrality policy framework to address neutrality problems that arise from the way an enterprise is run**. Finland has paid attention to getting the starting conditions right for competition between state enterprises and the private sector and this would be improved by the reforms to the Act and

> also by removing the income tax exemption. Nevertheless there remains a gap in the framework where government entities can undercut private competitors due to a softer budget constraint, i.e. they can earn a lower rate of return. Competition authorities can address this problem partly through advocacy and partly through sanctions against abuse of dominance or market power. However, the latter has a relatively high threshold and given the equity motivations for being concerned about competitive neutrality in these circumstances it is arguable that a lower threshold could be appropriate. A special and very broad competition distortion provision in the Finnish law is possibly applicable but it is untested in these circumstances. In considering options in this area the Finnish authorities could draw on developments in Netherlands and Australia. If the Finish Competition Authority were to be given extra responsibilities in this area it would need to come with commensurate extra resources.

A theme underlying the reform has been the separation of regulatory and ownership functions. This is essential for successful reform otherwise new entrants are likely to at least perceive non neutral regulation that protects the government owned incumbent. In Finland these functions remain within sectoral Ministries although there are strict Chinese Walls between these functions and apparently no real conflicts have arisen. Nevertheless, responsibility for these two functions comes together in a single Minister and a number of other countries have sought to improve on this position by explicitly separating these functions under the responsibilities of different Ministers. **It would be desirable for Finland to collect the ownership functions within one place in the Government to remove any perception for conflicts by a single Minister and also to improve on the uniformity of good governance practice**.

There is an interesting "paradox" in the overall approach to these reforms in Finland, which also occurs in a number of other countries. *On the one hand*, the process of commercialisation of state production functions has been progressed in a coherent and open way within a solid and agreed conceptual framework. This can be seen, for example, in the Government Decision-in-Principle on Reforms in Central and Regional Government 1993 where the government "decided on a complete overhaul of the nation's administrative machinery, to be embarked upon immediately and with complete unanimity". This decision required a continuation for commercialisation of government services into net budgeted agencies for non-market services, into state enterprises where ongoing public steering was warranted or as an interim measure, and into companies where competitive conditions prevailed. Specific reforms were implemented and these general principles have been followed ever since. The process can be regarded as very successful and this report finds relatively few shortcomings. *On the other hand*, the next and final step in the commercialisation process, which is privatisation, has not been conducted according to a solid and agreed conceptual framework. Privatisation has been careful, staged, and done on a case by case basis according to the pragmatic circumstances of the moment. There has apparently been relatively little substantive public debate on the desirable ownership boundaries of the state, nor have governments been ideologically in favour of, or implacably against, privatisation. Consequently, the Government has an ownership policy that sets out how it will exercise its ownership functions – this is a quite highly developed policy. The extent of privatisation is limited by Parliament mandates that are significantly influenced by a unionised labour view that significant ongoing government ownership in commercial entities is a form of insurance against job loss in adverse circumstances. This insurance is not costless. Privatisation has proceeded furthest in sectors which are purely commercial and do not have significant public policy elements. This is implicitly consistent with a well principled privatisation policy but ultimately the policy position about what the government should and should not own, and thus what it should or should not privatise, is fragmented**. It would be desirable to take forward privatisation more broadly, according to a principled policy if that would assist, as ultimately this will help the fiscal sustainability of the welfare state**.

## 2. POSTAL SECTOR

### *2.1. Introduction*

Across the OECD, traditional state-owned and regulated public utility industries have been transformed by reforms that have fundamentally changed the way these industries are regulated. The former reliance on state control and regulation has given way to greater reliance on competition and market forces, which have lead to a greater focus on efficiency, innovation and meeting the needs of consumers. Overall, the results in terms of improved performance have been significantly positive. But to date, these reforms have substantially bypassed the postal sector, notwithstanding some liberalisation moves. The postal sector in most OECD countries remains dominated by a state-owned vertically integrated monopoly, largely still protected by law from the forces of competition over most of the traditional letter mail sector.

The experience in Finland[45] is somewhat different from international norms. On the one hand, there has been complete *de jure* liberalisation of the postal market since 1994. There is no "reserved area" of postal items that can only be carried by the government incumbent. In addition, Finland Post Corporation is an incorporated company that is financially independent from the government Budget and it operates under an "arms length" regulatory regime. To that extent, Finland stands out as one of the leading liberalisers internationally and is well ahead of the degree of liberalisation mandated in EU Postal Directive. On the other hand, Finland Post remains 100% government owned and there has been no actual new entry into the traditional letter post market. A new entrant has been licensed to provide letter postal services for several years but has not in fact commenced operations. One of the factors constraining entry is a special turnover tax that is applicable to new entrants, which is designed to forestall "cherry picking" entry into only dense metropolitan markets. Consequently, the main competitive challenges faced by the government incumbent are in the high-value courier, parcel services and non-addressed mail segments of the market and, increasingly, through electronic communications - fax, internet, e-mail and electronic bill payment.

The experience in those countries that have liberalised the most is that concerns about the loss of market share by postal incumbents and consequential difficulties in delivering universal service obligations *due to liberalisation* have not been realised. That is certainly the case in respect of Finland. Indeed the efficiencies that have been spurred in part by the *threat* of loss of market share have helped to make Finland Post significantly profitable, while maintaining service quality and restraining price increases. There is scope to consider policy options which would further increase the threat of entry, such as by reducing or eliminating the special turnover tax applicable to new entrants or mandating interconnection with the networks of new entrants and access to postal infrastructure. There is reason to believe that Finland Post could further improve its efficiency and quality and range of services and additional competition would help to bring this about. That is the surest guarantee of ongoing financial viability in the face of technological change rather than market protection.

Looking to the future, electronic communications poses a substantive and increasing challenge to postal systems[46]. The greater part of letter mail is of a commercial character – bank statements, bills and other invoices, and direct marketing mail. So, further technological advances in e-security potentially bring the prospect of marked declines in traditional letter mail traffic. These matters are by no means certain, indeed the imminent demise of paper based transactions has been long forecast. Nevertheless, if it were to eventuate, such developments could ultimately raise question about the appropriateness of mandated universal service obligations as today's USO's are premised in part on the historical need for high standard letter delivery services. In addition, such developments could affect the cost and sustainability of USO's as these are financed in part by profits on high volume intra-metropolitan commercial mail. The tensions inherent between technological progress and presently mandated USO's could become more evident in

Finland prior to other countries as Finland as it is one of the most “internet connected” societies in the OECD. In fact, the traditional postal segment is already regarded as a declining market in Finland. This raises a range of basic issues that are well beyond the scope of this review. It can be noted however, that it may raise a policy challenge for Finland, which must agree relevant dimensions of postal policy within an EU context where other countries may face the identified pressures at a later stage.

### *2.2. Finnish Postal Sector Structure*

Box 5: **Basic Facts on Finnish Postal Sector**

Finland Post Corporation (Posti) is the universal service provider, created in 1994 as the result of incorporation under private law of separate post and telecommunications companies out of the former state enterprise Post and Telecommunications (P&T). P&T was created in 1990 from former governmental administration. Since 1998 Posti has been managed independently from telecommunications, after a de-merger of the two companies from the PT Finland Group. Posti remains 100% government owned.

In 2001 Posti:

- Handled 2.5 billion postal items – this volume has been basically flat since 1997. The number of business-to-business letters is falling.

- Achieved a profit of Euro 32 million on a turnover of Euro 1 billion. Some 35% of revenue was from letter services where Posti is a de facto monopoly. Since 1997, overall turnover has increased at relatively slow rate. This reflects a changing composition of revenue – most growth has been in logistics and new services while one off items, such as the cessation of banking services in 2000, has detracted from growth. Income on pension fund investments declined markedly in 2001, which necessitated a substantial increase in pension contributions and caused a fall in profits – the profit reduction was not significantly due a change in underlying business conditions. The return on equity was 6.5% in 2001.

- Employed 22,809 persons. This represents a decline of around 9% since peak employment in 1998 – prior to this employment had trended up slightly. Posti remains Finland’s second largest employer.

- Delivery quality is relatively high with 95% of first class mail being delivered on the following working day and 96% of second class mail within three working days. International delivery performance exceeds the EU requirement of 85% on D+3. 73% of business customers and 72% of private customers rated Posti’s service as good or excellent.

- Key Figures

| | 1997 | 1998 | 1999 | 2000 | 2001 |
|---|---|---|---|---|---|
| **Net Turnover (mill Euro)** | 953 | 1002 | 1014 | 1069 | 1046 |
| **Operating Profit (mill Euro)** | 85 | 56 | 75 | 92 | 32 |
| **Invesment (mill Euro)** | 85 | 112 | 77 | 85 | 161 |
| **Personnel (31 Dec)** | 25933 | 26344 | 25347 | 24763 | 22809 |
| **Postal Items (mill)** | 2530 | 2560 | 2595 | 2590 | 2573 |
| **- letters** | 835 | 841 | 871 | 898 | 892 |
| **- publicatons** | 738 | 763 | 763 | 767 | 806 |
| **- direct mail** | 930 | 930 | 936 | 948 | 875 |
| **Return on Investment %** | 17.7 | 11.6 | 15.8 | 20.4 | 6.5 |

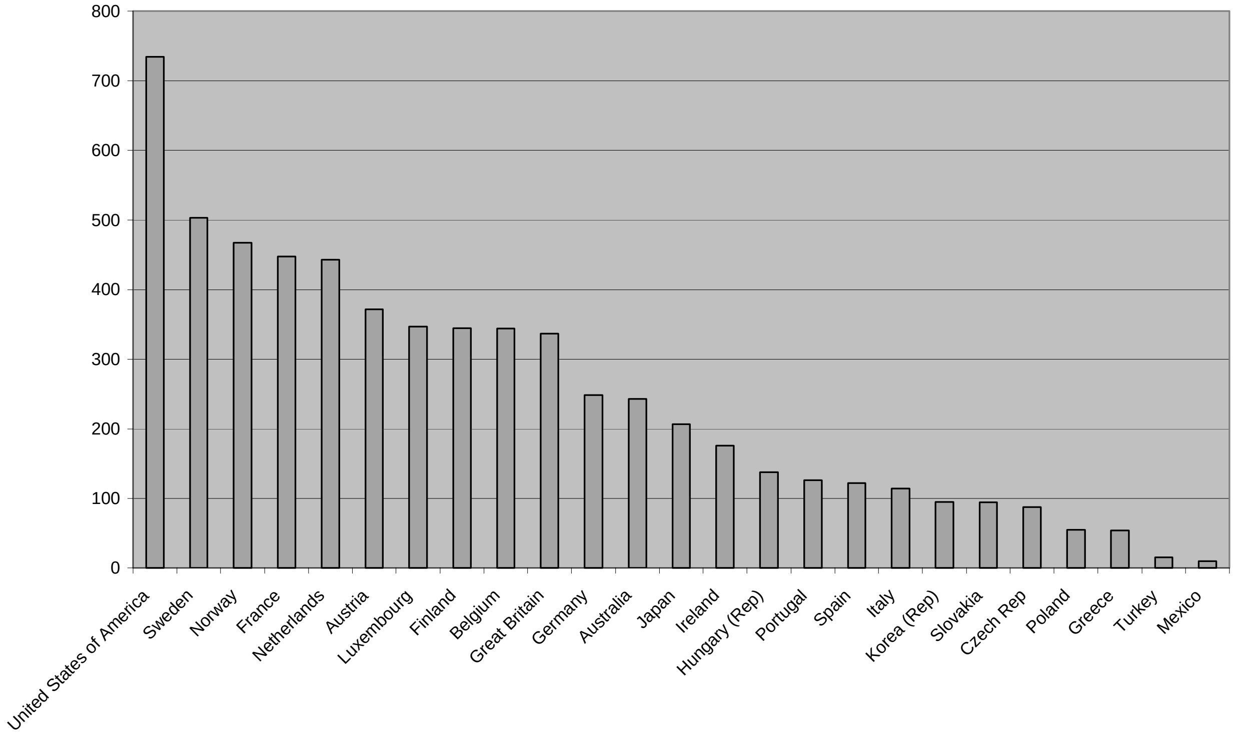
There are a large number (>200) of other entities that operate as couriers, including international courier firms for delivery of parcels, unaddressed mail and newspapers and magazines. The following table illustrates the relevant shares of the operators in these sectors in 2000:

| Type of Mail | Posti Revenue | Posti Number | Other operators Revenue | Other operators Number |
|---|---|---|---|---|
| Letters | 99.2 | 99.9 | 0.8 | 0.1 |
| Parcels | 52.5 | 66.0 | 47.5 | 34.0 |
| Unaddressed | 49.3 | 21.7 | 50.7 | 78.3 |
| News/Magazines | 63.0 | 73.6 | 37.0 | 26.4 |
| **Total** | 76.9 | 63.6 | 23.1 | 36.4 |

Source: FICORA: Postal and Small Freight Delivery Statistics 2000

The use of the postal system in Finland is comparable to other European countries as illustrated by the following chart.

**Figure 2: Average Number of Letter-Post Items Posted Per Inhabitant 2000**




Source: UPU

### *2.3. Regulatory Arrangements*

The postal sector, including Posti is subject to arms length regulation under Postal Services Act (313/2001)[47]. Operators for letter post items must be licensed and it is through the licence that legal obligations are implemented.

The first liberalisation step was taken in the Act on Postal Operation 1993, which set out the general framework for postal operations, with the key objective of defining and providing for the provision of postal services throughout Finland on equal terms and at reasonable cost. The Act separated regulatory from commercial functions, opened the market to competition and created a framework for regulation of postal operations, including through a licence procedure. The "universal service"[48] was defined as a postal service addressed mail up to 2 kg but this was not reserved to the incumbent – any licensed postal operator can provide postal services including for items within the universal service definition. The Act required a licence to be granted to an applicant that is well established and evidently capable of regularly providing postal services, if it is not contrary to the purpose of the Act. A licence could be restricted geographically or in respect to permissible post items. Express or courier services, parcels in excess of 2 kg and unaddressed mail, such as newspaper delivery, was not regulated by Act on Postal Operation. Such services were and remain fully liberalised.

The Postal Services Act 2001 made the postal law comply with the new Constitution, clarified a number of aspects of the prior legislation and made the quality requirement specified for the USO consistent with the EU Postal Directive[49]. The USO provider is obligated to maintain a presence in each municipality. A requirement for daily delivery and the required quality standards are applied to all postal operators, not just the incumbent. The domestic delivery quality standards is relatively high at D+1=95%.

The Act on Postal Services specifies that the Ministry of Transport and Communications is the responsible Ministry and that the Postal Administration (now within the Finnish Communications Regulatory Authority – FICORA) is the regulator responsible for ensuring compliance with the law. The Postal Administration is assisted by the Committee for Postal Affairs (or Postal Affairs Advisory Board) which is comprised of postal users (consumers and corporate), postal operators and the authorities. The committee has only advisory functions with all formal decisions being taken by FICORA. The objective of the Committee is to safeguard the interests of the users of postal services and postal operators as a whole. It is a co-operative forum to discuss policy, international co-operation and oversight postal operations.

The Act requires that "prices charged by a universal service provider shall be reasonable, fair and they shall allow all users to have access to the service. The pricing shall be transparent and non-discriminatory". Posti provides cost and price information to FICORA and the regulator has never objected to Posti's prices. Beyond these general principles there is no means of price regulation. The external control on prices is, in effect, through the threat of entry or the application of the competition law abuse of dominance provisions. VAT at 22% is applicable to postal services.

It is important to note that the Postal Services Act does not mandate access or interconnection of networks of different postal operators – consequently, by-pass or interconnection through bulk acceptance or delivery is negotiated purely on commercial terms[50]. This has not been a matter of substantive policy consideration in Finland. Relations between postal operators are governed only by section 28 of the Act, which sets out a co-operation obligation such that terms of agreements between postal undertakings should be fair and reasonable. Such agreements must be lodged with FICORA for approval and if not approved then FICORA may set a time limit in which the agreement should be amended. FICORA does not have the formal power to impose terms and conditions but it could presumably penalise a postal operator under the general penalty provisions[51] for not altering a connection agreement within the time period set by FICORA. FICORA has not in practice applied this co-operation provision because so far there has been no other postal operator actually entering on the market. Consequently, FICORA has not established any criteria to evaluate such agreements. The authorities suggest however that were the situation to arise they would most likely follow precedents in the telecoms sector, which involve a requirement of cost reflectivity and non-discrimination in prices. (Hence, prices charged to the entrant should be the same as those notionally charged within the company for the relevant service.)

The Act on the Fee Collected for Securing the Provision of Postal Service on Sparsely Populated Areas (708/1997 – the Postal Fees Act) was enacted in response to the expected entry of a new operator. This was a contentious matter and its context is explained in the following section. The Postal Fees Act applies a turnover tax to new entrants with a restricted licence that provide postal services only in regions where the average population densities is above a specified threshold. The charge varies according to the average population density in the area served under the restricted licence. The percentage fee is derived by dividing actual population density by the number 50, but it is subject to a maximum charge of 20% of turnover and minimum charge of 5%. No charge is levied if the average population density is below 250 persons per $km^2$. The following table provides selected examples.

As this is a turnover tax, and not a super tax on profits, its effect has to be assessed in proportion to possible gross profit margins and also the length of time before a new business was able to earn profits, which would ordinarily involve some delay from start up. Entry into the traditional letter post market can be regarded as relatively difficult in any event and irrespective of the special turnover tax applicable to entrants in Finland. The other issue bearing on the desirability and appropriate level of such a tax is the actual cost of delivering the USO. This point is analysed below. In summary, while it is recognised that the incumbent is subject to some cost penalty from the required maintenance of a universal network to deliver the USO, this network also provides significant competitive advantages in terms of economies of scale and scope and the potential to offer a ubiquitous delivery service. Arguably the turnover tax in Finland is significantly higher than it needs to be to achieve its policy purpose.

The intent of the Act is stated as to ensure the provision of postal services in remote areas. It is notable in that context that any fees collected under this Act are not hypothecated to a postal compensation fund to subsidise remote area services by the incumbent or any other new licensee providing services in remote areas. Any fees paid under the Act enter the Government's budget as tax revenue. It is feasible that, were it to become necessary, a budget appropriation could be raised to support remote area services. However, no such budget support for universal service costs is presently being contemplated by the postal authorities and it is considered unlikely in the near future given the strong financial position of Posti[52].

| Area | Land Area ($km^2$) | Population Density (persons/ $km^2$) | Municipalities (number) | Postal Fee (% of turnover) |
|---|---|---|---|---|
| Finland | 304,532 | 17 | 432 | 0 |
| Southern Finland* | 6,366 | 203 | 24 | 0 |
| Capital Region** | 743 | 1273 | 4 | 20 |
| Tampere | 523 | 369 | 1 | 7 |
| Turku | 243 | 708 | 1 | 14 |

* The Uusimaa region, including the capital.
** Helsinki, Espoo, Vantaa and Kauniainen.
Source: Country Questionnaire response.

Absent this contingency, the Act can be seen to further its objective by raising a special barrier to entry that is limited to population dense areas – so called "cream skimming" or "cherry picking". By limiting potential competition in these areas prices for postal services (in these areas at least) are likely to be higher than would otherwise be the case[53]. Thus the profitability of Posti is raised and the potential to cross subsidise loss-making services under the universal service obligation is underpinned.

It is conceptually possible for a new entrant to design an entry strategy that would include the population dense areas of the country and some additional non-dense areas in a way that would reduce its average density below the minimum threshold specified in the Act and thus avoid the charge. However, it remains that case that, while the charge could be avoided, doing so necessarily raises the cost of entry above that which a new entrant would face were they to pursue a more limited entry strategy focussed on population dense areas.

The competition law is applicable to the postal sector without exception, as described in Chapter 3. FICORA and the FCA do not have special co-operation arrangements to deal with matters where jurisdiction may overlap (e.g. abuse of dominance and settlement of disputes between postal operators). Should the entry arrangements be further liberalised it could be expected that co-operation between these agencies would become more formalised, as it is say in Sweden.

## 2.4. *Developments since Liberalisation*

*Licensing and Entry*

Posti is licensed to provide postal services nationally until 2021 and is thus obligated to provide the universal service to a specified quality level throughout Finland (excluding Aland). This includes maintaining at least one point of presence (branch or agency) in each municipality.

A licence application by a new entrant was lodged in 1995 and precipitated a significant political debate about the effects of competition on the viability of universal service provision. This debate focussed essentially on the issue of whether granting a licence, as provided or under the Act, would be fundamentally contrary to the purpose of the Act since it would undermine the viability of the USO the provision of which was the fundamental purpose of the Act. This debate was contentious and effectively led to the enactment of the Postal Fees Act in 1997. As noted above this Act significantly affects the economics of partial entry into the postal market.

With this fundamental debate and with court appeal processes against denial of the licence, the resulting licensing procedure took several years to settle.

- A restricted postal operating licence was granted to Suomen Suoramainonta Oy in March 1997, valid for three years. This licence covered a geographic area of Helsinki and surrounds and was limited in the class of letters and type of customer (essentially business-to-business mail). Under this licence a turnover fee of 20% would have been payable on any operations. In the event, Suoramainonta did not commence operations, but later in 1997 it applied for a licence with a wider geographic area. This application was rejected but this decision was subsequently overturned in a court appeal in 1999.

- Suoramainonta sought a ruling from the EU that the Act on Postal Operation and the Postal Fees Act were inconsistent with the EU Postal Directive that provided for more limited opening of the letter post market but contemplated a means to ensure the USO through funding channelled through a postal compensation fund. A ruling in this case is still outstanding.

- A new restricted licence application was submitted in Feb 2000 which was approved in June 2000, valid until June 2003[54]. This licence also permits consumer to consumer services and covers a geographic area that would not attract a fee under the Postal Fees Act as it is estimated by the postal authorities that the population density of the expanded licence area is likely to be less than 250 people per km$^{2.}$ However, Suomen Suoramainonta Oy has not commenced letter postal operations.

- Another licence application was submitted by a different company in 1996 but this application was withdrawn.

Suoramainonta is an established operator in the broader delivery market, focussing on the periodic delivery and on non-addressed items (e.g. free magazines, advertising items etc). Posti is its largest client, largest collaborator, and largest competitor. Suoramainonta is apparently “still interested” in the letter post market but perceives a number of barriers:

- Were it not for the Postal Fees Act, Suoramainonta believes that more limited geographical entry would be feasible (as has occurred in Sweden).

- The requirement for daily delivery[55]. Possibly delivery of 2-3 times a week in remote areas could significantly lower costs.

- The timeframe for developing the business is longer than the licence period (and while it might be expected that a licence would be renewed this raises some political risks). Suoramainonta believes a licence period of at least 25 years is required. (In Sweden licences are not time limited but are performance limited.)

- Posti owns the address register – which is a natural monopoly – and access and interconnection to postal infrastructure is difficult under contractual conditions. (In Sweden, the address register is owned by a co-operative company to which all postal operators can get access and the regulator has additional powers.)

In summary there appears significant distance between the conditions under which new entry would appear feasible (such as those in Sweden) and the present conditions in Finland. The Swedish experience is noted briefly in section 5.2.5.

*Competition Law Enforcement*

The competition authorities have been relatively active in this sector with a number of cases and a number of investigations by the FCA and advice to Posti. In summary:

- In 1994, the Supreme Administrative Court confirmed a decision of the Competition Council that Posti was dominant in the market for delivery of addressed letters and parcels. Nevertheless, Posti was not found to be dominant in a related market of the manufacture and marketing of letter boxes, which was the formal subject of a complaint by a letter box manufacturer that Posti had discriminated against it, and so no abuse was found.

- In 1995, the Competition Council investigated whether Posti had abused a dominant position in the market for daily delivery of magazines and newspapers to final consumers through price discrimination. Price changes had resulted from the removal of a government subsidy. The Competition Commission concluded that Posti had not abused its dominant position due to the fact that price increases were cost based.

- The FCA has conducted various investigations of possible abuse of dominance by Posti where it has been alleged that cross subsidies have occurred from income obtained from activities where Posti is dominant to support competition in other areas[56] potentially to the extent of predatory pricing[57]. In no case have these allegations been proven. The FCA found evidence of cross- subsidisation of bulk cargo transport in a 1995 decision, and of goods transport for schools in 1997 decision, but in neither case were these of a sufficient extent to amount to an abuse as Posti was not about to achieve a dominant position in that market nor had their been an essential distortion of competition. Nevertheless the FCA advised Posti to alter its pricing so that costs would be allocated to relevant services and to ensure that the pricing of Posti's transport services would thereafter contain all fixed costs. In other FCA investigations Posti was found not to have abused a dominant position in under pricing direct marketing delivery services to remote areas as the conduct was sporadic and there was no prospect of recouping losses given open entry.

- In 1995, after consultations with the FCA, Posti revised its pricing arrangements to make them more transparent, specifically by publishing prices for discounted services. Similarly, following FCA investigation Posti agreed to alter fidelity discount arrangements for large customers to reduce their tying and exclusionary effects. Transparency and cost reflectivity are now requirements under the Postal Services Act 2001 and, consistent with the EU Postal directive, separate accounts are maintained for components of the defined universal service.

- In 2000 FCA investigated suspected abuses of dominance by Posti when it raised the price of a stamp paid for in cash. The cost of cash transactions in these circumstances is relatively high and it was concluded that the price was cost based and did not amount to an abuse.

- In 2001FCA investigated whether increased prices for parcels amounted to an abuse of dominance. The FCA noted that Posti has a dominant position in the domestic parcel delivery market. But the FCA concluded that Posti had not abused its dominant position due to the fact that the price changes where necessary to the profitability of the domestic parcel delivery and to the development of the service.

*Governance and Innovation*

Posti could be described as a dynamic postal operator. It has been active in expanding its business base in strategic growth areas including electronic messaging, logistics services and direct marketing deliveries. It is also notable that the revenue yield from the traditional letter mail segment has continued to trend up, while volumes have been basically flat. Posti is relatively active in the purchase and sale of subsidiary companies in the mail/courier/logistics sectors to shape its market. It has progressively shifted traditional service delivery away from full service branch establishment to agency arrangements. In 2001, Posti ceased to provide banking services at its post office branches which had occurred under an agreement between Posti and Sampo-Leonia Plc (Postipankki) – typically the type of banking transactions carried out in post offices were relatively low yield activities. It is considered clear that the threat of competition has had a strong effect on management and employee culture.

As a private law company, Posti has an organisational structure, management and governance arrangements that are legally equivalent to any other private company and its employees have the status of "employee" rather than civil servants. The Board of Directors is comprised of four independent directors (including the chairperson and deputy chairperson), two union representatives and a representative from the Ministry of Transport and Communication. The Board does not include the Chief Executive Officer from management, nor is there other management representation. There is also a supervisory board, which is comprised mostly of elected Members of Parliament. The functions of the supervisory board are relatively limited[58] compared with the functions of other supervisory boards for government owned companies. According to the accounts, the supervisory board is not remunerated. No special corporate governance issues are seen to arise in respect of Posti beyond the general discussion in the previous part of the chapter.

The issue of overlap of regulation and ownership within the Ministry of Transport and Communications is not regarded as a significant matter by FICORA as there is in fact no actual competition within letter post items. As noted earlier in this chapter, this issue does arise with respect to telecoms, and it might do so in post if remaining regulatory barriers to competition in the letter post market were removed.

### *2.5. Postal Sector Reform – Main Issues*

*The experience of liberalisation in other countries*

A few countries have completely liberalised their postal sector and other countries retain a relatively small reserved area broadly similar to that proposed for the next stage of EU liberalisation. The liberalising countries have reported quality of service improvements, increases in profitability, increases in employment and real reductions in prices. See OECD (2000) for a general discussion of the liberalisation of postal markets and the experience of Member Countries. As of mid-1999 three countries have completely liberalised the postal sector - Finland, Sweden and New Zealand. Sweden and New Zealand have several operators competing in letter delivery. Australia and the Netherlands have also made significant reductions in the size of the reserved area.

Although fears are often expressed that reform will lead to a loss of employment in this sector, both Australia and the Netherlands report that the level of employment in the postal sector has increased during the reform process, due to a diversification of the range of services offered by the incumbent. In general, the resulting increase in competition can be expected to significantly enhance efficiency, productivity and innovation in the postal sector of OECD countries, contributing to overall competitiveness and economic growth.

In Australia and New Zealand the incumbent postal operator is profitable and has reduced real prices consistently over a number of years. New Zealand reported competitors offering significantly lower prices than the incumbent. Although neither New Zealand nor Sweden directly compensate the incumbent for non-commercial obligations, neither country reported problems in maintaining service quality. New Zealand reported that the postal incumbent was experimenting with an enhanced level of service quality in some parts of the country.

Sweden liberalised completely in 1994 and did not intervene with a barrier to entry like the Postal Fees Act in Finland. There are many licensed postal operators in Sweden, most of which are small local providers. The most significant operators are the incumbent (Sweden Post) and two new entrants (City Mail and the SDR-Group). Citymail and specialises in delivering business mail and bulk mail in the high population density areas – mainly in Stockholm, Gothenburg and Malmö. SDR Group is mainly active in the direct marketing sector but also distributes addressed mail. The new entrants had considerable difficulties attaining profitability and were subject to aggressive competitive responses by the incumbent[59]. Service quality has improved after liberalisation. Universal service remains strictly defined and is maintained without the need for compensation, no dramatic loss of market share has occurred and Sweden Post is profitable. More innovative services are available and prices of bulk mail have reduced substantially, which is available to some extent to household consumers that use mail consolidators. It is the case that some retail price increases have occurred , but these can be seen as a result of the imposition of VAT and in 1997 the use by Sweden Post of a one-off loophole in the price cap regulation which allowed it to raise the price of individual letters by approximately 30%. This is a case of error in detail rather than in the reform as a whole. This price rise provoked a strong entry response from small local operators and the number of operative licensees increased markedly in 1997. Overall, in circumstances that are significantly more liberal than in Finland the reform experience is positive – entry has spurred improvements in performance but it has not been so significant as to put at risk the provision of the USO by the incumbent. The Swedish Competition Authority in the submission to the OECD Roundtable on Promoting Competition in Postal Services concluded that, “The Swedish example proves that competition should be regarded as a solution and not as a problem.”

Critical to the success of competition in Sweden has been access to postal infrastructure on equal terms – this includes access to post office boxes, co-ordination of address changes and redirection of mail. Access to post boxes has been achieved through intervention by the authorities treating post office boxes as an "essential facility". Sweden Post is required to give access on reasonable and non-discriminatory terms, lest it be seen to abuse its dominant position. The Swedish Competition Authority has been very active in this market and has handled more than 100 complaints against Sweden Post concerning exclusive agreements and loyalty discounts.

*Universal Service Obligations*

The rationale for legislating a monopoly reserved area, or imposing special taxes on limited entry, is to realise a public interest objective, i.e. to fund the universal service obligation by means of cross subsidisation within the reserved areas from profitable services (e.g. mail within cities) to non-profitable services (e.g. rural area mail). A good policy principle, therefore, is to limit the monopoly or entry barrier to that which is necessary to realise the funding of the public service, but no more. This is indeed the principle that underlies the regulation of postal activities in the EU framework. However, as a practical matter where it is necessary to negotiate agreed maximum reserved areas, it is likely that the agreement will exceed what is believed or demonstrably shown to be necessary in some countries.

Most OECD countries – including Finland - impose requirements on the incumbent postal operator to provide certain services at a certain level of quality, at a price that would not normally be economically justifiable in some areas. Examples include requirements to provide a given frequency of deliveries or collections and to limit the maximum distance to the nearest post office outside of urban areas or geographically average prices.

At least some of these obligations are likely to be genuinely non-commercial. In most countries the costs of these obligations are financed through internal cross-subsidisation. Such cross-subsidies might be threatened by competition. The fear is that where there are cross-subsidies new entrants into the postal sector are likely to focus on the profitable low-cost markets, even when it is more efficient for these markets to be serviced by the incumbent. If the entrants are successful they will take business away from the incumbent in the profitable markets, leaving the incumbent in the unsustainable position of servicing only the unprofitable markets. However, as noted above, the actual experience with liberalisation has everywhere not been consistent with these fears. The reasons for this could be expected to apply equally in Finland.

It is clear that operating an ubiquitous nation-wide network, as required by the universal service obligation, is not only a cost for Posti but confers a significant competitive advantage in terms of scale and scope efficiencies. It also provides Posti with an asset in the nature of an essential facility, since any partial entrant must connect with that network if it is to offer its customers a full potential delivery service. Given the size and sparse population of much of Finland it is unlikely that a new entrant could economically enter on a full service/full coverage basis. Consequently, the only prospect for actual entry is seen by the authorities as being focussed on particular clients (specifically, large consignments by organisations) or particular regions being the largest cities and strong growth areas (the capital region and those of Turku, Tampere and Oulu).

Although there has been a lot of discussion of the cost incurred by Posti to provide the universal service, the Finnish authorities have not undertaken a detailed study to estimate the magnitude of the extra cost burden arising from the obligation to provide the universal service throughout Finland. Given the profitability of Posti and the relative flexibility it has to deliver the universal service through low cost agency arrangements it would suggest that the cost of the USO is not particularly large, notwithstanding the relative remoteness and low population density of much of the Finnish territory. In fact, data estimated by NERA for the EC during its deliberations on recent revisions to the Postal Directive supports this supposition. Using a full cost allocation methodology NERA estimated that the average burden due to the USO in EU countries was 5% of turnover. Yet for Finland, the estimated burden was only 0.7%[60].

Consistent with this, government authorities do not see competition in the letter mail market as posing a threat to the implementation of the universal service or to Posti. This view holds irrespective of whether the Postal Fees Act were to be abolished. In other words, the benefit of experience since 1997 suggests that a tax-like fee is not necessary to guarantee universal service delivery. In part this reflects a view that the letter post sector is a "sunset industry" which competitors would hesitate to enter.

Even if it were accepted that present USO cross-subsidies could be threatened by additional competition, there would be other solutions to underpin the USO that would be less distortive that restricting competition.

- One possibility is to tolerate geographic differences in pricing to allowing prices to be more cost reflective. This would act to discourage inefficient entry in population dense areas while allowing efficient entry – by comparison the present tax discourages all entry in population dense area as the tax rate is larger than any feasible gross profit margin. By way of example, Spain has long practised a two-tier pricing system, with lower prices for intra-city mail than for mail to other places. In New Zealand, rural mail customers have, in the past, had to pay an extra fee for mail deliveries to the farm gate. It should be recalled in considering these options that the cost of postal services represents a very small part of most household budgets and that moving prices to a more cost reflective status is not likely to cause significant financial strain.

- A second possible solution is to fund the cross-subsidies through a mechanism that is neutral to competition. Several countries have or are considering setting up mechanisms for raising the funds for universal service through charges on all postal operators. Where such funds are put in place the subsidies should be made contestable so as to ensure that they are provided efficiently, to minimise the size of the subsidy and to ensure that the incumbent does not receive compensation in excess of the minimum required. One possibility to achieve this would be an auctioning mechanism.

It is often difficult to determine, in advance of liberalisation, which of the imposed requirements are truly non-commercial. For example, private carriers often adopt a geographically averaged pricing structure. Based on the experience of those countries which have liberalised the most, it appears reasonable to conclude that the fear of loss of markets and an inability to cross subsidies USOs under liberalisation is much greater that the actuality. In the case of New Zealand, under the threat of competition, the incumbent operator is providing services in excess of the regulated minimum. In Sweden, the position was taken that the provision of a ubiquitous service was a competitive advantage for the incumbent operator, rather than a burden.

*Market Power of Postal Incumbents*

In the postal sector, incumbent operators may, through a variety of actions, such as selective discounting, tying or bundling, act anti-competitively in the competitive sections of the postal market. These practices are equivalent to discounting on the competitive market which may (if the discount is significant enough) amount to anti-competitive cross-subsidisation or predatory pricing. The likelihood of anti-competitive cross-subsidisation is higher in the case of state-owned firms (which may not have strict profit-maximisation objectives or hard budget constraints).

A firm is said to be engaging in anti-competitive cross-subsidisation if it is charging a price for the competitive service which is less than long-run average incremental cost. In some cases the floor under the prices charged by the incumbent may be set higher by the regulatory authorities, depending on the objectives for competition in the sector.

The European Commission recently decided that Deutsche Post had abused its dominant position by granting fidelity rebates and engaging in predatory pricing in the market for business postal services in Germany. It was found that Deutsche Post had been illegally cross subsidising from its profitable letter-mail monopoly to provide parcel services below *incremental* cost and that this had foreclosed competition in the market for mail order parcels. The remedy in this case is a structural one. Deutsche Post has agreed to separate its parcel activities into a separate subsidiary company. Any services provided by Deutsche Post to that company must be at market prices and these services must also be supplied at same price and conditions to any competitors of the new Deutsche Post subsidiary. The concept of incremental cost adopted by the Commission draws a distinction between network capacity and network usage costs. It was decided that the cost incurred to provide network capacity which gives everyone the option to ship parcels was part of Deutsche Post's universal service obligation as carrier of last resort. Consequently, Deutsche Post has to establish a network that has capacity to carry peak load and the costs of such spare capacity are regarded a common fixed costs that need not be recovered in standard unit prices. Cost for the use of the network – the long-term variable or incremental costs – must be recovered in pricing of competitive services. Such costs cannot be justified as necessary to fulfil the USO – indeed pricing below such costs requires subsidisation from the USO area.

Given the difficulties in obtaining reliable cost information, anti-competitive cross-subsidisation may only reliably be prevented through structural or regulatory measures such as privatisation (as in the Netherlands), liberalisation (i.e., elimination of the remaining reserved areas) or horizontal or vertical separation. Horizontal separation involves preventing the incumbent postal operator from providing competitive services such as express or parcel services. Several countries require such competitive services to be provided through an arms-length subsidiary – a further example being the forthcoming separation of this activity from Deutsche Post as described in the above paragraph. Vertical separation would involve separating final delivery from the remaining segments of the postal business. Although the final delivery of mail in remote and rural areas is contracted out in some countries, to date no country has systematically sought to separate the delivery activity from the remainder of the postal business.

It would appear from the experience in Finland with competition cases in the postal sector that the jurisprudence has evolved in a form that is relatively difficult to prosecute compared with recent EU developments, at least in so far as the need to demonstrate the "proximity" of actual damage to the alleged conduct and the apparent need to demonstrate the possibility of recoupment of foregone profits. Should additional competition emerge in this sector it may be that the Finish jurisprudence would shift.

### *2.6. Conclusions and Recommendations*

It is interesting to note that in the recent EU discussions concerning further possible EU wide liberalisation in the postal sector, broadly speaking those countries which have most liberalised their markets were most in favour of further liberalisation, while those which have liberalised the least were most resistive of further liberalisation. Perhaps this reflects the generally positive effects from liberalisation compared with earlier fears of its consequences, particularly in terms of the greater commercial orientation and improved financial performance of postal incumbents in more liberalised markets. In particular, employment levels by incumbents in liberalised markets have in general not declined significantly and indeed have often increased. Against that general background the particular experience in Finland would point to the following policy options for consideration:

- **Postal Fees Act**: The special barrier to limited geographic entry that is imposed by the Postal Fees Act is clearly much higher than is necessary to achieve its stated purpose of protecting the feasibility of delivering the USO in remote areas. Given the underlying economics of the postal market, the likelihood that the actual cost of delivering the USO is not particularly high, and the scope and scale benefits derived from a ubiquitous network, it can be concluded that the barriers to entry into letter post are very high in any event. Arguably, there is no need at all for a special tax to prevent inefficient entry. Consideration should be given to abolition of the Act. At a minimum, the rate of tax should be reduced markedly and consideration given to whether its base should be changed[61]. Absent these changes it would remain valid to criticise the tax as an arbitrary and blunt instrument. Given the complexity of more neutral arrangements it is probably best as a practical matter simply to abolish the tax.

- **Access to Infrastructure**: If additional competition is to be encouraged the regulatory powers of FICORA to facilitate interconnection agreements would need to be tested and quite possibly augmented. It would be necessary to ensure that access arrangements meet all the conditions for successful access that have been garnered from experience in other network industries. This includes cost reflective and non-discriminatory pricing, the possibility for the regulator to intervene to set prices and ensure that quality variation is not used to frustrate access. Access is necessary not only to physical infrastructure but also intellectual infrastructure, in this case the address register so that redirection is possible and address uncertainties can be resolved.

- **Licence terms**: Should be extended to a period that coincides with reasonable business planning.

- **Competition and Regulation**: In the event that additional competition was permitted by implementation of the above recommendations it would be important for the FCA to remain vigilant against possibly abusive conduct by the incumbent and to co-operate closely with FICORA with respect to issues that arose at the margin of FICORA's additional regulatory powers over access and the prohibition against abuse of dominance in relevant markets.

## ANNEX1: SIGNIFICANT STATE ENTERPRISES AND GOVERNMENT OWNED COMPANIES

**State enterprises still operating in this form:**

**Civil Aviation Administration**

Civil Aviation Administration (CAA) is the official Finnish aviation authority and maintains Finland's network of airports and the air navigation system and provides airport and air navigation services as well as their supporting commercial operations. CAA's turnover in 2001 was € 206 million, it employed 1826 persons and reached a result of € 12 million.

CAA functions under the supervision of the Ministry of Transport and Communications.

CAA, formerly a government agency, was transformed into a state enterprise on 1 January 1991 and has operated in this form for 11 years. There are no plans to incorporate the CAA.

**Forest and Park Service**

Forest and Park Service (Metsähallitus) is a state enterprise operating in the field of forestry, nature conservation and recreational services. Most of its turnover is generated by timber sales. In addition to business operations, the Service also has social and public authority duties, which are financed by the State. The Service manages 8.8 million hectares of land and 3.8 million hectares of lakes and waterways. The turnover of the enterprise in 2001 was € 235 million, result amounted to € 67 million and it employed 2 084 persons.

Forest and Park Service operates within the administrative sector of the Ministry of Agriculture and Forestry. However, in matters relating to nature protection it functions under the aegis of the Ministry of Environment.

Forest and Park Service, formerly a government agency, was transformed into a state enterprise on 1 January 1994 and has operated in this form for 8 years. There are no plans to incorporate the Service.

**Senate Properties**

Senate Properties is a state enterprise responsible for managing and letting the property assets of the Finnish State. The property stock includes university, office, research, cultural and other buildings, in total 3 600 properties, 4.3 million m2, valued at € 3.8 billion. Senate Properties mainly lets premises to government bodies. Senate Properties' turnover in 2001 was € 381 million and it employed 201 persons.

Senate Properties functions under the aegis of the Ministry of Finance.

Until 1995, National Board of Public Building and its predecessors managed most of the Finnish State's property. In 1995, National Board of Public Building was closed and the state's property was arranged into 15 property units. The largest of these units, State Real Property Agency (SRPA), was given responsibility for managing almost half of the Finnish State's property assets. 1 January 1999, SRPA became a government enterprise and on 1 March 2001 its name was changed to Senate Properties. There are no plans on incorporatisation or privatisation at the moment.

**Road Enterprise**

Road Enterprise is a state enterprise responsible for provision of road building and maintenance services. Its turnover in 2001 was € 552 million, result € 24.3 million and it employed 4 156 persons.

Road Enterprise operates under the supervision of the Ministry of Transport and Communications.

In 1998, the administrative responsibilities and the provision of services were divided into separate units within the government agency responsible for road administration. This separation of responsibilities was followed up on 1 January 2001, when the provision of road building and maintenance services was separated into a state enterprise called Tieliikelaitos (Road Enterprise). The administrative and regulatory tasks were entrusted to a government agency called Tiehallinto (Road Administration).

Road Administration will be buying all the building and maintenance services on the basis of open tender competition after the end of 2002 and all the planning and care-taking services after the end of 2004. During the transition period of four years (2001- 2005) Road Enterprise is providing some of these services without a tender competition. After the transition period Road Enterprise will only take part in the tender competitions together with the other, private undertakings.

**<u>State enterprises transformed into companies, but not privatised:</u>**

**Edita Ltd**

A fully state-owned limited liability company whose main activities are graphic production, digital communications and publishing. Edita's turnover in 2001 amounted to € 179 million and it employed 1 558 persons. The group made an operating loss of € 498 000.

Edita functions under the supervision of the Ministry of Finance and the chairman of the board is a civil servant from the MoF.

Edita's origins date back to 1859, when the Printing house of the Senate was set up to print and publish the Finnish legal acts. The State Printing Office functioned as a government agency until 1 January 1989 when it was transformed into a state enterprise. 1 January 1992 it was further changed into a limited liability under the name of Printing Office Ltd. In 1996 the company changed its name to Edita Ltd. Edita is still responsible for the publishing of the legal texts in Finland under a special and exclusive arrangement.

Edita has been active in acquiring majority and minority holdings in other companies in the sector and has, for example, a holding in a company called Wellnet Ltd, proprietor of a licence for digital television.

In December 2002 the Parliament authorised the Government to sell all of its shares in Edita.

**Finland Post Corporation**

A fully state-owned limited liability company offering postal services, electronic message delivery and logistical solutions. Post's turnover in 2001 amounted to € 1 046 million and it employed 22 809 persons in the end of 2001. The company's consolidated operating profit amounted to € 32 million.

Finland Post functions under the supervision of the Ministry of Transport and Communications and one member of the board is a civil servant from the MTC. Finland Post has a Supervisory Board of 19 members, 14 of which are members of parliament or otherwise on a political mandate. The sectoral economic regulator, Finnish Communications Regulatory Authority (FICORA) supervises the postal market.

The Post Office of Finland was founded originally in 1638, and after functioning 352 years as a government agency it was transformed into a state enterprise, separate from the state budget, on 1 January 1990 under the name Post and Telecommunications of Finland. The regulatory functions were transferred to the MTC in 1987. 1 January 1994 the enterprise was transformed further into a limited liability company Post and Telecommunications Ltd. The postal services functions were separated from the telecommunications services into a separate company, Finland Post Corporation in 1998. Finland Post Corporation is the only company holding a countrywide license for delivery of postal services and it has also a general service obligation to provide postal services in Finland.

In the end of 2000, the Finland Post group consisted of 20 companies active inter alia in the fields of transport, forwarding and warehouse services, motor vehicle leasing and maintenance services as well as cleaning services.

**Sonera Corporation**

A partially state-owned (52.8 %) corporation providing telecommunications services in both fixed and mobile networks. In 2001, Sonera's revenues totalled to € 2,2 billion, and profit before extraordinary items and taxes was € 0,45 billion. Sonera employs about 10,000 persons.

Sonera functions under the supervision of the Ministry of Transport and Communications. The sectoral economic regulator, FICORA supervises the telecom sector.

The first telegraph office was opened in Finland in 1855 as a part of the Russian imperial telegraph office and after the Finnish independence in 1917 it became a government agency. In 1927 the Telegraph Office merged with the Post Office. In 1981 the agency was renamed as Post and Telecommunications Finland and in 1990 transformed into a state enterprise, separate from the state budget. Already in 1987, the regulatory functions were transferred to the MTC. 1 January 1994 the enterprise was transformed further into a state-owned limited liability company Telecom Finland that belonged to the Post and Telecommunications Ltd group. In 1998, after the Finnish parliament had approved the privatisation of the company, Telecom Finland changed its name into Sonera and was listed on the Helsinki Stock Exchange and on NASDAQ. In 2000, the Parliament made a decision allowing for a total privatisation of the company.

In November 2001 Sonera raised approximately € 1 billion through rights offering to its shareholders. The company offered to shareholders primary rights offering the right to purchase their pro rata share of the new shares being offered. The State of Finland participated in the rights offering and purchased new shares in the relative share of the pre-existing ownership, totalling to 196 million new shares in a total price of € 530 million. In March 2002, Sonera and the Swedish incumbent telecom company Telia announced their plans to merge to form a leading telecom group in the Nordic and Baltic regions. The merger was completed in December 2002 to form TeliaSonera. The merged entity is domiciled and headquartered in Stockholm, Sweden. The holding of the State of Finland of the merged entity's shares is 19 % and the State of Sweden's 45 %.

**VR-Group Ltd**

A wholly state-owned company group whose main activities include rail freight and passenger transport as well as building and maintenance of the railway network. The group, consisting of 24 separate companies, also provides truck and bus transport, practises catering activities and real estate management and produces data technological and telecommunications services for the transport and logistics sectors. The Group's turnover in 2001 was € 1.151 billion, result € 42 million and it employed 14 913 persons.

VR-Group Ltd operates under the supervision of the Ministry of Transport and Communications. One of the members of the board is a civil servant from the MTC. VR Group has a Supervisory Board of 21 members, of which at least 12 are members of parliament or otherwise on a political mandate. A net-budgeted government agency, the Finnish Rail Administration, is in charge of maintaining and developing the rail network and responsible for the safety of rail traffic.

The first railway connection opened to traffic in Finland in 1862. After a period of both private and public rail operations, the private railroad companies were merged into State Railroads due to the lack of their economic viability. The State Railroads functioned as a government agency until 1990, when it was transformed into a state enterprise, separate from the state budget. In 1995 it was further transformed into a limited liability company VR Group Ltd. At the same time, the management of the rail infrastructure was separated into the Finnish Rail Administration.

**Finnish Motor Vehicle Inspection Ltd**

A fully state-owned limited liability company, which provides mainly motor vehicle inspection and safety services. In 2001 the company's turnover was € 57.5 million and it employed 1040 persons in 151 vehicle inspection facilities.

Motor Vehicle Inspection Ltd functions under the Ministry of Transport and Communications. The administrative and regulatory responsibilities in the sector belong to the Finnish Motor Vehicle Administration, AKE.

The government agency Motor Vehicles Registration Centre was transformed into a state enterprise on 1 January 1993. In 1994 the motor vehicle inspection services were liberalised (formerly a monopoly of the Motor Vehicles Registration Centre) and the administrative and regulatory aspects and supervision were separated into a government agency, the Finnish Motor Vehicle Administration, AKE. 1 January 1996 the state enterprise was further transformed into a limited liability company carrying out the inspection services, Finnish Motor Vehicle Inspection Ltd.

In March 2002, the government forwarded a bill to the Parliament asking for an authorisation to sell the shares of Finnish Motor Vehicle Inspection Ltd. The Parliament is currently processing the issue.

**Raskone Ltd**

A fully state-owned limited liability company providing repair and maintenance services to heavy-duty trucks, excavators, earthmovers etc. as well as to their appliances. The company's turnover in 2001 was € 30 million and it employed 340 persons.

Raskone Ltd functions under the aegis of the Ministry of Transport and Communications.

Raskone Ltd was formed first as a state enterprise under the name of State Repair Centre in July 1994 mainly from the repair and maintenance facilities of the Road Administration. 1 January 1999 the entity was further transformed into a limited liability company.

**Inspecta Ltd**

A fully state-owned limited liability company providing inspection and product approval services, certification services, measuring and testing services as well as services for jewellery production (analysis and hallmarking). The company's turnover in 2001 was € 17 million and it employed 250 persons.

Inspecta Ltd operates under the supervision of the Ministry of Trade and Industry.

In 1995 the government agency, Technical Inspectorate was divided into a state enterprise responsible for the provision of services related to inspection and product approval and a new government agency responsible for the administrative and regulatory tasks. The new organisations began their operations in November 1995. 1 January 1998 the state enterprise Technical Inspectorate was further transformed into a limited liability company. In 1998 the provision of all inspection and approval services had been gradually opened to competition.

**Some strategic state-owned companies:**

**Alko Oy**

A wholly state-owned alcohol retail monopoly. Alko's net sales in 2001 were € 419 million and operating profit € 33 million. Alko employed 2 399 persons and operated 284 retail outlets.

Alko Oy operates under the aegis of the Ministry of Social Affairs and Health. The chairman of the Board of Directors is the Director General of the National Public Health Institute and one of the members is a civil servant from the Ministry of Finance. The Company has also a Supervisory Board of 13 members, 12 of which are members of parliament and one a civil servant from the Ministry of Social Affairs and Health.

Alko was founded in 1932 to carry out the retail sale of alcohol after a 13 year long prohibition. (During the prohibition the predecessor of Alko had produced alcohol for medical, technical and scientific purposes only.) Upon its foundation the company was granted exclusive monopoly on the importing, exporting, making and selling of all alcoholic beverages. In addition, the company had responsibilities relating to alcohol administration and policy.

In 1994, when Finland joined the European Economic Area, the administrative and some alcohol policy responsibilities of Alko were transferred to the Ministry of Social Affairs and Health. In 1995 the new Alcohol Act entered into force keeping only the retail of alcoholic beverages as the monopoly of Alko and requiring the separation of the different operations into different companies within Alko Group. In 1996 the remaining alcohol policy responsibilities of Alko are transferred to the Ministry of Social Affairs and Health. In 1999 the companies responsible for production, wholesale and distribution were subordinated to the Ministry of Trade and Industry (Altia Oy, see below) and Alko Oy remains solely as a retail monopoly under the control of the Ministry of Social Affairs and Health.

**Altia Corporation**

A wholly state-owned company active in the fields of production, wholesale, marketing and import of alcoholic beverages. Altia's net sales in 2001 were € 227 million and operating profit € 28 million. Altia employed 697 persons.

Altia Corporation functions under the supervision of the Ministry of Trade and Industry. The chairman of the board is a civil servant from the MTI.

Altia's roots go back to 1888 when a distillery was founded at Rajamäki. The distillery was bought by the state when the prohibition entered into force in 1920. In 1995 the production, wholesale and distribution as well as retailing activities of Alko were separated into different companies within the group. In 1999 the companies responsible for production, marketing and export (Primalco Ltd) as well as marketing, wholesale and distribution (Havistra Ltd) were subordinated to the Ministry of Trade and Industry. On 1 May 2002, the two subsidiaries merged with the parent company to form a new entity under the name Altia Corporation. Altia has also a 55 % holding of a subsidiary called Finlandia Vodka Worldwide Ltd, set up in 2000 and responsible for the business operations of Finlandia Vodka.

The plans for partial privatisation of Altia have been postponed and all negotiations cancelled in February 2002 due to the loss of interest on the part of the interested international buyers after an earlier decision by the Parliament to retain a controlling state holding in the company. The Parliament's decision was a result of a strong political lobbying campaign for the national solution and against sale to international buyers.

**Finnair Oyj**

A partially (58.4 %) state-owned airline company active also in other fields, such as travel agencies, package tours, catering, travel information and reservation services. The Group comprises of 13 Finnish and 3 foreign subsidiaries and two real estate companies. Finnair's turnover in 2001 was € 1.6 billion and operating profit € 13 million. Finnair employed 10 847 persons in 2001.

Finnair operates under the aegis of the Ministry of Transport and Communications. One member of the Board of Directors is a civil servant from the MTC. Finnair has a Supervisory Board that consists of 18 members of which 10 are members of parliament or otherwise on political mandate. The Civil Aviation Authority operates as the sectoral regulator in the aviation sector.

Finnair started operating under the name Aero in 1923, which makes it one of the oldest airlines in the world. In 1946, the majority holding of the company was transferred to the State of Finland and the remaining 30 % was shared by private shareholders. The name of the company was changed into Finnair Ltd in 1968. In May 1989 Finnair Ltd was listed on the Helsinki Stock Exchange. In 1994, the Parliament gave a permission to reduce the state's holding in Finnair to 50.1 %.

**Fortum Corporation**

A partially (70.7 %) state-owned energy company the operations of which cover the entire energy chain, from the production of oil, gas, power and heat to refining, distribution and marketing, and to energy related engineering, as well as operation and maintenance. Fortum's net sales in 2001 were € 10.4 billion and operating profit € 914 million. Fortum employed 12 856 persons.

Fortum operates under the supervision of the Ministry of Trade and Industry. The Secretary General of the MTI is member of the Board of Directors and one member of the Supervisory Board is a civil servant from the MTI. Fortum has a Supervisory Board that consists of 17 members of which 13 are members of parliament or otherwise on political mandate. The Energy Market Authority operates as the sectoral regulator in the energy sector.

Fortum Corporation was formed in the beginning of 1998 as a result of a merger of two state-owned energy companies, Imatran Voima Ltd operating in the electricity sector and Neste Ltd operating in the petrochemical, gas and chemical sectors. Imatran Voima was originally founded in 1932 and Neste 1948. Neste's initial public offering and listing on the Helsinki Stock Exchange took place in 1995. After the merger, in December 1998, Fortum Corporation was listed on the Helsinki Stock Exchange and Neste become a subsidiary of Fortum. The Parliament has given an authorisation to reduce the state's holding in Fortum to 50.1 %.

**Kemira Oyj**

A partially (56.2 %) state-owned chemical industry group operating in areas such as pulp and paper chemicals, water purification chemicals, paints and coatings, speciality fertilisers and industrial chemicals. Kemira's net sales in 2001 were € 2.5 billion and operating income € 144 million. Kemira employed 10 207 persons.

Kemira operates under the aegis of the Ministry of Trade and Industry. One of the members of the Board of Directors as well as one of the members of the Supervisory Board are civil servants from the MTI. Kemira has a Supervisory Board that consists of 15 members of which 5 are members of parliament or otherwise on political mandate.

Kemira was established as a state-owned company already in 1920 under the name Valtion rikkihappo- ja superfosfaattitehdas to produce, as its name implied, sulphuric acid and superphosphate. Later the company changed its name to Kemira and was listed on the Helsinki Stock Exchange in 1994.

In August 2001 the Government's Ministerial Committee for Economic Policy approved the outcome of negotiations on the sale of Kemira's shares owned by the Finnish State to Dynea Oy, a company owned by Industri Kapital of Sweden. The purpose of the arrangement was to form a new Nordic group in the chemical industry, in which the Finnish State would have owned a 34 % stake. The Government has an authorisation to reduce the holding in Kemira to 15 %, but the deal required a further authorisation from the Parliament to relinquish completely the State's shareholding in Kemira. The arrangement, however, faced strong criticism and opposition from the labour unions and the agricultural lobby resulting in a negative vote on the authorisation in the parliamentary Agriculture and Forestry Committee. Therefore, in December 2001, the Government decided to retract the request from the Parliament and cancelled the deal. At the moment, the Ministry of Trade and Industry continues to investigate other possibilities to develop Kemira.

**Patria Industries Oyj**

A partially (73.2 %) state-owned Aerospace and Defence Group whose core business areas are integrated military vehicles and weapon systems, defence electronics, helicopter and military aircraft life cycle support and composite materials. Patria's net sales in 2001 amounted to € 219 million and consolidated income before extraordinary items to € 4.4 million. Patria employed 2 257 persons.

Patria operates under the supervision of the Ministry of Trade and Industry. One member of the Board of Directors is a civil servant from the MTI.

Patria was set up in 1996 from several companies operating in the defence sector (Lapua, Vihtavuori, Vammas, Finavitec and later also Sisu Defence). In 2001 the Finnish State sold 26.8 % of the shares to European Aeronautic Defence and Space Company, EADS NV. The Government has obtained from the Parliament an authorisation to reduce the shareholding to 50.1 %.

**Oy Veikkaus Ab**

A wholly state-owned company operating the football pools and lottery monopoly. The company's net sales in 2001 amounted to € 1 065 million and operating profit to € 358 million. Veikkaus employed 350 persons. The net income from the company is used to finance activities in the fields of art, sport, science and youth work.

Veikkaus operates the monopoly under a license granted and supervised by the Ministry of Interior. In addition, the Ministry of Education supervises the company, and one of the members of the Board of Directors is a civil servant from the Ministry of Education. Veikkaus has a Supervisory Board of 15 members comprising of two representatives of employees and 13 members of parliament.

The predecessor of Veikkaus was set up in 1940 when first football pools were introduced by a company called Oy Tippaustoimisto Ab. The variety of games was increased in the 1970s when lottery was added to the traditional pooling. The Finnish State purchased the whole stock of shares in 1975. There are no plans to privatise the company.

**Yleisradio Oy**

A wholly (99.9%) state-owned national public service broadcasting company operating five national television channels and thirteen radio channels as well as 25 regional radio programmes. YLE's operations are financed mainly by television fee (€ 165.15 per year) as well as a fee collected from the commercial television companies, as the programming carries no advertising. The turnover of Yleisradio in 2001 was € 381 million and company made an operating loss of € 108.6 million. Yleisradio employed 4 511 persons.

Yleisradio operates under the aegis of the Parliament and the Ministry of Transport and Communications. The company is supervised by an Administrative Council appointed by Parliament, comprising of 21 members of parliament or other political figures and three representatives of the employees. The Board of Directors does not include members from outside the company.

Yleisradio was set up and started radio sending in 1926. It became a state-owned company in 1934. In 1949 the responsibility to appoint the Administrative Council was transferred from the Annual General Meeting of Shareholders to the Parliament. In 1958 Yleisradio began regular television sending. In 1977 the radio fee was abolished. In 1999 the distribution network of Yleisradio was separated into another company called Digita Oy and in the end of 2000 Yleisradio sold 49 % of Digita Oy to TDF of France.

**Some associated companies:**

**Outokumpu Oyj**

A partially (39.9 %) state-owned metals group operating world-wide and focusing on base metals production, stainless steel, copper products and technology. Outokumpu's net sales in 2001 amounted to € 5.3 billion and operating profit to € 183 million. Outokumpu employed 19 010 persons.

Outokumpu Oyj operates under the aegis of the Ministry of Trade and Industry. One of the members of the Board of Directors is a civil servant from the MTI.

Company's origins date back to 1910 when first test drillings for copper ore took place in village Outokumpu. The first shipment of copper took place in 1914. Due to lack of private capital in Finland and in order to keep the mine in domestic hands the Finnish State took over ownership of Outokumpu in December 1924. In 1932, Outokumpu was officially incorporated as the firm acting today as the Group's parent company, Outokumpu Oyj. In the 1950s and 60s Outokumpu branched out into the nickel, cobalt, zinc and ferrochrome business and technology sales. In 1970s Outokumpu began building its network of metal marketing companies around the world. The 1980s were a time of growth; sales tripled with international acquisitions and business boomed in 1988-90. However, the 1990s spelled restructuring, streamlining and focus on core businesses.

Another major trend for the 1990s was the broadening and internationalisation of the ownership base. Outokumpu's shares are listed on the Helsinki Stock Exchange and the Finnish State holds 39.9% of the Company's shares and voting rights. In accordance with a decision taken by the Finnish Parliament in June 2001, the Finnish Government can reduce the State's shareholding to 10%.

**Rautaruukki Corporation**

A partially (40.1 %) state-owned steel company manufacturing flat and long steel products, upgraded products based on them and providing related services. Rautaruukki's turnover in 2001 was € 2.9 billion and operating profit € 93 million. Rautaruukki employed 13 678 persons.

Rautaruukki operates under the supervision of the Ministry of Trade and Industry. One of the members of the Board of Directors is a civil servant from the MTI and another civil servant from the Ministry of Finance. Rautaruukki has a Supervisory Board consisting of 14 members, of which 6 are members of parliament and 4 representatives of employees.

Rautaruukki was set up in 1960 by the Finnish government mainly to manufacture the steel required by the Finnish metal industry. 1960s were an active period of building production facilities, the first of which started production of raw iron in Raahe in 1964. After that the company has started to produce hot rolled steel plate, hot rolled strip products, cold rolled and galvanised sheet, tubes as well as long steel products. In 1991 Rautaruukki expanded into manufacturing products for construction systems. Today the Group has production in 14 countries and sales companies on three continents.

In 1989 Rautaruukki was listed on the Helsinki Stock Exchange. At the moment, the Government has an authorisation from the Parliament to reduce the State's shareholding in Rautaruukki down to 20 %.

**Sampo-Leonia Plc**

A partially (40.3 %) state-owned financial conglomerate providing banking, asset management, insurance and investment banking services to private persons, companies and corporations. Sampo has over two million active retail customers and 170 000 corporate customers. In 2001 Sampo's turnover was € 5.6 billion and operating profit € 1.3 billion. Sampo employed 10 162 persons.

The Ministry of Finance controls the Finnish State's holding in Sampo. The Board of Directors, however, does not contain any civil servants.

The current financial conglomerate Sampo was set up in October 1999 when the owners of a private insurance company Sampo (founded in 1909) and the Finnish Government resolved on the merger between Sampo and fully state-owned bank Leonia (formerly Postipankki, originally set up in 1887) to form a new full-service financial group. The operations of the new Sampo were initiated at the beginning of 2001. Mandatum Bank, which started its operations on 1 August 1998, became a subsidiary of Sampo-Leonia in February 2001. Mandatum Bank plc positioned itself as an asset management bank offering services for private customers, with its focus on asset management, stock brokerage for domestic customers as well as the investment bank.

Sampo is listed on the Helsinki Stock Exchange. The largest shareholder is the Finnish State with its 40.3 % holding, foreign investors hold 30.6 % and domestic investors the rest. The Government has an authorisation from the Parliament to relinquish completely the State's shareholding in Sampo.

**Stora Enso Oyj**

A partially (15.1 %) state-owned integrated forest products company producing magazine papers, newsprint, fine papers, packaging boards and wood products. In 2001 Stora Enso had sales of € 13.5 billion, made an operating profit of € 1.5 billion and had approximately 15 million tonnes of annual paper and board production capacity. The Company employs some 43 000 persons in more than 40 countries.

The Ministry of Trade and Industry controls the Finnish State's holding in Stora Enso. There are no civil servants in the Board of Directors.

The current company Stora Enso is the result of a merger between a Swedish forestry and paper company STORA and a Finnish, partially state-owned forestry and paper firm Enso in 1998, and an acquisition of an American forestry and paper company Consolidated Papers in August 2000. Enso's history dates back to 1872, when a Norwegian businessman, Hans Gutzeit set up the first steam powered saw mill in Finland in Kotka. The company remained in Norwegian ownership until the Finnish State bought it in 1919 after the production had completely halted due to a civil war in Finland.

Stora Enso's shares are listed in the Helsinki, New York and Stockholm Stock Exchanges. The Government has an authorisation from the Parliament to relinquish completely the State's shareholding in Stora Enso.

# ANNEX 2: EU POSTAL SECTOR FRAMEWORK

The Postal Directive 79/67/EC of the European Parliament and Council has the effect of harmonising the maximum permissible scope of the state monopoly in postal services (the so called "reserved area".) It specifies:

- That there will a universal postal service in the long term, involving a minimum harmonised standard of universal service (countrywide, regular guaranteed delivery at prices everyone can afford.) Prices may be uniform nationally. Standards specify access point density, clearance and delivery frequency (at least once per working day/five times a week) and must be independently verified.

- Mandates separation of national regulatory authorities from any postal operator.

- Universal service is defined as collection, transport, sorting and delivery of letters, catalogues and parcels within weight limits - two kilograms for letters and ten kilograms for parcels. Universal service includes registered and insured items and domestic and cross border services.

- To guarantee funding of the universal service, certain services may be reserved. The maximum extent of reservation is specified as domestic correspondence of less than 350 grams/5 times the price of a standard letter. This excludes books, catalogues, newspapers and periodicals and self- provision, "new services" or document exchange, but includes cross border and direct mail.

- Licences for private operators for non-reserved services may be made subject to universal service obligations, either directly or financially by means of contribution to a "compensation fund" for the universal service provider.

- Separate accounts based on a fully distributed cost system must be kept for reserved and non-reserved activities (and accounts for non-reserved activities shall identify whether services are within the universal service definition or not). in order to ensure that cross-subsidies from the reserved sector to the non-reserved sector do not adversely affect competitive conditions in the later. Accounts must be audited and published.

The Directive implements a very moderate liberalisation of the sector, with the non-reserved area (letters of more than 350 grams weight or at a price five times the standard letter) accounting for only around 3 per cent of receipts of universal service providers. The European Lisbon Council provided a mandate for faster liberalisation of the postal services market as part of Europe's efforts to "develop the most competitive and dynamic knowledge based economy in the world in ten years time". Based on this mandate the European Commission made a proposal in 2000 for a further directive to open up a substantial share of the postal services market to competition by 2003, with a further liberalisation then to be decided up to 2007. Following further discussion among member States and consideration by the European Parliament it was agreed that a new directive would be fomalised that provides for letters and direct mail weighing more than 100 grams would be liberalised from 2003 and more than 50 grams from 2006. All international outgoing mail would be liberalised (with the exception of some remaining restrictions in Greece, Ireland, Luxembourg, Portugal and Spain). This liberalisation would open some 50% of USO revenue to potential competition.

EU competition law applies in the sector, both within the reserved sector and in the unreserved area. The Commission has issued a notice[62] that it regards the postal operators within the reserved area to have a dominant position in the national market for the distribution of correspondence and hence the rules relating to abuse of dominance are relevant. Abuse of dominance in this context could include not providing a service within the reserved area or providing a seriously inefficient service and failing to take advantage of technical developments. The competition law applies clearly to any cross subsidisation from reserved to non-reserved activities that could distort competition if this involves predatory pricing. (Cross subsidisation within the reserved area would not be covered - indeed that is essentially the very reason for having the reserved area so as to finance the USO.) As a consequence the Commission has indicated that competitive services offered by the US operator should in principle be priced at least equal to the average costs of provision - including direct costs and an appropriate proportion of common costs.

Restrictions on state aid also apply. If aid to cover losses in the reserved area activities was excessive this could be used to cross subsidise operations in sectors open to competition.

Finally, there should be non-discriminatory access such that intermediaries can choose among access points at prices based on costs and which take into account the actual services provide.

# NOTES

1. By way of illustration, employment in state owned industrial activity (state owned enterprises and majority state owned companies) has declined significantly the past decade, including as a result of privatisation. However, general government employment has declined only slightly, notwithstanding that a substantial number of persons have transferred out of the general government sector into commercialised enterprises as a result of the reforms. At almost a quarter of total employment, general government employment remains one of the highest shares in the OECD.

2. Wasting resources means that taxes have to be higher for any desired level of service delivery by the state or that for any given level of taxes the service delivered by the state will be less or of lower quality.

3. One comparative measure of such "state control" has been constructed from the OECD International Regulation Database (see OECD 20003). For 1997-98, when the data was collected, Finland was ranked 5th highest in the OECD.

4. In this sense, the state enterprise process can be seen as a strong form of reforms based on the separation of purchaser and provider functions. The weaker form of such reforms involves separation of these functions within an entity so as to allow the introduction of (quasi) markets, outsourcing and competition.

5. This statement is a simplification of the actual legal position but does reflect practice other than in respect of budget mechanisms that account for remaining administrative functions.

6. There is a significant "measurement issue" that is implicit in these reforms which we do not substantially address in this report. The challenge to ensure the productive and efficient use of state owned assets and employed labour to further the proper objectives of the state occurs at all levels of government. But, for a substantial part of state activity this problem is statistically hidden because it is difficult to measure and value outputs. Specifically, in the general government sector (e.g. education, health, and defense) outputs are not sold to the public so the value of the output cannot be measured from market transactions. Consequently, GDP measures for much government output are taken to be equivalent to the measured inputs, irrespective of the actual efficiency of the use of the inputs - i.e. the productivity level is an assumption. Inefficient government results in an equivalent increase in both actual measured inputs and estimated outputs As a specific illustration, two general government employees digging holes will produce twice the GDP output value of one employee, irrespective of how much actual "hole" is dug. Modern budgeting techniques based on an "outcomes and outputs" framework can be interpreted in this respect as a mechanism to break this statistical circularity, at least for internal purposes, so as to offer some meaningful information about productivity. This information is usually "soft" - it is useful for decision making at the management level since outputs (such as "holes") are identified and their costs are measured. The information only becomes "hard" where the value of the output (holes) is established by some independent reference or benchmark valuation. Such independent valuations or "pricing reviews" are done periodically rather than systematically. Consequently, these budgeting techniques do not substantially influence the statistical measurement and productivity assumptions used to compile GDP estimates. The measurement problem does not exist where government owned entities are involved in commercial activities - here the output can be valued by commercial transactions. Consequently, the efficiency of government operations in these segments can be measured and be meaningfully incorporated into GDP measures. Achieving measurability is the first step in meeting the efficiency challenge – the second and more difficult policy challenge is putting in place regulatory, governance and management systems to achieve it, i.e. to direct the enterprise to the meet objectives determined by the government which will include efficiency and other factors.

7. The previous Act on State Enterprises ( 627/1987) lists the further details of the policy objectives as:

- to improve the competitiveness of state enterprises;

- to develop the quality of the services of the state enterprises;

- improve the operating conditions of the state enterprises;

- to develop the possibilities for operational and economic guidance of the state enterprises in accordance with the
goals set by Parliament, the Government and the competent Ministry;

- to emphasise the economic responsibilities of the enterprises themselves;

- to improve the management possibilities of the state enterprises;

- to offer the enterprises a possibility for a competitive personnel policy; and

- to slim the management of the enterprises and to simplify and speed up their decision making.

8. See OECD (1998) Reforming Public Enterprises PUMA/SBO(98)6 and PUMA/SBO(98)6/ANN

9. The formal definition of a core public good is that it is non-excludable and joint in consumption. "Non-excludable" means that if the good is produced it is directly consumed without a consumer having to opt into consumption by paying a price. "Joint" means that a consumption of the good by one person does not preclude consumption of the same good by another. The classic public good is the provision of defense or law and order services. Some goods have one but not the other characteristic. Viewing a movie in a theatre is joint up to some scale but it is excludable since entry to the theatre is controlled by ticket sales. Conceptually, education is joint up to some scale but is also excludable.

10. Salminen and Viinamäki (2001) "Market Orientation in the Finnish Public Sector – From Public Agency to Privatise Company" Ministry of Finance Research Report 2/2001.

11. The service, operational and performance targets set by the Government for the CAA are set at a fairly broad level, as follows for 2001:

- It is the aim of the CAA to ensure that aviation is carried out as safely, efficiently, appropriately and economically as possible.

- The CAA must provide and develop its services in accordance with profitable business practice whilst taking account of the needs of its customers, including the military aviation services and the general public.

- Finland's airports and its air navigation system must be maintained and developed as a unified entity, and such developments must correspond to the demand for these services. Above all it must strive to ensure the necessary services for regular, scheduled transport.

- The CAA aims to exploit areas of land which belongs to it in the vicinity of airports, in the most effective manner for both air transport and society – with proper operation of airports being the prime concerns. [Note: this was the only substantial change from the previous year.]

- The profit target set by the Council of State for 2001 was €10.4 million.

12. A major difference between these categories is that civil servants have “lifetime tenure” which essentially means that so long as they perform their duties to a requisite standard then they cannot be dismissed, while employees may be dismissed for “economic” reasons relating to the financial condition of the enterprise that they work for.

13. One exception to that generalisation was the case of the formation of Engel Group when former civil servants were given notice and offered contract employment on lower wages – this caused significant problems and resulted in lengthy litigation.

14. This constraint operates in part through Parliamentary mandates which are necessary for privatisation but which are more limited that proposals developed by the Government.

15. See subsequent discussion of evidence on this point.

16. The actual legal position is that a state enterprise is not a “limited liability” structure, with the Government guaranteeing and ultimately being responsible for its debt. Similarly, a state enterprise administers state assets but these remain formally owned by the state. In this sense a state enterprise is not a separate asset entity but for the purposes of the following paragraph and in so far as the competition implications are concerned the state enterprise can be treated “as if” it were a separate entity.

17. A detailed study of this issue for particular state enterprises is beyond the scope of this report since it would require very substantial empirical analysis

18. A minor exception is that inputs used in public administrative and regulatory functions are not subject to VAT.

19. Productivity Commission (1998) *Rate of Return Issues*, Commonwealth Competitive Neutrality Complaints Office, Australia.

20. Chapter 3.

21. These Articles cover the standard rules concerning abuse of dominant position and collusive arrangements.

22. An example is an entity licensed with the exclusive right to provide an electricity network in a defined area.

23. Activities which result directly from tasks assigned to a government organisation pursuant to a statute or decision of an administrative body are not subject to this access rule nor, consequently, the conduct rule. For example, the provision of education services by state run schools is not subject to the market and government framework. Similar exceptions apply in respect of: activities pursuant to international treaties and agreements, the use of residual capacity of fixed assets that are used to perform the duties of a governmental organisation; and *de minimus* activities (<€75,000).

24. 15 years in the case of a government owned company with partial private ownership.

25. Formally, the problem arises only when shareholders lack complete information of management decisions, which as a practical matter is almost always.

26. The following discussion draws on OECD (1998) Corporate Governance, State owned Enterprises and Privatisation, and the studies therein, particularly that by Saul Estrin (1998) State Ownership Corporate Governance and Privatisaiton.

27. Excluding partly privatised government companies.

28. See subsequent discussion on privatisation.

29. Since government ownership is likely to be less efficient than private ownership, a regulated private monopoly should be preferred to a government monopoly so long as there is confidence that the regulatory task can be achieved adequately.

30. As an alternative, some countries have adopted a strategy of having public holding companies that are interposed between the state and the state's commercial firms, with the objective of applying private sector governance practices to the subsidiaries. However, experience with this approach has not been particularly successful. See for example Bauman, H. (1998) "The Costs and Benefits of Public Sector Holding Companies", in OECD (1998) Corporate Governance State-Owned Enterprises and Privatisation

31. Note that this statement is equivalent to a view that governance structures for SOE are inherently less able to motivate efficiency than private governance due to the blurring of political and business objectives and that these "deficiencies" cannot be addressed fully by reforms to governance structures.

32. A view based purely on efficiency concerns would tend towards the conclusion of "privatise everything".

33. The following discussion draws on the discussion in OECD (2001) The Implementation and Effects of Regulatory Reform: Past Experiences. Economic Studies No.32.

34. For a survey of these issues (such as sequencing, partial of full privatisation, sale process, role of advisors and different government participants) see OECD (2002) Privatising State –Owned Enterprises in the OECD Area: An Overview of Policies and Practices, DAFFE/CA/PRIV92002)1

35. OECD (2000) Privatisation, Competition and Regulation

36. Except where pre-reform prices were unsustainably low and substantial new investment was required to maintain services.

37. The position varies from enterprise to enterprise. Delegations exist in respect of Finish Institute of Public Management, Forrest and Park Service and Senate Properties

38. State Audit Office (2001) The Performance Management and Owner Control of State Enterprises. Document No: 358/54/01

39. As discussed the exemption would only not have this effect if performance steering of state enterprises was set on a before tax rate of return basis such that final prices were not distorted by the tax exemption.

40. The Ministries are: Trade and Industry, Transport and Communications, Agriculture and Forestry, Education, Social Affairs and Health, Defence, Foreign Affairs, Finance, and Environment

41. It should also be noted that the CAA has significant commercial functions in the ownership and operation of provision of airports.

42. Economic profit is taken to be after tax accounting profit less a charge for the capital employed in the enterprise.

43. See (2001) pp 32-34 for a survey.

44. See "State Shareholdings in Finland: 2001"

45. In this study, postal services in the autonomous province of Aland are not addressed. Aland comprises a group of 6,500 islands in the Baltic Sea between Sweden and Finland. It has an independent postal administration that is separate from the Finnish mainland system.

46. In material collected for a recent OECD Roundtable on "Promoting Competition in Postal Services (See OECD Series Roundtables on Competition Policy No.24, 1999) it was estimated by senior postal official that the reduction in letter traffic due to electronic communications was in range of 15-30%.

47. Which repealed the prior Act on Postal Operation (907/1993)

48. Although the 1993 Act did not use the concept of "universal service" it had the effect that is commonly understood as a universal service

49. Consequently under the 2001 Act (and earlier in a 1999 licence revision) the USO was expanded to include parcels up to 10 kg and registered and insured items. See Annex 2 for an overview of the EU Postal Directive.

50. FICORA has a duty to settle unresolved dispute about the terms of delivery and delivery of mail. However, disputes arising from additional service agreements are a contractual issue which arise for settlement in a court.

51. These provide, for example, for the imposition of a fine or the threat of suspension of operations.

52. Any such assistance would be subject to the regime for control of state aids and the provisions in the EU postal Directive which provide for a government to establish a compensation fund if the universal service is regarded as an unfair financial burden on the universal service provided. Such funds must be independently administered and both payments from and contributions to the fund must meet principles of transparency, non-discrimination and proportionality. It is also possible that the competition law could apply to any such support, if it were seen as introducing a distortion of the competitive environment – see discussion in chapter 3. However, it would be conceptually possible to avoid distortions if robust mechanisms were utilised to ensure reliable measurement of the cost, net of any offsetting benefits, of providing the USO. One possibility would be an auctioning mechanism. Such mechanisms are used in some other countries to identify least cost operators to deliver specified community services – e.g. Norway uses a subsidy auction system to ensure regional air services on otherwise unprofitable routes.

53. Although there is a requirement for uniform pricing for 1st class letters throughout Finland, this does not preclude contractual arrangements at prices lower than the standard letter rate for bulk mail that could be focussed in population dense areas.

54. The restriction applies to the provision of postal services in the municipalities of Askola, Espoo, Helsinki, Hyvinkää, Järvenpää, Karjalohja, Karkkila, Kauniainen, Kerava, Lapinjärvi, Liljendal, Lohja, Myrskylä, Mäntsälä, Nummi-Pusula, Nurmijärvi, Pornainen, Tuusula, Vantaa and Vihti for senders and addressees that are private persons, enterprises, communities and other legal persons. Consequently, Suomen Suoramainonta Oy is not licensed to provide postal services outside of these municipalities.

55. Daily delivery is an EU mandated service level requirement for the universal service provider. In Finland the Postal Services Act applies this obligation to <u>all</u> licensees and not just the universal service provider.

56. For general discussion of competition law see chapter 3. Under Finnish case law such cross subsidisation is an abuse only if it has been: "1) so continuous an extensive that it establishes a supreme competitive advantage over other operators in the competitive field and 2) that the aim of the arrangement is the achievement of a dominant position in the subsidised field or its evident result is such an essential exclusion or barrier to competition that entering and taking over a new industry and, through that, the expansion of a dominant position, becomes possible, or the arrangement otherwise distorts the industrial structure of the field to a major extent an thus leads to a long-term decrease in efficiency. See OECD

(1999), Promoting Competition in Postal Services, Series Roundtables on Competition Policy, No.24. Finnish submission.

57. Under Finnish law, pricing may be considered predatory when: 1) prices charged in the target market are less than marginal costs/average variable costs or less than average total costs where other circumstances indicated a decisive exclusion of competitors and 2) the market conditions in the field have changed or are about to change as a result of the arrangement so that, after the exclusion of competitors, it is possible to raise the prise level to the extent that it may compensate for the income losses resulting from the under-pricing. See OECD (1999), Promoting Competition in Postal Services, Series Roundtables on Competition Policy, No.24. Finnish submission.

58. The Annual Report notes only that the supervisory board met to consider the annual accounts and auditors report. Formally, the supervisory board proposed to the Annual General meeting of shareholders that the accounts be adopted and concurred with the proposal of the Board of Directors concerning the disposal of profit.

59. It is notable that Citymail experienced severe financial difficulties and was placed into liquidation in 1992 and 1995, and was for a brief period in 1995 a subsidiary of Sweden Post. For the latter part of the 1990's Citymail was 2/3 owned by Consignia plc (previously Royal Mail UK) until a management buy-out in 2001. Under a transaction that is now part complete, Citymail will be majority owned by Norway Post by 2006

60. See Commission Proposal for Further Market Opening of Community Postal Services: Background Information. Version 0.6. European Commission (2000)

61. Arguably, turnover is conceptually a better base than say profits, if the objective is to deter inefficient entry. However, perhaps consideration could be given to whether the tax should phase in over a period in recognition of start-up costs and the limited financial resources of smaller entrants. There is also a possible question of whether the structure of the tax – in particular its geographic basis – is the most neutral design. If the present structure of the tax is retained there should be some mechanism that should link the rate of tax and revenue raised to the effect of entry on the possibility to cross subsidise the USO, and the tax revenue should be paid to the incumbent. This would necessarily be complex. Alternatively, if the structure of the tax were changed, a more simple arrangement could be implemented. For example, a small turnover tax could be applied to all operators (including the incumbent) designed to raise the actual net cost of the USO and this would then be paid to the incumbent. In any event, it would be important in that context to accurately measure the cost of the USO. If at a latter point the delivery of the USO were to become problematic the issue of funding the USO could be revisited. If so that would need to take into account all the forces acting on the issue, the largest of which might be technological change. In that case, special taxation of a declining base of letter traffic might not be a financially viable means to ensure the USO.

62. Notice on Application of Competition Rules and Assessment of Certain State Measures 1998

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