What Europe can learn from British Privatisations

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www.econ.cam.ac.uk/dae/research/regulate/
The business of Government

‘The Conservative party has never believed that the business of Government is the government of business’ (Lawson, 1981).

Sales receipts:

- non-utilities: £(95) 30 billion
- utilities: £(95) 37 billion

55% from sale of public utilities
Scale of UK privatisations

• Govt receipts £87 billion (1995) prices = 12% GDP
• privatised co.s ~5% of GDP
• consider efficiency gain of 10%
  ⇒ increase GDP by ½ of 1% for ever
  ⇒ PDV ~ 10% GDP
• worth having but not large
Types of privatisation

- commercial activities
  - airlines, oil, aerospace, cars, banks, etc
- utilities/essential facilities
  - BT, gas, water, electricity, airports, ports
- non-commercial service providers
  - rail, prisons, …
Objectives

• increase the role of the market
• increase the share of private ownership
• reduce the power of unions
⇒ stimulate productivity
• remove constraints on investment
• reduce budget deficits, national debt
⇒ stimulate growth
Lessons from commercial sales

- removes obstacles to competition
  - British Airways and airline liberalisation
- replaces Government by market financing
- motivates managers and workers
  - commercial test relaxes investment constraint
  - National Freight Co: workers gain, performance improves
Privatising utilities

- Privatise potentially competitive utilities
- Telecoms: rapid technical change
  - State poor at managing innovation and risk
  - Enables BT to catch up with best practice
- Gas, electricity - unbundle, restructure
  - Competition delivers impressive results
  - But market power creates problems
- Water - to shift financing to private sector
The critical role of regulation

• competition may be possible over networks
• but networks are natural monopolies
• regulation inevitable
  – to protect consumers
  – to finance investment
• benefits from separation from ownership
• but who regulates the regulators?
Restraining regulatory opportunism

US system:
- Constitutional guarantees
- Separation of powers: DoJ, FCC, PUCs
- Administrative law to challenge regulatory discretion

UK problem: Parliament sovereign
- need to restrain Government
- licences upheld by courts
The British contribution

- Legislation defines duties
- Licences to provide credibility
- Regulator to insulate from politics
- RPI-X for incentives and inflation
- Periodic review for rent transfer
- MMC/CC for dispute resolution
Price-caps

- RoR leads to gold-plating
- Price-cap to mimic competitive market
- but how is X reset?
- Benchmarking, efficiency audits
- Resetting requires agreement
- must be able to finance investment
The British utility experience

• BT privatised 1984 as *de facto* monopolist
• Facilities-based competition
• Duopoly ends 1991 - competition starts
• Gas privatised as monopoly 1984
• lengthy strong regulatory pressure to unbundle until 1996 Gas Act
• Electricity unbundled *before* sale in 1990
Lessons from utility privatisation

Before privatisation:

• restructure for competition
• clarify regulation and licence conditions
• create dispute resolution procedures
• ensure strong competition authority
• National champions extract domestic rents!
Lessons from Britain

• competition improves performance
• unbundling needed for effective competition
• competition requires privatization?
• Privatization precipitates further reforms?
• But better to get it right at start.
‘Non-commercial’ privatisation

• Railways - face competition from road
  ⇒ cannot charge average cost
  ⇒ requires continuing public subsidy
• tension between independence of regulation and control of subsidy
• complicated by Health and Safety
• contrast with Water
Water - a monopoly service

• only constraint on charges is political
• privatising relaxes this constraint
• multiple regulation raises costs
  – Drinking water quality, river/beach quality,..
• Lack of public budget constraint raises costs
• Need for Cost-benefit test for regulations
Impact on capital markets

• wider share ownership encouraged
• IPOs develop capital market
• share ownership facilitates private pensions
• Inappropriate privatisations and breaking regulatory compact increases risk/cost
  – Windfall tax
  – Railtrack put into administration
  – PPP/PFI as off-balance sheet manipulation
Impact on public balance sheet

- Britain has curious PSBR constraints
  ⇒ public borrowing bad, private good
- Privatisation relaxes self-imposed constraint
- but public sector still needs to invest
- Underlying problem has not been resolved
- Public net assets have been eroded
Unlearned lessons

• RAB and RPI-X work for privatised capital-intensive natural monopolies
• ensure investment financed at WACC
• so why cannot public sector do this?
• What is role of PFI/PPP?
  – Risk allocation?
  – Management?
  – Creative accounting?
Part II

Cost-benefit studies of British Electricity privatisation
British contrasts

• England and Wales
  – unbundle CEGB into 3Gs, T, gross pool
  – separation and competition

• Scotland
  – retain 2 vertically integrated companies
  – no imports, little competition
Audit of CEGB: first five years

- labour productivity doubled
- coal prices fell 20% real
- coal sales fell from 74mt to 30mt
- CCGT rose from 0 to 25%
- fossil fuel cost/kWh fell 45% real
- nuclear fuel cost/kWh fell 60% real
- emissions/kWh fell dramatically
Net benefits of privatizing CEGB

Cost savings: \( PDV \text{ at } 6\% \) £ billion

- net fuel switching 3.6
- efficiency gains 8.8
- restructuring costs -2.8
- Total R&P gains 9.6

Environmental gains:

- \( \text{SO}_2 \) (£1b) \( \text{CO}_2 \) (£1.4b) 2.4

*levellised reduction per kWh* 5.7%
CEGB: who gained, who lost?

£ billion

Consumers -1.3
Govt. excl sales -8.5
After-tax profits 19.4
Net benefits 9.6
Govt. sales proceeds 9.7
Net govt. position 1.2
## RECs: who gained, who lost?

Discounting at 6% to 2000 £ billion incl post 2000

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<th>Category</th>
<th>Discounted To 2000</th>
<th>Discounted Incl Post 2000</th>
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<td>Producers</td>
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<tr>
<td>Government</td>
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<td>-0.5</td>
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<tr>
<td>Consumers</td>
<td>-7.2</td>
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<tr>
<td>Total</td>
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<td>6.3</td>
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Scottish ESI: who gained, who lost?

<table>
<thead>
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<th></th>
<th>£ billion</th>
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<tbody>
<tr>
<td>Consumers</td>
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<td>Govt. sales proceeds</td>
<td>3.6</td>
</tr>
<tr>
<td>Net govt. position</td>
<td>-1.6</td>
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Structural reforms

- initial choice of unbundling critical
- in Gas achieved by regulatory pressure 1984-96
- Licences the key to negotiated restructuring
- MMC can investigate structural problems
- divestiture “encouraged” by threat of MMC