



# Public Utilities: Privatisation and Regulation

by

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# Aims and Learning Outcomes

## Aims

- To survey issues relating to public utility privatisation and regulation
- To stimulate ideas for assessment

## Learning Outcomes

Following this session you will be able to

- cite reasons for state ownership of public utilities.
- critically consider whether state ownership is an inappropriate governance structure for public utilities.
- explain the nature of regulation toward public utilities



# What is Privatisation?

## Broadly defined

- ❖ Privatisation refers to the processes by which assets or activities owned and controlled by the public sector are subjected to market forces.

## These include

- the closure of plants in ‘sunset’ industries;
- the competitive tendering for activities once carried out solely by public service organisations;
- the deregulation of markets; and
- the transfer of assets to the private sector by share flotation or private sale.

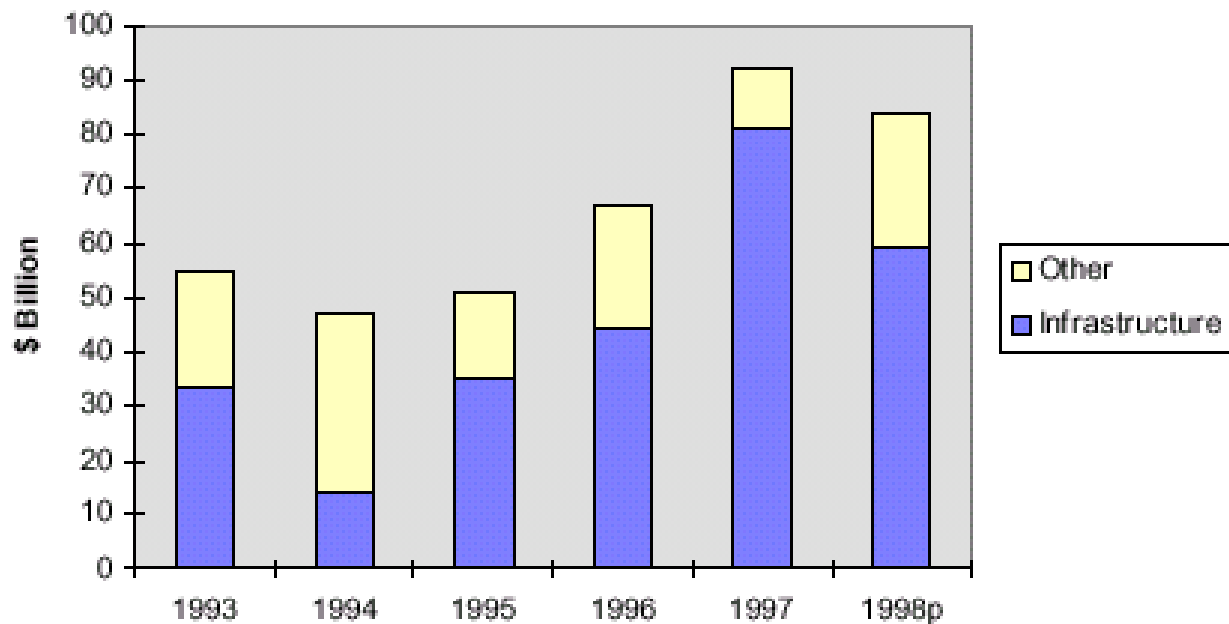


# Public Utilities

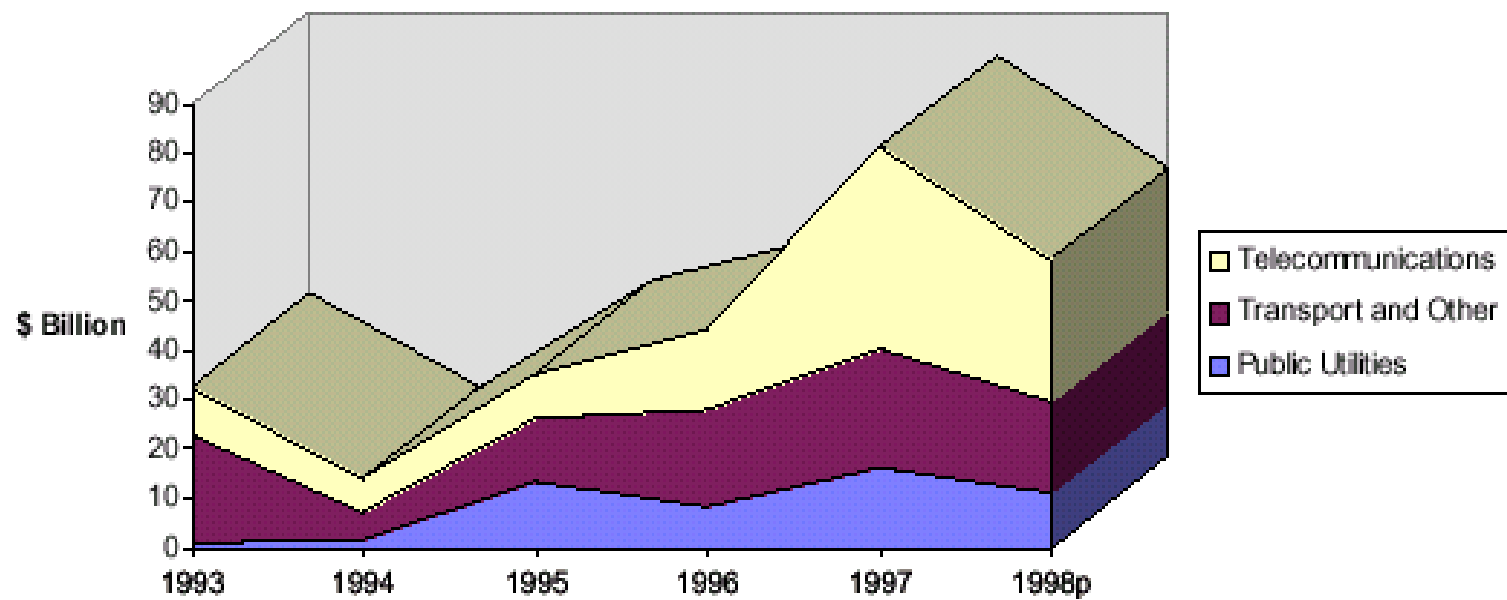
- ❖ These are network infrastructure industries, providing a wide range of goods and services to businesses and consumers.
- ❖ Vertically integrated
  - production, distribution and supply
- ❖ Significant effect on the GDP of most economies



**Chart 2: Infrastructure Privatisation In OECD Countries,  
1993-1998p**



Source: OECD, Financial Market Trends



(\*) Public utilities includes electricity, gas and water supply

Source: OECD, Financial Market Trends

# Rationale for state ownership of Public Utilities

- ❖ to ensure social ownership of production
- ❖ to allow economic planning of key sectors
- ❖ to distribute income
- ❖ because they can provide positive externalities
- ❖ because they create a less adversarial industrial relations environment
- ❖ and, because of the existence of Natural monopoly.

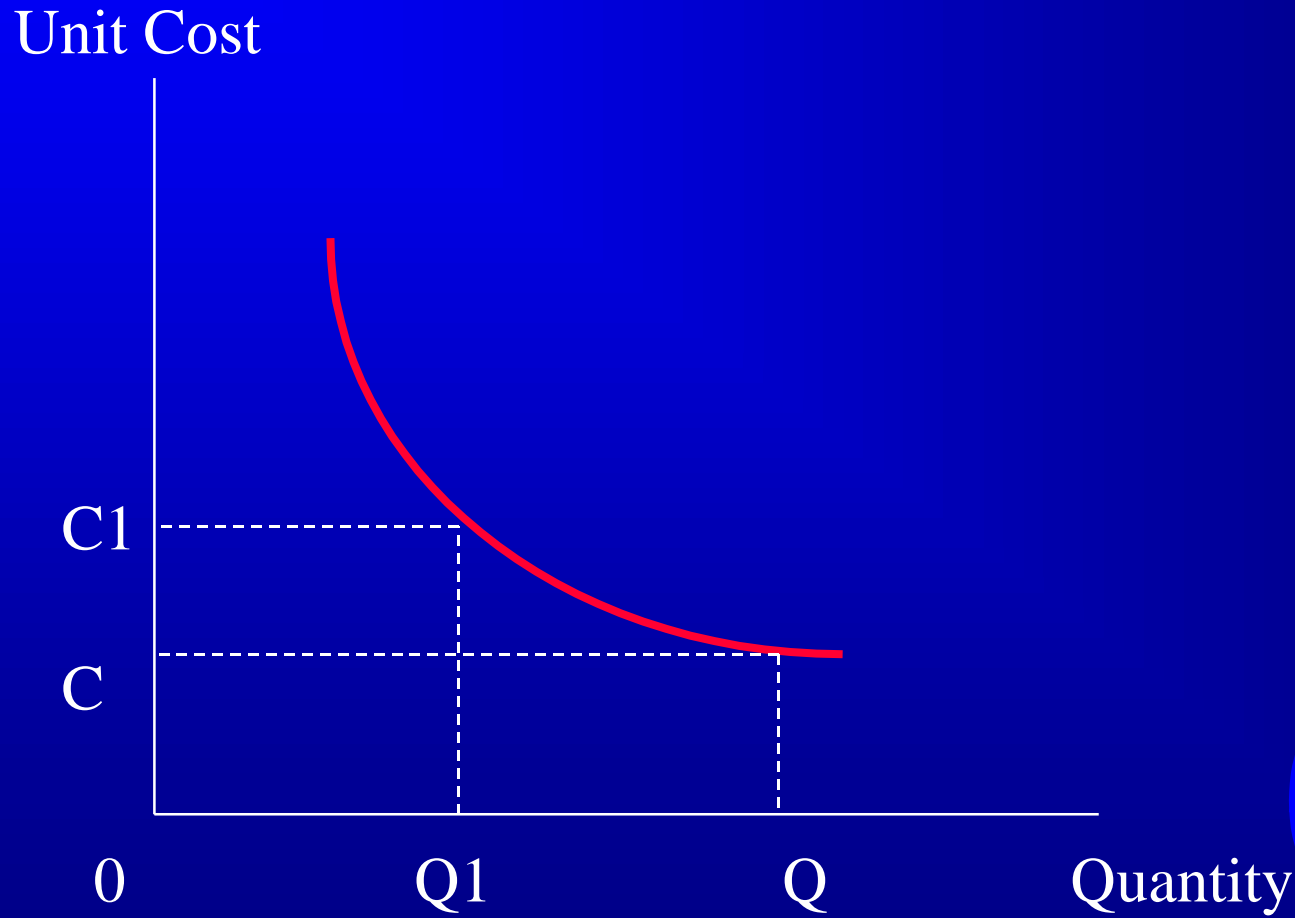


# What is a natural monopoly?

- ❖ A natural monopoly arises where it is cheaper for one firm to supply a portfolio of products or services than it is for two or more firms.



Where scale economies exist one firm is cheaper than two



# State ownership of Natural Monopoly is Good...Isn't it?

- ❖ The state was seen, until recently, as the best vehicle for ensuring efficient outcomes from NM provision.
- ❖ From societies' point of view it would be inefficient to duplicate expensive networks.



Not if you believe in ....

## 1. Public Choice Theory

- ❖ Govt employees motivated by self (rather than public) interest.
- ❖ Politicians shape policies to maximise votes, justifying any kind of policy as in the public interest; even though this may involve considerable tax burdens.



Not if you believe in ....

## 2. Property Rights Theory

- ❖ There is no direct interest in the yield from state assets because there are no shareholders (i.e. owners with property rights).
- ❖ Management is less constrained in nationalised industries. Poor management will not depress the capitalised value of the enterprise and tend not to be visible.



# The privatisation steamroller

- ❖ privatisation also required the spur of competition.
  - deregulation or liberalisation (i.e. reducing the rules and regulations prohibiting competition), sometimes even before privatisation (e.g. the Telecommunications Act, 1981, which, among other things, allowed competition with BT on equipment supply).
  - the theory of contestable markets demonstrated the possibility of changes in natural monopoly status.



## ...changes course.

- ❖ criticisms of contestable markets.
- ❖ In particular, sunk costs due to networks.
- ❖ In the early privatisations the government was unconcerned by this. e.g. Telecomms
- ❖ However, in the case of energy competition has been slow in coming.
- ❖ Divorce of network ownership and network use. (Vertical disintegration)
- ❖ Use of Chadwick-Demsetz auctions. e.g. Railway routes



# Regulating the market

- ❖ Agencies, e.g. OFTEL, OFWAT,
- ❖ regulators of public utilities are called upon to ensure that competition prevails across networks.



# Evolution of Regulation over 3 stages of market structure

Regulatory Intensity

Intensity

**Phase 1:  
Monopoly**

Regulation focuses on the prevention of monopoly abuse in downstream markets

**Phase 2:  
Monopoly and  
Competition**

Competition gradually introduced, regulation deals with retail and access prices, emerging competition issues and public service obligations.

**Phase 3:  
Competition**

Light-handed regulation needed to ensure fair trading practices and the maintenance of public service obligations

Time

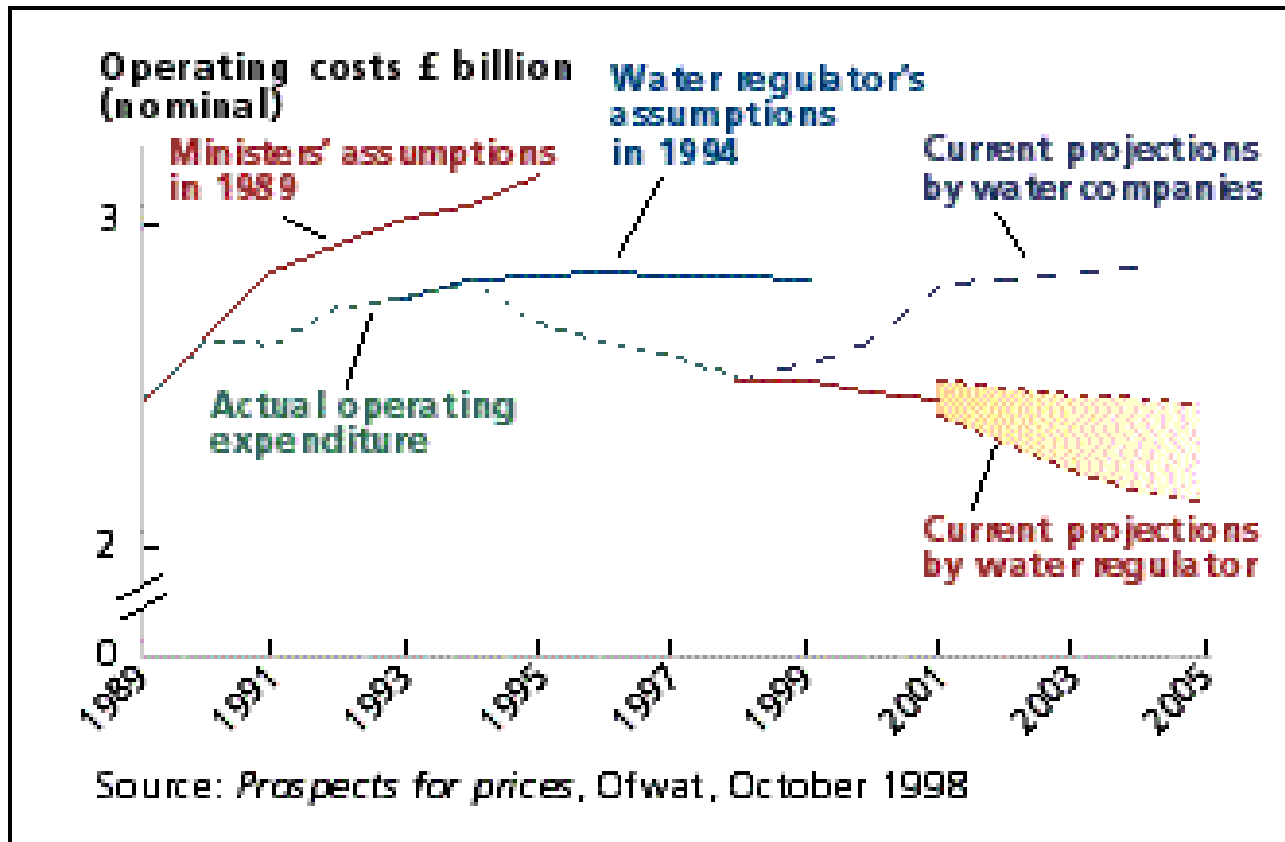


# Regulating the Market

- ❖ UK regulators have practised the RPI-X scheme (with variations depending on the industry) where RPI refers to the retail price index and  $x$  is a cost efficiency factor determined by the regulator.
- ❖ Problems:
  - need to manage the regulator
  - Information asymmetry
  - Quality Issues
  - The Barman Problem



## UK water industry operating cost projections and outcome



# No role for the state?

- ❖ Privatisation implies that the state is allocatively and productively inefficient.
- ❖ However, the evidence is somewhat mixed.
  - Managers in the public sector
    - ◆ can act in the public interest,
    - ◆ are accountable (to the Audit Office, the Press and their peers in the managerial labour market)
    - ◆ can be induced to improve on their performance (via incentive schemes, by product market competition and freed from political constraints).
- ❖ EC is neutral with regard to ownership structures, as enshrined in Art. 222.



# Test

- ❖ What are the main reasons for state ownership of public utilities?
- ❖ What 2 theories questioned the need for state ownership of public utilities?
- ❖ What is a contestable market and why was it inadequate in facilitating privatisation?
- ❖ What form of regulation has been adopted in the UK?



# And Finally...

- ❖ Summary
- ❖ Have you covered the Learning Outcomes?
- ❖ Any Questions?

