



Public Utilities: Privatisation and Regulation

by

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Rationale for state ownership

- ✦ 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.

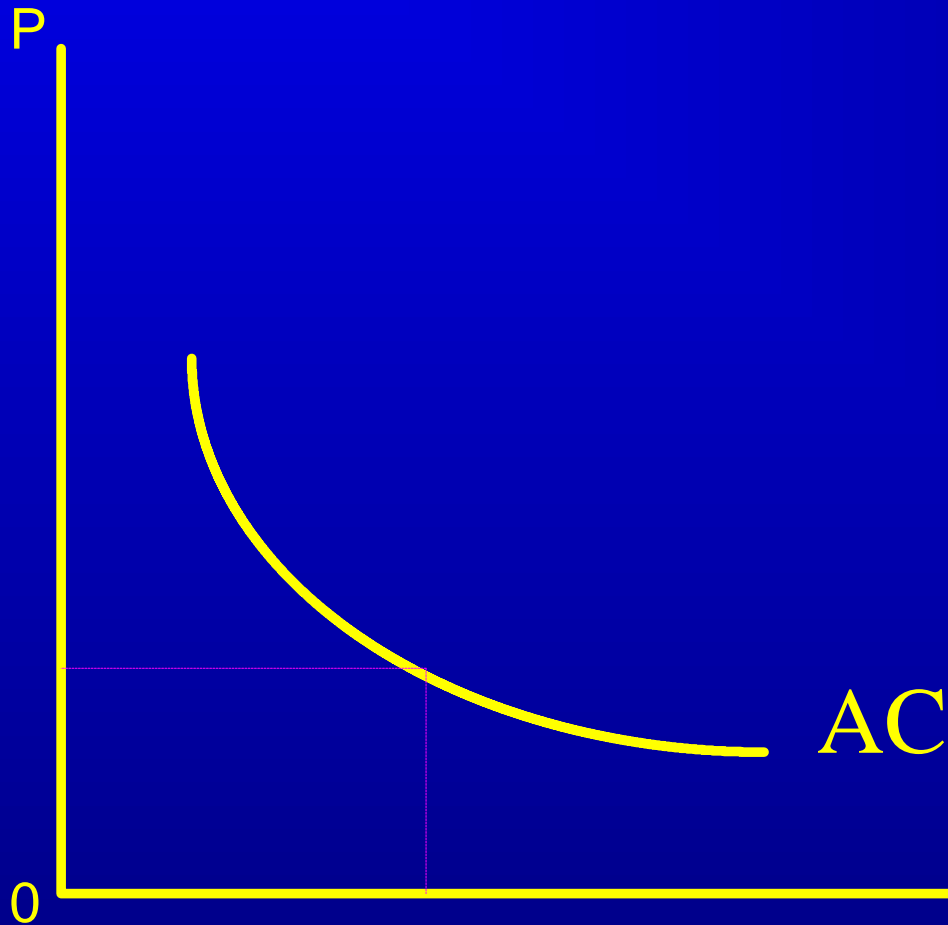


What is a natural monopoly?

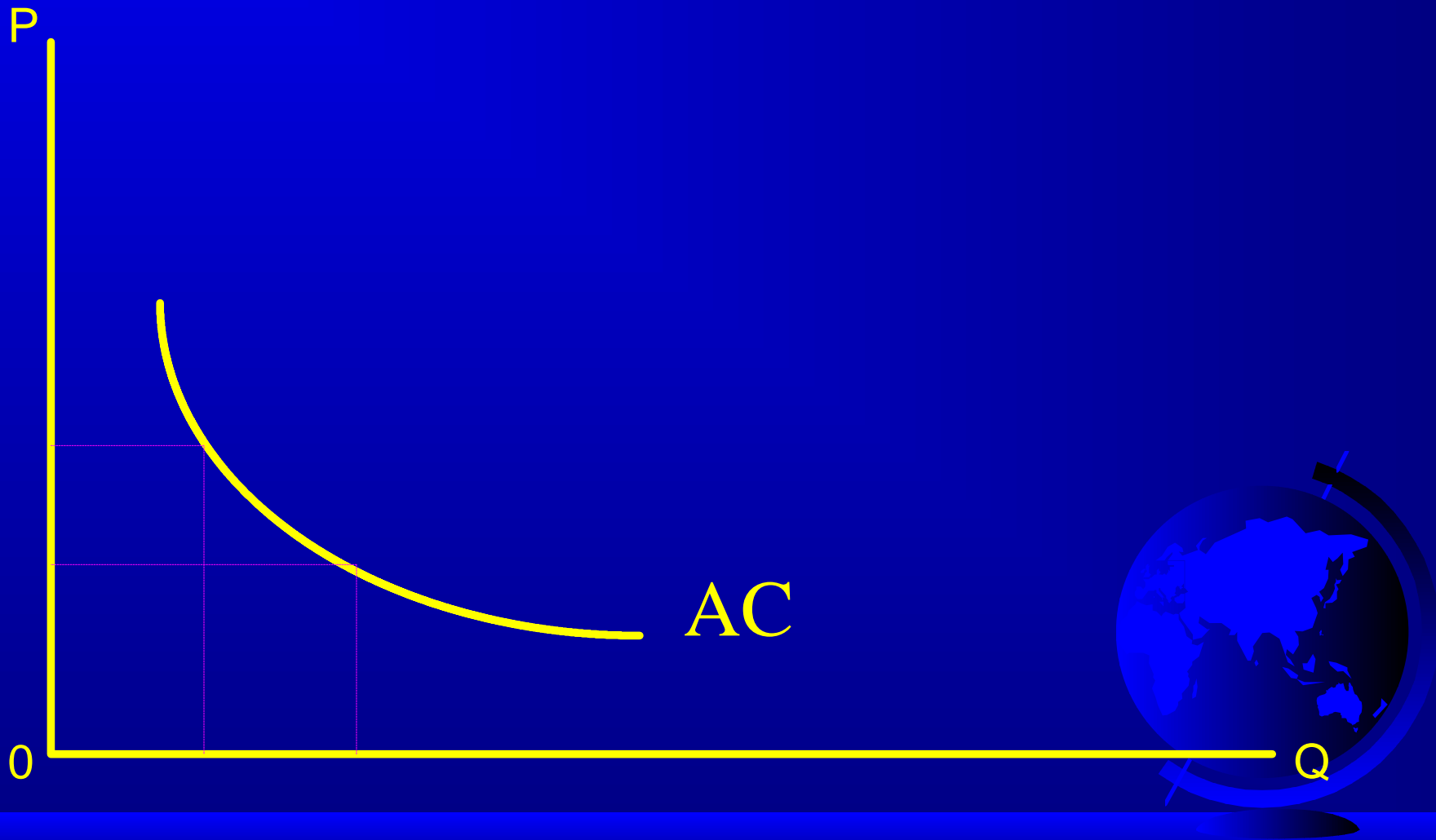
- ◆ A natural monopoly arises where it is cheaper for one firm to supply a portfolio of products or services than it is for two or more firms.



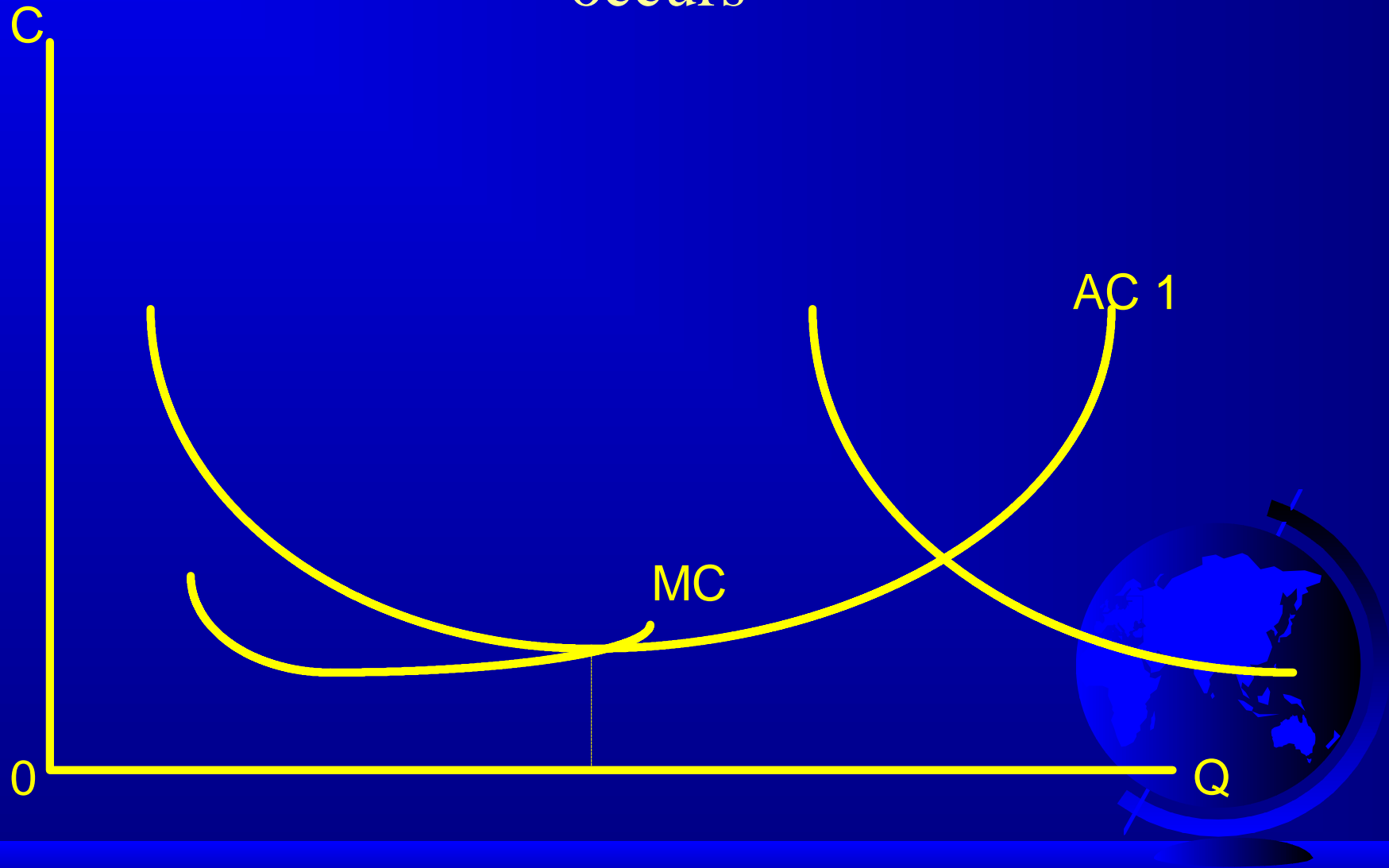
Where scale economies exist one firm is cheaper than two



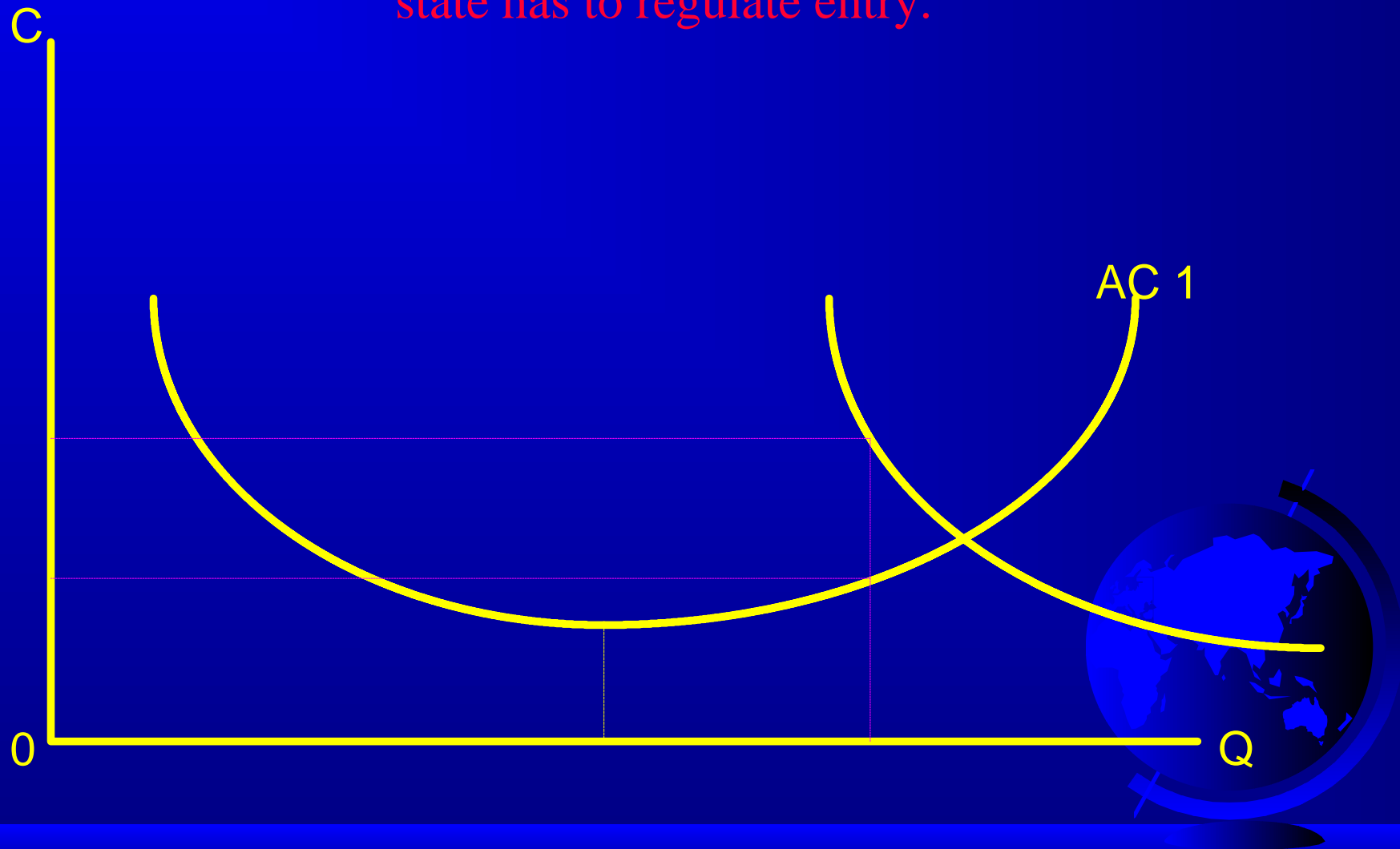
Where scale economies exist one firm is cheaper than two



Even where scale economies do not exist one firm is cheaper than two. But a problem occurs



Even where scale economies do not exist one firm is cheaper than two. But a problem occurs: an entrant can undercut the incumbent. Thus, the state has to regulate entry.



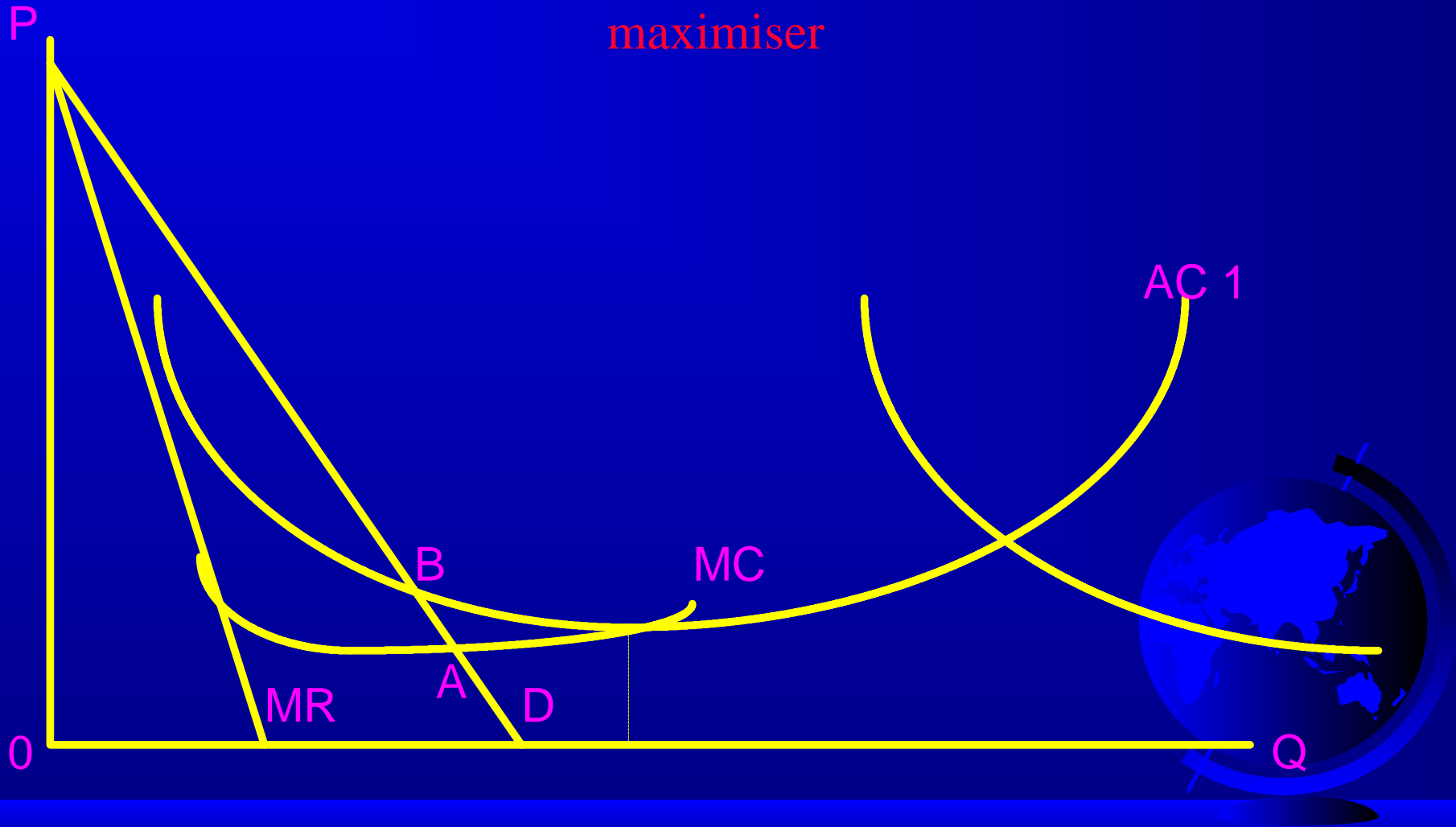
State ownership of Natural Monopoly is Good...Isn't it?

- ✦ 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.



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

Marginal cost pricing at A leads to losses but average cost pricing (B) offers better returns from society than a private profit maximiser



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 (ie reducing the rules and regulations prohibiting competition), sometimes even before privatisation (eg 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.



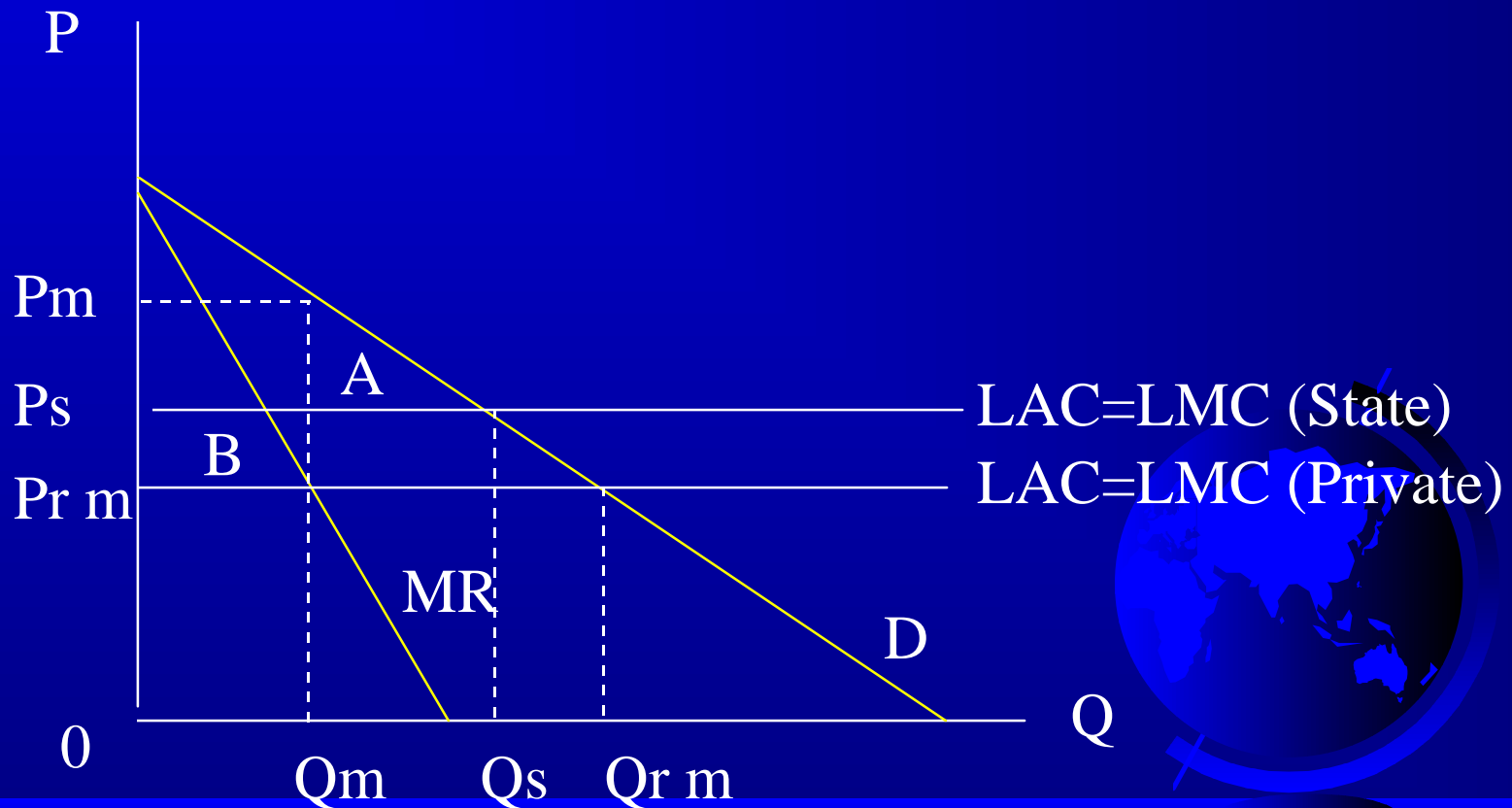
...changes course.

- ✦ 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 gas competition has not been forthcoming.
- ✦ Divorce of network ownership and network use.
- ✦ Use of Chadwick-Demsetz auctions. e.g. Railway routes



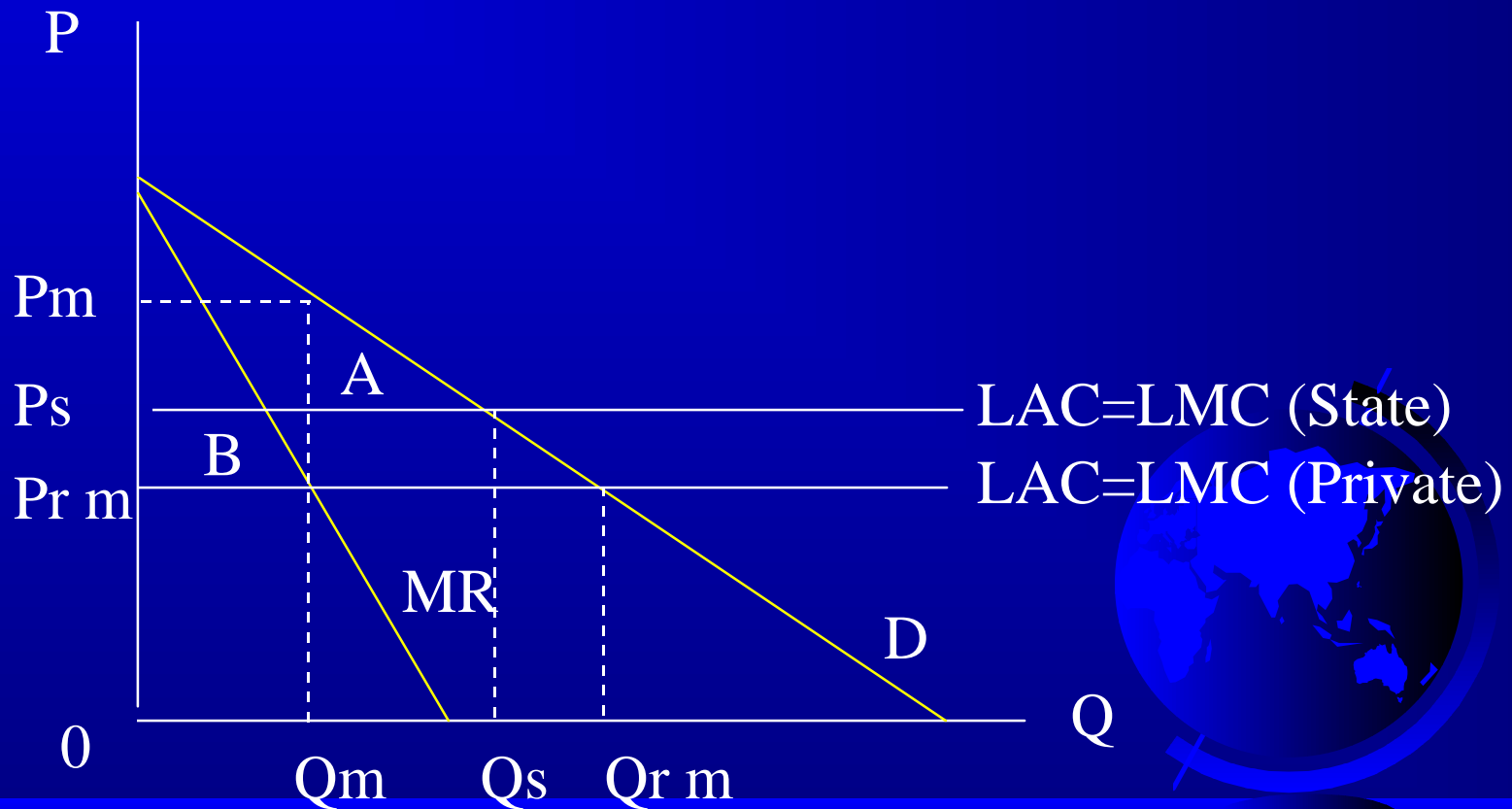
Regulating the market.

Note: the X-inefficiency of State Control implied by the higher AC and MC curves. Thus, the welfare loss of private monopoly (A) may be offset by the latter's productive efficiency (B).



Regulating the market.

Note: Good regulation of private firms requires price $0P_{rm}$



Regulating the market (2)

- ✦ 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.
- ✦ regulators of public utilities are called upon to ensure that competition prevails across networks.



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 if freed from political constraints).

