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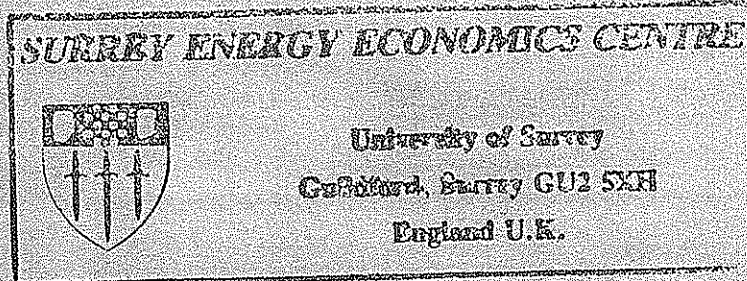
RESTRUCTURING THE ENERGY INDUSTRIES:  
THE POLITICAL ECONOMY OF BRITISH  
ENERGY PRIVATISATION

by Colin Robinson

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Editors: David Hawdon, Peter Pearson and Paul Stevens  
Department of Economics, University of Surrey,  
Guildford, Surrey GU2 5XH

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# RESTRUCTURING THE ENERGY INDUSTRIES: THE POLITICAL ECONOMY OF BRITISH ENERGY PRIVATISATION<sup>1</sup>

by Colin Robinson  
Professor of Economics, University of Surrey

One reason why there was a British privatisation programme in the 1980s (1), and why governments headed by Mrs Thatcher were re-elected in 1983 and 1987, was the changed intellectual climate compared with the 1960s and 1970s. In Britain, as in other countries, disillusionment with the results of government action led to the belief that markets should have a greater role in resource allocation decisions. Nevertheless, although in Britain privatisation schemes were conceived and implemented by a government apparently dedicated to much greater use of markets than in earlier postwar years, they were (like nationalisation schemes) political acts which appear, to economists, to exhibit many failings in conception and implementation. There is no evidence that, *ab initio*, there was careful consideration of the objectives of privatisation, of what to privatise, and of how to privatise. The government evidently stumbled into a large-scale programme of privatising state-owned corporations, after some early privatisation schemes had proved popular with the electorate, without giving much thought to the economic principles of such a programme.

Because privatisation is a political act, the economic theories of politics and bureaucracy (positive public choice) (2) can help understanding of why it takes particular forms. This paper, which summarises research reported in more detail elsewhere (3), begins by discussing the political and bureaucratic calculations which underlie privatisation British-style. It then considers, for the energy industries in particular, whether some gains (other than political advantage) are likely. The model used is one in which the form of privatisation is determined principally by the interplay between pressure groups and government which is potentially the most powerful group of all since it has powers of coercion, including the power to tax, and enjoys a monopoly (between elections) in the supply of policy. The government is assumed to be primarily a vote-seeker which treats citizens unequally, for example

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<sup>1</sup> This paper is an updated version of a paper given at the 15th Annual Conference of the International Association for Energy Economics in Tours, France, in May 1992

favouring producer pressure groups which appear able to deliver or to influence large numbers of votes.

### **THE BRITISH PRIVATISATION PROGRAMME**

In terms of public choice theory, the early stages of the British privatisation programme represented a period in which government was feeling its way forward through the fog which, according to Downs (4), surrounds political decision-making when the views of the public on an issue are unformed (since it is rational for voters to remain ignorant on complex matters because the costs of gathering relevant information are likely to exceed benefits). The effects of privatisation on voting intentions must, in the early 1980s, have seemed very uncertain to the government. Consequently, it proceeded cautiously, leaving untouched the big utilities which Labour had nationalised in the 1940s. They were complex in technical terms. Moreover, they contained natural monopoly elements which would require independent bodies to regulate them after privatisation. Britain had little experience of that kind of regulation (though nationalisation itself is a regulatory device) and US experience seemed generally rather unhappy.

By late 1984, however, the recently re-elected Conservative government evidently felt sufficiently encouraged by the reaction of the electorate to move on to much bigger privatisation schemes which, *inter alia*, involved the utilities. In November 1984, 50 per cent of British Telecom was sold to the public in what was deemed to be a successful flotation. British Gas was sold in 1986, the ten water companies in England and Wales in 1989 and electricity supply in late 1990 and 1991. Following the 1992 General Election, Mr Major's government has privatisation of the coal industry (5) and the railways on its agenda.

### **POLITICAL LIMITS TO LIBERALISATION**

An apparent paradox of the privatisation programme is that, though its philosophical basis was a belief in the virtues of competition and the government in office certainly professed such a belief, the outcome of the bigger schemes (including energy) was very limited market liberalisation - most of it achieved, not by the original privatisation schemes, but by subsequent action by the industry regulators and the

Monopolies and Mergers Commission. However, the paradox is more apparent than real. Governments engaged in privatisation have aims other than liberalisation which they believe will yield greater political benefits: those aims therefore take priority.

Four principal aims can be identified in the British privatisation programme: widening share ownership, raising revenue, depoliticisation of decisions in the industries concerned and market liberalisation. The first two objectives were vigorously pursued because of the size of the potential political benefits. Share ownership in Britain was widened, though not deepened (6), by offering the public shares in the privatised corporations at prices which generally were at a substantial discount to initial market valuations. In addition, employees and customers were given special deals and applicants for small numbers of shares were favoured so as to spread the available number of shares to as many people as possible. An opportunity was presented which appeared irresistible to many - either of buying privatisation issues and then selling quickly in order to realise their cash handout from the state or of holding on and feeling wealthier. The bigger schemes were very popular and, no doubt, they brought a return in terms of increased votes.

Possibly even more important than widening share ownership was revenue-raising. Despite the discounts at which shares were offered, privatisation offered government an apparently painless means of raising large revenues and applying the proceeds to the reduction of public borrowing and the lowering of interest rates which seemed very desirable political objectives, especially in the early and mid 1980s.

The third objective (reducing politicisation) was an article of faith for a non-interventionist government. Objective four - market liberalisation - was also an article of political faith. But the evidence suggests it had very low priority, despite the lip-service paid to it. Product market liberalisation was pursued half-heartedly in most cases. Nor were the capital markets allowed to operate freely. Typically the government held "golden shares" to allow it to veto a change of ownership after privatisation (though it did not exercise its veto in the cases of the Ford takeover of Jaguar and the BP takeover of Britoil) and in some case there were limits on individual shareholdings in privatised companies.

## EXECUTION OF THE PROGRAMME AND THE ROLE OF PRESSURE GROUPS

Execution of the British privatisation programme demonstrates a common problem in economic policy-making. Since policies are executed by politicians, where conflicts in objectives arise those objectives which have the biggest expected political returns (often because they are supported by strong pressure groups) predominate. In the case of privatisation, the main conflict was between the wider share ownership and revenue-raising objectives on the one hand, and market liberalisation on the other. The more a product market is liberalised, other things equal, the worse the earnings prospects for the companies concerned, the less appealing the shares and the smaller the revenue likely to be raised from flotation. When one considers the constituencies which favour each objective, it is clear why liberalisation has a low priority. There is no organised constituency which supports it. There are, however, several organised groups against.

Senior management of the corporation concerned, though wanting the greater freedom and higher salaries which privatisation brings, wishes to retain its market power and the industry's unions will want it to do so since they will expect to be able to conclude much cosier arrangements with a monopoly than with a firm operating in competitive conditions. Both groups are likely to favour golden shares and other restrictions on hostile takeovers so as to give them quieter lives than they would otherwise enjoy. Company management is in a powerful position because it can significantly delay a scheme which is not in its interests. The City, though it does not favour restrictions on takeovers, is generally happier in floating product market monopolies (provided they are only lightly regulated) rather than firms in a competitive industry; it is easier and usually more profitable.

The interests of politicians often coincide closely with those of these interest groups. They want to raise large sums quickly, without management obstruction and with the help of the City, from the sale of corporations which face little competition and therefore appear to have good earnings prospects. The social benefits from increased competition appear rather intangible and, in any case, they will not be realised within the normal political time scale. Before embarking on a policy, politicians must perceive that there are likely to be many more winners than losers.

Moreover, the winners must realise that they are winners so that they can repay their gains with votes. Thus there is an inherent bias against competition-promoting policies simply because it is often difficult for people to recognise that they have won. Benefits, even if large for society as a whole, may be thinly-spread. They may not readily be identifiable with the originating action, both because they take time to appear and because they will be in comparison with what would otherwise have happened rather than with recent events.

On this view, privatisation schemes in Britain have generally been illiberal because it has been in the interests of powerful interest groups that they should be so. But there is more to the political calculus than that. What British experience now suggests is that, subsequent to the initial privatisation schemes, government will try to realise some of the benefits of liberalisation via the competition authorities and the industry regulators.

After the flotation, the original coalition against liberalisation will disband. The alliance of producer groups, politicians and bureaucrats will have been held together only by a dislike of competition-promoting policies. Its cohesion disappears once the government has raised its revenue and widened share ownership, company management has accomplished its goals, unions have collected privatisation "perks" for their members and the City has been paid its fees. Furthermore, new pressure groups in favour of competition may emerge as the effects of private monopoly become apparent. Large producer groups which also have a consumer role because they purchase the goods or services of the newly privatised corporation are likely to begin to express their discontent.

The political advantage of avoiding liberalisation in the initial scheme but leaving it until later is that the consequent upheaval (inevitable in markets which have been monopolised for years) cannot be blamed directly on the government. If instead it is attributed to the actions of the competition authorities and independent regulators, government can gain the political benefits of the original privatisation but sidestep the subsequent costs of liberalisation.

As a result of these highly imperfect political processes, Britain now has a number of important industries which have been denationalised but not liberalised to any significant extent. Their regulators are struggling to inject more competition. It

is an uphill task, especially in gas where privatisation left British Gas with its monopoly intact and in electricity where a poorly-devised and uncertainly-executed scheme makes entry to generation difficult.

## **ELECTRICITY AND GAS PRIVATISATION IN BRITAIN**

British Gas was the first major energy corporation to be privatised when it was sold as one unit to the public late in 1986. Not only was no competition introduced into the product market, like many other privatised corporations British Gas was kept outside the market for corporate control, protected from takeover by a golden share and by the restriction of individual shareholdings to no more than 15 per cent of the voting shares.

The unitary form of privatisation suggests that the powerful interest groups described earlier had prevailed in agreeing with government a form of privatisation in which the market power of British Gas was barely disturbed. That is hardly surprising since their interests were virtually coincident with those of the Treasury. Gas privatisation was a political success in that it raised nearly £8 billion (in share proceeds plus new debt) for the government at a time when it was very keen to bring down public borrowing. The other political yield was a considerable number of contented voters who had either bought discounted shares in British Gas and sold them quickly to obtain their cash handout from government or who had held on and felt wealthier.

However, within a year, late in 1987, the privatisation outcome was disturbed by complaints from larger consumers who claimed that British Gas was abusing its monopoly position in the industrial market. The government therefore referred the Corporation's industrial pricing practices to the Monopolies and Mergers Commission (MMC) which in October 1988 (7) made a number of recommendations intended to reduce the monopsony and monopoly power of British Gas and to ease entry to the gas market. Subsequently, the regulatory body for gas - the Office of Gas Regulation (Ofgas), headed by Mr (now Sir) James McKinnon - took up the attempt to inject a measure of competition into the British gas market though it has had a difficult task, given that British Gas was privatised as a monopoly and predictably has behaved like one.



Ofgas has had to proceed slowly, using a mixture of threats and persuasion. However, the process of creeping liberalisation accelerated after a report in 1991 by the Office of Fair Trading which resulted in BG's agreeing early in 1992 to sell some of its already-contracted gas to competitors and to splitting off its pipeline and storage division. At the same time, it was agreed that foreign trade in gas should be liberalised and that BG's exclusive franchise market should be reduced so that its competitors can supply smaller consumers (8). Most recently, following a disagreement with Ofgas over the appropriate rate of return on its pipeline business, British Gas itself asked for another MMC reference so that a comprehensive review of the gas business in Britain can be carried out (9). This new inquiry promises to be the most thorough investigation yet of how the gas industry should be structured, The industry regulator has already made known his view that British Gas should be split, leaving the pipeline and storage business in a separate company (10).

To most economists, the government's privatisation scheme for British Gas seems absurd. First the Corporation was privatised with its monopoly and monopsony power virtually intact. Then, as the consequences for consumers became plain, the government relied on the MMC and the industry regulator to bring some stirrings of competition to the gas market. Because of the regulator's limited powers, the whole process has so far been painfully slow and, not surprisingly, it has been resisted all the way by British Gas. Only when a second MMC inquiry appeared inevitable in mid-1992 did British Gas decide to take an initiative and widen the scope of the reference in the hope that it would fare better in a wide-ranging inquiry than in one restricted to the pipeline business.

The attitude taken by the Corporation's management since privatisation is hardly surprising. It did, after all, believe itself to be running a monopoly and its shareholders believed they had invested in a monopoly with good prospects for earnings growth. Thus BG has had to be coaxed over six years into accepting a degree of competition which could have been achieved in 1986 by a differently designed privatisation scheme.

But the advantage to government of the route which has been followed is that the original privatisation plan went through smoothly without opposition from BG management, it created many new shareholders who were potential supporters of the

government, and it raised large sums of money which were applied to reduce public borrowing. In other words, the powerful interest groups of the time outside government were satisfied with the 1986 scheme and the government itself reaped considerable political benefits. The backdoor route to competition on which government has now embarked has considerable political advantages over the open introduction of competition at the time of privatisation. It assuages the wrath of the interest groups upset by the consequences of the original privatisation scheme (principally large gas consumers) whilst concentrating the ire of the interest groups which stand to suffer from the introduction of competition on the industry regulator.

### **ELECTRICITY PRIVATISATION**

Indeed, the political advantages of leaving an industry regulator to sweep up difficult problems which government does not wish to face are such that it was only to be expected that a similar route would be followed in the case of electricity. The main difference was that a limited degree of competition was introduced from the beginning - by splitting the CEGB into two generating companies, by establishing a separate transmission company and by providing for access to the transmission and local distribution networks at specified use of system charges. Perhaps the government was impressed by the arguments of economists about the need to avoid illiberal privatisation schemes. Possibly it was anxious to minimise the complaints from large electricity users. Whatever the reason, it presumably believed that the gestures it made in the direction of competition would not be too disturbing for the interest groups concerned. Otherwise, it would not have risked making them.

Whereas the original privatisation plan for gas was, in economists' eyes, plainly a wasted opportunity, the benefits and costs of electricity privatisation are less easy to assess. There are novel features of the new electricity structure which distinguish it not only from the nationalised regime but from electricity supply industries elsewhere in the world. To that extent it is an experiment and the outcome is uncertain. There is also a significant degree of interaction between gas and electricity privatisation, the effects of which are not easy to unravel. Finally, electricity privatisation will inevitably disturb the policy of heavy protection for indigenous energy industries which British governments have built up over the years (11).

Abstracting from the impact on energy policy (which is too big an issue to discuss in this paper), the biggest puzzle is the extent to which there will be continuing new entry into generation (either new companies or companies new to generation for public supply) which will provide competition for the market despite the initial lack of competition in that duopoly-dominated market. A significant number of actual and potential entrants would tend to reduce generating costs and prices compared with what they would otherwise have been, leading to efficiency gains both in the short run and the longer run (as technological advance was stimulated). Furthermore, entrants would compete to supply larger consumers. In such circumstances, both costs and prices to consumers should be reduced and more appropriate price signals should appear. Gains in productive, allocative and internal efficiency would be likely, with longer run gains from greater entrepreneurship and innovation than have been evident in the industry in the past.

Several factors are working in favour of entry despite the power of the two incumbent generators (12). They arise primarily from inter-relationships between gas privatisation and electricity privatisation: gas privatisation, despite all its imperfections, has allowed would-be generators access to North Sea gas producers other than BG and so has helped undermine BG's monopoly. The principal method of entry in the foreseeable future is by building Combined Cycle Gas Turbine plant which, from the potential entrants' viewpoint, reduces the minimum efficient scale of generating plant, expected construction times and both the expected costs (including those of meeting environmental requirements) and the risks of building new generating plant. It seems that by the mid 1990s, new entry will be equivalent to nearly 10 per cent of existing generating plant, though further expansion of gas-fired generation may be curbed by the government in an effort to reduce the impact on the indigenous coal industry (13).

Whether or not entry occurs on a sufficient scale to influence the behaviour of the incumbents will be the crucial test of whether the new structure will provide substantial economic benefits. At this early stage, one cannot be sure of the outcome. It is, however, relevant to point out that entry is now possible whereas under state ownership it was impossible. Furthermore, imperfect as is the new regime in electricity supply, it replaces a very unsatisfactory structure under which a monopoly generator (the CEGB) subject to constant political manipulation, dominated a cost-plus, supply-driven industry which gave no choice to consumers.

Looking beyond the government's privatisation scheme to what may eventually happen, experience with gas suggests that if, as is quite likely, the initial structure of the industry proves an impediment to competition and large electricity users become ever more vocal in their complaints, the regulator will take action and there will be references to the MMC. As with gas, the route to competition will be chosen not for efficacy but for political convenience. If the market power of the generators is undermined, they will blame the MMC and the regulator not the government which had seemed sympathetic to their desire to keep competition under control.

### SOME CONCLUSIONS

It is hardly surprising that energy privatisation in Britain has so far been dominated by political considerations since it has been conceived and implemented by politicians. Consequently, it falls far short of what most economists would like. Any economic benefits will probably arise not from the initial privatisation schemes but gradually over time from efforts of industry regulators and the Monopolies and Mergers Commission. Because of the inadequacies of those initial schemes (as seen by economists), regulation has a much wider scope than simply supervising "natural monopoly" sectors of the privatised utilities. Ofgas and OFFER have, in effect, to keep a watch over the whole of the activities of the industries they regulate. Energy is not so much being de-regulated as re-regulated. Supervision by Ministers and civil servants under nationalisation is being replaced by supervision by regulatory bodies which have, perhaps inadvertently, been given considerable power.

But, though there are large elements of political fix and lost opportunity, the new regime is not without benefit compared with its predecessor. Eventually and belatedly, a degree of competition is emerging in gas. In electricity, there will probably be some competition both in generation and in supply though it will again be slow in coming. However, compared with the monopolised gas and electricity regimes prior to privatisation - and similar regimes which still flourish in most European countries - it is in Britain now possible, if difficult, to enter the relevant markets and to obtain access to a gas or electricity transportation system which leads to consumers. At least, that gives ingenious people an opportunity - which previously they did not enjoy - to find ways around the monopolistic forces which undoubtedly still remain.

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