

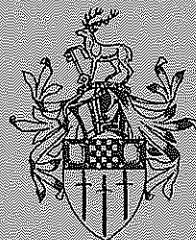
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# Regulation as a Means of Introducing Competition

Colin Robinson

February 1995



Department of Economics  
University of Surrey

SEEDS 80  
ISBN 1-85237-148-X

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Enquiries about Surrey Energy Economics Centre may be made to:

**Director of SEEC:** David Hawdon

*E-mail: D.Hawdon@surrey.ac.uk*

**Secretary:** Isobel Hildyard

*E-mail: I.Hildyard@surrey.ac.uk*

**SEEC**, Economics Dept, University of Surrey, Guildford GU2 5XH, UK.

Telephone: +44-1483-259379

Fax: +44-1483-303775

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Colin Robinson  
University of Surrey and  
Institute of Economic Affairs

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This paper was originally presented at *Public Services: Towards a New Model of Operation?* An International Conference organised by Institut Euro '92 at the University of Paris IX-Dauphine on 13-14 October 1994.

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ISBN: 1-85237-148-X  
February 1995

British Library Cataloguing-in-Publication Data.  
A catalogue record for this book is available from the British Library.



## **REGULATION AS A MEANS OF INTRODUCING COMPETITION**

The conventional model of regulation arises from theories of imperfect competition. Regulation is seen as a means of achieving the results of perfect competition whilst avoiding the messy and apparently wasteful process of competition itself. It is essentially a method of remedying market 'imperfections' and 'failures', based on notions of static efficiency attained at points of equilibrium which can be observed. Thus regulators can simulate the results which markets would have achieved had they been allowed to operate.

But what if static efficiency is an irrelevance? What if markets are never in equilibrium? What if competition is not a state but a process in which knowledge appears, entrepreneurship flourishes and new ideas are implemented? Then it is impossible to reproduce the results of markets: those results are a consequence of the discovery process and are impossible to achieve except by that process. The consequences for regulation are uncomfortable: it seems plain that regulators can never have the knowledge to simulate market outcomes.

On this view, regulation is so unsatisfactory that it should be avoided except where it appears absolutely essential. It may, as explained below, be necessary in certain 'natural monopoly' areas though even there it has its dangers. There may also be a case for regulation as a means of promoting competition where competitive markets do not already exist. It is on this second issue that this paper concentrates, analysing Britain's experience of pro-competition regulation. It begins with some discussion of Britain's privatisation programme and how the peculiarly British form of regulation arose from it. Then it examines the conduct of pro-competition regulation and how privatisation and regulation are affecting British utility markets.

### **1 FROM NATIONALISATION TO PRIVATISATION**

In the 1980s, the Thatcher administrations in Britain embarked on a wide-ranging programme of privatisation, including utilities such as telecommunications, gas, electricity, and water as well as local authority housing. The Major government has continued, somewhat more tentatively, with privatisation. Most of the 'commanding heights' of the British economy (or, as the late Jack Wiseman memorably described them,

the 'abysmal depths')<sup>1</sup> which had been nationalised by Clement Attlee's first post-war Labour government have been returned to the private sector. The privatisation and subsequent regulation of these corporations, and in particular the utilities, is the principal concern of this paper.

As I have argued elsewhere, there was a large unplanned element in the 'programme' of privatisation.<sup>2</sup> At first, the government moved very cautiously, privatising smaller companies and those which, like British Aerospace, Jaguar and Cable and Wireless, were already in competitive markets. It began to privatise the major utilities in 1984 only after it emerged from the initial 'fog' which, according to Anthony Downs,<sup>3</sup> surrounds political decision-making when the views of an electorate on some issue are unformed (because of the rationality of ignorance). Nevertheless, even though the Thatcher governments stumbled into privatisation, it turned out to be the most important change in British policy towards industry since nationalisation. The consequences have been far-reaching and, as with most human action, to a significant extent unintended.

## 2 PRIVATISATION AND REGULATION

### 2.1 Nationalisation as a form of regulation

With privatisation came regulation of the utilities. Of course, nationalisation is itself a form of regulation in which civil servants and politicians, who believe they can perceive the 'national interest' and formulate plans which will achieve it, steer the actions of a company, usually by backdoor methods. Britain had plenty of experience - extremely unhappy, on the whole - of that kind of regulation, but little of the US variety where a supervisory board oversees the actions of a private company. Some lessons were learned from the problems which the USA had experienced - inflation of rate bases, regulatory capture, regulation which is arranged for the benefit of the regulators and so on - but to a

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1 Jack Wiseman, 'The Political Economy of Nationalised Industry', in *The Economics of Politics*, IEA Readings No.18, Institute of Economic Affairs, 1978.

2 Colin Robinson, 'Privatising the British Energy Industries: The Lessons to be Learned', *Metroeconomica*, No.1-2, 1992.

3 Anthony Downs, *An Economic Theory of Democracy*, Harper and Row, 1957.

large extent the form of regulation which now exists is inextricably bound up with the way in which privatisation was carried out.

## 2.2 Price capping: a significant difference?

One apparently unusual feature of British utility regulation is its emphasis on price caps rather than rate of return or profit controls. In an attempt to move away from the well-known problems of rate of return regulation (such as the Averch/Johnson effect<sup>4</sup> or 'gold plating'), prices in British utilities are generally governed by a price cap (RPI-X) type formula in which prices are allowed to increase at the rate of increase of the retail price index minus a deduction to promote efficiency improvements. In some cases, there are additional (Y or K) terms in the formula which allow certain costs to be passed through to consumers. The differences between Britain and elsewhere on this account can, however, be exaggerated. In practice, both when the government sets the original X and more particularly when the X term has to be reset (generally every five years) by regulators, there is a tendency to take into account the actual and expected profits of the industry. Thus, price cap regulation tends to revert to rate of return or profit regulation: under the British regime, as under rate of return systems, the regulated companies have some incentive to enjoy the advantages of high costs rather than those of high profits.

## 2.3 Competition-promoting regulation

There is, however, a more significant and far more interesting distinction between British utility regulation and what is common elsewhere. It is the attempt to use regulation as a means of promoting competition. If conventional regulation is an effort to achieve static efficiency without having competition - that is, it is market-displacing - the British version can be seen as a means (probably not intended by its authors) of promoting dynamic efficiency by market-improvement. Even more remote from the intentions of its authors, but as an 'unintended consequence' which would have delighted Friedrich Hayek, one can see behind British utility regulation an 'Austrian-type' market process in which regulation promotes market entry which promotes rivalry which in turn removes the need for regulation. That is one theme on which I wish to dwell.

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4 H. Averch and L.L. Johnson, 'Behavior of the firm under regulatory constraint', *American Economic Review*, December 1962.

Because of the close relationship between British regulation and the nature of British privatisation schemes, I begin with a brief public choice-type analysis of privatisation<sup>5</sup> so we can examine the source from which regulation sprang. In particular, there is one mystery we need to address. Given that Britain privatised its utilities, why should subsequent competition-promoting regulation be required? Why was privatisation itself not such a liberalising force in product and capital markets that competition flourished without the need for regulators to help it along?

### **3 A PUBLIC CHOICE VIEW OF BRITISH PRIVATISATION**

#### **3.1 The paradox of privatisation**

At first sight, there is a curious paradox in the British privatisation programme. Those economists who supported privatisation did so primarily because they saw it as an opportunity to liberalise product markets which had long been monopolised. In office was a government which professed to believe in competition. Yet the bigger privatisation schemes (such as telecommunications, gas, water, and electricity) introduced only very limited competition. The degree of liberalisation achieved so far in Britain has arisen not so much from the original privatisation schemes as from subsequent efforts by industry regulators and the competition authorities.

How can one explain this apparent paradox of a government which says it believes in competition but, when the opportunity arises to introduce it, fails to do so, leaving it to others some time after privatisation? In fact, there is no paradox. It is entirely predictable, in terms of public choice theory, that a government will give priority to objectives other than market liberalisation when carrying out a privatisation programme.

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5 For a more detailed account, see Robinson, *Metroeconomica*, *op. cit.*



### 3.2 Objectives of privatisation

Though the objectives of British privatisation were never set out in public nor were priorities openly assigned to them by government Ministers,<sup>6</sup> there were probably four broad aims - widening share ownership, raising revenue, depoliticising decisions in the industries concerned, and liberalising markets to enhance efficiency. Reducing the monopoly power of unions in nationalised industries was probably also a goal in some privatisation schemes, though to the extent that union monopoly power derived from the monopoly power of employers such an objective is not distinct from product market liberalisation.

The first two objectives were vigorously pursued. Share ownership in Britain was widened, though not deepened,<sup>7</sup> by offering the public shares in the privatised corporations at prices which were almost invariably at a substantial discount to initial market valuations.<sup>8</sup> In addition, employees and customers were generally 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. A large part of the populace was therefore given a choice (which came close to the proverbial free lunch) of *either* selling recently acquired shares and therefore in effect accepting a cash handout from the state *or* of holding on and feeling wealthier. In either case, the government might expect votes to be exchanged for its policies.

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6 One of the few discussions of the privatisation programme by a government Minister is in a speech in 1985 by Mr John Moore, *The Success of Privatisation*, HM Treasury Press Release, 107/85.

7 In the three years after the British Telecom sale in 1984, the proportion of the adult population which owned shares increased from 7 per cent to 21 per cent (though not all the increase was attributable to privatisation). In 1992, the percentage was 22. However, in the 1980s, the proportion of UK company equity held by individuals was declining - from 28 per cent in 1981 to 21 per cent in 1992. See 'Biggest expansion in share ownership since 1987', *The Financial Times*, 13 December 1989, 'Lamont seeks share ownership in depth', *The Financial Times*, 15 May 1991, and 'Share ownership: risk aversion', *The Economist*, 6 November 1993.

8 There were two cases in which share issues were a failure - a tender offer of Britoil shares in November 1982 when the oil market was weak and an offer for sale of the government's remaining stake in British Petroleum in October 1987 just after the stock market crash.

Perhaps even more important than widening share ownership was revenue-raising. It soon became clear that, despite the discounts at which shares were offered, privatisation provided politicians with an apparently painless means of raising large revenues, the proceeds of which could be applied to the reduction of public borrowing and the lowering of interest rates. The Treasury, which is by far the most powerful force in the British civil service, was also intent on reducing public borrowing.

The third objective (reducing politicisation), was inherent in privatisation. For years the governments had intervened extensively in the pricing and investment plans of the British nationalised corporations, to the extent that management felt it was constantly being second-guessed by politicians and civil servants and was not permitted to manage. There was less interference after privatisation though, as explained below, some of the effects of the ownership change were modified because government placed obstacles in the way of subsequent takeovers: thus privatised companies were not clearly in the market for corporate control and the possibility of political interference remained.

Objective four - market liberalisation - was in the 1980s an article of political faith, parts of the Conservative party having recently (and perhaps temporarily) been converted to a belief in market economics.<sup>9</sup> But the evidence shows that it had a very low priority, despite the lip-service constantly paid to it by Ministers. Product market liberalisation was pursued half-heartedly in most cases. Nor were the capital markets allowed to operate freely in the cases of the privatised industries. As just explained, governments were reluctant to allow newly privatised companies to enter the market for corporate control. 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 or Jaguar and the BP takeover of Britoil) and in some cases there were limits on individual shareholdings in privatised companies (generally of 15 per cent).

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9 Richard Cockett, *Thinking the Unthinkable*, Harper Collins, 1994

### 3.3 Principals and agents

Execution of the British privatisation programme illustrates a very common problem in economic policy-making. In formulating and implementing economic policy, as in other matters, politicians are the agents of the electorate and a typical principal-agent problem arises. Voters, who lack information about alternative policies and their consequences, find it difficult to monitor and control the actions of their elected representatives. In such circumstances, where conflicts in policy objects arise, governments tend to take decisions which yield the biggest expected political returns though, as explained earlier, they will justify their actions on 'public interest' grounds.

### 3.4 Conflicts in objectives

Conflicts clearly do exist among the privatisation objectives specified above. In particular, pursuit of objectives one and two (widening share ownership and raising large revenues) appears inconsistent with market liberalisation. 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 had a low priority in British privatisation schemes. There was no organised constituency which supported it; there were, however, many organised groups against.

### 3.5 Is illiberal privatisation inevitable?

Indeed, a pessimistic view of privatisation is that illiberal schemes are inevitable in representative political systems, even when governments which claim to favour competition are in office because of an irresistible combination of powerful forces which favours retaining existing monopolies when state corporations are transferred into the private sector.<sup>10</sup>

Senior management of the corporation concerned, though wanting the greater freedom and higher salaries which privatisation brings, will want to retain its market power and the industry's unions will wish it to do so

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10 See Colin Robinson, 'Liberalising the Energy Industries', *Manchester Statistical Society*, March 1988.

since they will expect to conclude cosier arrangements with a monopoly than with a firm operating in competitive conditions. Both groups are likely to favour restrictions on hostile takeovers so as to give them quieter lives than they would otherwise enjoy. Company management is capable of scuppering or at least significantly delaying a privatisation scheme which is not in its interests.

Bureaucrats in the relevant sponsoring government department, who may well sympathise with the corporation's view (even if they have not actually been captured), may join with company management and unions in pointing out the complexities (and consequent political uncertainties) of liberalisation. In Britain the City, though it does not want 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 will often coincide closely with those of these powerful groups. They will 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 intangible and most of them will not be realised within the normal political time-scale. Pursuit of a given policy requires that *ex ante* politicians perceive there will be many more winners than losers. Moreover, the winners must realise they *are* winners so they can repay their gains with votes. There is probably 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, except by really assiduous seekers after information who do not count the cost, both because benefits take time to appear and because they will be in comparison with what would otherwise have happened rather than with recent events. Furthermore, the impact effect, especially in markets which have been monopolised for many years, may well be to create many losers who will complain vigorously.

On this view, privatisation schemes in Britain achieved only limited liberalisation not because governments were incompetent nor because they were unable to perceive the economic benefits to which liberalisation would eventually lead. Failure to liberalise was a consequence of the

influence of powerful groups (including politicians) which saw more competitive markets as against their interests.

### **3.6 Belated attempts to liberalise**

However, the outcome of privatisation British-style suggests there is yet more to the political calculus. Experience now shows that, subsequent to the initial privatisation schemes, a government may try to realise the benefits of competition by backdoor means, principally by encouraging the competition authorities and the industry regulators to pursue market liberalisation.

Why should liberalisation appear more attractive politically at this later stage? The probable reason again relates to pressure group interactions. After the flotation, the original coalition against liberalisation tends to disband. The alliance of producer groups, politicians and bureaucrats will have been held together by dislike of competition-promoting policies but by little else. 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 helped to sell a monopoly and been paid its fees.

By this time, new pressure groups which favour competition are likely to emerge as the effects of private monopoly become apparent - in particular, large companies which also have a consumer role because they purchase the goods or services of the newly privatised corporation. Complaints from such groups have been extremely important in Britain in persuading government and regulators that liberalising moves should be made in gas (see 4.4 below), telecommunications and electricity. Post privatisation, as these groups draw attention to the illiberal nature of the privatisation schemes, government perceives there are votes to be won by injecting more competition.

### **3.7 Political advantages of belated liberalisation**

There is, in any case, political advantage in avoiding liberalisation in the initial scheme but leaving it until later: the government can blame the consequent upheaval on someone else. Liberalising markets which have for many years been monopolised is bound to create many losers in the early stages. If the upheaval can be attributed to the actions of the competition authorities and independent regulators, government may be able to gain the political benefits of the original privatisation but sidestep the costs which will be attributed to others.

Privatisation is thus a complex phenomenon in political and economic terms. A welfare economist, who assumed that privatisation was being carried out by a disinterested body intent only on pursuing the public good, would be completely baffled by the way it has been approached by the British government.

It is, of course, obvious that since any programme of privatisation will be carried out by politicians, it is likely to be dominated by the pursuit of political interests even if the language used to justify political action appears to be that of economists. In Britain, the consequence has been a number of large privatisation schemes which, despite the emphasis on competition in public pronouncements, initially did little to liberalise the relevant product markets. After the flotations were over, however, more competition began to appear at the instance of the competition authorities and the industry regulators.

### **3.8 The pro-competition duties of regulators**

Utility regulators took action because the legislation which established them gave them the duty to promote competition, though there was in some cases an accidental element in their gaining such powers. In gas, for example, which was the worst example of the transformation of a state monopoly into a private monopoly, as explained in 4.5 below, the competition-promoting provision for the regulator resulted from a last-minute amendment to the 1986 Gas Act.

## 4 REGULATION TO PROMOTE COMPETITION

### 4.1 Competition-promoting regulation as evolution

I have explained in more detail elsewhere how the process described above operated in the British gas and electricity markets and how it influenced privatisation structures and the conduct of regulation.<sup>11</sup> Analysis of that process leads me to conclude that competition-promoting regulation is not some brilliant original device conceived after careful thought by a host of experts who studied regulation elsewhere and concluded that Britain needed something different. More accurately, it is the means which has evolved of remedying deficiencies in politically-inspired privatisation schemes.

If you think that view somewhat cynical, let me add that, like many unintended consequences, regulation as a means of promoting competition is a rather important development. If it had not evolved, Britain would have had to discover it: otherwise, many of the potential gains from privatisation would have been lost. Starting from where we are in Britain - that is, from privatisation schemes which transferred into the private sector very powerful incumbents, usually protected against takeover for a period - pro-competition regulation is an essential means of bringing benefits to consumers.

### 4.2 The wide scope of regulation

Another consequence of the relatively illiberal form of British privatisation schemes is that the scope of regulation is extremely wide, covering virtually the whole of the markets concerned.

Had the British government introduced competition, at the time of privatisation, into those areas it could reach, utility regulators could have

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11 Robinson, *Metroeconomica*, *op. cit.*, and Colin Robinson, 'Gas After the MMC Verdict', in M.E. Beesley (ed.), *Regulating Utilities: The Way Forward*, IEA Readings No.41, Institute of Economic Affairs, 1994.

concentrated on supervising the 'natural monopolies' which were left<sup>12</sup> and the scope of regulation would have been much narrower than it is. In electricity, for example, generation would have been rivalrous and so would the supply of electricity: only the network of wires would have been subject to price controls or rate of return regulation. Similarly, in gas only the pipeline network would have been regulated. Instead the regulators, faced by incumbents with considerable market power, have had to supervise the industries as a whole. The Office of Electricity Regulation, for example, has spent a considerable amount of time watching the activities of the two large generators (National Power and PowerGen) formed from the old Central Electricity Generating Board and trying to curb the exercise of their power to influence prices.

### 4.3 Experience in the gas market

Regulating whole industries, rather than 'natural monopoly' sectors of those industries is obviously a difficult task. To illustrate how the regulators have approached that task, how they have interacted with the other competition authorities in Britain - the Monopolies and Mergers Commission (MMC) and the Office of Fair Trading (OFT) - and what role consumer pressure groups have played. I outline what has happened in the gas market.<sup>13</sup>

### 4.4 A consumer uprising

After gas privatisation in 1986, events moved at surprising speed. Predictably, the trigger was the increasing power of consumers. At the time of privatisation, the consumer voice was not heard (or perhaps not heeded). But, once privatisation was accomplished, the unholy coalition of interests which had secured an illiberal gas market dispersed. The politicians had gathered in their revenues and widened share ownership (and soon afterwards won a General Election); management was feeling satisfied with its retention of market power; the unions were happy that

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12 I should add a word of caution about so-called 'natural monopolies' which exist only in a given state of technology. In telecommunications, at the time of privatisation in 1984, the network of wires was regarded as a natural monopoly but that monopoly has rapidly been undermined by technological progress. We should be wary of the assumption that those activities now considered naturally monopolistic will be so for ever and so will always require regulation.

13 A more detailed discussion is in Robinson, 'Gas After the MMC Verdict', *op. cit.*



their members were working for a monopolist; the City had taken its commissions. But into the vacuum which had been created moved a new pressure group consisting of disgruntled consumers - not unorganised small domestic consumers, but large companies which had expected but had not received considerable price benefits from gas privatisation. They were potentially a very significant lobby, arguing that their competitive position was being threatened by the pricing policy of British Gas Corporation (BGC).

Within only a year of privatisation, after complaints from such consumers that British Gas was abusing its monopoly position in the industrial market, it was referred to the Monopolies and Mergers Commission (MMC). The MMC's report in October 1988,<sup>14</sup> though not proposing any structural changes, made a number of recommendations intended to stimulate competition in the gas market - in particular that BGC should contract initially for no more than 90 per cent of any new gas field, that it should publish a schedule of gas tariffs to contract customers and not discriminate in pricing or supply, and that it should publish rates at which it would be willing to transport gas for other suppliers through its pipeline system.

The MMC's objectives were to reduce BGC's monopsony power, freeing some North Sea gas for other suppliers; to allow entrants and potential entrants which wished to supply gas to large consumers to see what rates were being charged by BGC; and to provide access for those entrants to BGC's extensive pipeline network.

#### **4.5 Action by the regulator**

More important than the 1988 MMC report, the Office of Gas Regulation (Ofgas), headed by Sir James McKinnon - and pursuing its duty to act in a way 'best calculated to enable persons to compete effectively' in the contract market - was from the beginning intent on easing entry into gas supply. The competition-promoting provision was, incidentally, only inserted in the 1986 Gas Act at the last minute by Mr Michael Portillo (then a backbencher), apparently because of his concern at the illiberal nature of the privatisation scheme. It turned out to be very important.

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14 Monopolies and Mergers Commission, *Gas*, Cm.500, London: HMSO, 1988.

Ofgas used its competition-promoting powers in 1990 to persuade BGC to relinquish its rights to some already contracted gas supplies in order to speed up the introduction of competition: Ofgas' aim was that 1.2 billion therms a year (over 300 million cubic feet a day or about 30 per cent of the firm contract gas market, excluding sales to power generation) should be supplied by BGC's competitors by 1993.<sup>15</sup> After some resistance, BGC offered to surrender to competitors 150 million cubic feet a day of gas. The gas would be available until October 1992 and would have to be repaid over the next five years.<sup>16</sup>

In addition, the new and potentially very large power generation market for gas, which emerged in the early 1990s as the government lifted the ban on gas sales for electricity generation and many Combined Cycle Gas Turbine plants were planned, was competitive from the beginning. North Sea producers were very keen to supply power stations direct and they quickly gained a bigger market share than BGC.

#### 4.6 The OFT intervenes

Then in 1991 radical proposals to enhance competition were made in a report by the Office of Fair Trading. It proposed that BGC should separate its pipeline and storage system from the rest of its operations, either by sale or at least by placing it in a separate subsidiary; that some of its contracted gas supplies should be sold to competitors; that gas imports should be freed; and that the prohibition on supply by competitors to consumers of less than 25,000 therms a year should be eased, with a new threshold of 2,500 therms a year for the 'tariff market' and possibly no limits at all after 1996.

The government accepted the proposed lowering of the threshold to 2,500 therms from 1993 onwards. BGC also gave undertakings to the Director General of Fair Trading in March 1992 that it would reduce its share of the non-tariff market (other than power generation and chemical feedstock use) to 40 per cent by 1995; that it would release gas to other suppliers so that they could supply the remainder of the market; and that

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15 *Regulating the Future for Gas Supplies*, speech by James McKinnon to NEMEX 1990, 4 December 1990.

16 'British Gas May Cede 10% of Market', *The Financial Times*, 31 January 1991.

it would establish a separate pipeline and storage unit with transparent and non-discriminatory pricing.<sup>17</sup>

#### **4.7 Revising the price cap**

At about the same time Ofgas agreed with BGC that, from April 1992 onwards, there would be changes to the price cap formula for the tariff market instituted at the time of privatisation. Not only was the X element in the RPI-X formula increased from 2 to 5, but the full pass-through of gas purchase costs allowed under the original formula (which gave BGC minimal incentive to keep down those costs) was modified.

#### **4.8 Successes of pro-competition regulation**

By 1992 pro-competition regulation had certainly achieved some successes in gas. In 1988 all supply to non-tariff consumers (the market open to competitive supply) was by BGC and at the time of the OFT report in 1991 BGC's share was still 95 per cent. In May 1993, however, BGC had only about two-thirds of that market (outside power generation): it was still the only seller of interruptible gas but competitors had 55 per cent of 'firm' gas supplies to the non-tariff market outside electricity generation.

#### **4.9 Intrusive regulation?**

Despite its agreement to various undertakings and to the revised price cap formula, by the latter part of 1992 BGC was becoming increasingly concerned at what it saw as the intrusiveness of gas industry regulation. Intrusiveness was inevitable, given the amount of market power BGC possessed on privatisation and given the regulator's duties. Had the government at the time of privatisation placed the pipeline system in a separate company and taken other measures to liberalise the gas market, regulation could have been confined to the natural monopoly sector of the gas industry (the network of pipelines) and it would have been much less adversarial. Consumers would have been protected by competition, and possibly by temporary price regulation for domestic consumers until competition developed in that market.

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17 Monopolies and Mergers Commission, *Gas and British Gas plc*, Cm.2314-2317, HMSO, 1993, Vol.2, Appendix 1-2.

As it was, BGC was so concerned about the intrusiveness of gas regulation that, whilst negotiations were in progress about the rate of return appropriate to the BG pipeline network under threat of another MMC reference, the company itself decided it should refer the whole gas business to the MMC.<sup>18</sup> The Commission's report was published in August 1993.

#### 4.10 The August 1993 MMC report

The August 1993 MMC report<sup>19</sup> was much more thorough and radical than the 1988 investigation. It performed one of the functions at which the MMC is particularly good - prompting the powers-that-be to think about the future of a market and forcing them to face up to issues which they would prefer not to confront.

One major proposal was that British Gas should divest itself of its trading activities by 1997 (with accounting separation of those activities within BGC in 1994) to become an exploration, production, pipeline and storage company in Britain but no longer a trader in gas. The MMC recommended that, prior to separation, BGC's non-tariff activities should be subject to market share limits and to the publication of price schedules. A slightly less onerous price cap would be applied: the present RPI-X formula for the tariff market would be adjusted from RPI-5 to RPI-4 from April 1994.

Under another recommendation, competition would be extended to smaller consumers because the British Gas monopoly would from 1997 be confined to consumers of less than 1,500 therms a year bringing about 400,000 homes and 100,000 businesses into the competitive market. The report suggested that the monopoly could be abolished three to five years later.

The government did not accept the MMC's recommendations as they stood. It went further in terms of abolishing the monopoly, proposing that it be eliminated by 1998 - so that, in principle, even the smallest consumers will have a choice of supplier. However, the government did not accept the recommendation to break up British Gas: the company will, instead, by internal re-organisation, separate its pipeline business from

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18 'Simmering Row Comes Into the Open', *The Financial Times*, 3 August 1992.

19 Cm.2314-2317, *op. cit.*

other functions. Legislation to put into effect the government's proposals is still awaited: it may go through Parliament in the 1994/95 session.

## 5 GOVERNMENT, CREATIVE DESTRUCTION AND REGULATION

To conclude by looking at the whole process of privatisation and regulation so far, I would characterise it as follows. Privatisation was a *necessary* act of government disengagement which lifted the prohibitions on entry which had been the root causes of the problems which existed in the British nationalised industries. It was not *sufficient* to establish rivalrous markets from the beginning. Nevertheless, though over-powerful incumbents remained, once entry became possible the way was open for ingenious people to move into the market. It was difficult to do so, because of the relatively illiberal privatisation schemes. But at least it was no longer impossible. A Schumpeterian 'gale of creative destruction' - or, at least, a mild breeze in the early stages - could begin to blow.

In the British system, or in any system which leaves privatised companies with substantial market power, regulators play a key role in this Schumpeterian process because they can help to ease entry into the privatised markets. Their task is hard one, for the reasons I have given. Nevertheless, significant (probably unintended) features of the regulatory regime make them concentrate on competition-promotion. First, since it is one of their primary duties, they know that their success in market liberalisation will be one of the principal ways in which their performance will be judged (and may well determine whether or not they are re-appointed). The ultimate in regulatory success is presumably to promote competition to such an extent that regulation (and the regulatory office) become redundant: there should be large rewards for such behaviour though I cannot honestly say that I expect any British government to provide them!

The second feature (which was clearly unintended but which is very important) is that under the British system capture has not, so far anyway, appeared as a problem: confronting a regulator with a near-monopoly, but giving him or her the duty to promote competition, is a sure recipe for the kinds of conflicts which have emerged in the gas and telecommunications markets. Thus, unless there is an unusually passive regulator, an adversarial relationship between regulator and regulated seems virtually

guaranteed so long as monopoly exists. That sort of relationship seems to me the right one if monopoly power is to be curbed.

I have been very critical of privatisation in Britain, particularly in the energy industries where governments missed an opportunity to liberalise markets at the time of privatisation.<sup>20</sup> However, ten years after the first utility privatisation, it seems that liberalisation is well under way. It will almost certainly progress further in the next few years. There is already significant rivalry to supply larger consumers of utilities and that rivalry will soon extend to small consumers. On present plans by 1998, residential consumers of gas and electricity will have a choice of supplier; there is already some choice of supplier of residential telecommunications services. The consequences are likely to be far-reaching. As well as lower prices, consumers should enjoy better standards of service and they should be able to choose their own levels of supply security instead of having them dictated from the centre (as has been the case, for example, in electricity).

There are, of course, stirrings of liberalisation around the world: other countries are beginning to free their utilities from the tight state control which used to be the norm. But, so far as I can see, no other large or medium-sized industrial country will in the 1990s go so far along the road to competition as Britain.

Much of the success Britain has achieved up to now is due to regulation (including in that term both industry regulators and more general competition watchdogs) of industries where government's main contribution was to abolish the prohibition on entry and sometimes to carry out a little re-structuring. Pro-competition regulation, as I have argued, was to a large extent an accidental outcome of flawed privatisation schemes. But, given that unintended consequences of government action are everywhere to be found, we should be grateful that sometimes they eventually work to the benefit of consumers.

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20 Colin Robinson, 'Liberalising the Energy Industries', *op. cit.*

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