Energy Privatisation in the United Kingdom

*By Lord Nigel Lawson**

I would like to say a few words about energy privatisation, and I would like to focus on only one key aspect of this.

The success of private sector oil companies in developing the industry and the market since its earliest beginnings is so obvious as to make it clear that state ownership of the oil sector is anomalous and unnecessary, and usually a historical relic of little relevance to the present. So the privatisation of oil, although important, should be uncontroversial – and the same goes for coal.

But gas and electricity are a different matter, and it is this on which I wish to focus, drawing on our experience here in the UK, which is what I know best.

There used to be a widespread assumption that, whereas privatisation might make perfectly good sense for industries in the competitive traded sector, a public utility had to be state-owned, otherwise the consumer would be exploited and security of supply endangered. Indeed, if you could not introduce competition, the argument went, where was the benefit of privatisation anyway?

I believe that there are a number of myths here.

Certainly that was the conclusion reached by the government in which I served during the 1980s. I would like to spend a little time on the logic of public utility privatisation.

In the first place, when one looks closely at it, although there is probably an irreducible degree of monopoly in the public utilities, it is in fact much less than people used to take for granted. There is far greater possibility of introducing competition, and thus of deriving the economic benefits of competition, than those who run state monopolies customarily imagine.

The apologists for state ownership invariably extend the boundaries of monopoly far further than is necessary so to do.

In the UK, for example – and although this may be a trivial example, you would be surprised at how much passion this generated in Britain at one time – the former state monopoly in the gas industry extended even to the sale of gas appliances, so that only the state-owned gas industry was able to sell gas appliances to domestic consumers.

That is clearly not a natural monopoly.

In the electricity industry, far more fundamentally, although the distribution of electricity has some elements of natural monopoly, notably the network or grid, the generation of electricity is certainly not a natural monopoly. Yet it used to be automatically assumed in the UK that the whole electricity supply industry, both generation and distribution, was an irreducible natural monopoly.

It is only when one comes to privatise that it becomes clear that one can introduce competition into a number of areas where it was said there could not be competition.

Thus it is that today we now have a substantial degree of competition even in the distribution and supply of electricity – and the same goes for gas.

There is a further important point: Monopolies, where they exist, have to be regulated, whether they are in the public or the private sector. But it is far healthier if the regulator and the owner are not one and the same. Otherwise, you have a clear conflict of interest.

The most striking example of that is in Eastern Europe, where there used to be a full-blooded socialist system, with full-blooded state ownership of everything. As a result, there was the most appalling environmental degradation.

It is of the first importance, whether in terms of environmental regulation or price regulation or whatever is necessary to prevent the exploitation of the consumer and the public, to have ownership and regulation separated. That is what privatisation can achieve and has achieved in the UK. That is what did not happen during the period of state ownership, when the state was both the owner and the regulator. That is another practical advantage of privatisation.

What it did mean, however, was that, for the public utilities, privatisation was a particularly difficult and complex process, since it had to go hand in hand with setting up a proper and explicit regulatory structure. This meant an independent regulator, supported by a small staff, and armed with the powers required to prevent the consumer from being exploited.

We rejected the method, which used to be favoured for public utility regulation in the United States, of a limit on the permitted return on capital, as that can lead all too easily to the gross inefficiency of so-called gold-plating – that is, the practice of boosting profits through the extravagant use of capital.

Instead, we relied on price control, characteristically allowing the company to raise prices each year by x per cent less than the general rate of inflation, the number for x being chosen by the regulator on the basis of a reasonable expectation of the company's cost and productivity improvement, coupled with – and this is of the first importance – charging the regulator with the responsibility to promote competition in the industries.

The idea was that, over time, this second element, competition, would become increasingly important, and as it did the first, price control, would gradually fade away.

Yet another major advantage of privatising public utilities is that, not only does one get rid of the harmful effects of politicisation, but a completely different psychology is created. Even where there is no competition in the normal sense, in the goods and services markets, there is still competition in the capital markets for capital. That alters the way in which companies behave.

If they have to go out and compete for capital, there exists a very important form of competition, which is sometimes overlooked.

There is also the discipline of the share price.

The fact that companies are being judged every day by the markets and that this judgment is shown in the prices of their shares, however inadequate and imperfect that may be, is an added discipline which does not exist at all – by definition – under state ownership.

For all these reasons we came to the conclusion in the UK, and some (although not all) other countries have come to a similar conclusion, that even in the case of natural monopolies and public utilities (which as I have indicated are not coterminous), and which are particularly important in the

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energy industry, but also extend outside it, notably in water supply, there is a clear practical economic advantage in privatisation.

There is also a degree of transparency that has to exist by law with privatised concerns, but which does not exist under state ownership. That was a benefit which we did not see in advance, but which we discovered once we had embarked on privatisation.

The first major utility privatisation that we decided to do was in telecommunications, with the privatisation in 1984 of British Telecoms.

When we came to look at this industry, although the state-owned corporation knew its overall financial results, it turned out that it had no idea which parts of its operation were profitable and which parts were loss-making. It had no idea of what cross-subsidies were taking place within it, and it was only when proper accounting was put in, which it had to be for privatisation, that this emerged.

Another important example of the facts only coming to light as a result of the preparations for privatisation concerned the true cost of nuclear power. While the nuclear power industry, and the electricity supply industry of which it is a part, remained in state hands, the true cost of nuclear power was concealed. By that I mean the best guess cost of the eventual storage or disposal of nuclear waste and even more important, of decommissioning the nuclear power stations at the end of their lives. The true level of these costs was concealed from successive governments. It may have been that the industries themselves were not aware of them, that they had not done the sums.

Why should they? They did not need to.

I am not accusing the people who ran the nationalised electricity industry of deliberate concealment from ministers. Although ministers were not aware of the facts, it may have been that those who ran these industries did not know themselves.

Certainly it is the case that it was only in the course of preparation for privatisation that these costs – which were not obvious because at that time no nuclear power station had ever had to be decommissioned, so that there was no history to look into – were far greater than the state owned industry had been providing for.

As a result, nuclear power generation had to be separated from the rest of the industry and only privatised subsequently after the issue had been properly addressed. That was an example of transparency which was clearly desirable and which only came about in the course of the move towards privatisation.

Over the years, mainstream economists have, I believe, made a big mistake. They have focused almost exclusively on the issue of competition versus monopoly, which is certainly an important issue, but not the only one.

The benefits of competition are very real, but the issue of ownership is almost as important as the issue of competition. That has been demonstrated in a very practical way by the wave of privatisation which has engulfed the world and which has had results that in almost all cases have been highly beneficial.

When we first embarked on privatisation in the UK – and we were, of course, the first country ever to do so, so much so that we had to invent this rather ugly word ‘privatisation’ to describe what we were doing – most observers took it for granted that the motive was simply to raise money. This assumed – not altogether without some foundation – that governments always like to raise money, and that we had now found a clever new way of doing so.

But that was not the motive at all.

Indeed, had it been, we would not have reduced the market value of the public utilities by subjecting them either to a rigorous regime of price control or to the imposition of competition, let alone both.

No: the motive was to improve the performance of the economy as a whole by improving the performance of this very important sector.

That has been achieved to a remarkable extent. When the industries were state-owned, they invariably either made losses, or, if they were profitable, made a grossly inadequate return on capital.

In the private sector these same industries, even though subject to considerably more competition than they ever experienced under state ownership, are now all profitable and making the same sort of return on capital as other private sector companies. And, this marked turn-around has also greatly benefited the public finances.

Whereas the state sector of industry, with its frequent need for subsidy, tended to be a drain on the public purse, these same industries are today providing the Treasury with substantial tax revenues from the taxation levied on their profits.

In the gas and electricity industries the improvement in economic performance has been particularly marked. This has come, essentially, from two factors. First, given the rigorous price control to which I have already referred, private ownership provided for the first time an incentive to boost profits by cutting costs, and to do so by driving out waste, overmanning, and other inefficiencies.

The improvement in efficiency was quite remarkable. I think it is fair to say that, at the time of privatisation, no-one was aware – none of us in government, nobody in the financial markets – just how inefficient these industries had been under state ownership.

Hence, incidentally, what with the benefit of that marvellous attribute, hindsight, appears to have been a serious underpricing of the shares at the time of privatisation and the consequent phenomenon of the so-called “fat cats”.

The second factor behind the marked improvement in economic performance in the electricity and gas industries since privatisation has been the progressive introduction and extension of competition, where the regulatory (and <u>de</u>regulatory) authority, OFGEM, under the outstanding leadership of Callum McCarthy, has played the crucial role, to great effect. So much so that today, of the energy activities that were subjected to regulation – chiefly via RPI-X price control – at the time of privatisation some dozen years ago, roughly three quarters are now entirely free from regulation.

The former monopolies of retail gas and electricity supply, of gas storage, and of gas and electricity connections have all been brought to an end and replaced by vigorous competition, thus eliminating the need for administered price controls. Competition in gas and electricity metering is on the way; and in general regulation is being maintained only for the irreducible natural monopolies of the networks them-

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