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# Electric Utility Privatization

## What We Can Learn from the British Experience

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Privatization takes many forms. The act of privatization, however, always involves “selling state-owned assets to the private sector, or... allowing private enterprise to perform functions previously handled by the state.”\* That definition, of course, includes outsourcing of functions, or partnering arrangements between the government-owned entity and a private firm.

Outsourcing is just a new word for contracting out. Any well-managed business will engage another firm to perform for it functions that it cannot perform well on its own. That is just good business. Selling the entire government-owned business to the private sector is the most dramatic form of privatization. Governments whose business ventures are disasters and governments in a desperate hurry to raise money do not think about outsourcing. They go all the way.

The most famous privatization effort, that of the Thatcher government, put the concept on the front pages. It embraced privatization with zeal. It pushed out the privatizations with the enormous gusto and fervor of the true believer. The government raked in billions of pounds. Millions of new investors bought shares in dozens of companies. Those investors cleaned up, in most cases.

Is everybody happy? Unfortunately, they are not. True, the Thatcher government showed that the government could sell the dullest businesses. The newly energized managements demonstrated how to revitalize seemingly moribund enterprises. But the privatizations left a legacy of problems. We can learn from them.

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\*Leonard S. Hyman, *The Privatization of Public Utilities* (Vienna, VA: Public Utilities Reports, 1995), p. xi.

## WHY PRIVATIZE?

Governments privatize not for fun but rather to accomplish something that they cannot accomplish without doing so. Or so one would think. But that is not completely true. Let us detour, for few moments, in order to list the major reasons for privatization.

1. Governments, as a matter of principle, should restrict their roles in the economy. They should not engage in any activity that a private sector firm could fulfill. (This is a religious argument, a matter of dogma. You accept it or you do not.)
2. Government is inherently less efficient than the private sector. Society, therefore, would operate more efficiently if the government sector were smaller. (Advocates of this belief can trot out powerful anecdotal evidence of wasteful government activity.)
3. The government needs money, but nobody wants to raise taxes. As an alternative to raising taxes or slashing social functions, the government can raise huge amounts of money in a hurry by selling off government-owned businesses. (I cannot quarrel with this motive. People in an obvious hurry to sell, though, do not get the best prices.)
4. The government desires to redeploy its resources from business-type activities into the social services sector. (Institutions with limited resources do have to decide what they want to do.)
5. The government-owned corporations are incredibly incompetent, corrupt or politicized. Rather than attempting to untie the Gordian knot, the government decides to cut it, get out, and let someone else fix the problems. (In truth, private operators have straightened out some unbelievable messes.)
6. The industry in which the government operates has changed, from slow-moving, stable and monopolistic, to fast-moving and competitive. The government decides to withdraw for two reasons. First, a government-owned business would have unfair advantages that would discourage the entry of private firms. Sec-

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ond, the government should not risk taxpayer money in uncertain ventures. (In reality, is the government nimble enough to run a competitive firm?)

7. The government wants to encourage widespread share ownership. That will broaden the base of capitalism and encourage the populace to save and invest. Selling shares in a solid, well-known local company, such as a public utility, at a reasonable price, without brokerage commissions, will get the ball rolling. (Combine that move with the right tax laws and savings plans to produce lasting results. Otherwise, people may buy for a fast buck, selling the shares as soon as they go up.)

Why did the British act? Government enterprises in the public utility sector were, in the main, large, unexceptional, moderately profitable corporations: neither disasters nor winners. The government did not act out of desperation. The businesses, after all, did function. I believe that the key motives were:

- Restricting the role of government in the economy
- Raising money for the government
- Improving economic efficiency by means of private ownership
- Spreading share ownership in the population.

Now, let us move on to what happened across the pond.

## COMMON THREADS

The British government sold off all kinds of leftovers from the days of socialism accumulated since the 1920s. I will stick to the privatization of domestic public utilities: the telephone, natural gas, electric and water companies.

The two early, big privatizations, British Gas and British Telecom, exhibited remarkable similarities. The corporations controlled almost their entire markets. Despite all the talk about the virtues of competition, the government left these enormous organizations intact, set up a so-called “light” regulatory regime, and inferred that market forces would keep these monopolists in line.

Setting loose industries in that fashion ignored industrial organization research and the developments already taking place in the United States. Competitors barely made a dent in the market. The regulators, operating under the new rules, had a choice of two methods of persuasion: the wet noodle or the sledgehammer.

Privatization had spawned two privately-owned monopolists in place of two government-owned ones. It took over a decade of threats, legal battles, and revisions of the rules to pry open markets that could have been open from the beginning.

But, understand that the Thatcher government did face a dilemma. It wanted to successfully sell the two companies. Nobody had sold such vast enterprises to the public before. Perhaps the public would not have purchased smaller entities that had to operate in a competitive market. The government could not risk a colossal failure at the beginning of the privatization process.

Therefore, it made sure that potential investors would see liquid, financially strong, profitable enterprises with prospects for robust growth of earnings and dividends. I believe that designing a successful sale of the properties took precedence over assuring more responsive or economical service to consumers and over giving competitors a fair chance to succeed. Governments have to make choices.

The light regulatory scheme, originally devised to control the price of condoms, had good and bad aspects. The procedure, in theory, did not set a return on investment. The British understood—correctly—that rate of return regulation tended to encourage excessive capital investment and to discourage productivity. After all, the utility earned a profit based on investment, so it had an incentive to invest beyond the minimum needed to provide reliable service.

Rate of return regulation is a cost plus system: cost of operating plus a return on capital invested. If the utility reduced its costs, it had to reduce its prices. None of the cost reduction flowed through to profits where regulators did their job right. Therefore, the utility had no reason to reduce costs or run better, other than self-satisfaction, a motive that padded nobody's pockets at the company.

The British decided to create a better regulatory system, one that motivated utilities to run more efficiently while still giving consumers benefits from improved utility productivity. Price cap regulation (often called RPI-X after the formula used), that fallout from condom regulation, allowed the utility to increase its prices by the same percentage as

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the change in the cost of living index (RPI) less a factor for productivity (x) every year for the period of the regulatory contract.

For instance, if the regulator set RPI-3 as the formula for a five year period, and the cost of living index rose 4% in the year, then the utility could raise prices by 1%. If the cost of living index rose only 2%, then the utility would have to lower prices by 1%.

If the utility's costs in a particular year rose more than the price formula allowed, too bad for the utility. If costs rose less than the formula, the utility made more profit. The utility had a real reason to increase its productivity more than the X factor. It shared productivity gains with customers only up to the X factor. Any gains above that number stayed in the pockets of the utility's shareholders.

The price cap system gave the companies a powerful incentive to improve productivity and it assured that consumers would collect some of the benefits of the productivity gains. The system, though, also gives the utilities incentives to cut corners, defer capital expenditures and let service levels slip. Nobody has devised a perfect regulatory scheme. That is why so many people, nowadays, advocate the discipline of the market as a substitute for the discipline of the regulator.

The water privatizations offered a different set of problems. How to set up a competitive system was not one of them, although some diehard free marketeers did mumble about moving water around Britain, as I recall. The water companies faced enormous capital expenditures in order to bring their operations up to European standards. The pricing system, as a result, had to raise rates by more than the increase in the cost of living, so that the water companies could finance their spending programs.

Remember, previously, I said that the British regulatory regime, "in theory," did not set rate of return. Clearly, in the case of water, the regulators did worry about the necessary return to attract capital. The water privatization must have been the most unpopular of all. The Labor Party, in fact, said that it would renationalize the water industry if it won the next election, which it did not.

After privatization, despite numerous well-publicized disputes between regulator and water executives, the water companies racked up big profits, and they even diversified, with the usual mixed results.

By the time the government got around to the electricity supply industry, it had accumulated considerable experience. As a starter, it divided the privatization process into three sales, stretched over a

period of time, rather than one massive and confusing effort.

This time around, the government wanted to start off with a competitive structure, so it broke up the industry. Twelve regional electric companies would distribute electricity, on a regulated basis. They would operate under a price cap scheme. Two large generators would produce and sell electricity on an unregulated basis, competing with many smaller producers that had set up shop and with the Scottish generators and with power from France. Two integrated utilities in Scotland would supply that region and sell surplus power into England and Wales.

The sale of the regional electric utilities was a smashing success. The companies proceeded to demonstrate how well that they could reduce costs and pile up big profits. Regulated monopolies can do exceedingly well under the right regulatory regime. In fact, they did so well that they became the targets of predators eager to get into such a rewarding business, and of generators that prefer to sell to customers that they own.

The government ran into a real problem at the generating end. It had created only two generating companies, far below the minimum required for effective competition. One was far larger than the other, created that way because the government had hoped to sell the nuclear plants as part of the package. They understood that the company that owned the nukes had to be large, although they must have known, too, that the big generator would be so big as to dominate the market.

Then the bankers told the government that they could not sell a nuclear company to the public. The government took the nuclear plants back. At that stage, the government had the opportunity to carve up the generating sector into smaller components, but it could not have done so quickly enough to privatize the generating sector and still meet self-imposed political deadlines.

As a result, the generating sector—which was supposed to be competitive—started out with a suboptimal number of players, and accusations of gaming the system—a polite term for rigging the bids—followed fast and furious. The regulator followed up by putting a cap on prices and forcing the companies to sell off power stations.

In other words, because the government was in a hurry, the industry started with the wrong structure and that led to many disputes and accusations that the customer was not getting the benefits of competition. Having said that, despite the imperfections of the process,

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the Thatcher government probably did more to validate the concept of a competitive electric generating sector than any government other than the Pinochet regime in Chile.

The Scots, never dear to the hearts of the Tories because they kept voting for Labor, had the chance to privatize their electric utilities after everyone else. The government reshuffled some assets, then sold two integrated utilities in Scotland. Various critics had accused the government of selling the previous offerings at low prices that produced inordinate profits for the purchasers. If I remember the government did not underprice the Scottish companies in the same manner. Live and learn.

## QUIBBLES?

The question of share prices brings up a number of controversial issues. Let us start with the matter of pricing stock for sale. Investment bankers customarily advise the selection of a price for a new issue at roughly 10-20% below its real value. Doing so facilitates the sale. It brings in customers who see the opportunity to realize an immediate profit that makes investment in the unseasoned security worthwhile.

Admittedly, the seller might collect more money if it holds out for the best possible price, but holding out for top dollar might drive away potential buyers and therefore reduce the number of shares sold. Picking the right price is an art, not a science. A small price increase after the offering makes buyers and sellers happy. The buyers see an immediate profit and the sellers figure that they did not leave much on the table, and in return have a group of happy shareholders.

When the new issue goes up spectacularly, though, then the banker has done a poor job of judging the market, and the seller has lost the opportunity to raise far more money. In effect, the seller has grossly underpriced what it has to sell.

I bring up the arcane topic of the pricing of new issues because the British government consistently underpriced the privatization offerings by most standards. A number of the offerings produced spectacular speculative profits for those who purchased the shares. Opponents of privatization accused the government of selling the family silver at fire sale prices.

Did the government not know how to value what it wanted to sell? Or did it know what it was doing? I would argue that one makes a spectacular mistake of that sort only once. After that, most people would take steps not to repeat the performance. One could argue that the government took property owned by everyone through the trusteeship of the government and sold that property at cut rate prices to those who could afford to buy the shares—a reverse Robin Hood policy.

On the other hand, that policy may have been designed to spur capitalism and investment, to encourage economic growth in Britain. If the pro-business policies produced greater prosperity, then the seemingly inequitable policy may have had value to the country as a whole.

The government's policy toward competition has schizophrenic aspects, too. It has always professed belief in the free market, but has not structured any of the privatizations in a way that let effective competition flourish. Now, mergers and acquisitions reduce the number of competitors, and potential takeovers put together business sectors that had previously been separated, supposedly, to facilitate competition. I am not being contradictory. Several of the privatized sectors had, finally, reached the point at which greater competition was possible. Will the merger wave short-circuit that progress? Stay tuned.

The regulatory system has come in for criticism, too. Each industry is under the wing of one regulator, each of whom seems to operate compartmentalized from the others. The regulators seemingly lack the powers that regulators have elsewhere. Utilities earned profits that would have been the envy of counterparts elsewhere.

Now that the Labor Party has won the recent election, the regulatory regime may undergo change. Labor, also, wants the utilities to disgorge their allegedly excessive profits by means of a special tax. Ex-post revision of the rules, however, represents the sort of activity that we warn less developed countries not to engage in if they want to attract investors. But, under British law, each Parliament gets to set the rules. So, the investors should have considered themselves warned.

## CONCLUSION

The privatizations in the United Kingdom removed the government from businesses that private owners could easily run. Privatizations shook up complacent enterprises, increasing their effi-

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ciency and decreasing the prices that customers paid (with the exception of water consumers). The efforts helped to revitalize London as a financial center, and launched enterprises that have now ventured forth from England's green and pleasant land into the rest of the world.

The U.K. also made sure that the British remained in control of all the new companies upon privatization. Many governments seem to forget that local ownership can create a critical mass for the development of business. Foreign ownership may divert new business opportunities to the headquarters country. Admittedly some countries have no choice but to sell to foreigners due to lack of local capital and expertise, but the British had a choice and made it.

On the other side of the balance, the British government, on occasion, acted in haste, with meeting a politically imposed deadline more important than getting the structure right. It left a great deal of money on the table after each sale. It confused the appearance of competition with effective competition. It created a string of regulatory agencies that lacked the tools to effectively control the utilities absent the effective competition that was supposed to supplement "light" regulation. And the privatizations put a lot of people out of work in the regulated industries and the businesses that supplied them.

I am sure that Baroness Thatcher or Tony Blair would have other things to say. On the whole, though, I believe that the British government produced positive results, but could have produced even more positive results. We can learn from the British experience.

#### ABOUT THE AUTHOR

**Leonard S. Hyman, CFA**, is a senior industry advisor to Smith Barney. Previously he was managing director of Fulcrum International Ltd., as well as an independent consultant specializing in the economics and finances of energy and telecommunications utilities.

From 1978 to 1994, as head of the Utility Research Group and first vice president at Merrill Lynch, he supervised and maintained equity research on foreign and domestic energy and telecommunication utilities. He was a member of privatization teams for offerings of British, Spanish, Mexican, Argentine and Brazilian utilities and consultant for other restructuring studies. Prior to joining Merrill Lynch, he was a partner at a New York Stock Exchange member firm and an officer at Chase Manhattan Bank.

Mr. Hyman has written and spoken on utility finance and deregulation.

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Author of *America's Electric Utilities: Past, Present and Future*, co-author of *The New Telecommunications Industry: Evolution and Organization* and editor of *The Privatization of Public Utilities*, he has contributed to other books and to professional journals.

For more than a decade, Mr. Hyman was cited by *Institutional Investor* as one of the leading research analysts in his field. He is a Chartered Financial Analyst (CFA). He holds a BA from New York University, where he was elected to Phi Beta Kappa, and a MA in economics from Cornell University, where he majored in Industrial Organization and minored in Latin American Studies. He speaks Spanish and Portuguese.