

Prime Minister 1



I shall commend
this on your behalf
to Nick Ridley

10 DOWNING STREET who is
coordinating
privatisation?

Prime Minister

MUS 15/4

Enclosed is a summary
of an article by Beesley
& Littlechild on a programme
for privatisation. It is
a good basis for the
next five years.

Kenneth Baker is
very enthusiastic as you
will see from the enclosed
letter.

AW

14/4

BEESLEY AND LITTLECHILD ON PRIVATISATION
SUMMARY BY A.A.WALTERS

1. The criterion for privatisation should be the aggregate net benefits to all UK consumers (not the stock market value of the issue).
2. The prospectus should specify:
 - a. The structure of competition, above all conditions of entry.
 - b. Regulatory system.
 - c. Obligations for the provision of non-commercial services.
3. The net benefits of privatisation consist of:
 - a. The allocation of capital by the market rather than by a political process.
 - b. Much greater motivation of management.
 - c. The diversification and use of assets profitably unconstrained by statutory limitations.
4. For competition the main action needed is:
 - a. To remove artificial restrictions on entry.
 - b. To split up the large nationalised industries so that they are in smaller (competitive) units.
5. Regulation by rate of return controls should be abolished since it leads to higher not lower prices and requires a large (and captive) bureaucracy. But predatory price competition should be prohibited and enforced.

6. In priorities, large growing and unreformed industries offer most potential benefits.

GROUP A Potentially competitive industries with good demand prospects such as electricity generation, Telecom (excluding local), and coal offer the most benefits from privatisation.

GROUP B Technical monopolies with poor demand prospects such as rail and perhaps the Post Office, offer good benefits since there is a strong case for reallocating their resources more profitably.

GROUP C Natural monopolies such as the distribution of electricity, gas, local telephones and airports - need additional competition and would not provide substantial benefits from privatisation.

GROUP D Competitive industries with poor demand prospects such as steel, shipbuilding, British Leyland - have already been slimmed down and made more efficient so the benefits of privatisation would necessarily be small.



14 April 1983



FROM THE
MINISTER OF STATE
FOR INDUSTRY AND
INFORMATION TECHNOLOGY

KENNETH BAKER MP

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12 April 1983

Dear Alan.

I don't know whether Stephen Littlechild has sent you a copy of an article which he has done for the Lloyds Bank review for July 1983. If not, I enclose a copy. It is excellent. It is our major programme for the next Parliament. It analyses the criteria for the privatisation of nationalised industries and suggests a list of priorities. I particularly liked his approach in putting customers' interests first. The PM is almost certainly too busy to read all of this, but could you submit a summary to her. We have learnt a great deal from the BT liberalisation and privatisation programme over the last 4 years. It is real pioneering work and we have developed whole new techniques (the Littlechild pricing formula), a statutory system of regulation beyond political interference (OFTEL) and methods of introducing competition into the supply of equipment (BABT). What we have done can provide a programme that can be applied to other nationalised industries.

But Littlechild rightly says that much work has to be done - the detail is very important since it determines the outcome. Is this work being done now? How many other colleagues have really addressed themselves to it? Shouldn't we have a team working out the details and the timetable. It is also essential that this is sold politically. It is a most attractive programme. The customer comes first; services are protected; market forces are introduced; the exclusive privilege of certain trade unions ended. Not a moment should be lost.

You have every right to be proud of your pupil!

KENNETH BAKER

M87/M87AAO



The University of Birmingham

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To Mr Ewson... ~~copies~~
For ADVICE (AND Ps/18
DRAFT REPLY IF Mr Solomon
APPROPRIATE) Mr Laidlaw
PLEASE BY: 13/4 Mr Bradbury

Mr. K. Baker,
Department of Industry,
1 Victoria Street,
London SW1.

30th March, 1983.

Dear Mr. Baker,

The enclosed draft paper discusses the principles of privatisation. It supports the privatisation of British Telecom. However, it argues that greater economic benefits could be secured by privatising electricity generation, coal, rail and posts than other industries which are more frequently mentioned in this connection, such as steel, BL, British Airways and shipbuilding.

The paper has been accepted for publication (subject to revision) in the Lloyds Bank Review in July 1983. We are sending draft copies to a small group of ministers on a confidential basis, in the hope that it may be of relevance to policy discussions. We should be pleased to discuss these ideas further if that were thought helpful. Any comments would also be appreciated.

Yours sincerely,

S. C. Littlechild

PRIVATISATION: PROBLEMS, PRINCIPLES AND PRIORITIES

M.E. Beesley and S.C. Littlechild

Fifth draft 24.3.83

I. Introduction

1. In the event of a Conservative government being returned to a second term of office, it seems reasonable to assume that a further programme of privatisation will be adopted. It is therefore relevant to examine what kinds of problems are likely to be encountered, what principles should be adopted in resolving them, and where the priorities for privatisation should lie.

2. Economists seem to have written little on these issues. The present paper is not claimed to be definitive; its conjectures and technical assumptions will need to be closely examined by those familiar with each industry. Nonetheless, we hope to provide a useful structure for the analysis of privatisation, within which relevant questions, choices and criteria can be identified.

3. The term 'privatisation' is a relatively recent one, with as yet no precise meaning. The underlying intent is to change industry performance by increasing the role of market forces. This can take many forms, such as freeing of entry to an industry, encouraging competition in it, permitting joint ventures with private companies, introducing private capital into the nationalised industry's liabilities, and so on. Market forces can also be increased by restructuring the nationalised industry itself, to create several successor companies which may be publicly or privately owned. In

this paper, however, we are mainly concerned with privatisation in the sense of forming a Companies Act company and the subsequent sale of at least 50% of the equity to private shareholders.

4. Because market forces can be helped or impeded in many ways, it is important to recognise that the benefits accruing from privatisation depend critically upon accompanying policy with respect to competition, industry structure and regulatory arrangements. The nationalised industries differ greatly with respect to demand conditions and likely future market prospects. They also differ with respect to cost conditions and likely developments in technology. Accordingly, any privatisation scheme will have to anticipate the possibilities opened up by economic change. For example, it will be necessary to decide whether there should be one or several successor companies. The danger of monopoly exploitation will be lessened if there are several companies and if further newcomers are encouraged. On the other hand, if future cost conditions favour the emergence of a single successor company, consideration will have to be given to alternative forms of regulation of a single, privatised entity.

5. In some cases, the benefits of privatisation could be outweighed by the disadvantages (e.g. where costs favour a single supplier and monopoly power cannot be curbed sufficiently). More substantial benefits might be expected from various measures other than privatisation (e.g. removing statutory monopolies in order to facilitate competition). For political and other reasons, however, the introduction of competition can often be secured only as a consequence of privatisation. The various measures to increase market forces are thus sometimes alternatives, and sometimes complements. In order to secure maximum benefits, considerable thought needs to be given to designing a set of measures, including privatisation as one essential element, for each particular industry.

6. We are seeking criteria to analyse and answer the following central questions:

- i) whether a particular nationalised industry should be a serious candidate for privatisation;
- ii) how the industry should be structured and the regulatory environment designed;
- iii) what should be the priorities for privatisation among the available candidates.

7. The paper is organised as follows: Section II sets out our proposed criteria for privatisation. Sections III to VI discuss, in turn, the principles to be adopted with respect to privatisation, competition, regulation, competition policy and non-commercial obligations. Section VII identifies criteria for choosing priorities, and takes particular industries to show how, in outline, they may be applied; and Section VIII summarises the conclusions.

II. Criteria for Privatisation

8. It is helpful to structure the problem as a cost-benefit analysis. In principle, one might examine the costs and benefits of each alternative privatisation proposal, as they impact upon various different interest groups. The latter would include existing and potential customers, suppliers of labour, capital and other inputs, taxpayers, etc. Trade-offs could be established between the various parties, and decisions made concerning them.

9. To begin to establish priorities, we propose to short-circuit this procedure somewhat by specifying a single criterion, namely, the present value of aggregate net benefit to all UK customers. This will be measured by the reduction in prices of currently available goods and services (offset, of course, by any price increases). Account will also need to be taken of changes in the level of output, in the quality and variety of goods and services available, in the rate of innovation, and so on. Typically, there will also be release of resources, benefitting the consumer in other ways. Depending upon the particular industry, it may be important to consider the effects on the distribution of benefits (e.g. by geographical area or by classes of persons), and on employees, suppliers, exports, taxpayers and so on. Privatisation schemes will need to be designed with all these aspects in mind (as indeed were the original nationalisation statutes). Nonetheless, the criterion of aggregate net benefit to consumers seems a simple and appropriate starting point, because unless this promises to be considerable, the political costs of change will scarcely be worth incurring. (But public opinion on matters such as privatisation is probably changing continually, and indeed seems to be have done so markedly in the present Government's term. In the event, political 'costs' may be significantly less than they now appear.)

10. We do not assume that privatisation should be adopted for its own sake. Respectable arguments can be made to support such a view, for example, invoking the concept that political freedom depends on private property, or the desirability of minimising government intervention, on the grounds that the larger the government sector, the larger the threat to liberty. We do not take these lines here. Privatisation is looked at strictly as an economic instrument. It follows that privatisation in certain industries (or parts thereof) could be ruled out as simply not beneficial to consumers.

11. It should be noted that the stockmarket value of the successor company or companies is excluded from our criterion. This value could clearly be artificially increased (e.g. by granting a monopoly or announcing lesser restrictions on entry), but to do so would be counter-productive from the perspective of consumers. Similarly, the (alleged) poor proceeds of sale, either realised or in prospect, should not in themselves be a deterrent to privatisation. The right sale price is simply that which investors are prepared to pay, once conditions and timing of sale have been determined by the net benefit criterion.

12. This is not to say, however, that what is realised on a sale does not matter. The proceeds may be thought of as the price at which the present owners of the company's assets (viz. the taxpayers) transfer these assets to the future owners (viz. the shareholders). Careful thought should be given to the precise method of flotation, so as to minimise the likelihood of severe over- or under- subscription. We see no merit in making a gift to fortunate 'stags' or imposing losses on unfortunate underwriters. Nevertheless, the difficulties of estimating future stockmarket prices, real though these are, (as experience with Amersham, Britoil and

Associated British Ports indicates), should not significantly influence the decision as to whether privatisation itself is worthwhile.

13. The important decisions about the flotation concern the design of the privatisation scheme. Consider some of the things that have to be decided in order to write prospectuses for one or more successor companies about to be floated:

- KEY
- i) The number of successor companies must be specified, together with the assets and liabilities of each, and their intended aims and scope of business.
 - ii) The structure of the industry in which the company (or companies) operates has to be described, with particular reference to competitors and conditions of entry, and relationships with suppliers and customers.
 - iii) The regulatory environment will need to be defined, making reference where appropriate to competition policy, controls on investment, prices or profits, efficiency audits, etc.
 - iv) Non-commercial obligations need to be specified, e.g. with respect to employment, prices or provision of services. Any sources of funding for these obligations will also be relevant, e.g. direct subsidies from government or local authorities.
 - v) The timing of the privatisation scheme has to be decided - not merely the final flotation date, or dates in a case of progressive sales, but also the times at which new competition is allowed and/or regulation is instituted.
 - vi) Where the government retains a shareholding, assurances have to be given as to the conditions under which the associated voting power will be used, and some indication of intentions as to future levels of shareholding.

All of these and other relevant considerations, will condition the future prospects of each company, and thus the feasible offer prices. The market will assess the underlying decisions on the structure of the scheme translating this into a market price. Once a decision on them has been made, a judgement can be formed so as to minimise the windfall gains and losses. Avoiding windfalls is a question of reading the market in advance. Particularly in the case of the biggest flotations, there is a strong case for supplementing professional advice with organising some form of futures market - e.g. selling limited quantities of shares to employees or consumers at low prices in advance of a main flotation.

III. Benefits and Costs of Privatisation

14. Our criterion for privatisation involves benefits for two sets of consumers: actual or potential consumers of the industry in question; and other consumers, who will gain benefits from any saving in resources which may accompany privatisation. Our short-cut criterion thus involves assuming, for example, that if less subsidies are paid, as will be the case, consumers will benefit via less taxation. Subsidies represent real resources which could be consumed elsewhere.

15. Privatisation is likely to generate net benefits for consumers because privately-owned companies have a greater incentive to produce goods and services in the quantity and variety which consumers prefer. Companies which succeed in discovering and meeting consumer needs make profits and grow; the less successful wither and die. This process is accentuated by the discipline of the capital market, whereby access to additional resources for growth depends upon a previously-demonstrated ability to make profits. The essential element which selling a nationalised industry imparts is that the discipline of the market is substituted for the public influence on capital acquisition and allocation. Resources tend to be used in ways that consumers dictate, rather than according to the wishes of government, which must necessarily reflect short-term political pressures, and considerations of managing the public sectors' overall demands for capital.*

* To support this there is growing empirical evidence, mainly from the USA, that privately-owned companies make more efficient use of labour, capital and other resources, and are also more innovative.

✓ 16. But gains are not all one-way. Privatisation is intended to change motivations of management towards profit-making per se. Three groups of persons may be adversely affected by management more actively seeking profit. First, a privately-owned company may have greater incentive to exploit monopoly power. To the extent that means of limiting this are not devised, benefits to consumers from privatisation will be less than they otherwise would be. Second, privatisation will also make a company less willing than its predecessor to provide uneconomic services. The resources so released will be put to more beneficial use. But there will be particular sets of consumers who stand to lose by the change. This raises the question of how such losses, often thought of as social obligations, should be handled. Third, the elimination of inefficient production, expansion of the better parts of the industry, and less restrictive labour practices would mean the release of resources from the loss-making company. This would be to the benefit of consumers outside the industry. However, there would also be other gainers and losers - such as taxpayers, and those exploiting the nationalised industry's monopoly power - whom the criterion does not explicitly recognise.

✓ 17. Some have argued that the question of ownership is largely irrelevant, and that most of the benefits of a privatisation package could be obtained without the change in ownership. We have already noted in para 15 why ownership does matter: consumers in general will be better served. But also, for political reasons, privatisation may be a necessary accompaniment to the other measures envisaged. Take competition. It is questionable whether the recent extension of liberalisation of entry into telecommunications, announced in February 1983, would have been politically feasible if the transfer of British Telecom to private ownership had not by then been envisaged and in process of realisation. It is also arguable

that competition policy is (and certainly could be) more effective against a private company than against a nationalised industry.

18. Similarly, there are political limitations on alternative ways of increasing market pressure. The benefits of privatisation derive in part from a greater ability to diversify and to use assets in more profitable ways, unconstrained by the statutes of nationalisation. It may be that these statutes could be relaxed without transferring ownership. However, this would undoubtedly be opposed by rival firms (and taxpayers and consumers) fearing government-subsidised competition or uncontrolled expansion. Or again, it has been argued that efficiency would increase if governments refrained from intervening in the industries (e.g. on macro-economic grounds). But as long as the industries are nationalised, it seems implausible to expect such self-restraint. Privatisation, then, makes it possible to decouple useful moves from politically difficult circumstances. This additional benefit should be set against the political costs of privatisation itself, which chiefly concern the losses of certain interest groups. These losses can themselves be minimised by wise choices in the design of privatisation schemes.

IV. Competition

19. The most important mechanism for maximising net benefit to consumers, and for protecting them against monopoly power, is undoubtedly competition. The essence of competition is rivalry and freedom to enter a market. Different views can be tested as to what consumers want and how much innovation is worthwhile. This offers the best chance of discovering and supplying the range of goods and services which consumers most prefer. Of course, none of the nationalised industries converted to private ownership could ever approach the 'perfectly competitive' concept of neo-classical economic theory, but then no real-world industrial markets ever do. The concept of some ideal market is not a very helpful benchmark. What counts is the existence of a competitive threat, which may come from potential as well as existing competitors. The relevant comparison is between the level of competition that could realistically be created, and the present state of competition (or more often lack of it) in the nationalised industry. In other words, one is looking for some practical means to introduce or increase rivalry.

20. Several of the present features of nationalisation need attention, whatever the ownership form finally adopted. The first need is to remove the artificial restrictions on entry embodied in the statutory monopolies which were granted to most of the earlier nationalised industries. Second, proprietary rights to new advances in technology should no longer be reserved, as they often are, to nationalised industries. Third, existing government controlled resources can be made available to new entrants (e.g. radio spectrum, airspace and landing rights, mineral rights on land and sea etc.) without differential consideration being given to nationalised industry incumbents.

21. The starting structure for the successor private company or companies is extremely important. In some cases, different parts of the industry could compete against each other if formed into separate companies (i.e. horizontal separation). In other cases, resources or assets currently controlled by the industry could be transferred or made available to potential entrants. Separating the industry into different companies by level of process (vertical disintegration) could also generate competition at the interface. If, for example, British Telecom's International division were floated separately from the Inland division each division would encourage alternative sources of supply (including self-supply) and, by the same token, have to compete for custom itself. Reform within a nationalised industry framework is most unlikely to be as effective.

22. A qualification needs to be made here. Splitting up an organisation could involve the sacrifice of economies of scale or scope, and the gains from increased competition may be offset by increased costs of production or transacting. However, there is little reason to believe that the present structures of the nationalised industries maximise net benefit to consumers, since these structures have been largely determined by political pressures or administrative convenience, rather than by market forces.

23. Because one cannot know in advance precisely what industry structure will prove most efficient, two further rules of thumb for creating successor companies seem to be suggested. First, the successor structure must be effectively competitive. In those cases where potential buyers have enough experience of like situations to assess outcomes with some confidence, this knowledge should be used to determine the initial structure of an industry. Thus, in disposing of British Rail hotels and North Sea Oil licences, potential bidders were able to nominate and bid for

✓ whichever bundles of assets most suited their own purposes. This is undoubtedly more efficient than having the government or British Rail attempt to collect this information and specify the bundles in advance.

The industries to which the privatised assets were added were themselves already competitive.

24. Second, where analogies from previous experience are less certain (as, perhaps in telecoms), as far as possible the future growth of the industry should not be constrained to the pattern established at flotation. Companies should be allowed to expand or contract, specialise or diversify, as market forces and their own evolving policy objectives dictate. A corollary is that, when in doubt, smaller rather than larger successor companies should be created, but allowed to merge thereafter subject to rules of competition policy discussed below. In these cases, where there are no or very few existing outside competitors, the starting structure must be designed to create effective competition.

V. Regulation and Competition Policy

25. In some industries, even the introduction of such competition as is feasible may still leave the incumbent with a significant degree of monopoly power. How should this be dealt with? Government will no longer have available the direct and indirect powers it has over a nationalised industry. Nonetheless, alternative means of influencing or regulating conduct are available. (The promotion of competition is itself one such means, of course.)

26. One favourite prescription is to influence the charges made by limiting the profits earned, expressed as a rate of return. The US has had much experience of this. The control developed there seems unlikely to increase net benefits to consumers. Some of its defects are all too well-known: the disincentives to efficiency, the 'cost-plus' mentality and the expense of operating it. Other defects are gradually becoming better understood, notably the vulnerability to 'capture' of the regulatory commission by the regulated industry, and the associated tendency to limit competition among incumbents and to restrict new entry. The result of regulation in the US has generally been higher rather than lower prices. US regulation in fact embodies a similar philosophy to nationalisation, and has had similar effects. Privatisation in the UK has been paralleled by deregulation in the USA. Thus, on the whole, rate of return regulation should not be thought of as a relevant accompaniment to privatisation.

27. There is considerable pressure in some quarters for efficiency audits or value for money audits, on the grounds that monopoly industries may have inadequate incentive to increase efficiency. In the absence of sanctions for non-compliance, such audits are likely to be ineffective.

However, if they are used as the basis for setting and varying tariff restrictions, and controlling investment plans, then the system essentially amounts to rate-of-return regulation, itself defective, for the reasons just indicated. The pressure of competition and the incentive of the firms themselves not to waste resources is likely to be a more effective inducement to efficiency than the creation of a government nanny.

22. An alternative is to limit prices directly by explicit tariff restrictions. An example is in British Telecom, where proposed control is that the price of a bundle of telecommunications services should not increase by more than X percentage points below the Resale Price Index (the RPI-X formula) for a period of five years. This could be applied to a narrower or wider set of services - e.g. as they might appear in the bills of a representative consumer. The purpose of the constraint is to reassure customers of monopoly services that their situation will not get worse under privatisation. The level of X would, in practice, be the outcome of bargaining between BT and the Government. The limits would be set according to different views of changes in technology and input prices, the scope for gains from improved efficiency, and the likely consequences for prices and cash flows. However, an exhaustive costing exercise is not called for. The critical point about such a device is that it is short-term only. It holds the fort until competition arrives. It is a temporary safeguard, not a permanent method of control. It is precisely the 'one-off' nature of the restriction which preserves the firm's incentive to be efficient, because the firm keeps any gains beyond the specified level. Repeated 'cost-plus' audits would destroy this incentive and moreover, would encourage 'nannyish' attitudes towards the industry.

29. A preferable alternative to detailed regulation of costs, profits or prices would seem to be greater reliance on competition policy. In this paper we cannot analyse the past development of UK competition policy, and its present weaknesses in dealing with new circumstances presented by privatisation. But some directions for needed change can be indicated. In general, a shift in the direction of US-style anti-trust policy might be helpful. The main aims would be to protect existing and potential competitors likely to be at a disadvantage when competing with a dominant incumbent, who in the past has generally had the advantage of statutory protection, and who probably even now has certain significant legal and other advantages (e.g. rights of way).

30. In the UK at present, potential anti-competitive practices by monopolistic firms are first investigated by the Office of Fair Trading. If a practice is found to be anti-competitive, it may be referred to the Monopolies and Mergers Commission, which decides whether it is in the public interest. In the case of hitherto nationalised industries, a stronger line should be taken. Certain practices (e.g. price discrimination, refusal to supply, full-line forcing) might be explicitly prohibited if they are used by the dominant incumbent to eliminate or discipline specific competitors. Parties adversely affected should be able to sue, perhaps for triple damages. It is particularly important to discourage predatory competition because, as argued earlier, one wants to leave considerable degrees of freedom for new ownership structures to emerge after privatisation. One does not wish to disallow mergers, for example, which do not substantially affect horizontal market power. But one does want to curb the abuse of dominant power. Thus, so long as objectionable conduct is outlawed, companies must be free to order their own affairs.

31. These ideas may be illustrated by current proposals to privatise British Telecoms. The Telecommunications Bill, as amended in committee, explicitly prohibits predatory price competition. It also sets up an Office of Telecommunications alongside conventional anti-monopoly mechanisms, notably the Office of Fair Trading. One of the reasons for these measures is precisely the fact that present general anti-monopoly mechanisms are unlikely to be able to cope adequately with the incumbent's monopoly power, at least in the interim period before that power is itself modified by increasing competition. We would argue that the new mechanism should stress the question of dealing with market conduct, and not seek to emulate the features of industry regulation which have proven so troublesome in the US.

VI. Non-Commercial Obligations

32. Nationalised industries provide a wide variety of services, some of which are uneconomic at present prices and costs, although it is not at all clear that they are necessarily uneconomic. A successful private company or companies, operating on a commercial basis, might wish to raise certain prices and/or reduce certain services. If the main aim of privatisation is to ensure that resources are allocated to the most highly valued uses, the companies should not be prevented from doing so. Nevertheless, it may be felt socially desirable or politically necessary to ensure the continued provision of certain services (e.g. to rural areas).

33. Procedures for establishing non-commercial obligations need to be specified. Any company claiming that a service is uneconomic should be required to provide relevant financial data to support its case, accompanied by a request to withdraw unless subsidy is provided. The relevant public body (e.g. local authority) will then consider whether the case is plausible, whether another operator is willing to provide the service, and whether subsidy should be provided.

34. Where should this subsidy come from? One of the prime aims of nationalisation was to facilitate cross-subsidy. However, the extent of subsidy is largely hidden, and cross-subsidisation inevitably entails restrictions on competition so as to generate the source of funds. Cross-subsidisation and competition are therefore mutually incompatible. Economists have long recommended that explicit public subsidies should be provided.

35. What if the government is unwilling to do this? It has to be admitted that explicit subsidies have not proved politically popular to date. Other possibilities have therefore to be explored. In telecommunications it is currently envisaged that BT will charge an access fee to other networks, which will be used to finance emergency services, call-boxes and other loss-making services. This amounts to a tax on telecom operators to support socially sanctioned output. So long as the scope of the service is so supported, the tax remains small and applied to all relevant operators, competition will not be seriously damaged. This is possible, particularly in an expanding industry, if stringent tests of loss-making are applied. Such compromises may well have to be worked out for many cases of privatisation in which protection of particular consumers is deemed important. They will reduce net benefits to consumers; but political realities have to be faced. Unless safeguards are provided for groups adversely affected, privatisation itself could well be jeopardised. Once again, the design of the scheme is crucial.

VII. Priorities

36. We have argued that a nationalised industry should be privatised if the net benefits to consumers from doing so are positive. Many industries will meet this criterion, yet it would be impossible to privatise them all at once, if only because of the constraints imposed by the Parliamentary timetable. Which industries should then be given priority? Leaving aside political considerations, our criterion indicates those industries where privatisation will generate the greatest net benefits to consumers. It is therefore necessary to imagine what the output and prospects of each industry could be when privatised, and to compare this with the situation in which the industry presently finds itself. Four rules of thumb suggest themselves for assessing resulting benefits.

37. First, other things being equal, a larger industry offers larger potential scope for savings. That is, if costs and prices can be reduced by an average of $x\%$, an industry with a turnover of £2 billion offers twice the potential benefit of an industry with a turnover of £1 billion. Table 1 lists the nationalised industries in order of turnover. It shows that the largest three industries (electricity, telecommunications and gas) account for half the total turnover in the nationalised sector. At the other end of the list, there is relatively little to be gained by privatising the smallest seven industries, whatever percentage gains each one could generate, since together they account for less than 6% of total turnover in the nationalised sector.

38. Of course, other things are not equal, and the industries offer significantly different scope for generating benefits, as we argue in a moment. Nonetheless, the criterion of size must be constantly borne in

Table 1: NATIONALISED INDUSTRIES,* YEAR 1981/2

NAME	TURNOVER £m	(CCA BASIS)		CHANGE SINCE 1979/80
		CAPITAL £m	EMPLOYED WORKFORCE 000's	
Electricity Supply Industry (1)	8,057	32,605	147	-8
B. Telecom	5,708	16,099	246	0
B. Gas	5,235	10,955	105	0
N.C.B.	4,727	5,891	279	-5
B. Steel	3,443	2,502	104	-38
B. Rail	2,899(2)	2,746	227	-7
Post Office (3)	2,636	1,347	178	0
B. Airways	2,241	1,338	43(4)	-24
B. Shipbuilders	1,026	655	67	-18
S. Scotland Elec.Board	716	2,817	13	-5
National Bus Co.	618	508	53	-16
B. Airports Authority	277	852	7	-7
North Scotland Hydro.Elec.	270	1,981	4	-3
C.P.A.	206	162		
Scottish Transport Group	152	157	11	-17
B. Waterways Board	16	50	3	-2
TOTAL 5	38,217	80,465	1,487	

Notes:

- (1) Including CEGB, Council and Area Boards. Figures for CEGB alone are £6,364m, £23,357m, 55,000
- (2) Including government contract payments £810.2m
- (3) Including Giro and postal orders
- (4) 38,000 as at March 1983 (source: ITV programme)
- (5) Other companies which might be privatised include BL (Turnover £3082 m., workforce 83,000).

*Organisations classed as nationalised industries by the public enterprise division of the Treasury, as reflected in the White Paper Government Expenditure Plans, Cmnd. 8789 (Tables 3.4 and 3.5).

mind. In order to match a 1% saving in capital employed in the electricity industry, it would be necessary to achieve a saving of 2% in telecoms, 3% in gas, 5% in coal, 12% in steel, or 24% in posts or British Airways. Similarly, a 2% saving in manpower at the NCB and British Rail would be equivalent to a 1% saving in manpower in all other industries combined.

39. The second rule of thumb is that industries will offer less scope for savings if they have already been subject to severe remedial action, and more scope if as yet they are relatively untouched. By this criterion, British Steel, BL, British Airways and perhaps British Shipbuilders probably have relatively small further savings to offer. (See final column Table 1).

40. Third, the present value of consumer benefits is likely to be greater where an industry is growing rather than declining over the longer term. This is because benefits will apply to a greater output, expansion will be faster, and innovation will be more important and better achieved. Of course, the pattern of future demand is necessarily uncertain. However, most observers would expect the prospects for energy and telecommunications to be significantly better than the prospects for, say, steel, rail and posts. Broadly speaking, the effect of privatisation would be to limit further resources going into those industries with poor prospects, where possible redeploy more effectively the resources currently tied up there, and at the same time facilitate the flow of resources into the industries with better prospects.

41. Fourth, benefits to consumers are likely to be greater where future cost conditions favour the emergence of multiple ownership rather than a single organisation - that is, where competition rather than monopoly is likely to predominate. Steel and British Airways are probably in the first

group, rail and airports in the second. Cost conditions may in fact vary in different parts of certain industries: electricity generation is more amenable to multiple ownership than electricity distribution.

42. These ideas may be clarified by conceiving of each nationalised industry as located in a simple two-by-two matrix, where demand prospects are classified as Good or Bad, and supply prospects are conducive to Single or Multiple ownership. This of course simplifies the demand and supply conditions. But the contrasts between the industries are great enough for the divisions to be useful. By 'good' demand we mean principally favourable trends in typical services and products. In 'supply' are included prospective technological changes which will affect production conditions. This matrix is shown in Diagram 1, together with our own conjectures as to the quadrant in which each industry is located. More precisely, the industries are placed in the quadrants where they would be located if appropriately privatised. These are not necessarily the same quadrants as the ones in which they currently find themselves. As we shall shortly argue, privatisation may well be necessary in order to shift an industry from an "inferior" quadrant to a "better" one, where a "better" quadrant is one which offers greater benefits to consumers (and, in some cases, to employees also). There are also possibilities of dividing the present industries in ways which follow the diagram. For example, as noted above, the electricity industry is now composed of production and distribution activities. These could fall, after privatisation, into different positions: in quadrant C with respect to production, and in quadrant A with respect to distribution, including distribution systems and the grid. We now consider each quadrant in turn.

Diagram 1: Classification of Nationalised Industries Post-Privatisation

		Demand Conditions	
		Good	Bad
Supply Conditions	Single	A Electricity Area Boards and Grid Telecom (local) Gas Airports	B Rail Post (or possibly C) Waterways
	Multiple	C CEGB (excl. Grid) Telecom (excl. local) Coal B. Airways	D Steel EL Shipbuilders (or possibly C) Buses

Quadrant D

43. Industries in this quadrant need present no problems of monopoly power, since multiple ownership is quite feasible. However, the largest industries - British Steel, BL and British Shipbuilders - are currently characterised by excess capacity on a world scale. Their own efficiency - or lack of it - in operation is now a relatively minor factor. In particular, labour monopoly power has surely become a very small element. The industries are already subject to international competition, which secures prices as low as can be expected, and in future there will probably be increasing competition from superior sources abroad. These industries are thus always likely to occupy quadrant D, even though their levels of output may move up as the depression ends. The net effect of all this is that the consumer will gain little directly from privatisation.

44. It is true that the taxpayer will gain from privatisation. Private owners will be more willing and able than government departments to identify and rectify inefficiencies and to exploit new opportunities. Privatisation will therefore reduce the liability to chronic or periodic losses. It is quite wrong to defer privatisation merely in order to get these industries "into the black", by further subsidies, so that a "respectable" flotation price can be achieved.

45. Bus operations are, of all the nationalised industries, least suited to the scale of operations nationalised industries imply. But the prospects from privatisation as such are not particularly great for long distance traffic, an important element of NBC. This is because deregulation in that market occurred in 1980. Further gain could follow from complementary policies to lower barriers to entry into the long distance market, e.g. to favourable terminal locations. In urban areas, quite

different conditions prevail; entry is still toughly regulated. However, the incumbents are not strictly nationalised industries, but other forms of public enterprises. Here, there certainly would be a large gain from deregulation, not least in the redistribution of bus resources towards the more favourable routes. The problem for policy here, therefore, is not so much privatisation of nationalised industries as providing greater freedom of entry via deregulation, and dealing with collateral needs such as revising methods of subsidy and reducing underlying obstacles to entry. In sum, privatisation of industries in quadrant D will yield positive but small net benefits. A high priority is not indicated.

Quadrant C

46. Industries in this quadrant are characterised by good long-term demand prospects. They happen to be very large, and (with the exception of British Airways) are relatively untouched, so they presumably offer considerable scope for improvements in efficiency. They need present no significant problems of monopoly power, insofar as multiple ownership is viable. Thus, they are prime candidates for privatisation.

47. Interestingly, however, none of the four industries is organised as if it were in quadrant C at present. The CEGB and British Telecom are each a single organisation, though Mercury is now beginning to offer a challenge. Because of good demand prospects they would be put in quadrant A. The NCB is a single organisation whose prospects in the absence of privatisation are somewhat dim (quadrant B); and British Airways is part of a multi-ownership industry, but again its prospects without privatisation are unclear (quadrant D). In these four cases, privatisation involves recognising that the industries, or large parts of them, belong to quadrant C, and that benefits for both consumers and employers can be secured without invoking severe problems of monopoly power.

48. Careful attention would need to be given to the structure of these industries after privatisation. In the case of the CEGB, the grid should remain in public ownership for the present, perhaps integrated with the Department of Energy, but the generating stations should be sold to separate buyers, so as to establish competition in production. A similar policy would apply with respect to coal pits and accompanying local mineral rights. A firm would be allowed to bid for a group of stations and coal mines so as to achieve economies of horizontal and vertical integration. Other successor coal companies would be unintegrated with generating stations. The structure would thus be such as to make competition workable.

49 Privatisation would aim to move the British coal industry from quadrant B to quadrant C. Consumers would benefit directly from the lower prices due to competition, including the removal of restrictions on imports. But the prospects for the British coal industry would also be greatly improved. There are currently very dramatic differences in costs between different pits. Resources of capital and labour would be reallocated so that the more efficient pits - which would command highest prices on privatisation - would expand. There would also be benefits from a severe reduction in the monopoly power of labour. The relatively low capital-labour ratio (£21,000 capital employed per man in 1981/82) could profitably be increased. Some pits which are presently extra-marginal would become viable, as a result of more efficient management. Because long-term trends in demand are favourable to coal (particularly when synthetic fuels become viable), and because Britain has many favourably-placed locations for coal mining, the industry could once again become an expanding one. It is even possible that employment could increase in the British coal industry as a whole. In practice, privatisation seems necessary to secure these benefits. Closure of the least efficient pits would imply needs to cope

with social adjustment. A merit of privatisation is that it divorces the issues of industrial development from those of discharging society's debts arising from the past.

50. Since the Bill enabling the privatisation of British Telecom is currently passing through Parliament, it will not be discussed here. Suffice it to note that this Bill does not envisage the restructuring of British Telecom, as might be expected by the present analysis, but it does on the other hand explicitly recognise the need for developments in competition policy to prevent the exploitation of a dominant position, and the Government has concurrently announced measures to facilitate competition from new entry.

51. With respect to British Airways, no special steps are necessary to achieve a competitive market structure (though less restrictions on routes and allocation of airport landing slots on a more competitive basis would be desirable). However, as with British Steel and BL, it is not clear that the further gains to consumers from privatising BA would be substantial. Thus, in quadrant C, the prime candidates are the CEGB, British Telecom and the NCB.

Quadrant A

52. The industries in this quadrant are characterised by good demand prospects but the supply prospects do not favour multiple ownership. Local distribution systems for electricity, gas and telephones are characterised by high sunk costs. With the possible exception of telephones, they do not face much immediate technological challenge, and will be sustainable as local monopolies. Consumers are therefore at risk. Analogous remarks apply to airports.

53. Cannot the market process be used even if successor entities are sustainable monopolies? Some have argued for auctioning franchises to private bidders, thereby encouraging competition for the monopoly privileges. This method seems to be largely ruled out if one accepts the criteria for priorities we have suggested. The principal effect of franchising is to transfer the value of the inherent monopoly power to the seller - in this case the government. This is good for the taxpayer, but does little to help the consumer. There are great practical snags, too, in awarding the franchise to the bidder offering the lowest price to consumers, as experience in the US with franchising cable TV warns us. It is difficult to specify in advance the appropriate pattern and quality of output, and the costs of negotiating and monitoring contracts are substantial. Furthermore, it is difficult to sell a franchise only on the premise of sustainable monopoly. Bidders will usually look for, and get, statutory monopoly privileges, which in turn will not only create formal exemption from risks of entry but, more important, will create a position from which to exact further concessions from governments. Though we do not rule out the franchising option in all cases, it needs far more analytic attention than it has so far received before positive recommendations can be made.

54. This does not mean that nothing can be done to generate benefits for consumers in these industries. Restrictions on new entry can be removed, as is currently taking place in electricity. Dividing the distribution systems into regionally independent units would create market pressures in supplies of factors of production, not least in providing alternative opportunities for hiring and rewarding management talent. However, many of these benefits could be obtained even if the separate successor units in the industries were still nationalised, municipal, or other public bodies.

55. The situation of British Gas is perhaps slightly different. It currently has a statutory monopoly to purchase North Sea Gas. This is a means of extracting rent from producers which is then recouped by a special profits tax. In consequence, British Gas is not under great pressure to keep its costs down. Legislation in process envisages that producers will henceforth have the right to supply consumers direct, but the scope for competition is limited by problems of distribution. The national distribution grid could perhaps be made a common carrier, independent of British Gas (which would be responsible for local distribution only), and existing contracts for supply in the near future could be reallocated. The larger consumers would probably benefit. Privatisation logically implies removing the present restrictions on the export of gas. This also would tend to raise domestic prices from their present levels, though taxpayers would benefit by a profits levy on export sales. Thus the benefits to consumers are somewhat indirect, and may not be substantial.

56. To summarise, in the case of quadrant A, it is not clear that privatisation adds much which cannot be obtained by encouraging competition and market forecasting, by restructuring the industries and by removing restrictions on entry.

Quadrant B

57. The industries in this quadrant are characterised by declining demand prospects and supply conditions favouring a single organisation. Monopoly power may be a problem in some services, but it is generally not severe because the reason for the decline in demand is the emergence of substitutes preferred by consumers. There are, however, social and political problems associated with the withdrawal of services. Nationalisation was seen as a means of preventing decline: it led to continued

injections of new capital and the financing of losses, so that resources remained within the industries instead of moving to higher-valued uses. The aim of privatisation would be to speed up the movement of resources out of these industries and/or to use existing resources more fully by developing new products and services. However, privatisation schemes will need to be designed with careful thought to non-commercial obligations.

58. British Rail is in an unusual position among the nationalised industries. As far as rail operations are concerned, it would remain in quadrant B after privatisation. To a considerable degree, these operations are not divisible below reasonably sized and geographically separate sectors - e.g. the old regions. And no one is likely to want, or be able, to emulate such successor railway supply companies. So those monopolies will be technically sustainable. However, demand is, and will increasingly be, adverse. This particular combination of circumstances BR shares with at least one lesser nationalised industry, British Waterways. But BR is marked off from the other nationalised industries by its exceptionally high alternative use value. Its territory is immense, and in many parts very valuable indeed. Privatisation here would indeed be justly called an asset stripper's paradise, not just for selling land, but for all the myriad deals which can be constructed based on locational advantage.

59. Now, in the case of a declining industry of high alternative use value, asset stripping is very much in the consumers' interest. However, we are dealing here with perhaps the most politically sensitive of all nationalised industries. A practical compromise therefore presents itself. Successor companies could be floated which, in return for the command over assets, would have to bind themselves to a given programme of rail output. This of course would be achieved in a much more economical way than now -

thereby freeing up much track, stations, marshalling yards and the like.

The companies' rail output would be heavily passenger-oriented. The output constraint would, in effect, be financed by profits from other activities. Such is the inherent value of rail assets that we have little doubt that a quite considerable passenger output could be insisted upon. In particular, it would be possible, with such an approach, to achieve a rail output higher than that which the recent Serpell report thought necessary, were railway viability to be achieved by a reduction in the route mileage. Thus, privatisation would open up social solutions not now possible.

60. In the Post Office case, demand is probably decreasing, partly because of more direct competition from telecoms; but there are distinct market possibilities in new forms of collaboration with the new techniques. Though most would now place the Post Office in quadrant D, there are opportunities for its eventual emergence in C. Mainly because it is so labour intensive (capital employed the lowest of all Table 1's industries at £7,600 a man) there is considerable scope for improvements in labour deployment and substitution. The basic distribution network has great potential for development outside traditional Post Office work. One imagines that a useful form of privatisation would be a successor national company, or regional companies, which essentially would franchise their local operations to individual small groups, so that one could look forward not only to an improvement in postal services, but also a willingness to innovate to include such services as security and many kinds of delivery work.

VIII. Conclusions

61. Our main theme has been that privatisation, in the sense of selling off 51% of a nationalised industry, is a complex matter, calling for much action both in advance of deciding its precise form and in collateral policies to accompany it. Nationalisation Acts had a great deal of preceding intellectual argument and years of discussion about the form to be taken, accountability, representation of interests and financing. Part of this was indeed clap-trap; quite a lot was valuable. Privatisation needs at least the same care, hopefully far better applied. Like nationalisation proposals, privatisation proposals will have far more ideological support than constructive criticism, so their quality will depend on distinguishing prediction and analysis from wishful thinking.

62. Privatisation will generate benefits for consumers because the allocation of resources will be primarily determined by consumer preferences instead of by political pressures. In some cases there may be problems associated with monopoly power, withdrawal of services, or other social consequences. The promotion of competition, by allowing new entry and restructuring the industries, is the most effective means of maximising consumer benefits and curbing monopoly power. Stricter competition policy is to be preferred to rate of return regulation, efficiency audits, and other related forms of government "nannying". Clear ground rules will also have to be laid down concerning the criteria for the provision of uneconomic services and the sources of finance for these.

63. The benefits of privatisation will vary according to the industry. We have found it helpful to classify the industries into four groups. Group A are what are loosely referred to as "natural monopolies", notably

electricity, gas and telephone local distribution networks, plus British Airports. Increased competition wherever feasible, rather than privatisation, is indicated here. Group B are technical monopolies whose demand prospects are poor, notably Rail and Posts. These are strong cases for privatisation as a means of reallocating resources to higher-valued uses, while still taking account of non-commercial obligations. Group C are the potentially competitive industries with good demand prospects, such as electricity generation, telecommunications (excluding local distribution) and coal and, possibly, posts. These offer the greatest benefits from privatisation. Finally Group D consists of competitive industries with poor demand prospects, notably steel, BL and shipbuilding. These industries have already received substantial attention, and could receive more stimulus from further deregulation, as in buses. The consumer benefits from privatisation, albeit positive, would be low.

64. The present government has frequently declared its intention to privatise British Telecom, British Steel, BL and British Shipbuilders as soon as conditions permit. We do not argue against privatising these industries but, apart from British Telecom, our own analysis suggests rather different priorities; namely the CEGB, NCB, Rail and Posts. These five industries account for a rather greater proportion of the present nationalised sector as a whole than the current candidates (one half to two thirds, depending upon the yardstick adopted, compared to one third). Electricity generation, coal, rail and posts are seldom thought of as possible candidates for privatisation. In our view, however, privatisation of these industries would not merely be feasible, but (with telecoms) would generate significantly greater benefits to consumers than the privatisation of any other group of nationalised industries.