

PRIVATISATION OF PUBLIC TRANSIT: LESSONS FROM THE WIDER EXPERIENCE

: RUNQJ 3 DSHU1 R00000

David A. Hensher

Institute of Transport Studies
Graduate School of Business
The University of Sydney
NSW 2006
Australia

Michael E. Beesley

London Business School
London, NW1 4SA
United Kingdom



March 3, 1992

**Paper prepared for presentation at the 1992 Australian Bus and Coach Association
Annual Conference, Perth, April 5-9. The comments from Paul Hooper are
appreciated.**

ABSTRACT

Road-based public transport internationally is increasingly exposed to the economic elements of competition, private ownership and tendered operations as part of a strategy by governments to improve the efficiency of service provision and reduce the level of explicit subsidy from the State. The experience with increasing exposure to competition and privatisation is not limited to the passenger sector. In the United Kingdom for example, electricity, telecommunications, water and gas utilities have been privatised and opened up to competition. There are plans in progress to privatise the railways and the postal service. This paper reflects on the experiences to date across the set of utilities. The lessons for government, the role of efficiency objectives, exposure to capital markets, the weak bankruptcy constraint in the public sector, exposure to competition in the product market, price control, and the promotion of competition are addressed. The evidence has a direct bearing on future strategies for public sector transit agencies.

INTRODUCTION

Privatisation and increased competitiveness in all its manifestations continue to be attractive options for governments who seek greater efficiency. These governments recognise that they ultimately have responsibility for ensuring that socially necessary services are provided and that "fair-play" ensures the continuity of supply at prices (and quality) which are consistent with pre-defined objectives set for suppliers such as profit maximisation and (constrained) social welfare maximisation. But this ultimate responsibility does not require governments to own the services; indeed an effective umpire is one who has no vested interest in any of the players but an overriding commitment to ensuring that the game is executed efficiently, effectively and fairly. Any decision by government to provide direct financial support (albeit a subsidy) must, then, be justified solely on community service obligation. It is transparently easier to do this where there is an unambiguous separation between ownership, operation and regulation.

Privatisation and increased competitiveness is a learning process for governments and analysts, as is the relationship between the utility regulators and the more general pro-competitive institutions and legislation. The lack of experience and information acts as an inhibitor to change. The experiences in the last 10 years however provide a rich base of evidence to draw on as a spring board for ongoing debate. In this paper we document some of the important lessons including the role of efficiency objectives, exposure to capital markets, the weak bankruptcy constraint in the public sector, exposure to competition in the product market, price control, and the promotion of competition. The evidence has a direct bearing on future strategies for public sector transit agencies.

OBJECTIVES FOR CHANGE

Underlying the overt process of privatisation, especially in the United Kingdom, were two ideological objectives and a set of economic efficiency objectives. Ideology centres on the desire to shrink the direct state influence on economic affairs and the spreading of share ownership more widely within the population. "Shrinkage" was a synonym for reducing the influence of labour in State enterprises both in respect of the direct bargaining with unions and the incidence of labour in overall expenditure. Spreading share ownership either through listed acquisition or employee buy-outs was deemed to be incentive-compatible giving much more explicit links between principals and agents.

The great motivation for privatisation is the belief that more productive efficiency must be introduced into public enterprises. The loose association between tax payers ("principals") and governments ("agents") was shown to have limited if not negative incentives. Privatisation removes the Treasury's capital rationing constraint, which in the case of Telecom in particular was inhibiting profitable development. There has been a recognition that just because the market does not work optimally this is not a sufficient reason for government ownership. Government failure can be more serious than market failure. Privatisation also lessens substantially (if not solves entirely) the problem of multiple objectives imposed on public enterprises. Chief executives of State authorities continually complained in the 1970's in particular that they were never given an unambiguous brief with clear mandates and a single objective, which resulted in continuous "battles" between them and government. The introduction of a single commercial objective and an independent decision-making framework eliminates the hassles of dealing with government ministers and provides a more transparent basis for

identifying cost structures if government imposes or sought a community service obligation. The current status of the private bus industry in urban areas of New South Wales illustrates this benefit of private supply.

The manner in which privatisation has been implemented in the United Kingdom has exposed enterprises to market forces in various forms. The two major sets of market forces are exposure to the capital market and exposure to more product market competition. The former has not been given as much attention by economists as the latter. Creating market competition within the public transit sector has promoted a number of economic paradigms, ranging from economic deregulation to franchised "competitive" operating areas, with a number of variations on competitive tendering at the route and network level. Competitive tendering is somewhat more popular within urban areas and deregulation in the long-distance transit market. Competitive tendering in its various guises is a softer form of privatisation in which a service may be supplied by the private sector under a government determined set of operating requirements such as minimum levels of service prescribed in the 1990 NSW Passenger Transport Act. Specifically, competitive tendering forgoes the direct test for the existence of new or changed markets, available via free entry.

EXPOSURE TO CAPITAL MARKETS

The capital market discipline exposes a business to bankruptcy, to the possibility of takeover and has a direct influence on the supply of capital. In the context of promoting efficiency and competition the bankruptcy threat within a public enterprise is a very weak constraint. Although accountability for public money is never absent, the limits on behaviour when managing someone else's money (especially where "someone else" is not the transparent shareholder), are likely to be less binding. Exposure to capital markets also provides a real continuous market test of the value of an enterprise. Privatisation without flotation on the stock market means either a management buy-out (popular in U.K. bus privatisation) or sale by tender. The market is tested at the time of buy-out or tender, but there is no continuous test of the value of assets or of the appropriate opportunity cost of capital as there is in the case of a stock market flotation. But a private firm is always subject to the possibility of non-sustainable losses and hence the increased threat of takeover and merger. The incentives to be more efficient are very clear.

Exposing a business to the possibilities of takeover is closely allied to exposing an industry to managerial competition. Takeover is very largely a matter of one set of managers using the corporate vehicle to supplant another set of management. This increased rivalry among top management has an accompanying paradox - you cannot replace too many managers in a takeover otherwise you would have little to sell. The emphasis must be on top management, the individuals who receive the corporate gains and who are put at risk differentially in this process. There is strong evidence of a higher degree of turnover of top management in the lead up to and after privatisation. Government in the U.K. has progressively moved from a chauvinistic position in respect to takeovers (e.g. foreign shareholding restricted to 15%) to a more open policy, which will see a considerable amount of takeover after 1994. There appears to be no basis on ideological grounds for imposing "golden shares" for a fixed period which limits the powers of shareholders to change the direction of a business. The "normalisation" of a company should be open from the first day.

When there is a direct exposure to the capital market, a firm's cost of capital is now dictated by the required rate of return from shares of an equivalent risk class (or in the case of the absence of a trading market, by the opportunity cost of capital invested elsewhere). This strategically places a business in its correct risk spectrum, having an effect on the direct cost of raising capital at the margin. This has to be justified. Exposing an enterprise to stock market performance measures enables an assessment of share price behaviour relative to the market. This information feeds directly into the rating of managerial performance. Falling stock prices is an indication of poor management and the beginning of exposure to takeover. Unfortunately, the absence of a stock market indicator for private transit firms and the difficulty of creating a shadow market (given the problems of identifying the nature of risk due in part to the small amount of transacting) results in the use of a rate of return criterion based on an average return from alternative investments without due consideration of relative risk.

An additional advantage is that an effective monitoring system is created. There is an entire industry developed around financial advice which has a fiscal incentive to monitor performance and to take an interest in the affairs of the privatised enterprise.

In the United Kingdom experience with progressive privatisation of utilities - beginning with British Telecom, then gas, British airports, buses, water and finally electricity, has demonstrated the wisdom of increasing the potential for the market's influence over successive flotations by having smaller units to privatise. The number of privatised entities out of each utility has increased over time. For example, British Telecom and British Gas were kept intact, later there were 10 water entities, 12 electricity distributors and 70 bus companies. The need for more effort in restructuring before privatisation is essential. Why 3 English electricity generators when there are 72 generating sets? The answer must be guided by a combination of supply side considerations such as economies of scale and scope and estimates of the potential number of bidders under alternative packaging scenarios.

Privatisation requires a "track record" of at least 5 years accounts to put in the prospectus. Where an enterprise needs more preparatory time, corporatisation as an intermediate stage may have some appeal provided it is used as an opportunity to undertake the restructuring required for eventual privatisation. In the water and electricity authorities in the U.K. information and accounts were readily formed into several enterprises. In contrast, British Telecom prior to privatisation had a very inefficient accounting system and managerial structure resulting in it having little idea of business conducted with its largest customers. The top end of the market is where the greatest degree of competition is occurring. It took 6 years after privatisation to establish suitable accounting systems to identify the relationship with the 350 largest customers.

EXPOSURE TO COMPETITION IN THE PRODUCT MARKET

A desirable feature of a strategy to change the ownership profile of a business from public to private is to remove or lower barriers which have previously restricted competition. The private sector has a long history of presence in a competitive market. Critics have argued that not nearly enough has been done to lower entry barriers at the same time as privatisation. Consequently the gains from privatisation are not fully extracted, notably in the product market. The essential issue here is the extent to which a desirable condition for privatisation is economic deregulation. The key issue is what should government accept for selling "its property"? This increasingly relates to the

degree of competition ex post. This could be negative - with the government putting money in or donating property. In the larger utilities the political issue of selling the "family silver" cheap and Treasury's desires to use the proceeds for macro-economic purposes requires careful consideration of the timing of free entry for competitors. There is a rather different story for buses in the U.K.. Treasury was content to have "claw-back" rights for profits from property put into the management buy-outs. It could not hope for the cash flow associated with selling a big utility

In interpreting the "evidence" on deregulation, one has to be extremely careful to distinguish situations of ultra-free entry from situations with imposed conditions of entry. Evans (1990) has concluded on the basis of monitoring the performance of the local commercial bus route service market outside of London that a natural (private) monopoly on the supply side has evolved, leading him to suggest that there is a practical case for competitive tendering. However, entry was not ultra-free - the commercial registrant had to provide a minimum level of service, preventing in most situations the possibility of entry by the single vehicle owner driver or other smaller units of service. Cheap fares and subsidy have also been shown to be barriers to entry (Beesley 1992). Any restriction on entry in a partially deregulated market makes it extremely difficult to replicate the level of service supplied by an operator under a fully deregulated market. Regardless of the nature of economic deregulation, competition as a servant and not a master must be used to best advantage together with a clear specification of subsidy arrangements (where appropriate) and tendering conditions.

There is a conflict between exposure to the capital market and increased exposure to product market forces. You cannot sell anything to the capital market without selling something. What is it that is being offered to the capital market to attract funds? Even when a business has been dismembered, potential shareholders must have an incentive to invest. The incentive in a government enterprise with an unknown rate of return and risk portfolio is some value of a government right. This is some value of protection from entry - you have to sell the entity for something, so inherently if you want to get the capital market involved you have to pay the capital market for its participation. The premium is usually based on some arbitrary estimate based on the historical value of assets. Thus the practical privatisation process requires providing the capital market with some rents of the government position, including current barriers to entry for a period of time. The fundamental point is that there must be some demonstrated positive value for someone to consider investing in the enterprise. Without an appropriate market to reveal these rents (for example, what is the cash flow and profitability profile for a private supplier operating in the current catchment area of the public supplier of transit services?), government rights for a negotiated period become the carrot.

The process of establishing an attractive investment involves establishing the required rate of return by identifying an equivalent risk class. The value of what is being sold should be converted to present value terms. A firm with a present value of zero is a viable firm but not an attractive investment. The capital market needs a present value greater than zero. If the present value is to be greater than zero, the terms of sale have to be improved. This can and often is improved by a more generous price capping on cpi-x, for example. Since government both sets the x and wants security for the assets, there is no given solution to the trade-off. Hence an arbitrary value, such as historical cost is selected.

REGULATORY PROCESSES

A major feature of the privatisation process has been the accompanying divestment of regulation. Independent regulators have been set up in Britain for telecommunications (OFTEL), gas (OFGAS), water (OFWAT) and electricity (OFFER). These offices are responsible for two essential regulatory tasks - price control for (natural) monopoly and promotion of competition in situations where there is a typically high starting market share. They also provide a sharp focus for the first time for consumer complaints.

The enterprises which display a more or less permanent natural monopoly must be subject to price controls involving price caps (or rate-capping), popularly referred to as CPI-x. This formulation enables the regulator to exact reasonably tough conditions in terms of future financial performance and productivity. It is interesting to speculate the benefit of a CPI-x environment for the local private and public bus industry in Australia. An enterprise can make any changes it wishes provided that the average price of a specified basket of goods and/or services does not increase faster than CPI-x. The value of x has to be negotiated up front based on how a business or industry could perform, and then the agreement is in place for a fixed period. In the U.K., 5 years has been selected.

This form of price control has met with strong support. To ensure its effectiveness however, the independent regulator depends on three sources of information:

- . Cross-sectional comparisons (local or worldwide) in order to undertake bargaining of the separate monopolies if they are in place. This establishes best practice.
- . Cash-flow oriented predictions based on required rates of return. This information is critical. It requires a gradual move away from slavishly adhering to accounts as evidence on what the ex ante cash flow is going to be in the next 5 years or whatever period is agreed upon (20 years in the case of OFWAT).
- . Evidence of the required rate of return on assets.

These data requirements go deep into legislation. For example, the Water Act requires cross-sectional comparisons. It has consequently recognised explicitly the regulator's need to have comparisons by making very difficult any horizontal mergers in the English water industry. To preserve any challenges to incumbent managers, takeover is allowed provided there is no horizontal merger. The basis of any future change to the number of incumbents is conditioned on the need for the regulator to make comparisons. The possible disappearance of evidence is a strong counter merger requirement.

Furthermore, there has been a willingness to learn from stockmarket dealings about the required rate of return on capital. The challenge is to identify existing listed businesses which have a similar risk profile to the entity to be privatised. A capital asset pricing model is an important tool in this debate.

For industries without natural monopoly characteristics, the regulator has to ensure that competition is promoted and that fair play ensues. Gas supply, telecommunications, electricity generation and buses are examples of competitive industries. The regulator is charged with the task of creating opportunities to enter the market, using a managed competitive policy. Before the 1980's the U.K.'s general competition law was weak in

dealing with incumbent large firm power. Subsequently regulators had to be given power to stop predation, undue discrimination etc. The anti-trust law in the USA was not so weak because of the compensation possibilities which were absent in the U.K. In the USA, for example an incumbent proven to be damaging a competitor can be open to suits for damages at 300% of the cost of the damage. Under the competitive policy promoted by the independent regulator, there is a broad non-discriminatory clause so that a firm can be in breach of its licence if it discriminated unduly. The burden of proof of good behaviour is on the incumbent. This allows for the possibility that the incumbent might cost-justify any discrimination as might arise where he is trying to combat an entrant. For example, this feature of the process has prevented British Telecom from providing any effective counter to Mercury's capture of its big accounts. The cost to Telecom of trying to eliminate a small competitor is too high. The regulator's response would require British Telecom to discount to all customers rather than just the large customers (the latter being the set where competition from Mercury is most directed).

The strength of this approach comes from the regulator being pro-active with an ongoing monopoly or antitrust policy. The actual opportunities to enter the market are themselves a function of regulatory change. This makes for a very dynamic and market-responsive regulatory process.

The regulatory task in general involves two idea sets in economics, commonly referred to as the Austrian view and the neoclassical view. The neoclassical view starts from a paradigm of competitive equilibrium and considers variations in assumptions, shocks to the system and perturbations of cost and demand. The Austrian view generally regards market processes as signalling information with profits motivating a response. There is no equilibrium. Profit as the capitalist's engine comes from innovation, watered away eventually by competition, but with profits extracted along the way. Whereas the neoclassical view starts from the position of entry conditions being the same for all players, the Austrian view starts from the position of there necessarily being differences due to asymmetry of information for example. The Austrian view is centred on disclosure, profit seeking, information and disequilibrium, and the neoclassical view emphasises regulated prices, resource allocation and productivity. The Austrian view is central to a regulator managing competition, where the sources and disappearance of profits are the question - do they really exist or not. In contrast the neoclassical emphasis centering on long-run efficiencies and performance does not address the reality of making money against different changing opportunities.

The regulatory task then embraces both views in conducting a cost-benefit analysis on behalf of society, where some arguments are approached by the neoclassical response including welfare implications in line with a commitment to the consumer interest.

A paradox for the regulatory process is that if regulators get highly skilled in the areas necessary to run a competitively efficient business, there is a high probability of defection from the regulatory profession, with regulators entering the industry they previously regulated and making money as a consequence of the acquired skills. This is the reverse of regulatory capture.

CONCLUSION: SOME BIG LESSONS FOR GOVERNMENT

Privatisation highlights the extent to which public enterprises may have "conned" ministers over many years in respect of service and cost. The need to "turn stones" arises because of the focus on a prospectus. Disclosure processes often reveal the lack of price control and hence the state of inefficiency. The experience with independent regulatory authorities highlights the benefit of constructing a regulatory framework which minimises the costs of differences in information and objectives between the principal (government) and the managers of public enterprises (agents). Privatisation is particularly concerned with the role of ownership and management in this regulatory framework (Beesley and Hensher 1992).

There are clear efficiency advantages in the association of ownership and management, because it relieves incentive problems which arise if there is a separation between the ability to take decisions which have financial consequences. There are also efficiency gains if management is located at the place which holds fullest information about the effects of the activity.

Experience has demonstrated that the scope for privatisation via tendering principally exists in situations where the product specification is relatively uncomplicated and the technology is well known, so that the difficulties of prescribing contracts and of differences in the information available to the independent regulator and the regulated are relatively small. The public transit sector is well suited to privatisation.

REFERENCES

- Beesley, M.E. (1992) **Privatization, Regulation and Deregulation**, Routledge, London.
- Beesley, M.E. and Hensher, D.A. (1992) *Managerial efficiency, regulation and directional training in the public sector*, **Institute of Transport Studies**, Graduate School of Business, The University of Sydney, February.
- Evans, A.W. (1990) *Are urban bus services natural monopolies?* **Papers of the Australasian Transport Research Forum**, 15 (Part 1), 251-268.
- Farrell, P.:J. and Last, A. (1991) *Urban public transport institutions in Korea*, in M. Heraty (ed.) **Urban Transport in developing Countries: Lessons in Innovation**, PTRC Education and Research Services Ltd., London, 155-159.
- Kay, J.A. (1987) *Public ownership, public regulation or public subsidy?*, **European Economic Review**, 31, 343-345.