

How does Government exercise control over Privatised Industries?
The Case of Utilities in Victoria.

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Abstract:

This paper examines the electricity industry of Victoria in particular, and the utilities of Australia generally, identifying the mechanisms of control exercised by governments, which aim to regulate these, and similar natural monopolies.

The paper argues that as the markets for the outputs of utilities (water, gas, electricity, telecommunications, etc.) are less than perfectly competitive, such markets require the active intervention of regulators to ensure that consumers get “value for money”. Further, the prices “permitted” by regulators should reflect the full cost of service delivery, including the costs of any environmental degradation incurred in the production and delivery of services, the so called externalities of the economists! Further, the price to be permitted by the regulator should ensure that the rate of return to the service provider is commensurate with market rates of return for similar risk business activities.

The paper concludes with a research agenda to be pursued, which considers the comparative performance of the electricity industries in Victoria (privatised) and New South Wales (remaining in public hands).

Key Words: Electricity, Utilities, Accounting for Utilities, Externalities, and Regulation of Utilities, Australia, and Victoria.

How does Government exercise control over Privatised Authorities? The case of Utilities in Victoria.

INTRODUCTION:

This Conference seeks to examine issues, which will contribute to the enhancement of the efficiency and the effectiveness of the management of government business. It is clear that the last 12-15 years has seen significant change in the content and delivery of “government” services including, contracting out, build-operate-own-transfer schemes with the private sector, private-public partnerships schemes, and privatisation of government businesses. A common feature is the need to achieve efficient and effective outcomes in each chosen business structure within a wide variety of service and product delivery modes.

The questions raised in this paper include the following: -

- Are there general principles of the delivery of “government” services, which can be identified recognizing that service and product delivery systems vary widely?
- Are there any services and/or products that can be identified as “government” products and/or services?
- How should the delivery of such products and services be managed and regulated?

This paper examines the need for government regulation of utilities within a present political and economic environment, which heavily favours de-regulation of the economic system. What case can be made for the regulation of utilities such as gas, electricity and water? How should such utilities be regulated if regulation is necessary? Are the needs for the regulation of privatised businesses different from the needs for governance of non-privatised government activities?

If the needs for regulation of privatised businesses are different from methods of control over non-privatised government business, will this difference contribute to the fragmentation of governance within the public sector?

This paper argues that the privatisation of public assets, such as occurred in Victoria in the electricity and gas industries, requires that government create new models of governance, establish and invent new systems of control over such privatised businesses which will serve the “public interest”. As the electricity and gas industries are natural monopolies, and profit maximisers, it is clear that participant firms within these industries are able to control either the price of their output or the quantity of their output. Such control over either price or quantity will result in monopoly profits (rent) accruing to the participant firms as is demonstrated by classical micro-economic theory of the firm.

It may be true that consumers can choose between electricity and gas to meet power needs, which introduces into the market for energy an element of competition. Such being so, the ability of the producers of gas and electricity (and other energy providers) to control either price or the quantity of output may be constrained by competition between energy producers, perhaps resulting in constrained pricing or output decisions. Competition between energy producers could result in the market regulating prices or output in the interests of consumers. However, businesses established in both the gas and electricity, (sometimes the same business providing both types of energy,) also have established infrastructure for the delivery of their particular form of energy which inhibits the entry of new competitors into the industry, further limiting the effects of competition. Some consumers, particularly industrial users are also likely to experience difficulties and costs associated with the substitution of gas for electricity and visa versa.

As an example, it is a relatively simple matter for households to substitute a gas cooker for an electrical cooker, although such would occur at cost to the household. Households would be reluctant to make such a change at private cost with few likely benefits in the short or the longer term. It is a far less simple matter to substitute gas lighting for electrical lighting!

A further example demonstrates the difficulties associated with the substitution of energy. Manufacturers have usually identified the power supply best suited to their business, gas for brick factories and electricity for the aluminium smelter at Portland, Victoria. It is unlikely that either the brick manufacturer or the aluminium smelter will voluntarily change power supply because of the substantial set up costs associated with such substitution. In short, competition between suppliers of energy is likely to be weak and therefore unlikely to constrain the price or output decisions of providers.

Consequently, the argument that energy providers are, and can act as monopoly suppliers leads to the conclusion that they must be regulated to ensure that supply is maintained to consumers at reasonable prices, prices that provide a rate of return to producers which will permit their participation in the industry, and prices that are fair and reasonable to consumers. Price and or output decisions of suppliers must be regulated to ensure that profits earned by producers of energy are “normal” as defined by economists.

HOW SHOULD ENERGY PRODUCERS BE REGULATED?

We now consider how such privatised providers of energy are to be regulated. The following analysis refers particularly to the regulation of the Victorian electricity industry in the post-privatisation era.

Upon the privatisation of the Victorian electricity industry in the mid 1990's, the government of the day established the Office of the Regulator General (ORG), as the industry regulator. Further, and concurrent with the creation of ORG, the government capped electricity prices for a period of 3 years. This was actioned to provide ORG time and opportunity to establish a regulatory process, and to diffuse any likely public criticism of the pricing policies of the new private suppliers. A similar course of action was taken in the United Kingdom following privatisation; indeed much of the

regulatory framework adopted in Victoria was directly borrowed from the UK and implemented by staff with prior experience in the regulation of utilities in the UK.

Following a lengthy period of consultation with providers, consumers, industry and others, including the conduct of public hearings, ORG produced an Interim Order on 31st May, 2000 providing a ruling for the wholesale price of electricity for the 5 year period 2001-5. The ruling promulgated by ORG provided for a reduction in wholesale price within the range of 15%-20%. The new owners of the electricity assets were shocked as the reports in the press indicate. (Australian Financial Review, June 1, 2000, p1)

The new, mostly overseas multi-national owners of electricity assets, argued that the new price regime proposed by ORG was unfair, uneconomic and likely to result in reduced capacity investment in future periods. Further, producers argued that the rates of return upon their new, and substantial investments would be inadequate to sustain their medium to longer-term participation within the industry. How could this be so? The new owners of the assets of the industry had succeeded in buying the assets following a lengthy private tender process within which prospective purchasers had access to “private” (commercial in confidence) data provided by the government and its advisors on privatisation. Multinational corporations made decisions to purchase assets based upon the due diligence conducted by them. They made purchase decisions on the basis of information available to them as decision makers and investors. The highest bidders would win the prize! Prices paid by the ultimate purchasers were published and the government expressed delight as evidenced by the following statement of the Treasurer (Stockdale) to the Parliament of Victoria: -

“The electricity supply industry is radically changed. The monolithic SECV has gone, to be replaced by a number of distribution and generation companies all using a common transmission grid. The distribution companies have all been privatised, and we have also sold one of the generation businesses, Yallourn Energy (which was, incidentally, the largest privatisation to date in Australia). The remaining generation businesses will be sold as soon as commercially feasible.” (Autumn Economic Statement, Treasurer's Speech, 1996, p11)

The prices paid were clearly good from the perspective of the government and Treasury, however they were not good from the perspective of the new owners. The prices paid were in the range of 12.3 – 14.5 times the projected earnings before depreciation, interest, tax and abnormal items (EBDIT). (Norman, IPA, 2002, p3)

When price is 14 times earnings, it is the equivalent of a nominal rate of return of 7.14%, the rate of return being the reciprocal of the Price/Earnings ratio. At the time of privatisation, the risk-free rate of return as measured by the yield to maturity of a 10-year government bond was 8%! Inflation was approximately 3% per year at the time as measured by the Consumer Price Index; hence the real rate of return to the new purchasers approximated 4%, (7.14% less inflation 3%). This real rate of return

of 4% was below the nominal rate of return on a risk-free investment of 8%, and the real risk-free rate of 5%. Why would rational, profit seeking multi-national investors pay so much for the assets of the SEC? Were the new owners expecting higher returns in the future from electricity asset ownership? Were the new owners expecting anticipating a regulatory regime more favourable that ultimately delivered by ORG? The government had promised “light-handed” regulation of the industry, meaning that regulation would not be un-necessarily intrusive. The actions of ORG as the industry regulator, subsequent to the purchase by the private sector of the electricity assets, proved to be a great disappointment to the new owners of the assets. As a consequence, most of the initial purchasers of the electricity assets have departed and on sold assets to other organisations in subsequent years. (See Norman, 2002, p5-6)

The history of regulation by ORG, together with the constant changes in the ownership of Victorian electricity assets suggests the following propositions: -

- The new owners paid too much for the assets of the SEC; and
- As a consequence of paying high entry prices, the rates of return earned by the new owners were not sufficiently high to sustain ownership; and
- The price/output decisions promulgated by ORG created further problems for the producers by failing to permit price rises sought by the new owners; and
- The exit from the industry of ALL initial purchasers of SECV assets and the subsequent exit of most follow-on purchasers.

Are the above propositions evidence of successful or failing Regulation? Consider the following issues that emerge.

- Prices for Victorian electricity have risen in real terms since privatisation;
- Consumption of Victorian electricity has risen per capita since privatisation;
- Supply interruptions have risen since privatisation;
- Greenhouse gas emissions have risen since privatisation;
- The rates-of-return to the private providers listed on the ASX have rises since privatisation,
- Industry disruption has occurred following frequent changes in the ownership of the industry;
- ORG has been succeeded by a new regulator, the Essential Services Commission; and
- The foundation CEO of ORG has retired.

FRAGMENTED GOVERNMENT REGULATION

This paper has argued that the privatisation of the electricity industry in Victoria required the government of the day and subsequent governments, to install a regulatory regime that was particular, peculiar and necessary for the regulation of a natural monopoly in the public interest. Whether the form of regulation adopted by Victoria was successful remains to be evaluated and is a matter of continuing research noted in the conclusion to this paper. One consequence of the regulation of natural monopolies in Victoria (and elsewhere) is the necessity to establish a particular form of regulation for such industries. The establishment and maintenance of specialized

regulatory authorities with specialist staff and funding from government represents a cost to the community, which must be measured against the benefits of such regulation.

Such specialized regulatory authorities are not necessarily relevant to other forms of government oversight (or regulation) which occur in circumstances where market conditions of supply are competitive and not monopolistic, for example the supply of printing services to government which occur from within competitive markets which constrain price and output decisions of potential suppliers through the tender for supply system.

Further, regulatory systems such as those established for natural monopolies do not apply and are not relevant to the supply of goods and services to government which are subject to appropriation by the parliament, examples being the supply of judicial services to the community. The long established processes of parliamentary control over expenditures, reformed by Gladstone in the UK in the 19th Century, are not relevant or necessarily appropriate, to the supervision and regulation of natural monopolies.

As a consequence it is necessary for the government to establish, review and reform, from time to time, methods and systems of government control over expenditures, which will ensure efficient and effective service delivery.

Regulatory systems for natural monopolies can be extended to cover the regulation of all natural monopolies; gas, water, telecommunications as well as electricity, and some economies of scale can be achieved as a result of the establishment of Essential Services Commissions (or similar bodies). However it is noted that we do operate within a Federal system of government in Australia, and, in the case of energy markets, do have a national regulator (NEMCO) as well as regulators at each State level. Ownership differences are in evidence within the energy industry when considering the individual circumstances of each State, and therefore each State will require regulation suited to its particular circumstance. Do the benefits of such widespread regulation exceed the costs of such regulation?

CONCLUSION

All of the above indicates that privatisation requires particular regulation in the public interest, regulation in addition to the normal controls exercised by government over expenditures subject to the control of parliament. Fragmentation of government control is the inevitable result!

At the end of the day might it have been better, and in the public interest, to leave the ownership on natural monopolies in public ownership, thus subject to the direct supervision of parliament? Such would avoid the necessity to establish specialised regulatory bodies.

Are the now privatised natural monopolies more efficient and effective deliverers of goods and services? Research into this issue is continuing by comparing the efficiency and the effectiveness of the Victorian (privatised) electricity industry with the industry of NSW, which remains in public hands. Turning to other privatised natural monopolies, how efficient and effective has been the privatisation of rail and tram services in Victoria and Melbourne? We observe, as with electricity in Victoria, constant changes in ownership of transport assets. In the case of tram and metropolitan rail services, the re-establishment of a single service provider in each case!

To conclude, should not the Victorian government borrow funds at presently prevailing (historically low) interest rates, and buy back the privatised assets, thus avoiding the necessity to establish fragmented governance structures often beyond the clear control of the Parliament?

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