PRIVATISATION AND MONOPOLY POWER

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EXECUTIVE SUMMARY

SECTION I : INTRODUCTION

This paper explores the possibility of privatisation in those industries where monopoly is likely to be a problem, such as electricity, gas, water and airports. Section I is a statement of general principles; Sections II and III apply the analysis to electricity and airports.

SECTION II : GENERAL PRINCIPLES

This paper argues that the conventional "natural monopoly" argument - that in certain industries economies of scale are so great that competition cannot be sustained, hence regulation as public ownership is required - is of doubtful relevance and does not constitute an adequate basis for analysis. The real problems of creating competition stem from the asymmetric positions of incumbents and potential entrants with respect to

i) assets and costs

ii) access to resources and technology, and

iii) government granted rights and dispensations.

By reducing these asymmetries, appropriate public policy can facilitate new entry and stimulate competition, even in the industries under examination. Restructuring has an important role to play here. Moreover, the advantages of privatisation in maximising consumers' benefits are greater than commonly appreciated, and to a significant extent are achieved even in the absence of competition. The general conclusion is that, even in those industries where monopoly power is potentially a danger, privatisation can still yield consumer benefits. However, it must be accompanied by more substantial action to generate competition than is necessary in the case of other nationalised industries.

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SECTION III : ELECTRICITY

Two alternative schemes for privatising the electricity industry have been considered. One is regional separation: the entire industry would be privatised, but protection as well as efficiency requires significant moves to facilitate new entry and competition between regional companies. The alternative scheme involves functional separation: the generating stations would be sold independently as would the area boards, while the national grid would remain in public ownership. In the latter case, it might be possible to separate the area boards into publicly owned distribution networks plus competing private 'retailers'. Both schemes seem to be an improvement over the present arrangement, and would meet the criticisms levied at the industry. The second scheme perhaps offers potentially greater benefits to consumers, but would not be so straight forward or politically expedient to implement; it therefore requires further examination. Which ever scheme is adopted, the danger of poorer long-term planning seems minimal and the larger the number of successor companies the better the prospects for competition.

SECTION IV : AIRPORTS

The BAA should be split into separate airports because the economic objectives of the airports should be quite different from each other. Privatisation would lead to increased efficiency and flexibility in all cases, but the adverse consequences of private ownership differs in importance. At Heathrow it is important to allocate severely limited capacity to the most valuable uses; increased landing fees would be a beneficial rationing device. At Gatwick the danger from monopoly power is greatest, and the case for continuing public ownership plus performance indicators is quite strong; but on balance privatisation is preferred. At the other airports privatisation could secure financial viability, or it could mean retrench-

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ment or closure; if this is socially undesirable then subsidies need to be proved, which are best administered via public or municipal ownership.

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SECTION I GENERAL PRINCIPLES

Background

1 In a previous paper entitled 'Privatisation: Principles, Problems and Priorities' (Lloyds Bank Review, July 1983), we sought criteria to decide whether a particular nationalised industry is a serious candidate for privatisation, and how the industry should be structured and the regulatory environment designed. It was found convenient to classify the nationalised industries in a simple two-by-two matrix. Demand prospects were classified as Good or Bad, depending upon likely long term trends, and supply prospects as conducive to Single or Multiple competing ownership, depending upon likely developments in technology.

2. Using the criterion of aggregate net benefits to consumers, privatisation was recommended in three of four quadrants. The benefits of privatisation would not be outweighed by significant danger of monopoly power where multiple competing ownership was feasible, or where single ownership was faced with declining demand (due to the growth of substitutes). The appropriate means of privatisation, the measures necessary to strengthen competition, and the benefits to be expected, would of course differ according to the circumstances of each industry.

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3. The fourth quadrant (labelled A in the Lloyds Bank Review article) contained those industries (or parts thereof) where demand prospects were Good, but where supply prospects favoured Single ownership. (These are sometimes referred to as "natural monopolies".) Electricity distribution, gas distribution, local telecoms and airports were placed in this quadrant. (The water industry, often treated as a nationalised industry, might be added to this list.) Privatisation of these industries seemed likely to pose problems in curbing monopoly power. Our interim conclusion was that greater benefits could be expected from encouraging competition by restructuring the industries and removing barriers to entry.

The Present Paper

4. The purpose of the present paper is to investigate further the possibilities of privatisation for industries in this fourth quadrant. Is the present nationalised status in fact the best that can be designed? Would some modified form of privatisation (eg: regulation, franchising, or a privately financed but "not for profit" public corporation) offer any benefits? Can the industries be restructured to allow private ownership in parts of them?

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5. The feasibility and advantages of privatisation are related to the extent of competition. The present (nationalised) incumbents of the UK gas, water and electricity industries have dominant market shares, in some cases approaching 100%. Similarly, BAA accounts for over 70% of flights into the UK, and operates the two most important airports in London where it has a market share of 95%. Why is competition virtually non-existent in these industries, and would it be possible to increase it? More generally what patterns of structure, ownership, competition and regulation would be likely to maximise the benefits to consumers in these so-called "natural monopoly" industries?

6. The paper is divided into three main sections. Section II is concerned with general principles. It argues that the "natural monopoly" argument is of doubtful relevance and inadequate as a basis for analysis. Closer examination shows that public policy generally can stimulate competition, especially by restructuring and removing artificial barriers to entry. Moreover, the advantages of private ownership are greater than is commonly realised, even in the absence of competition.

7. To illustrate and test the approach, Sections III and IV apply these general principles to electricity and airports respectively. The aim has been to identify the important considerations involved, to provide a structure for analysis, and to highlight potential "solutions" which seem particularly promising or unpromising. Of course, there has not been time to carry out a thorough investigation of these industries, so the conclusions are necessarily tentative.

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II GENERAL PRINCIPLES

Natural Monopoly

8. The natural monopoly argument is briefly as follows. An industry is said to be a natural monopoly if it is less costly for a single firm to produce the required level of output than for two or more firms to produce the same output between them. Geometrically, this will be the case if the average cost curve is continually falling. In these circumstances, the largest firm will be able to undercut the prices charged by smaller firms. Eventually, it is argued, the largest firm will be able to drive out all its rivals, and subsequently raise its prices to earn monopoly profits.

9. Several objections have been raised to this argument. First, it has been pointed out that not all the activities of alleged natural monopolies are in fact characterised by ever-decreasing costs. For example, there seems to be a distinction in this respect between the generation and the distribution of electricity, and similarly between the transmission and local distribution of telecommunications. Indeed, Primeaux ( ) has argued that, on close examination, US electric utilities are not natural monopolies by any conventional definition (eg: they are not characterised by unusually large economies of scale or high fixed costs). Moreover, prices are in fact lower in US cities served by two competing electric utilities (Primeaux 1982). Thus, whether any industries are natural monopolies is not at all clear.

10. A second objection is to the logic of the argument that economies of

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scale (decreasing costs) necessarily lead to an absence of competition and to monopoly profit. Demsetz (1967) pointed out that a local authority (or other agent acting on behalf of consumers) could invite bids from potential producers. Although competition _within_ the field is not viable, competition _for_ the field may well be feasible, and this will eliminate monopoly profit. (Whether competition of this kind is effective will depend upon such things as transaction costs and the pattern of sunk costs: we discuss these shortly.)

11. More recent analysis by Baumol et al (1982) recasts and formalises the natural monopoly analysis. They define a monopoly as "sustainable" if there exists a set of prices at which the incumbent would make a profit but a potential entrant would not. If there is free entry (perfect contestability") the mere threat of entry will ensure that a monopoly is sustainable only at price(s) equal to minimum average cost. The incumbent will earn monopoly profit only to the extent that there are costs of entry. This of course is the Damsetz argument. Baumol et al, identify a theoretical possiblity of a natural monopoly which is _not_ sustainable, in which case new entry leading to _higher_ total costs may occur. No such case has yet been identified in practice, and it is not clear that it would be feasible even in theory. In any case, Baumol et al are at pains to emphasise that an unsustainable natural monopoly would not necessarily imply the desirability of restricitons on entry. (The value of this analysis for policy purposes is severely limited by its static nature and absence of sunk costs and demand-side effects; we return to these shortly.)

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12. A third objection to the natural monopoly argument stems from empirical work on the effects of regulation in the US electric power industry. If the purpose of regulation were to protect consumers against natural monopoly, one should observe lower prices in states where (private) electric utilities are regulated than in states where they are not (after allowing for differences in costs etc). Stigler and Friedland (1962) showed that this was not in fact the case: no significant differences in prices or profits could be detected. Stigler later conjectured that the real purpose of regulation was to protect producers rather than consumers. Further investigation by Jarrell (1978) confirmed that pressure for regulation did indeed come from the utilities themselves, seeking to escape the rigours of competition consequent upon the liberal granting of franchises by municipal authorities. Those states where regulation was instigated at an early date exhibited significantly lower prices and profits than did late-regulated states, and the effect of regulation was sharply to increase prices and profits.

13. Finally, it has been pointed out that even if the impossibility of competition is accepted, unregulated private ownership nonetheless has many advantages over regulation or public ownership (Posner 1968). Both theory and evidence suggest that unregulated privately owned firms are typically more efficient and more responsive to changing technology and consumer preferences (De Alessi 1974,1980). These advantages must be set against, and may outweigh, the disadvantages of unregulated monopoly pricing.

14. To summarise, the natural monopoly argument for government regulation or public ownership can no longer be taken at face value. (1) It is not clear that the conditions for natural monopoly apply in practice.

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(2) Natural monopoly does not necessarily imply monopoly profit. (3) The effect of regulation in the US has been to exacerbate rather than alleviate the alleged problem. (4) Private monopoly may be preferable to public monopoly. A more adequate framework of analysis must therefore be sought.

Problems of Entry

15. What are the problems faced by a firm considering entry into an industry? It will be helpful to consider them under the following three headings:

- asymmetric assets and costs
- asymmetric access to resources and technology
- asymmetric legal or institutional barriers to entry.

All three types of asymmetries may be exploited by anti-competitive conduct by incumbents.

16. The competitors in a market are seldom, if ever, on an equal footing. They do not start with a "clean sheet". The incumbents are in a quite different cost situation than potential entrants. An incumbent has specific and durable assets in place (embodying sunk costs), whereas an entrant has not yet committed himself to the purchase and installation of any such assets. (The incumbent may also have obligations of which the potential entrant is free.) Insofar as the entrant will have to incur capital as well as operating costs, his opportunity cost of production will typically be higher than the incumbent's. However, the entrant's relative position will be less unfavourable the shorter the physical or economic life of the incumbent's assets and the faster the rate of growth in market demand. At the one extreme, if existing assets are likely to

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last for 50 years, and if demand is more-or-less static, potential entrants are unlikely to see any prospect of a positive return on investment. At the other extreme, if existing assets are wearing out, and if the market is expanding beyond present capacity, then the potential entrant may be roughly on a par with the incumbent, and new entry is highly likely to occur.

17. Entry is precluded if incumbents have sole ownership of some necessary input for production. Entry is difficult if incumbents have access to superior resources. Conversely, entry is facilitated if entrants have access to better technology than is embodied in presently in capital.

18. Legal or institutional barriers to entry take a variety of forms, such as rights of way, planning permission, statutory monopoly or monopsony, licensing of competitors, exclusive or superior rights to resources or technology etc. Inadequately defined property rights (eg: in water supply) can also prevent competition from operating.

19. Incumbents can attempt to deter potential entrants in various ways. Frequently suggested examples include the bringing forward of new investment, predatory pricing, refusal to make available facilities required by competitors (eg: inter-connect), extension of monopoly power to competitive markets (eg: by tie-in sales or vertical integration) limiting access to new technology so as to limit the number of experienced rivals, etc. There is some doubt whether such tactics are sensible in a competitive market, and indeed whether they are sufficiently prevalent to warrant attention. However, there does seem cause for concern where

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the incumbent has an overwhelmingly dominant position (eg: approaching 100%), where this position is due not to superior performance but to statutory protection, and where the incumbent (under public ownership) may not be motivated by commercial considerations (eg: it might be willing to lose money in order to prevent entry).

20. Public policy can aim to alleviate these problems of entry, though the appropriate mix of actions will depend upon the circumstances of each industry. The asymmetric cost advantage may perhaps be eliminated or reduced by restructuring the industry (eg: dividing the single incumbent's assets between several successor companies), by imposing constraints on the incumbents's activities, and by separating activities where asymmetries are important from those where they are not. Technological development can be fostered independently of the incumbent. Anti-competitive conduct may be tackled by strengthening competition policy, restructuring the industry, removing institutional sources of monopoly or changing ownership.

Restructuring

21. The concept of restructuring is relatively unfamiliar, but likely to attain increasing importance in the context of privatising the industries under discussion in this paper. Some further outline of its nature and potential benefits may be helpful.

22. The production of any good or service typically requires a whole chain of activities, which need to be co-ordinated in some way. Those activities which take place within an organisation are directly co-ordinated by the management of the organisation, whereas activities by different organisations

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are co-ordinated by market transactions. In both cases co-ordination is means of a contract, but in the former case the "contract" is usually an implicit one, between different divisions of a single organisation, and there may not be any transfer of cash, whereas in the latter case the contract is usually explicit and specifies the cash payment to be made. In either case, both the parties will incur costs in achieving co-ordination (eg: communicating what is required and what can be offered, monitoring whether the contract has been properly met, resolving differences of opinion or interpretation, adjusting the contract in the light of changed conditions, etc).

23. Restructuring an industry means grouping the various activities in a different way, so that market transactions replace some former intra-organisation directives, and conversely. For example, using brackets to denote organisational boundaries, activities A, B, C, D, ... might be run by separate organisations (A) (B) (C) (D) instead of by a single one (ABCD), or the grouping might take place at a different stage eg: restructuring (AB) (CD) to (A) (BC) (D).

24. The structure of an industry might reflect attempts to secure or prevent monopoly power; this must be taken into account in restructuring. Equally important is the likely effect on costs. Ronald Coase (1937) argued long ago that a privately owned firm would use the market if and only if this were cheaper than to organise production itself, ie, it would compare the costs of the two types of contract. In the absence of monopoly, the structure of an industry (ie: the size and scope of firms in it, and whether it is characterised by vertical or horizontal integration) would tend to minimise the costs of co-ordination. Government enforced restructuring of a competitive industry might lead to higher

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total costs. However, the present structures of nationalised industries were not determined with cost minimisation in mind. Restructuring could well reduce both costs and monopoly power.

25. A dozen or so useful consequences of restructuring can be identified in more detail:

i) separation of an entity into those parts which are potentially competitive and those parts where monopoly power is more severe (eg: terminal equipment and local networks in telecoms) thereby easing the problem of regulation;

ii) creation of competition between hitherto component parts of an entity (a) "horizontal" competition (eg: break up of Standard Oil or NCB; (b) "vertical" competition via forward or backward integration;

iii) creation of markets for factors of production, notably management, therby providing alternative career prospects;

iv) replacement of intra-firm directives by market transactions, thereby enforcing more explicit valuation of costs and consequences;

v) offsetting or eliminating the sunk cost advantage of incumbent, thereby facilitating new enty;

vi) reducing the incentive and scope for anti-competitive conduct (eg: by removing "upstream' source of monopoly, or by reducing funds available for predatory pricing);

vii) facilitating regulation or competition policy by reducing the size and scope of each unit's activities;

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viii) clarifying corporate objectives (one objective per organisation);

ix) facilitating new entry by giving some successor companies incentive to encourage it (eg: to offset monopoly or monopsony position of other successor companies);

x) facilitating experimentation with different ideas:

xi) adding to the number of independent sources of knowledge in the industry;

xii) easing flotation;

xiii) improving effectiveness of capital market processes after privatisation, especially takeover.

26. At the same time, several potential dangers of break-up must be borne in mind:

i) an increase in costs of co-ordination between organisation;

ii) increased exposure to risk, leading to less investment;

iii) exposure of monopoly power hitherto not exploited because located entirely within an organisation

iv) new organisations without individual track records may be more difficult to float.

27. It is commonly believed that integration facilitates co-ordination between different parts of the organisation, hence improves long term planning. If so, break-up would lead to poorer planning. But the argument is by no means obvious. As noted earlier, internal organisation has costs, just as using a market does. Splitting-up an organisation would increase the knowledge available for planning, because each successor organisation,

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faced with the need to make commercial decisions, would have to think more explicitly about its objectives and alternatives (eg: precisely what form of contract would be best?). The successor organisation would also need to think more clearly about planning than was previously necessary in view of the protection afforded by risk-spreading under vertical integration.

28. It will generally be difficult to predict whether one form of structure will lead to higher or lower costs than another; it may be easier to predict the effects upon competition. The emphasis should therefore be upon restructuring to maximise the prospects for competition, with flexibility for the successor companies to merge or demerge as market forces reflecting relative costs suggest, provided that competition itself is not jeopardised.

29. It will not be possible to generate as much competition as one would like, particularly in static or declining industries where institutional barriers are difficult to remove. In may cases, however, worthwhile improvements can be made, notably in industries where (a) the market is characterised by change and growth (b) where there have been substantial barriers to entry which can be removed or reduced and (c) where anti-competitive conduct can be precluded or policed. Furthermore, restructuring of an industry promises benefits even where other conditions are not favourable: restructuring reaches the parts that other methods cannot reach.

Private Ownership

30. Suppose an industry is restructured and entry barriers are reduced with a view to increasing the role of competition. What further benefits are

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to be gained from a transfer from public to private ownership? Do these benefits depend entirely or mainly upon the existence of competition?

31. Economists, as well as the general public, have stressed the danger that a private monopoly will raise prices, reduce output and thereby reap increased profit at the expense of consumers. But each aspect of this argument can be challenged. Competition from substitute products may prevent any significant price increase. Existing prices can be "too low" (eg , due to externalities) so that a price increase may be in the public interest. (Government pressure to increase gas and water prices is refeuded partly on such grounds; airport pricing discussed in Section IV below is another example). Private owners have a greater incentive to use price discrimination and flexible tariffs, which may well have the effect of increasing output. Evidence from the US electric industry suggests that private companies have higher prices but greater output per customer than public companies. Fianlly, monopoly profit need not be received by the monopolist or its private shareholders: since the market price of a company capitalises the expected future profit stream, the entire monopoly profit may be captured by the government (on behalf of taxpayers) at the time of flotation, so that shareholders receive only a normal return on their investment.

V. theoretical

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32. Our previous paper's four main points concerning the benefits of private ownership were first, that it increases responsiveness to consumers wishes:-

> "...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 witherh and die. The discipline of the capital market accentuates this process: access to additional resources for growth depends on previously-demonstrated ability."

33. Second, private ownership has to be seen against the realistic alternative of a UK nationalised industry, not against some hypothetical ideal public enterprise. Nationalised industries are constrained by governments with respect to pricing, investment and employment. These constraints necessarily reflect short-term political pressures and macro-economic considerations. Efficiency is not deemed unimportant, but ranks low in the hierarchy of aims. Within a nationalised industry, greater weight is placed on convenience, on minimising disturbance and effort, and on a "quiet life", than would be the case in private industry. Privatisation thus substitutes market discipline for public influence and managerial convenience.

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34. Third, private ownership makes competition more effective. Consumers benefit from competition only if each company seeks to provide better service than its rivals, rather than seeks a "modus vivendi" with minimum effort, and if it responds to poor results by increased efficiency rather than by mounting losses.

35 Fourthly, privatisation may be politically necessary to increase competition. Governments are reluctant to open up nationalised industries to competition, or to apply competition policy to the. Privatisation provides the opportunity - perhaps the obligation - to modify entry barriers and reallocate monopoly rights or resources.

36 In the context of the present discussion, some further elaboration of the nature and inter-relation of competition and private ownership is appropriate. There is a tendency to measure the extent of competition merely by the number of firms in the industry, and to suppose that a monopolist is immune to market forces; under such assumptions the case against private ownership seems overwhelming. But neither assumption is correct, and the case for private ownership is significantly stronger than is at first apparent.

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37 In the static model of the economic textbook, the decision-maker chooses prices and quantities of 'given' outputs and inputs. Private ownership merely changes the criterion for choice (the objective function); it is thought to lead to lower costs of prodcition (improved 'X-efficiency') but to lower output and higher prices (worsened 'allocative efficiency'). But in the ever-changing world of reality, there are opportunities to develop new techniques and design new products. Private ownership provides greater incentive to discuover or create these opportunities: these long term consumer benefits must be set against - and may well outweigh - any short term disadvantages of higher prices or restricted output. (Put in textbook language, the development of new products and markets, and the consequent redeployment of resources, means that private ownership may well increase both 'X-efficiency' and 'allocative efficiency'.) This suggests that the case for privatisation will be stronger the more rapidly are technology and the pattern of demand changing - or could change if the incentives to do so were provided.

38 Even where there is little apparent competition for the firm, there is always competition within the firm, between managers vying for promotion. Each manager will seek to prove his ability and desirability to those in overall charge of the firm. His conduct will therefore reflect the objectives of the firm. If it is privately owned, hence profit-oriented, he will be seeking to reduce the costs of the operations under his command, improve the productivity of his assets, increase sales, etc. The private capital market enhances this process in two ways: insofar as takeover bids replace poor management, the thread ot takeover keeps managers altert, thereby increasing managerial efficiency. There is also a carrot as well as a stick: managers with demonstrated ability are more likely to get attractive offers of

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employment from other organisations. One of the best indicators of performance is of course the profit record and the stock market ranking of the firm. The stock market provides a signal. Thus, both restructuring and privatisation increase managerial efficiency, to the advantage of the consumer, by creating better functioning markets for executive talent.

39. Finally, focus on the number of firms in an industry deflects attention from competition between forms of organisation and contract (Alchian 1983, Williamson 1981). Choices have to be made between sole proprietor, partnership, limited liability, 'not-for-profit' friendly society and public ownership; between franchising and employee-operated branches; between 'make' and 'buy' arrangements; between vertical integration, joint ownership, long-term or short-term contracts, etc. Which types of arrangement, and under which conditions, most encourage investment by limiting risks, best correlate reward with productivity soonest identify and promote ability, most flexibly respond to changing market conditions? The evolution of organisations and contracts is a significant feature of the competitive process. Such competition is likely to be more intensive, and more oriented to the consumer, under private ownership than under public ownership. Where changes in procedure require acts of parliament or ministerial agreement arrangements once adopted become ossified. With respect to forms of organisation and contract, as in methods of production and variety of product, private ownership offers significantly greater flexibility and responsiveness to changing conditions.

Alternative Forms of Ownership

40 In some monopolistic areas, it may be possible to use market processes to retain rivalry among firms if the assets can be bid for, and a 'franchise' awarded - i.e. a permission to be the sole operator. Reported experience

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of such franchising is not encouraging, but much of the difficulty may be attributed to the mixing of objectives by those authorities giving the franchises. An example is Cable T.V. in the U.S.A. where efforts were made to impose extraneous elements of non-commercial behaviour as a condition of contract. Since these conditions were not practically able to be monitored, and the social costs of cancelling the contract were high on the authorities' side, many very sloppy contracts were revealed. There is also the difficulty of setting the re-contract period so as not to deter continuing investments. One possibility to deal with this would be to give very long term franchises, but to rely upon the capital markets to pursue take-overs of the franchisee. If these take-over threats were really serious, this would encourage efficiency in the exploitation of the purchase. Obviously, the larger the firms the less likely this is in practice. The device does find a place in opening parts of certain nationalised industries to privatisation, as argued below in the case of airports.

41 Another possibility is the conversion of nationalised industries into independent, self-financed but non-profit making organisations. The aim is to protect the organisation from arbitrary intervention by government (which has undeniably operated to the disadvantage of most consumers of nationalised industries), while at the same time relying on the capital market to ensure an element of financial discipline. Where the context is one of strong competition, there is no reason to expect an unacceptable performance by a non profit organisation; it has to emulate to survive. But the context we are supposing is very different. The various advantages of the profit motive under full private ownership have to be sacrificed, and there is the difficulty that the governing body of the organisation must be held to embody the public interest. This is unlikely to seem attractive to governments, not least because of the failure of the Morrisonian ideal for nationalised industries (which was that the public interest could be secured by suitably selected Boards).

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The question of how to influence the trustees to further consumer interests, without either constructing something akin to departmental supervision of nationalised industries or relying on market forces as in privatisation, seems insoluble. The non-profit corporation requires one to delegate the interpretation of the public interest. Governments in practice refuse to do this.

42 To summarise, Section I, competition and private ownership are both devices for increasing the role of market forces, and hence securing the distribution of resources in accordance with consumers' wishes. But they are complements, not substitutes. Each is necessary to ensure maximum benefits from the other. Moreover, the benefits of private ownership are greater than commonly believed, not least in those industries where competition appears to be absent. If privatisation at first sight poses problems of monopoly, wherever possible means should be sought to increase competition to counter this, rather than sacrifice the benefits of private ownership.

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SECTION IV ELECTRICITY

Outline

43. We first note the various criticisms of inefficiency which have been levelled against the U.K. electricity industry. Regional separation has been proposed: would not necessarily lead to lack of coordination, but neither would separation alone be expected to increase efficiency. Private ownership of the regional companies would increase efficiency, but would also constitute an increased threat of monopoly. Regulation intended to curb monopoly power would reduce the incentives of efficiency. The various problems of new entry are examined, and measures to promote competition are proposed as preferable alternative to regulation.

44. Restructuring of the industry along functional lines would have certain advantages, especially at the generating stage, where effective competition could be envisaged. To curb the monopsony power of the area Boards, the national grid might need to be left in public ownership, but taking on a relatively passive role (transmitting current but not buying and selling on its own behalf). It might be possible to apply a similiar idea ot the area Boards, so that competing 'retailers' would buy and sell power across nationalised local distribution networks. The feasibility of these arrangements requires further investigation.

Criticisms of the Industry

45. The electricity industry is expanding and is a profitable one. It has not been subject to the criticisms levied at the declining and loss-making nationalised industries. Perhaps the relative lack of competition

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has concealed any inefficiencies. Nevertheless, it has not been immune to criticism.

Some of the recent allegation are as follows (of Peyke[1981], Redwood[1980]):

i) Poor demand forecasting and slowness to respond to changing economic conditions;

ii) Delays in construction;

iii) Choice of wrong nuclear reactor type;

iv) Excessive planning margins;

v) High manning levels and low productivity, especially at power stations but also at area Boards;

vi) Willingness to pay high prices for U.K. coal, and to hold high stocks;

vii) Overall losses on appliances, installations, servicing and other contract work;

It is worth noting that criticism is also levied at the government's role in the industry - for example, in pressuring the industry to buy British and increase the power station order rate. The electricity industry has been used to maintain the work load of ancillary industries and to manipulate public expenditure and finance.

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46. There is thus ample scope for increasing efficiency and operating more directly to the benefit of consumers. The scope for improvement is probably greatest at the generating stage, but by no means confirmed thereto.

Regional Separation

47. One possibility is that the electricity supply industry should be restructured along regional lines, with each regional company responsible for both generation and distribution within its own region. A regional company would thus comprise those generating stations, and those parts of the national grid transmission lines and local distribution network which fall within its region.

48. The national grid would disappear as an organisation, but the physical grid transmission lines would still remain, owned solely or jointly by the appropriate regional companies. They could therefore transfer power between themselves by mutual agreement i.e. as embodied in a market transaction. This would not necessarily cause any increase in costs or loss of efficiency compared to the present arrangement. The CEGB in fact operates on a regional basis at present. Each of seven CEGB regions is responsible for generating power for its own region, and for periodically conveying to National Control information on expected availabilities, demands and marginal costs; National Control then adjusts transfers between regions as necessary. Under the proposed alternative system, regions would make their own transfer decisions against a 'market price' for bulk power, rather than leave National Control to make transfer decisions against a 'national cost' standard.

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The expertise presently held at National Control (e.g. re comparative costs) would be diffused among the regions. Alternatively, independent 'power brokers' might set up in business, specialising in forecasting demands and availabilities knowing where to buy cheaply, bearing risks by buying on long term contracts and selling short-term etc. A system of this kind is apparently in operation in Florida.

49. With respect to new investment, also, the regional companies separately take on the forecasting tasks of the CEGB. Each company would have to compare the costs and risks of expansion of its own capacity against the costs and risks of buying in from other companies: in this way there would be a tendency towards a cost and risk minimising pattern of investment across the country as a whole.

50. There are three main disadvantages of the regional companies. First, they would not alleviate the problem of monopoly. Consumers in each region would have only one source of supply (except to the extent that competition could be facilitated - see below). Second, regional separation alone would not necessarily lead to any increase in efficiency. The incentives would be unchanged, and the vulnerability to government pressuures would remain. Third the companies might be disinclined to buy or transfer power from independent generating stations. New entry at the generating stage might thus be discouraged, since the entrant would be faced by a monopsonist. Thus, regional separation may be part of a solution to the problem, but is not at all sufficient on its own.

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Private Ownership

51. Suppose regional separation were accompanied by the transfer of these regional companies from public into private ownership. There is very considerable evidence on the effects of ownership in electric power utilities in the U.S.A.

> 'The evidence suggests that municipal firms, relative to privately-owned regulated firms, in general will charge lower prices; have greater capacity; spend more on plant construction; have higher operating costs; engage in less wealth-maximizing price discrimination, including fewer peak-related tariffs; relate price discrimination less closely to the demand and supply conditions applicable to each group of users; favour business relative to residential users; offer a small variety of output; change prices less frequently and in response to larger changes in economic determinants; adopt cost-reducing innovations less readily; maintain managers in office longer; exhibit greater variation in rates of return." (De Alessi 1974).

52. Private ownership of the regional companies should to a considerable extent reduce two of the problems noted at the end of the last section. Private owners have little incentive to engage in 'empire-building' for its own sake. They will be more interested in securing the cheapest and most reliable source of power, regardless of whether this is self-generated or purchased from another regional company or from an independent company. It will be in the interests of the regional companies to promote new entry at the generating stage.

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53. There are two drawbacks. First, the effectiveness of the profit incentive depends in part upon a well-functioning capital market. It must be possibl for inefficient regional companies (and indeed those whose profits are not as high as they might be) to be taken over. Second, private ownership might exacerbate the exploitation of monopoly power. This is by no means certain - as noted earlier, private US electric power companies tend to offer a wider range of tariffs and exhibit greater sales, so customers may well be better off. Nevertheless, the danger has to be considered.

54. Would price or profit regulation aleviate the problem? It is not clear that reputation would in fact operate in consumers' interests, but there is a more serious objection: to the extent that curbs on profit were effective, they would reduce the incentives to operating efficiency. Empire-building would again become attractive, and low-cost power generation would be jeopardised. Franchising, too, would have drawbacks, particularly insofar as it would hamper the operation of the capital market. (A more market-oriented version of franchising is considered below).

55. This suggest that alternative means should be found to tackle the problem of monopoly. One possibility is the stimulation of competition; the other is further restructuring of the industry along functional lines.

Problems of New Entry in Electricity

56. We consider in turn the three problems of entry - asymmetric costs, technology and institutional barriers - as they apply to the UK electricity supply industry. We then consider what might usefully be done to alleviate these problems, in the form of restructuring, removing barriers and competition policy.

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57. a) Asymmetric costs

There is currently excess capacity in the generation of electricity, and power stations have long lives (20-30 years). However, demand is likely to grow steadily in the logner term, and improvements in design of power stations (especially if the bugs in nuclear stations can be ironed out) should make new investment attractive within a few years. We do not know the present extent of spare capacity on the national grid, but demand will grow here too. New investment will also be required to accommodate changing locations of power stations and centres of demand. (The present configuration is admitted to be no longer optimal). The local distribution network is likely to provide adequate capacity for existing customers, but will need extension and reinforcement as the pattern of demand changes.

58. If the above comments are correct, present capacity provides least deterrent to entry at the generating stage and most deterrent at the local distribution stage. Some rough statistics can be brought to bear on this point: in 1981-2 the CEGB decommissioned about 4% of its plant and commissioned an additional 7% while the corresponding figures for South Eastern Electricity Board circuits in 1982-3 were 2½% and 6½%. However, the 1981-2 CEGB figures were exceptionally high: over the last decade the CEGB averages were nearer 2% and 4%. Perhaps, after all, there is no significant difference in the rates of investment between the different sectors of the industry. Nevertheless, it would seem easier to compete by offering a new plant or a major new transmission link than by distributing investment over a large number of local distribution lines. Asymmetric costs would not seem a barrier to entry in the former cases.

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59. b) Access to Technology

Technology is changing in generation, and potential entrants would not seem at a disadvantage since knowledge is widespread. Prospective changes in technology of transmission and distribution are probably minimal.

60. c) Barriers to Entry

The statutory monopoly on electricity generation has recently been lifted. Under recent legislation independent companies can produce electricity (for resale) as their main business, and the grid is obliged to transmit power between the independent contracting parties. Access to the local distribution network will probably be necessary if such activities are to expand. The nationalised incumbents also have a significant advantage in respect of wayleaves: presumably independent suppliers have to purchase rights of way from landowners and other existing owners of wayleaves. New entry may thus be stifled for these reasons.

61. d) Anti-competitive conduct

The electricity supply industry has not hitherto been exposed to competition from within the industry, though its marketing tactics vis a vis gas have occasionally been criticised (e.g. re the wiring of new estates at lower prices if electricity only is installed). It has also been criticised for offering poor terms to independent companies wishing to sell surplus power to the grid.

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Stimulating Competition

62. The previous section suggested that new entry could be viable in various parts of the industry if it were encouraged, or at least not hindered, by public policy. It may also be possible to stimulate competition between the proposed regional companies. The following are seven suggestions to these ends.

63. (i) 'Common carrier' type obligations (similar to those in the recent Act) would need to be imposed on the regional companies e.g. to allow the non-adjacent regional companies to transfer power between them across a third company, or to allow an independent generating station access to regional companies beyond the confines of the company on whose territory it happens to be located. (This activity is known as 'wheeling' in the U.S.A.). The effect would be to stimulate competition in generation.

64. ii) The regional companies should also be required to transmit power contracted for by large individual consumers, whether from independent generators or form other regional companies.

65. iii) Similarly, groups of adjacent consumers (e.g. businesses on an industrial estate or households on a particular street or neighbourhood) should be allowed to purchase power from other suppliers than the immediate regional company.

66. (iv) Extending this idea still further, it might be possible for non-adjacent consume-s to form a group to purchase power on more favourable terms than the regional company offered. Trade associations might organise

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such groups; alternatively electricity 'retailers' or 'brokers' might develop, specialising in knowledge of market conditions for power. (We discuss this idea further below).

67. (v) If whole areas (e.g. towns and villages) were able to make contracts in this way with other regional companies, it would be sensible to enable the local distribution network itself to change hands. In the short-term, effective competition might take place only at the edges of the regions, but over time one would expect the patterns of territory to be redrawn. The more efficient companies, offering more attractive tariff structures, would expand at the expense of the less efficient.

68. (vi) To facilitate such competition, territorial sharing arrangements between regional companies should be prohibited, or at least made subject to restrictive practices legislation. The focus of competition policy shuold not be on securing 'fair prices' but on penetrating anti-competitive practices.

69. (vii) At present the nationalised incumbents have rights of way to install overground or underground cable. Thus must be a very significant barrier to new entry. Independent distributors should therefore be put on an equal footing with present incumbents. Local authorities should be obliged to adopt pricing policies and rules of access which would facilitate entry (yet prevent excessive digging up of streets). Competition policy should therefore apply.

70. The ideas just noted constitute a form of franchising. But they involve franchises given directly by groups of consumers, not by governments or

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local authorities on their behalf. The problems of the latter arrangement have already been noted: the difficulties of deciding how the contract should be designed, how to balance the different interest groups, the tendency to build-in non-commercial obligations, the costs of monitoring etc. These problems could be reduced if consumers themselves negotiated the franchises or 'retailers' did so on their behalf. The objectives and incentives would be clearer. Governments should impose no constraints e.g. on duration of contracts, as terms for resale of distribution links etc: these should be left to the parties concerned to negotiate.

71. A final observation is that competition is likely to be enhanced if there are more rather than fewer regional companies (partly because there would be more alternatives, partly because capital markets would be improved). The CEGB has seven regional divisions; there are a dozen Area Boards in England and Wales, but each of the area boards is subdivided for purposes of internal organisation. Two or three dozen regional companies would not be inconveivable. The economies of scale with respect to area of distribution are probably small, and the economies of scale with respect to generation would not be sacrificed by increasing the number of companies, since 'wheeling' of power would replace self-generation.

72. To summarise, restructuring the electricity industry on a regional basis would be a viable alternative. Private ownership would be necessary to secure increased efficiency, but this might pose a threat of monopoly. Profit regulation might seem to offer protection but would jeopardise efficiency. A preferable solutionwould be to increase competition by facilitating new entry and the trading of power.

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Functional Separation

73. An alternative (or complement) to regional separation is the concept of functional separation. Suppose the Area Boards are retained as the basis of the regional companies, but the generating stations are operated separately and independently of each other under private ownership. This would mean that Area Boards would have to purchase all their power on the market. They would have a greater incentive to seek lowest cost for given risk and equality etc.). The generating stations would need to compete amongst themselves for business. The net effect would be an increase in efficiency. This would apply also to investment: as before, the market would serve to co-ordinate long-term planning, and there is no reason to believe the benefits of an integrated system would be lost. Area Boards would have incentives to offer long term contracts to potential entrants in their area, in order to reduce risks on both sides.

74. The main problem of this scheme concerns organisation and ownership of the national grid. If it is to be divided between the Area Boards as before, each Board will have a degree of monopsony power over generating stations in its own area. Leaving the area boards in public ownership would not alleviate this problem - each generating station would still face a monopsonistic buyer, although the buyer's objectives might now pertain more to convenience than price. Some of the advantages of competition at the generating stage would be lost.

75. Alternatively the national grid might be preserved as a single entity. In this case, it would be important to reduce the grid's activities to a minimum. If it were to buy and sell power in its own right, it would

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constitute a national monopsony and monopoly. Rather, it should have a passive role; to transmit power between generating stations and Area Boards (for a fee to cover expenses). The prices and other contract terms would have already been negotiated by the ultimate buyers and sellers. Profit maximisation would not be a desirable aim for such a grid, and the scope for innovation is relatively small, so public rather than private ownership may be appropriate here. (The main disadvantage to consumers would be if the Department of Energy intervened to promote 'social considerations' or to implement an 'energy policy' involving the restriction of one fuel to promote a rival fuel).

76. A third possibility would be to split the national grid into two or more grids, even into its separate constituent transmission links, which could then be operated by separate organisations. As argued earlier, the advantages of coordination need not be lost, but competition might be increased as facilated. If any one link did not have significant monopoly power, it could take on the role of broker, or buy and sell on its own account, and private ownership could be advantageous. This possibility requires further examination of the precise grid design and pattern of flows.

77. Finally, we may consider further the possibility of developing concept of the 'retailer' of electricity as a means of curbing monopoly power at the area board (distribution) level. In the previous section the transmission of power from one company or generating station across a second company's network to a third company ('wheeling) was assumed to be a relatively small part of total activity. But suppose all power could be bought and sold in this way. That is, suppose all customers are 'retailers' acting on their behalf, were to buy power direct from the generating stations, with the local network acting merely as a passive transmitter.(as suggested above for the national grid). (Whether such a complete separation of distribution and retailing is feasible and cost-effective of course needs further invest-

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igation.)

78 The great merit of this scheme is that there are probably not significant economies of scale in the administration of contracts, so that 'retailing' in this sense could be a fully competitive activity. There would be no local monopoly in retailing, since a given street could just as cheaply be supplied by, say, four different retailers as by one, even though there would be only one distribution line under the street. The local distribution network would reamin in public ownership.

79. What proportion of current expenses are accounted for by distribution as opposed to retailing (i.e. by the monopoly element as opposed to the competitive element)? A summary of the Electricity Area Board accounts for 1982-83 provided by the Electricity Council suggests that distribution of electricity accounts for just under half of the Area Board costs, while consumer service costs amount to just over half. (Here, distribution costs include employment, repairs and maintenance, and depreciation; while consumers service costs include meter reading, billing and collection; administration and training; rents, rates and insurance; and contributions to the Electricity Council.) Thus, in the case of electricity distribution, the essential monopoly problem, which is the main cause of concern, is approximately half the size it at first sight appears to be.

Conclusions

80. Two alternative schemes for privatising the electricity industry have been considered. One is regional separation: the entire industry would be privatised, but protection as well as efficiency requires significant moves to facilitate new entry and competition between regional companies.

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The alternative scheme involves functional separation: the generating stations would be sold independently as would the area boards, while the national grid would remain in public ownership. In the latter case, it might be possible to separte the area boards into publicly owned distribution networks plus competing private 'retailers'. Both schemes seem to be an improvement over the present arrangement, and would meet the criticisms levied at the industry. The second scheme perhaps offers potentially greater benefits to consumers, but would not be so straightforward or politically expedient to implement; it therefore requires further examination. Whichever scheme is adopted, the danger of poorer long-term planning seems minimal and the larger the number of successor companies the better the prospects for competition.

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SECTION IV AIRPORTS

Introduction

81. The BAA has been the subject of less criticism than perhaps any other nationalised industry, and is widely believed to be efficiently managed. Is there any benefit to be obtained from privatising it, particularly in view of the undoubted monopoly power of each airport?

82. Criticism has not been entirely absent. The airlines have complained about landing fees, but at the same time it might be argued that insufficient use has been made of such fees. Is the allocation of landing rights too much determined by past usage and political/diplomatic pressure rather than by market forces? Has long term planning been as accurate and flexible as it might have been? Are the resources under the BAA's control deployed in the most effective way? The main economic decisions facing airport managers have to do with the allocation and use of space (land). The mix of services competing for land is extremely complex: one desideratum for policy is to focus attention on the problem of maximising the social return on land within airport boundaries, and on the decision whether to expand or contract these boundaries. As we shall see, private ownership will have an important role to play in this context.

83. The question also arises whether in deciding on privatisation, BAA should be treated as a whole or as separate airports. Separation would increase competition, but only to a small extent in the "product" market. In the light of previous argument, it will be apparent that separation will make the greater effectiveness of the labour and capital market processes (more and smaller airport companies facilitate job-change and takeover). Moreover the creation of more market transactions will en[illegible]nce evaluation and

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planning. A further argument, particularly important in the present industry, is that the airports within the BAA have very different social and economic circumstances, hence require quite different management objectives. Indeed, it may be appropriate to privatise some of the airports but not others. This different treatment would be difficult, if not impossible, if BAA remained a single entity.

84. We begin by examining the nature of competition in this industry. Each sizeable market area for airports is observed to have relatively few, often only one, supplier of the essential service, namely the collection and transfer of passengers from ground to air and vice versa. Each conurbation outside London tends to have a dominant airport; London has one very large provider (Heathrow) and a major second order provider (Gatwick), with the rest (Luton and Stansted) playing minor roles. The first question is the source of this scarcity of airports, because the question of diversity of objectives arises most acutely for managements when there is considerable market dominance. Entry potential limits this; to what, then, can the manifest lack of challenge to airports market position be attributed?

There are four principal potential sources:

i) Plant scale and other production economies

ii) Asymmetric costs

iii) Market scale advantages

iv) Exclusive privileges granted by government.

We explore these in turn. Afterwards, we consider separately the appropriate form of ownership and structure for Heathrow, Gatwick, and the remaining BAA airports.

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Scale Economies

85. Scale economies have to be realised at one location. The option is to transport the product or service. When the airport process is analysed, scale economies do not strike one as impressive. Airside, the major concern is traffic control; costs of this are increased by scale of activity at one ground location over rather low levels. Landing facilities consist of one or more run-ways, turn-offs, and taxi ways. The capacity of one runway is potentially very large indeed: Gatwick is the outstanding example. However, the cost of runway replication is not of itself prohibitive for entrants. Old airsites, defence airstrips, suitable flat land abound. (Whether these are available is quite another matter, to do with iv) later.) Multiple runways were, at some point of airport development, important in giving options to aircraft when landing in different weather conditions. These no longer have substantial importance. An entrant could be quite effective with a one runway operation.

86. Passenger handling at the airport, plus the services for passengers and aircraft (including stands, maintenance, etc) allow great flexibility in locational choice. Passengers and luggage could, of course, be processed by the airlines either at airport or at other locations (and in the past have been). The minimum provision at airport is dictated by safety considerations, and presumably immigration and customs have to give a minimal control. Otherwise, how much service is provided at an airport for passengers is optional; it could be provided off airport, or not at all. So also for air cargo. There are no economies of scale here; rather, there is an active margin of service competition, evidenced by the differences in space devoted to first class passengers, presence or absence of duty free operations, etc.

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87. Much the same applies to servicing aircraft. There must be minimal provision for parking and lay-overs etc. But the costs of this cannot be formidable for the entrant. Beyond the minimal provision it is possible to have great variations in the services provided, and indeed airports vary considerably in this dimension. Heathrow, because of historical development and policy decisions, has retained a substantially wider scope of services than other BAA airports. Addition of more or less elements of service does not evoke scale economies.

88. Land-side distribution of passengers and cargo, their assembly, and that of aircraft inputs (fuel etc) involves principally the local road network. Most road costs will not be borne by airports. But from the social point of view, their provision is important. Road (and rail) distribution displays strong economies of scale when traffic is to be conveyed from A to B. Whether airports in or near urban areas (the main markets) evoke such economies is at best dubious. For one thing, diverse connexions are needed. For another, adding urban road capacity will usually mean rising marginal opportunity costs. Even the larger scale of main route to the centre is probably bought with rising costs.

89. From these arguments, the conclusion is that to focus on scale economies as a deterrent to entry is misleading.

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Asymmetric Costs

90. Asymmetric costs, by contrast, do appear to be important, but differentially so at different airports. They concern the position of the incumbent airports vis a vis possible entrants. There are several questions of strategy: namely, what will an entrant at an effective scale of production add to output; what are his avoidable costs compared with those of the incumbent; and how will the development of technology and related property rights affect the profit expectations of the parties? When one considers the separate BAA airports, great differences emerge.

91. Asymmetric costs arise from the sequential process of investment. Heavy investment (which may well have been uneconomic) can create a position in which incumbents can scarcely be challenged, and for two of the above-named reasons. Entrants would add further capacity, forcing down prices obtainable; and would face higher avoidable costs than the incumbent, who could price down to its lower avoidable costs (so long as whatever additional cash flow is contracted for can be covered - e.g. for loan servicing) and thus threaten price retaliation. Entry is very unattractive in such circumstances; most, if not all, of BAA's provincial holdings are in this position of excess capacity. The management problem there is to raise returns on existing excessive investment, and/or slim down assets, if necessary by closing the airport.

92. Heathrow and Gatwick clearly have important asymmetric costs, but their significance seems to differ for each. Demand is expanding at Heathrow, and one suspects that Heathrow's avoidable costs without expansion may not be much below that of a potential entrant to its market area (were such a hypothetical event to occur). Though it has not been calculated so far as we are aware, one suspects that expansion costs at the margin - e.g. to add a fifth terminal - might well exceed those for the entrant. All this

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is, of course, not to say that entry could occur (for reasons adumbrated later) but it serves to emphasize the point that, with strongly rising marginal costs of expansion, the principal questions for economic policy at Heathrow concerning pricing of existing capacity as well as, from earlier argument, the allocation of land uses.

93. Gatwick is more clearly in the position of an incumbent with advantages from asymmetric costs. Its avoidable costs probably lie below that of a potential rival. Its market is expanding; it is able, and intends, to pass many more passengers through its one runway. We argue later that there is a limited prospect of market challenge, and it has more to gain than Heathrow from whatever traffic shifts between them. Gatwick poses for policy the most clear case of market power, with discretion about its exercise.

Market Scale

94. Market scale advantages are another important, but again differential, source of discouragement of entry. The argument, in brief, is that an expanding market improves the ability to offer inter-lining, but that only one airport at any location will be able to exploit this advantage. Distance from main urban centres is the prime determinant of market share for airports. Compared to other London BAA airports, Heathrow has a pervasive and long standing advantage. Its central importance was well bought out by the Roskill exercise. Though not finally considering any airport sites sufficiently near to central London to offer passenger convenience of Heathrow's quality, Roskill did light upon the nearest site to Heathrow of its four, namely Cublington; and Cublington's nearness to populations was its key advantage. The London pecking order is clear,

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with Gatwick second and Stansted a very poor third. Heathrow's position virtually guarantees a perpetual problem of congestion, given inhibitions on a relevant entrant (though a revised pricing policy could alleviate this problem). Gatwick, for its part, has the commercial problems of exploiting a good location, but is by no means as secure from effective locational competition around London's fringe.

95. Airports gain market advantage from sheer size, because of interlining advantages. The connexion service offered is better, the more alternative cities are flown to. This feature has often been the subject of airport competitive advertising; and it certainly weighs heavily in the minds of airlines making choices about routeing their flights. In the UK, the issue is virtually confined to the London airports. We must be careful not to overplay it however. For one thing, London is at the northern end of the main European corridor for air travel. Other European cities are basically better placed to win in interlining competition. More importantly, the real question for airlines is whether they can (individually) profit from building a hub-and-spoke operation at a favourable location. As competition among airlines increases in the future, as it surely must, even in Europe, aggregating slots at such a location will be even more critical (caompare Delta's strength at Atlanta, and other airlines attempts at emulation elsewhere). Whether this will become a matter for economic policy depends on the degrees of freedom which individual airports have to provide the means for differential advantage among airlines. Heathrow would be the most natural location from airlines' point of view. However, because there is a strong tradition of sharing out rights to the prime location, and expansion which would generate the useful degrees of freedom is limited there, one suspects that Gatwick is a more likely candidate. Also Heathrow's advantage as this prime London location for interchange would be increasingly subject to reservation about costs imposed on travellers as it attempted to expand further. Consider the likely impact of a fifth

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terminal on interchange hassle!

Exclusive Privilege

96. The fourth category of inhibitions to entry is the granting of privelege, or the prevention of acquisition of rights, by governments. This, we would argue, is the most potent source of monopoly power enjoyed by airports. Governmental motives here are clear and cumulative. Airports display just about every reason which stimulates governments to restrict land uses:- they are historically prime sources of social costs, noise in particular. They have grown from defence needs, thus evoking extreme bureaucratic lag. Location requirements - proximity to large populations plus favourable terrain - make airports a natural focus for competition in land use; thus, where land use planning exists, it must a fortiori flower with respect to airports. Airports are natural foci for fears about public safety. For all these and many other reasons, defensible and otherwise, governments create scarcity in airport locations. The upshot is that we can be confident that economic policy has to deal in practice with existing airport locations and their present geographical boundaries. There will in fact be no substantial entry from major new locations. This has different implications, however, for the different BAA airports.

97. It must, first, imply most for Heathrow. The location scarcity will be most felt there. Accordingly, the issues of use of land within the airport, and rationing of scarce capacity, will be endemic. The key question is - if Heathrow is privatised, how likely is it that 'correct' social policies will be followed? A privatised Heathrow must be assumed to be a profit-maximising company with an asset base (the land at Heathrow) which will not be expanded, despite its extremely high value in existing use. Moreover, withdrawal from performing at least the basic air service is unlikely to be sought or allowed. The scope for improved decision making

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seems very restricted. Nevertheless, the danger of monopoly seems great, but we shall argue that the likely outcome is not so far from what would be socially desirable as at first sight might be supposed. Partly, this is because the alternative of non-privatisation (continuing as a nationalised industry) inspires little hope that past policies will be essentially changed.

98. Planning and other restrictions underpin Gatwick's market position somewhat less securely. In the longer term another major location might arise to challenge it (as at Stansted). There are other potential challengers not worse located, as at Luton. General aviation airfields can also be expected to continue to grow. One of Gatwick's chief market strngths lies (because of Heathrow's basic dominance) in leisure traffic, known to be more sensitive to price and other forms of competition than business traffic. On the other hand, Gatwick's development will not, for quite a long period, evoke extra major planning inhibitions. It can use its spare capacity in whatever way seems to be of benefit to its own finances. For these reasons, again, Gatwick's position as a privatised concern will present government with problems most akin to those facing it with respect to public utilities - the degrees of freedom available to exploit monopoly power as different market opportunities dictate, and reasons to want to strengthen that power.

99. Planning restrictions apply to BAA's other (provincial) airports; but with respect to possible privatisation, the constraints are not economically significant: even if they were relaxed, no entry would occur. The prime question for public policy for these airports is under what conditions they can survive as privatised concerns, and to what degree subsidy would have to be provided to sustain their output, if this is deemed a worth social

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objective. Management in a regime of pervasive subsidy is not an attractive proposition either for capital markets or management themselves. However, the argument against privatisation on those grounds (of necessary subsidy) is not conclusive, as we shall argue.

100 The arguments of this section suggest that the economic under-pinning, and thus the likely management foci, of privatised airports will be substantially different as between Heathrow, Gatwick, and the rest. Prima facie, it is a bad principle, and worse practice, to group together in one organisation highly diverse overall management objectives and concerns. To do so is to invite indecision, uncertainty in motivation, including promotion prospects, and power vacuums, which are unpredictably filled. We should therefore, ask the questions, given that separate treatments are warranted, which if any of the airports should not be privatised, but retained in the public sector. We also should consider alternative arrangements in each ownership option.

Heathrow (a) Pricing Policy

101 The major concern at Heathrow must be - how far would the policy of a privatised concern diverge from what is socially desirable compared with what is likely under continuing public ownership?

102 Heathrow presents a future prospect which will call, in airport terms, for quite unusual willingness and ability to match pricing to changing demand and supply conditions. After 1985, for example, when Terminal 4 is due for completion, there will be a period when there will be pressure on management to fill extra capacity. The anticipated need to encourage

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traffic is already manifest in the marketing efforts on Terminal 4's behalf noted in the current annual report. (It may of course be the case that the new capacity has been obtained at very high costs when all the necessary inputs are counted. The catalogue of works in and around the airport noted in the report also impressive. It is uncosted except for BAA's £30 million outlay in the year in question.

103 However, when Terminal 4 is in operation, investment will be bygones; pricing strategy will be directed towards traffic attraction until - as at some point it must - congestion sets in. Then a quite different, and older story, will be relevant. To judge from the past, it may well be manifest no longer, as recently, in air terminal capacity, but elsewhere in the system. In the early 1970's, for example, congestion was primarily a runway problem. It may arise, in principle, anywhere in the cooperating services needed to transfer the passenger. Heathrow's London market dominance, together with predicted future growth of London originating and destination traffic, will then increasingly present a need to emphasise rationing by price in its stewardship. Capacity is limited, costs of airport operation may safely be assumed to be rising at the margin, passengers' costs (in terms of time spent queuing in the air or on the ground) will grow. Airline costs will be similarly affected. Irrespective of the elasticity of demand for passenger travel at Heathrow congestion cost will escalate unless rationing is applied, because demand will continuously shift outwards.

104. Alternative methods of rationing capacity include the arbitrary or consultative transfer of traffic to worse-located airports, and voluntary methods such as airline committee allocation of landing slots. Both fail to apply market tests for demand; both discourage entry of new operations which

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challenge incumbent users markets; both, but especially the first, open the prcess to undue influence by the airport owner itself. Pricing is therefore the preferred method of rationing.

105 BAA's past policies of differentiating landing fees, at Heathrow from those of other London airports and its use of peak hours differentials have for a long time been supported by arguments about allocative efficiency in the face of congestion. Practice has never been pushed as far as acutally meeting the basic allocative rule, to equate prices with marginal social costs. (This would include all the parties affected, whether using the airport or not.) Indeed, the landing fee differentials were fixed by first estimating cash needs to meet financial targets, and then deciding upon a just division as between those contributing to airport revenue. The allocative argument was useful to bolster particular extra charges to be faced by certain parties - e.g. airline landing fees - but allocative arguments have not been the starting point for the revenue calculation. We are suggesting that this will become more critical as time passes.

106 Charges at Heathrow have been the subject of vociferous objections, by airlines in particular. The question arises whether pricing for allocative efficiency would encounter even stronger and more effective opposition if the airport were privatised. For several reasons, we would argue that such opposition would be less effective, even with much higher charges, than now. First, the target would not be a whole nationalised industry. BAA is now a focus point for opposition by the coalitions of interest groups. Its own statutes and past practices make it extremely difficult to rebut charges of 'exploitation'. By contrast, a privatised Heathrow would operate in a context making it a much more difficult

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target. Second, as seen later, competition, not cooperation, between airlines would be promoted. Third, a privatised Heathrow would have to be opposed by anti-monopoly mechanisms, not the nationalised industry departmental network. Finally, assuming that the Government on privatisation will absorb very large prospective monopoly profits itself, it will be difficult to show 'abuse' of that power by successors after flotation. (High revenues will not generate a high return on capital.) But quite aside from strategy concerning monopoly 'abuse', the chances of a substantial correction of pricing at Heathrow under continuing nationalised industry sponsorship are very low. There is nothing in any nationalised industry or public sector activity history which might encourage such optimism.

107 The pursuit of allocative efficiency of course involves sacrificing the objective of using cross-subsidy to finance socially desired objectives. All privatisation, seriously intended, that is in the interests of promoting market forces, involves the same sacrifice. BAA's principal cross-subsidising activity is towards Scottish airports. Privatisation means finding other means to fund them - perhaps by a lump sum tax on the profits generated from the Heathrow and Gatwick private operations. We shall not pursue this line of objection and solution further here; unless market disciplines are seriously intended, privatisation is reduced to a policy of maximising short term inflow of cash to the Treasury. As we shall see, however, allocative efficiency and a good (not necessarily the best conceivable) realised value from the sale are not incompatible.

108. The allocative argument for privatising Heathrow separately is thus that pricing policy can be expected to be closer to the "ideal" P equals MSC

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then if nationalisation is continued. It is also more likely to be the case than if BAA were privatised in toto. We are not aware of any work on marginal avoidable costs which might usefully represent the whole set of relevant social costs, in the short and longer run, such as could be set against estimates of shifts in demand and its elasticity. These would be needed to estimate the "optimal" and profit-maximising prices (and also to calculate what the rent of location would be). We have a fair confidence, however, that a privatised Heathrow, relatively untrammelled in pricing policy, would get closer to "ideal" prices than either of the alternative scenarios of retaining nationalisation or privatising BAA in toto.

Heathrow (b) Land-use

109 Flexible adjustment in prices over time to reflect market strength and marginal cost conditions is not the only important aspect of privatisation, however. Heathrow represents the prime case of selling Government-inspired rights to air uses from a given land holding. Another need, as seen earlier, is to allocate the land uses there correctly. It is conventional to think of revenues from air passengers and visitors (because an alternative source of revenue) is in some sense an offset to landing fees and other charges which occasion more organised protest. In allocative terms, this is a wrong perception. All land uses at Heathrow yield a potential rent derived from the Government constraints on use. These raise air-related returns above alternative non-air uses. The problem is how to maximise these returns - and to be sure that, when appropriate, the land is free to revert to its next best (non air-related) use. Such concerns, if they are to be reflected in action, are most likely to be pursued by a privatised operation.

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110. It is true that duty free concessions are a particular source of revenue strength at airports. These, however, represent an additional sale of a government right or privelege, which could in principle operate at any location. The Government has the option of adding them to a privatised airport operation. If it does so, it would be selling an opportunity which the new users will take into account in allocating land to the differing uses. This opportunity will turn up as part of the price raised on flotation. It will not reduce landing fees, or otherwise improve quality of service.

Heathrow (c) Organisational Structure

111. The basic form of privatisation would therefore involve selling certain Government-inspired rights. So that the Government can realise the potential gains from these, there has to be mechanism for bidding. We envisage that a Heathrow Land Corporation should be established with rights for, say, 25 years, for which offers are made. There would be no obligation to use the land for air purposes; the economic constraints imposed on this elsewhere are sufficient to guarantee that such uses would be uppermost, but not exclusively so, in the corporation's mind. (i.e. there is a possibility of variation at the margin).

112. The Land Corporation would inherit the existing set of fixed assets at Heathrow. However, there is a need to ensure that the objective of allocative efficiency among land uses is never allowed to become mixed up with the temptation to use monopoly power in irrelevant ways e.g. by integration into operations simply to create a bigger organisation or in other ways to generate managerial pay-off. To this end, the Corporation

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would not be permitted to operate air services itself at Heathrow. It would therefore have to enter various forms of contract to provide air-related services.

113. One advantage of a separate Heathrow Land Corporation is that it would be treated on the Stock Exchange as a property company, and its risks and returns compared with other such companies. Its capital would also be significantly smaller than Heathrow at present, so that capital market processes would operate more effectively i.e. the threat of takeover would be more real.

114. A second advantage is that the sub-contracting process gives the opportunity for further privatisation measures. For example, there could be an Air Services Company, comprising the assets and manpower at present not sunk in specialised traffic control operations and/or airport mangement. The company would be free to compete elsewhere in the UK and overseas to get air service management contracts. Equally, the Heathrow Land Corporation would be free to secure the best option available to it to get its air to ground operations provided.

115. The Land Corporation would probably find it most efficacious to auction rights for runway, taxiing, parking and terminal units to airlines, who have then to decide on their view of risks and returns attending Heathrow operations. Whether to sell off existing buildings, the length of tenure, rights to resell etc. would be settled between the parties; the land corporation will get higher bids from more favourable conditions as seen by the airlines, and vice versa. Similar considerations apply to other air-

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related uses, where these are not included in airline bids, e.g. servicing, freight forwarding, public transport and taxi operations etc. In practice, one expects most of the activity to be handled via airlines.

Gatwick: The Public Interest

116. The argument for privatisation of Heathrow, and for considerable separation of ownership and operating interests within it is based on allocative efficiency: effective prices will be closer to marginal social costs than they would otherwise be. Gatwick presents a different problem of social objectives.

117. For various reasons, Gatwick will be in an increasingly favourable position to exploit monopoly power. Though placed lower on the London rent surface than Heathrow, it will increasingly inherit the benefit of Heathrow's restrictions, helped by the rational pricing policy which Government should seek for Heathrow. (i.e. Gatwick's demand curve will shift outwards.) Forward plans already call for a doubling of present traffic at Gatwick by the 1990's. To judge by the trend of the past 10 years, Gatwick will increasingly modify its reliance on relatively elastic leisure-oriented traffic, to encompass more business traffic, (scheduled passengers now account for 40% of traffic). It is becoming a considerable cargo mail airport. By 1982 it was shifting about 1/4 of Heathrow's quantity (whereas 10 years ago the proportion was 1/10). Its degrees of freedom to pursue differentiated pricing to increase profits are growing.

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118. On the cost side, Gatwick has a prospect of expansion at relatively low outlay to increase its capacity. The basic runway configuration will not have to be substantially altered, partly because aircraft technology is becoming more favourable to single runway operation. It can exploit a falling average cost curve. Moreover, it inherits from BAA a position where investment to support expansion is almost wholly produced by cash from customers (99.4% in 1982/3). This is an irrational way to finance expansion in the interests of profit maximisation, and would certainly be corrected if Gatwick were privatised. To the extent that financing in future is by equity, finance costs become postponable, giving flexibility. In sum, management would have a strong hand in dissuading potential entry: the only sanctioned entrant so far, Stansted, is an inferior alternative vis a vis the basic London market. Apart from the facts of demand and costs, all the existing prejudice against having a new airport site, on planning grounds, could be harnessed against it. It is long odds that, in a privatised regime, Stansted will not expand substantially.

119. The public interest in policies pursued at Gatwick centres on (a) monopoly exploitation in pricing and services and, (b) the possibilities of inefficiency including the selection of inferior productive methods, leading to higher costs than might otherwise be achieved. One must assume exploitation of privatisation occurs: unless policies to maximise the return on the priveleges given are pursued, there is no point in looking to market forces at Gatwick. In contrast to the Heathrow case, there is no prospect of exploitation approximating the public interest. (The only congestion problem Gatwick will face is the problem of peak demands at holiday periods.) The question then becomes, comparing the options of privatising and retaining

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public ownership, which form is likely to perform better on the dimensions cited? Public ownership we take here to mean extending the present style of nationalised operation, possibly with minor variations. On the other hand, privatisation must mean - that version which is calculated to perform most efficiently while exploiting monopoly power. (e.g. something akin to our Heathrow model.)

Gatwick Under Public Ownership

120. As to prices, influences can be direct or indirect. Direct price control is normally avoided, and with good reason. If direct price control is contemplated one might as well opt straight away for the privatised solution: at least one would get other benefits associated with private operations (allocation of land, service levels and costs etc) as well. With nationalised industries, all these dimensions are in question, which is why performance variables for them have been developed. So we must consider indirect means of influencing prices. In the case of the nationalised version, this would be by rate of return control and performance variables based on cost. In the privatised version, indirect influence would be via anti-monopoly legislation, British and European. We consider first the nationalised system.

121. Rate of return control is the more effective, the more assets are expected to change in the future relative to existing operation. There is more for critical scrutiny to bite on. Gatwick, having quite a lot of investment expansion yet to do, is relatively open in this respect, though one cannot weigh this heavily. Performance variables would focus on costs per passenger, or other manifestion of costs related to output. Stability in expectations on both sides of the Department - nationalised industry relationship are critical to departmental influence here; also there must

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be a good prospect that interpretation of performance is not going to be severely disrupted by change in exogenous variables. (These provide alibis to management who can only be held accountable for endogenous matters).

122 On both counts, Gatwick might inspire a mild optimism. It does have a prospect of a good run of expansion in passengers, giving better chances for performance expectations to be established. As to exogenous influences, air passenger forecasting has had a great deal of the false optimism about the effect of real income squeezed out in recent years. We may be in for a period of more accurate assessment.

123. Similar comments about conditions favouring their effectiveness apply to service performance indicators. It is always more feasible to operate such a system if there is expansion, which gives management scope to respond to Departmental pressures without too much risk of the relationship deteriorating into trench warfare. In this connexion, we may note that Gatwick has in fact a more impressive record of improvement than the other BAA airports. Thus, for example, it did better on complaints for 1000 passengers over 1979-83 (see 1982/3 Annual report p.17). There is at least a history of relative success to build upon.

124. When it comes to X inefficiency, our mild optimism ceases. The cards here are almost wholly in the hands of the airport operator. What are best or better methods of operation is a highly technical matter. Particular application to an airport is necessary. The possibilities of alibis are almost limitless. The asymmetry of information between nationalised industry and Department is much harder to compensate for than it is in the case of other financial and cost performance variables. On the other hand,

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it might be argued that at least Gatwick has more technical world airport analogies than Heathrow, and that drawing on analogies is the critic's stock in trade. This seems small comfort, however. There is really no effective substitute here for the pressure of the capital markets and profit seeking - in other words, privatisation must score heavily on this dimension.

Gatwick Under Private Ownership

125. Turning to that option, is there any reason to believe that indirect influences on behaviour will be effective? The track record of MMC is not notable for its robust treatment of single-company market power, and in any case, in the UK system, relies ultimately on the Government sponsor Departments taking action. (e.g. to sanction price recommendations of MMC). This converts the problem back into the nationalised industry-department mode, without the advantages to the Department of meanwhile having maintained close long-term relations, and therefore, acquaintance, with the subject company. EEC procedures under Article 86 seem more likely to be evoked in practice. It is too early in the development of EEC policy here to be certain, of course, but to judge from experience so far, abuse of dominant power which is discrimatory between parties dealt with, and direct inhibitions to trade and entry is more likely to be pursued than objections to high prices. If this is so, then there must be a strategy open to the privatised concerns - the 'Gatwick Land Corporation' in particular - to avoid effective action yet still retain most advantages.

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126. Since public disquiet about monopoly power will attend privatisation of Gatwick, it may be realistic to think of the imposition of some form of price control analogous to RPI-x in BT's case. We have argued elsewhere that this makes sense only as a temporary influence on behavior, in the context of increasing competition. Otherwise, there is a growing danger of 'capture' in the regulatory interchange. No such increasing competition can be assumed in Gatwick's case, as seen earlier. As also remarked above, if direct price control alone is contemplated, the private option is better, because though not effective in curbing monopoly, at least allows for an efficient monopoly operation.

127. The upshot of this discussion is that we believe that the balance of advantage still lies with privatisation - in the mode indicated. If the price-raising aspects are stressed in public concerns, more strongly than others, there are better reasons in Gatwick than elsewhere in BAA's airports, particularly than for Heathrow, to think of more effective control in the nationalised industry form. The argument that Heathrow and Gatwick should be separated seems, in any case, to be greatly strengthened by the argument about effective ways of wielding influence.

BAA: Other Airports

128. We should briefly indicate our position on the issue of privatisation versus retention of the nationalised industry form for these, concentrating on the substantial loss-makers. It hinges on the initial determination of the Government to face the political difficulties of writing off asset values. All the airports (singly or collectively) could become profitable privatised operations given a willingness to sell off at the price the

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market will fetch. If this is done, preferably on the model suggested earlier of selling the land plus airport rights, with services contracted out, one is probably creating organisations with great keeness to increase volume rather than increase price as the way to improving profits. All the efficiency and land allocation bęnefits would flow - quite a lot of land asset-stripping might well occur, and some airports might be closed down.

129. If this prospect is too daunting in its presentational difficulties (and if minicipalisation cannot be substituted) then the prospect is for loss-making activities to carry on, starting much as they are now, with a very modest prospect of becoming viable. (Without much greater access to the accounts, it is impossible to be sure how to place particular airports in the prospective loss dimension.) In general, subsidy operations with a supply monopolist (each airport concerned) are best conducted knowing that a "stand-off" relationship between the Department and the organisation cannot be satisfactorily maintained. This is basically because combining subsidy with commercial incentives relies on outside reference points for the subsidy given. There must be enough commercial activity in the business to prevent the subsidy element dominating management strategy on one hand, and to give the subsidy - given commercial guidance on the other. The prospects are very dim when supply monopoly is present and subsidy large. In effect, the subsidy-giver has to take over the top management decisions directly. One then is working with a model of integrated Department - airport production of air services; and this is inevitable. We think that the right solution here is again privatise (and defy economic superstitions); but we are dubious about the will to accomplish it.

Franchising?

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Conclusion

130. The BAA should be split into separate airports because the management problems of the airports are quite different from each other. Privatisatio would lead to increased efficiency and flexibility in all cases, but the adverse consequences of private ownership differs in importance. At Heathrow it is important to allocate severely limited capacity to the most valuable uses; increased landing fees would be a beneficial rationing device. At Gatwick the danger from monopoly power is greatest, and the case for continuing public ownership plus performance indicators is quite strong; but on balance privatisation is preferred. At the other airports privatisation could secure financial viability, or it could mean retrenchment or closure; if this is socially undesirable then subsidies need to be provided, which are best administered via public or municipal ownership.

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