

# Vertical separation in utility industries: UK policy and experience

Professor Stephen Littlechild

ACCC Conference on Regulation,  
Industry Structure and Market Power

Gold Coast, 31 July 2003

# Outline

- Inherited structures
- Restructuring
- Electricity
- Rail
- Conclusions

# Inherited structures 1

- Nationalised industries “just grew”
- sometimes to protect monopoly
  - eg post, telegraph, telephones
- or to extend control in absence of market threat or challenge on cost
  - e.g. 1983 CEGB buying cable laying ships
  - 1989 CEGB designing own power stations
- political influence used for macro purposes
  - eg employment, pricing, investment
  - at expense of efficiency

# Inherited structures 2

- Inherited structures of utility industries perhaps had political logic initially
- But little economic logic of economies of scale or scope, or management efficiency
- Little knowledge of what structures would be most economic in future
- And that would change anyway over time
- So did initial privatisation structure matter?

# Restructuring 1

- In retrospect, Yes: a case for maximum fragmentation of each industry at vesting?
- offers best conditions for efficiency
  - understanding and control of businesses
  - maximise number of outsource decisions for each organisation to maximise efficiency (Beesley)
  - opportunities for emergence of new competitors
  - easier to merge than demerge hence to evolve
- also offers better prospects for regulation
  - less market power & political influence, more info.

# Restructuring 2

- Limited restructuring within public sector
  - eg British Telecoms split from Post Office
- In practice political & other obstacles meant several utilities privatised as single entities
  - eg British Telecoms - inadequate accounts to split
  - eg British Gas - industry resistance to split
  - eg British Airports - planning & security stopped split
- Complaints arose about lack of competition
  - pressure to restructure Electricity and Rail

# Electricity 1: Restructuring

- Electricity: aim to get competitive structure
  - but how to do it? Can a utility be broken up?
- Important to split transmission & generation
  - evidence of previous problems in absence of split
- EW generation & distribution already separate
  - no support to split vertically integrated Scottish cos
- Split distribution and supply? too abstract
  - what is retail competition? Important? Is vertical separation needed? Worth the hassle? Difficult to change structure too much. Suffice to require separate accounts?

# Electricity 2: Transmission

- Experience confirms that splitting transmission from generation was right
  - assisted new entrants into generation
  - held ring between generation & distribution/supply
  - efficiency from specialisation of functions
  - incentive regimes that reduced system operator costs would not have been possible if also in generation
- Some thought of transmission + distribution
  - discouraged - would mean loss of objectivity and independence vis a vis other distributors

# Electricity 3: Generation, supply & distribution

- Need for more competition has dominated
  - Generation allowed to compete in supply
  - Distribution/supply allowed to compete in generation
- Prohibiting generation + supply difficult
  - already allowed, and potential economies here
  - if both competitive (ultimately) - let market decide
- Ambivalence on generation + distribution
  - benefits mainly financial (earnings stability)?
  - monopoly + competition a concern - but trade-off:
  - sale of plant in return for merger increases competition

# Electricity 4: Restructuring & gas

- Regulatory pressure to split British Gas
  - noting success of electricity restructuring
  - would help competition in gas supply & retail
- Voluntary BG company decision to split:
  - Upstream, Transmission+Distribution, Retail
- Each business considered itself better off
  - undivided management attention, not held back
- Recent merger NGC elec and Transco gas
  - possible gains from new management
  - separate gas distribn price controls to allow sell-offs

# Electricity 5: Distribution & supply

- Separate accounts proved insufficient
  - complaints increased as supply competition extended
- New entrant (BG Centrica) argued network & retail supply split possible & desirable
- Political case not strong enough to require separate ownership, but more separation
- Utilities Act 2000: separate legal entities, directors, staff, location, facilities & licences
- Separate ownership if companies wished

# Electricity 6: Present structure

- Many companies chose to restructure
- Initially 3 EW generators, 12 EW distribution/suppliers, 2 integrated Scots cos
- Now many generators, 3 distribution cos, 2 suppliers (G+S), 5 integrated cos (G+D+S)
- Restructuring subject to strong ring-fencing
  - increased efficiency, no loss of vertical economies?
- But concern if further horizontal mergers?

# Rail 1: Restructuring

- Extensive: over 100 successor companies
  - 1 Railtrack (network)
  - 3 Rolling Stock Companies
  - 13 track maintenance and renewal companies
  - 25 Train Operating Companies (TOCs) compete for franchises to run services at lowest subsidy
- Aims:
  - separate monopoly and competitive activities
  - maximise competition including to reduce subsidies
  - limit regulation to contract enforcement

# Rail 2: Perceived problems now

- Congestion, overcrowding, fatal accidents, inadequate investment, much dissatisfaction
- Railtrack bankrupt, TOCs in financial problems, maintenance cos exploitative?
- Competition on rail networks not viable?
- Rail restructuring a failure?
- Integrated companies a better solution?

# Rail 3: Successes of privatisation

- But many successful features as well
  - Competition: eg 3 services Bham to London
  - Variety of services & fares: £158-£10 return B-L
  - Passenger km up 50% by 2000
  - Efficiency increased: TOCs ave. 2% p.a.
  - Increased investment in track and rolling stock
  - Bidding for franchises reduced subsidies greatly
  - Average delays reduced 16%
  - Accident rate no greater than before
- Restructuring has contributed to net benefits

# Rail 4: problems with Railtrack

- Not prepared for increased TOCs demand
  - former British Rail geared to managing decline
- Poor asset register problem for mgt & regln
- Not enough maintenance expenditure?
- Adequacy of supervision of contractors?
- Unrealistic budgeting for expansion
- Over-response to major accident at Hatfield
  - speed restrictions lost sympathy, traffic, revenues
- Better management with *more* Railtrack split?

# Rail 5: TOC contract problems

- TOCs given additional task of planning and financing network upgrades to meet demand
- routes awarded on 7 year franchise contracts
- short term franchises facilitated repeated bidding to minimise operating subsidies
- subsidies reduced and traffic stimulated
- but franchise durations too short for TOCs to finance investment in network
- regulator had limited ability to intervene

# Rail 6: outcome today

- Core of rail industry effectively re-nationalised
  - Railtrack now Network Rail no equity finance, has taken maintenance in house and cut back on investment plans
  - Strategic Rail Authority has taken over from TOCs planning and funding of upgrades, reduced contracts
  - rail outcome now taxpayer risk instead of shareholder risk
  - Efficiency & funding problems ahead?
  - Increasingly political not economic decisions?
- Was restructuring source of most rail problems?
  - No: Railtrack management, contract length, limited scope for regulation, active government role more problematic

# Conclusions

- Restructuring is a continual process
  - at vesting driven by economic and non-economic factors
  - market drives subsequent restructuring within constraints
- Telecoms, gas, airports not restructured
  - subsequent competition problems, pressure to restructure
- Electricity and rail restructuring beneficial
  - promoted competition and efficiency, strong regulatory role (where allowed) minimises merger & other problems
- Case for maximum restructuring to allow later evolution within strong separation conditions