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Growth 50

Privatisation

A Review of the Australian Experience

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CEDA

Committee for Economic Development of Australia

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A Review of the Australian Experience

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Contributors

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Paul Fearon has had 21 years electricity industry experience. He commenced with the SECV in 1981, holding various positions in production, planning and treasury. In 1992–93 he was seconded to the Kennett Government as Energy Advisor, and from 1994 to 2002 he held a number of senior executive positions with CitiPower.

CitiPower was sold by American Electric Power on 1 September 2002 to a consortium of Cheung Kong International (CKI) and Hong Kong Electric, whose holdings also include ETSA and Powercor. CitiPower's retail business was contemporaneously on-sold by CKI to Origin Energy.

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Margaret Mead is Deputy Director of Research at the Committee for Economic Development of Australia. She has previously worked at the OECD in Paris and the Faculty of Economics and Commerce at the University of Melbourne. She is currently Executive Editor of CEDA's magazine, *Australian Chief Executive.*

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Louise Sylvan is the Chief Executive of the Australian Consumers' Association (ACA) and the elected President of Consumers International. An active member and worker in the consumer movement nationally and internationally for over 15 years, Louise is well known for her work in enhancing consumer rights in health, on food issues, financial services, e-commerce, as well as in competition and consumer protection policy.

Louise has advised governments in a variety of areas over the years, including serving for six years on the Australian Prime Minister's Economic Planning Advisory Council, the Expert Group in E-Commerce, the Advisory Board of the Australian Bureau of Statistics, the ACCC Consultation Committee, and many years on the Federal Minister's Consumer Advisory Council on Consumer Affairs. She represents Consumers International in a range of international forums including the OECD, the WTO, the World Economic Forum, a range of UN meetings, and in consultations with various nation-state government officials.

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Professor Glenn Withers AO has been Professor of Public Policy at the Australian National University since 1997 and is a Vice President of CEDA. He is a Monash and Harvard graduate, has headed a range of Australian government inquiries and bodies, including the Economic Planning Advisory Commission and the National Population Council, and has consulted extensively for the private and public sectors. He has published books and articles in public policy, labour economics, population issues and cultural economics.

Executive summary

This publication contains a range of views on aspects of privatisation and contracting-out in Australia. While some of the views expressed differ, there are also a number of areas of agreement.

Lessons learnt from privatisation

- Most economic commentators agree that privatisation is beneficial when it results in private firms operating in a competitive market. However the public is skeptical of the benefits of privatisation.
- The crux of the privatisation debate now lies in those areas where the market may not achieve the desired objectives. In some areas (including parts of the transport sector, the transmission and distribution business in the energy sector and some other infrastructure services) competition may not be viable, so private ownership will mean a regulated monopoly provider. In other areas (such as pollution management, waste disposal and health services) externalities may mean private incentives are not aligned with public welfare, even if the market is competitive.
- The case for private ownership of natural monopoly assets remains contentious.
- Government intervention is required in those parts of the economy where there is a conflict between the profit-maximising behaviour of private firms and social welfare. In these areas governments can intervene through a variety of combinations of regulation and ownership. Privatisation is about designing an optimal mix of ownership and regulation to achieve the best outcomes for society. Private ownership with regulation is one option. In other cases, government ownership (possibly combined with contracts for private sector operation) may better achieve society's objectives.
- Governments should not be allowed to use privatisation as an expedient source of funds. A formal alteration to government accounting is required so that privatisation revenues cannot be used to prop up a government budget.

Privatisation is about designing an optimal mix of ownership and regulation to achieve the best outcomes for society. Private ownership with regulation is one option. In other cases, government ownership ... may better achieve society's objectives.

What is the future of privatisation?

- There are still major government assets which could be sold, but many of these assets support services which are not fully financially viable—some may be loss making (such as public transport), others may be priced to meet equity objectives (such as health and education).
- These sectors are more likely to involve private sector participation through long-term contracts, rather than divestment. But governments will need to improve their skills in allocating finance, and designing and managing contracts, to attract private capital into these sectors. There is a need to improve contract management skills within the public sector.
- One of the key elements of any contracting exercise is the allocation of risk. While risk should be allocated to the party best able to bear it, government bears the residual risk—if a contract for the provision of, say, public transport fails, the government is obliged to ensure the service continues and to bear the higher costs. This is sharply different to the way risk is born in privatised assets. However, risk can be transferred on the financing, procurement and provision of services, provided contracts are designed to achieve this. Contract management is critical—and does not come naturally to government.

- Most contributors to this volume do not see reversing privatisation as an option. However, among the alternative views is a suggestion that some natural monopoly assets are best held by governments.

Public accountability

- Accountability mechanisms which apply to competitive entities formerly in the public sector have broadly been accepted by the community. For example, the privatised Commonwealth Bank, Qantas and ANL are all subject to the accountability arrangements (some of which are quite extensive) applying to those industries. But when a monopoly business activity is privatised, the public applies a more stringent accountability test, reflected, for example, in the public opposition to the privatisation of New South Wales electricity generation plants, and the sale of the remaining government holdings in Telstra. Governments are grappling with the need for a new or extended accountability model for such privatisations.

> When a monopoly business activity is privatised ... governments are grappling with the need for a new or extended accountability model.

Impact on employment, consumers and public opinion

- Although the overall impact of privatisation in competitive markets has been beneficial, unions argue that it has contributed to growing job insecurity and widening income distribution in Australia. Privatisation has been one of many factors driving the growth of part-time, casual and temporary employment.
- From a consumer perspective, the overall verdict on privatisation is one of mixed success, with insufficient attention to consumer outcomes.
- Privatised industries argue there have been service improvements, although removing cross-subsidies has sometimes reduced consumer price benefits.
- National public opinion surveys indicate little support for privatisation among the general public.

Politics of privatisation

- A number of cultural and political factors have constrained privatisation in Australia, including:
  - a high degree of national identity, often equated with the national interest, attached to many GBEs;
  - a public perception that many Australian GBEs have performed relatively well, which has weakened the efficiency case for privatisation;
  - the three-year electoral cycle which impinges on the long lead times and careful management required by government for successful privatisation programs;
  - the Senate voting system which has allowed minority parties and independents to hold the balance of power since the early 1980s, giving rise to major clashes of mandates, including over privatisation;
  - a general lack of public confidence in the independence and effectiveness of the regulatory system.

Overview

Margaret Mead

Since the early 1990s, Australian governments have undertaken a major program of privatisation and contracting-out of government assets and services. Initially this followed policies implemented in the United Kingdom in the 1980s, but by the mid-1990s Australia, along with New Zealand, was setting the pace for privatisation around the world.[1] As Jamie Carstairs notes in this volume, total revenue from privatisations in the 1990s was $85 billion, with around 45 per cent coming from the sale of electricity and gas assets, and 33 per cent from the sale of Telstra. The Commonwealth received the largest share of privatisation revenues (from the sales of its airports, 50 per cent of Telstra and the Commonwealth Bank), while at the state level, Victoria's revenues from privatisation exceeded those of all other states put together and were dominated by sales of government business enterprises (GBEs) in the electricity and gas industries.

The aim of this publication is to assess what privatisation and contracting-out have achieved. Have the projected benefits materialised? What have we learnt about the process? Do current approaches require modification in light of the outcomes and experiences of the last decade? What has been the impact on workers, consumers and the public in general? What role have political factors played? Finally, what is the future of privatisation? Is a reassessment of the relative roles of the public and private sectors now required?

In CEDA's tradition of promoting independent discussion and debate, the collection of papers in this volume present a range of views on these issues. An overview of the main themes follows.

Private or public ownership?

Stephen King commences discussion in Chapter 1 with a general review of privatisation in Australia. He notes that motives for privatisation are generally twofold: to improve the performance of the firm or business and/or to raise revenue for the government. He asks:

- why does ownership affect the ability of a business to operate efficiently? and
- is there a conflict between efficient private operation and social objectives?

King observes that many economists believe competition, not ownership, drives efficiency, and 'in the absence of competition, both privately- and publicly- owned firms can set inefficient prices and use wasteful technology'.

According to King, privatisation is usually beneficial when it results in private firms operating in a competitive market. 'Most of the time, competition and private ownership provide an excellent way of organizing production and distribution throughout society'.

However, the crux of the privatisation debate lies in those areas where the private sector does not necessarily operate appropriately. In some areas (such as transport, energy and other infrastructure services) competition may be unviable, so private ownership will mean a monopoly provider. In other areas (such as pollution management, waste disposal and health services) externalities may mean private incentives are not aligned with public welfare, even if the market is competitive.

Many economists believe competition, not ownership, drives efficiency, and 'in the absence of competition, both privately- and publicly- owned firms can set inefficient prices and use wasteful technology'.

King argues that government intervention is required in those parts of the economy where there is a conflict between the profit-maximising behaviour of private firms and social welfare. In these areas governments can intervene through a variety of combinations of regulation and ownership. Privatisation, says King, is about designing an optimal mix of ownership and regulation to achieve the best outcomes for society. Private ownership with regulation is one option. In some cases, government ownership may better achieve society's objectives.

Three recent cases of privatisation are then considered: the sale of the Commonwealth Bank, the partial sale of Telstra and the privatisation of the Victorian electricity industry. King comments that:

- The sale of the Commonwealth Bank made perfect sense—it operated in active competition with private banks and its functions were essentially identical to the private competitors.
- On the other hand, telecommunications involves a natural monopoly element—the customer access network (CAN)—and the partial privatisation of Telstra failed to adequately address issues of access to this natural monopoly technology, which has resulted in wide ranging and costly regulation.
- The privatisation of the Victorian electricity industry avoided issues of access by separating the competitive generation from the natural monopoly elements of the industry, but the price regulation of transmission and distribution has been contentious.

Governments should not be allowed to use privatisation as an expedient source of funds.

King suggests that some previous privatisations may need to be radically re-evaluated. For example, Telstra could be restructured with private shareholders owning the competitive assets, while government retains the CAN; and the Victorian electricity transmission system could be returned to government ownership.

Importantly, concludes King, governments should not be allowed to use privatisation as an expedient source of funds. A formal alteration to government accounting is required so that privatisation revenues cannot be used to prop up a government budget.

The future of privatisation

Jamie Carstairs assesses the future of privatisation in Chapter 2. He notes two possible routes for private provision:

- private investors buying government assets in markets where they earn revenues direct from consumers; and
- private investors entering long-term contracts, where at least part of their revenue is dependent on continued government funding.

He concludes there are still major government assets which could be sold, but many of these activities are not fully financially viable—some may be loss making (such as public transport), others may be required to meet equity objectives (such as health and education). These sectors are more likely to involve private sector participation through long-term contract, rather than divestment. But governments will need to improve their skills in allocating finance, and designing and managing contracts to attract private capital into these sectors.

What lessons have we learnt from the contracting experience to date? Carstairs says there is much evidence that contracts can deliver efficiency and financial gains—but a lot depends on how it is done. Overall success in long-term contracts for private provision has been mixed. Long-term BOO or BOOT contracts for toll roads in New South Wales and Victoria appear to have been successful, but of two contracts to build and operate hospitals in Victoria, one reverted to public sector operation due to financial difficulties, and of three contracts to build and operate prisons, also in Victoria, one was taken over by the Government after difficulty in meeting operational requirements.

One of the key elements of any contracting exercise is the allocation of risk. While risk should be allocated to the party best able to bear it, government bears the residual risk—if a contract for the provision of, say, public transport fails, the government is obliged to ensure the service continues, and to bear the higher costs. This is sharply different to the way risk is born in privatised assets. However, risk can be transferred on the financing, procurement and provision of services, provided contracts are designed to achieve this. Contract management is critical—and does not come naturally to government. Carstairs stresses the need to improve contract management skills within the public sector.

There is much evidence that contracts can deliver efficiency and financial gains—but a lot depends on how it is done.

Public accountability

In Chapter 3 Tony Harris examines public accountability issues related to privatisation and contracting-out. He notes that although the transfer of assets from the public to the private sectors is not new, governments are now transferring functions which have traditionally been delivered only by the public sector. These privatised monopoly functions—often previously delivered by government utilities—require a different level of accountability than is needed for the privatisation of other public assets.

Harris argues that accountability mechanisms which apply to competitive entities formerly in the public sector have broadly been accepted by the community. For example, the privatised Commonwealth Bank, Qantas and ANL are all subject to the accountability arrangements (some of which are quite extensive) applying to those industries. But when a monopoly business activity is privatised, the public applies a more stringent accountability test, reflected, for example, in the public opposition to the privatisation of New South Wales electricity generation plants, and the sale of the remaining government holdings in Telstra. According to Harris:

> *Governments are grappling with the need for a new or extended accountability model as they try to convince the public that these community functions can be delivered efficiently and safely by the private sector … Apart from Victoria, State governments have been unable to privatise their monopoly business ventures. It seems that the public does not have sufficient faith in the adequacy of government accountability frameworks to support the transfer of monopoly powers to the private sector.*

The public appears more accepting of arrangements where government retains control of a public utility but contracts out some or all of its operations under tightly defined arrangements. Harris cites apparent public acceptance of the franchising arrangements for the operation of public transport in Victoria as an example. But contractual arrangements may become problematic in sectors facing financial difficulties—and recently the Victorian Government was forced to supplement the payments required under the transport franchise agreements.

The Victorian electricity industry

A case study of the privatisation of the Victorian electricity industry is presented in Chapter 4 by Paul Fearon. The Kennett Government (1992-1999) implemented an extensive program of electricity reform involving disaggregation of the industry, a comprehensive privatisation program and the establishment of a competitive retail and wholesale electricity market. A key objective of the reform program was the separation of the potentially competitive elements of the industry (retailing and wholesale generation) from the monopoly elements (distribution and transmission). Retail and wholesale prices were to be subjected to the competitive disciplines of the market, while distribution and transmission tariffs would be subject to regulatory oversight and review.

In 1993 the SECV was disaggregated into three corporatised businesses covering transmission, retail/distribution and generation. Between 1994 and 1997 these businesses were further disaggregated into five distribution/retail companies, three brown-coal generating companies, one hydro-generation business, one gas-fired generation business and one transmission company.

The early years of electricity reform were a period of 'great liberation and confidence' for the privatised companies, but by the late 1990s the process had stalled.

Fearon asserts that electricity industry reform had a profound impact on Victoria. The sale proceeds alone, at over $30 billion (for all energy assets), were able to pay down nearly 90 per cent of state debt, and underpinned the revitalization of the State's economy. Customers have generally experienced better reliability, improved customer service and lower prices, and the industry has benefited from productivity improvements and the infusion of international expertise and private equity.

Nevertheless not all stakeholders have benefited—structural dislocation has occurred in some communities, and union membership in the sector has fallen significantly. Moreover, the industry is currently facing major challenges: in particular, whether the new market structure will continue to deliver the infrastructure required to meet anticipated increases in demand.

Fearon observes that the early years of electricity reform were a period of 'great liberation and confidence' for the privatised companies, but by the late 1990s the process had stalled. Controversy arose over the regulation of distribution tariffs (which were set at levels substantially less than purchasers has assumed) and debate continues over a number of other regulatory issues.

The surprise election of the Labor Government in 1999 further slowed the reform process, as the new government 'tried to make sense of what had happened to the electricity industry.' Much of the spare capacity originally in the new system had been used by 2000, and at the same time a surge in the wholesale cost of electricity and other factors put upward pressure on retail prices. In December 2001, the Victorian Government capped retail prices—hitting urban retailers hard. This accelerated the consolidation of retail energy businesses—from eight original incumbents to three. After some delays, full retail contestability was introduced in January 2002—although customer switching rates have been relatively low so far.

Fearon argues that while the industry faces significant challenges, this is not an argument for government ownership or radical redesign of the market. 'The current design of the electricity market must be given the opportunity to work … The genie was let out of the bottle in 1992. It can never be put back.'

Impact on employment

In Chapter 5, Grant Belchamber argues that although quantification of the direct effects of privatisation on employment is difficult, it has contributed to growing job insecurity and widening income distribution in Australia. Privatisation has been one of many factors driving the growth of part-time, casual and temporary employment and the rise of subcontracting.

Belchamber identifies a process of labour market fragmentation whereby those at the top work longer and longer hours and receive higher and higher salaries, while employment for those at the bottom is increasingly precarious and part-time. The rapid escalation of executive salaries following privatisation compares with stagnant pay rates for the individual contractors who no longer receive casual loading, holiday or sick leave. According to Belchamber, privatisation and contracting-out have clearly contributed to the increasing polarization of market incomes and working hours, and the rise in work-related stress and job insecurity.

Privatisation has been one of many factors driving the growth of part-time, casual and temporary employment and the rise of subcontracting.

Consumer perspectives

Louise Sylvan presents the views of the consumer movement in Chapter 6. The overall verdict is one of mixed success, with insufficient attention to consumer outcomes. She argues that from a consumer point of view, a well regulated private provider can be as good as, sometimes better than, direct government ownership—but that issues arise when the entity being privatised is a monopoly. The evidence suggests that attempting to control a private monopoly through separation and regulation is often less than successful. For example, the privatisation of Sydney Airport facilities led to price increases of 100 per cent.

Sylvan concludes that consumers are somewhat neutral about who owns a product or service—provided the price and quality are good. She urges caution in further privatisations of essential services such as energy and telecommunications, and warns that ideology should not triumph over commonsense.

Public attitudes to privatisation

Public opinion about privatisation is surveyed in Chapter 7. Jonathan Kelley and Joanna Sikora present the results of national sample surveys conducted since 1986 on attitudes to privatisation. They report little support for privatisation among the general public. Specific findings include:

- support for privatising Telstra has eroded steadily since the mid 1980s—by 2002 just over 70 per cent of respondents were opposed, compared with around 50 per cent in 1986;
- the same pattern of declining support exists for privatising Australia Post, the Commonwealth Bank, Qantas and the railways;
- privatisation is seen as a single issue—those who support it in one domain tend to support it in all others, and *vice versa;*
- overall support for privatisation is declining by a little over one point a year.

According to Kelley and Sikora, if government continues with privatisation under these circumstances, it will be a case of elite leadership, rather than of government representing the views of the average voter.

The politics of privatisation

In Chapter 8, Kenneth Wiltshire analyses the political forces which have shaped Australia's privatisation initiatives. He notes that political attitudes to privatisation in Australia generally follow party lines, but there are some important qualifications. The Australian Labor Party does not favour privatisation, but this is not true of Labor governments. The National Party generally favours private ownership, but opposes policy initiatives which threaten service delivery in 'the bush'. While the Australian Democrats and Greens favour public ownership but may support privatisation if they can have some say in the use of the proceeds.

Wiltshire identifies a number of cultural and political factors which have constrained privatisation in Australia. These include:

- a high degree of national identity, often equated with the national interest, attached to many GBEs (such as Qantas, Telstra and the Commonwealth Bank);
- a public perception that many Australian GBEs have performed relatively well, which has weakened the efficiency case for privatisation;
- the three-year electoral cycle which impinges on the long lead times and careful management required by government for successful privatisation programs;
- the Senate voting system which has allowed minority parties and independents to hold the balance of power since the early 1980s, giving rise to major clashes of mandates, including over privatisation;
- a general lack of public confidence in the independence and effectiveness of the regulatory system.

The major political issue concerning privatisation relates to community service obligations (CSOs), most notably the provision of services to 'the bush'. Other CSOs relate to the way business customers subsidise domestic customers and concessions for the aged, the young and the disadvantaged.

Wiltshire says the major political issue concerning privatisation relates to community service obligations (CSOs), most notably the provision of services to 'the bush'. Other CSOs relate to the way business customers subsidise domestic customers (and *vice versa*), and concessions for the aged, the young and the disadvantaged.

Other major political issues include concerns about:

- the standard of service following privatisation—in areas such as electricity provision, rail trains, prisons and welfare services, there is a significant public perception that privatisation has led to falls in service levels (even failure) and/or increased prices;
- short-term unemployment which may be created as newly privatised entities seek to reduce costs; and
- lack of accountability in the privatisation process, particularly the determination of the sale price of public assets.

Wiltshire concludes that the debate about privatisation in Australia remains a very uneven one. The advocates of privatisation often have hard quantitative data at their disposal—successful growth rates, profitability, market share, dividends, etc. The opponents generally have to rely on qualitative arguments—falls in standards of service, market failure, job losses, avoidance of community service obligations, regulator capture, etc.—all of which are hard to measure and hard to attribute directly to privatisation *per se*.

Re-nationalisation: thinking the unthinkable?

In the final chapter, John Quiggin argues for rethinking the roles of the public and private sectors in economic activity.

He notes that the dominant policy trend of the 20th century was not privatisation, but nationalisation. In almost all countries the range of economic activities undertaken by governments was substantially larger at the end of the 20th century than at the beginning. During the last 20 years, however, there has been a sustained attempt to roll back the growth of government. But by the late 1990s the pace of privatisation had clearly slowed, and in the first years of the 21st century it slowed even further. In some English-speaking countries a countervailing trend has emerged. Nationalisation, or re-nationalisation, has occurred on a significant scale—examples include nationalisation of airport security in the United States, the effective re-nationalisation of Railtrack in the United Kingdom and the re-establishment of a publicly-owned bank in New Zealand.

Quiggin argues that analysis shows that privatisations of the Commonwealth Bank, the Commonwealth Serum Laboratories, Telstra, the NSW State Bank and the Victorian electricity sector all indicate a net welfare loss from privatisation, although in the case of Victorian electricity, the loss was borne by the buyers, who paid prices which were, in retrospect, excessive.

According to Quiggin, it is unlikely that privatisation of efficiently-run GBEs in core areas of government activity, such as infrastructure, is ever likely to be beneficial, except during market 'bubbles' when buyers may be willing to pay prices that exceed the long-run market value of assets.

He argues that until about 1980, the idea of substantially reducing the scale of public sector economic activity was unthinkable—and until recently arguments that the appropriate response to the failures of privatisation is a return to public ownership have been ignored. But, as noted above, the position is slowly changing.

Quiggin stresses that privatisation is not irreversible and that a systematic and rational reconsideration of the appropriate roles of the public and private sectors should be undertaken.

> *The evidence … suggests that a number of privatisations already undertaken have reduced both public sector net worth and the welfare of the community as a whole. It follows that … re-nationalisation would improve welfare. … The strongest candidate for re-nationalisation in Australia at present is Telstra … [and] it would be highly desirable to restore full public ownership of the road system and to replace the present arbitrary patchwork of tolls with a rational system of road-user charging. Less urgent, but still highly desirable, is the re-nationalisation of monopoly infrastructure, such as water supply in South Australia and electricity distribution in South Australia and Victoria.*

In a mixed economy (such as in most OECD countries), 'it is possible to adjust the boundary between the private and public sectors optimally in response to new information and changed circumstances', he concludes. CEDA leaves it to readers to make their own judgement on this balance.

The dominant policy trend of the 20th century was not privatisation, but nationalisation ... During the last 20 years, however, there has been a sustained attempt to roll back the growth of government. But by the late 1990s the pace of privatisation had clearly slowed.

Endnotes

1 See Wiltshire in this volume.

1. Why privatisation? Lessons from Australia

Stephen P. King

1. Introduction

Privatisation, the transfer of state-owned assets to private ownership, occurred throughout the world in the 1990s. In Australia, governments sold businesses in a vast range of sectors including finance, transport, energy, telecommunications, pharmaceuticals, health and business services. Since 1990, privatisation has yielded over $100 billion for Australian governments.[1] Annual privatisation revenues grew throughout the 1990s, peaking in 1997–98 at almost $25 billion. Privatisation is continuing, albeit at a slower pace, with the sales of National Rail and FreightCorp, and Sydney airport being finalised in 2002.

Australia's privatisation program followed the United Kingdom's privatisation policies of the 1980s.[2] However, during the 1980s and 1990s privatisation programs were embraced in both developed and developing countries, and privatisation became a major part of the reform of Eastern Europe and other 'transition' economies.[3] In developing and transition economies, privatisation is often part of a broad-based reduction in the government intervention associated with former socialist and communist regimes. In developed countries like Australia, privatisation is used both to improve the performance of the relevant firms and to raise revenue for the government.

In this chapter, I use the Australian experience to analyse the first of these two motivations for privatisation—the relationship between private ownership and economic performance. Why does ownership affect the ability of a firm or business to operate efficiently, and is there a conflict between efficient private operation and social objectives?

In Australia, privatisation has been part of general 'microeconomic reform' that has included the corporatisation of government business enterprises, the competitive tendering and contracting-out of a variety of formerly government-provided services, and the reform of utility industries.

2. Background to Australia's privatisation reforms

In Australia, privatisation has been part of general 'microeconomic reform' that has included the corporatisation of government business enterprises (GBEs), the competitive tendering and contracting-out of a variety of formerly government-provided services, and the reform of utility industries, such as telecommunications, energy, water and transport. Microeconomic reform took hold in Australia during the 1980s with the deregulation of the financial sector and airlines (Forsyth 1992; Quiggin 1996), and accelerated in the 1990s after the release of the final report of the independent committee of inquiry on National Competition Policy (the Hilmer report) in 1993.[4]

The zeal for reform was driven by a number of factors. First, there was a perception that the Australian economy was performing poorly. The Industry Commission, in its first annual report, argued that Australia's productivity growth in the late 1980s had been low compared to other OECD countries and was particularly poor in the areas of electricity, gas and water.[5] It estimated that long-term gains from reform in areas such as transport, utilities and industry assistance could lead to a 6.5 per cent increase in real GDP.[6] Other economic research also suggested significant potential gains from reform. For example, Albon (1988) estimated gains of over $200 million per year (at 1985–86 prices) from pricing reform in telecommunications.

A second factor was government requirement for fiscal rectitude. As Maddock (1995) argued, disaffection with high taxes, particularly direct taxes, created a political need for governments to both reduce GBE expenditure and raise revenue from alternative sources. Privatisation provided the perfect opportunity for Australian governments to raise large amounts of short-term revenue, to either retire government debt, fund spending or cut taxes. Privatisation receipts enter the government accounts in the year that they are received as either revenue or as negative expenditure.[7] As such, privatisation either reduces the government budget deficit or increases its surplus. While the revenues are offset by the sale of a long-lived asset, privatisation can reduce the fiscal constraints facing governments in the short term.[8]

Pusey (1991) argued that microeconomic reform and privatisation were driven by the dominance of economists in the Canberra public service, who sought to implement orthodox economic ideas. These 'economic rationalists' pursued privatisation for ideological reasons. While ideology has been central to the (often misinformed) public debate on privatisation, it would be naïve to suggest that the bureaucratic tail wagged the political dog in Australia. Also, such an Australian-centric view does not explain the worldwide nature of privatisation. More likely, privatisation occurred in Australia and elsewhere because of a mixture of economic ideas and political expediency.

Privatisations in Australia fall into two groups. Some asset sales, particularly in the early 1990s, involved government-owned businesses operating in competition[10] with private firms. Most privatisations, however, involve assets that create potential regulatory problems. Because of this, privatisation is often accompanied by the creation of new regulations and regulatory institutions.[9]

When a government business is actively competing with private firms, privatisation is relatively easy. Assets simply move from government hands to the private sector, sometimes without even changing the business name. For example, the Commonwealth Bank, the State Bank of New South Wales, Suncorp-Metway, the State Bank of South Australia and BankWest were all government-owned financial institutions that competed with private banks and finance companies before being privatised. Similarly, GIO in New South Wales and SGIO in Western Australia were government-owned insurance firms that could easily move to a competitive insurance market, while the Commonwealth Serum Laboratories were a government-owned pharmaceutical company facing worldwide competition.[10] In the near future, it is likely that Medibank Private, a government-owned health insurance company that actively competes with private insurers, will also be privatised.

If the government sells assets that occupy a strategic (often monopoly) position in a market, privatisation is unlikely to lead to a competitive environment. Selling a monopoly firm might be a good way for the government to raise revenue but it is likely to involve a high social cost if the new private owners can exploit the firm's monopoly power without constraint. As a result, when GBEs that have significant market power are privatised, the sale is often accompanied by the introduction of new regulations to limit and control the behaviour of the privatised firms. This is particularly the case when the privatised firms have a natural monopoly technology, as is the case for many infrastructure firms.[11]

When a government business is actively competing with private firms, privatisation is relatively easy. … when GBEs that have significant market power are privatised, the sale is often accompanied by the introduction of new regulations.

The sale of electricity in Victoria and South Australia, the sale of Commonwealth-owned airports, including Sydney airport in 2002, and the partial privatisation of Telstra were all associated with new and increased regulation. In electricity, privatisation was associated with new procedures governing the generation, transmission, distribution and sale of electricity under the National Electricity Market. The partial privatisation of Telstra has been accompanied by extensive telecommunications regulation, including a new Part 11B and 11C of the Trade Practices Act, while privatised airports were initially subject to extensive price controls.

Not all privatisations have been successful. A number of privatised services and assets have moved back under government control, including the Deer Park correctional facility and the ambulance dispatch service in Victoria. Re-nationalisation has also occurred overseas. The Californian electricity crisis in 2000–01 resulted in the State Government effectively replacing private retailers with a state-controlled supply.[12] Problems in the airline industry after the terrorist attacks in the United States on 11 September 2001 led to the collapse and re-nationalisation of SwissAir. Similarly, in 2001, ongoing problems with the UK rail system resulted in the Government taking back control of the rail infrastructure.[13]

Not all privatisations have been successful. A number of privatised services and assets have moved back under government control, [and] some [other] privatised firms have either been in dispute with government-appointed regulators or have sought explicit government assistance.

Some privatised firms have either been in dispute with government-appointed regulators or have sought explicit government assistance. In 2001, for example, distribution companies took action in the Supreme Court of Victoria over a pricing determination made by the Office of the Regulator-General. In the same year, the privatised public transport operators in Melbourne sought additional financial assistance from the State Government, claiming that they would otherwise be unviable. To understand privatisation, we need to understand why these problems have occurred.

3. Why privatisation?

Privatisation often appears to be driven by political expediency and ideology rather than by economic theory. This dislocation between theory and practice led Kay and Thompson (1986) to declare privatisation in the United Kingdom a ‘policy in search of a rationale’. In fact, there has been significant economic research on optimal ownership in the past 20 years, including the comparison between government and private ownership. This work provides the basis for understanding both the success and failure of privatisation.

3.1 Competition

In many markets, economists view competitive conduct as desirable. When consumers can choose between actively competing suppliers, those suppliers can only profit by producing high-quality products that satisfy consumers’ needs using cost-efficient production and then selling these products at prices that match or undercut their competitors. Competition leads to a socially desirable mix of goods and services being produced efficiently and sold to those consumers who most value the products. In economic parlance, competition promotes technical, productive and allocative efficiency.

The importance of competition as a driver for efficiency has led some economists to conclude that competitive interaction, not ownership, will lead to desirable market outcomes. Kay and Thompson (1986) and Yarrow (1986) argue that competition is the key to efficient production. In the absence of competition, both privately- and publicly-owned firms can set inefficient prices and use wasteful technology. In an early study, Caves and Christiansen (1980) compared publicly- and privately-owned railways competing in Canada. They found that ownership did not alter efficiency. More recent studies, however, tend to suggest that private ownership can provide benefits, even if markets are competitive. Shirley and Walsh (2000) surveyed the empirical literature and concluded that out of 16 studies involving alternative ownership in fully competitive markets, 11 suggested that private ownership improves performance in terms of profits, labour productivity or total factor productivity, while five studies detected no difference.

3.2 Objectives and performance monitoring

If public and private firms behave differently even when they face the same market environment, then the incentives that face the people who manage the day-to-day operations must systematically differ between public and private firms. There are two reasons why this might be the case. Either public and private owners set different objectives for their managers, or the ability of public and private owners to monitor and control the actions of their managers must differ. In fact, both of these are likely to be true.

Private owners care about profits. A well-managed private firm will seek to maximise owners' profits by lowering production costs and producing innovative products. In contrast, the political masters who monitor public firms face a range of objectives. These may include efficient operation and even profit maximisation. However, they are also likely to include electoral imperatives, such as maintaining employment or providing universal service, even to those customers who would be unprofitable for a private firm (Dixit 1997). Given these different objectives, we would expect to see private firms operating with higher profits and potentially lower costs than equivalent GBEs.

Private owners use a variety of methods to both motivate and monitor their managers. Capital markets externally evaluate the performance of private firms. If a firm is publicly listed on the share market, the share price provides an indicator of the firm's performance. A well-managed firm, that is likely to grow and have increased profits in the future, will have a relatively high share price. In contrast, a poorly managed firm that does not serve its customers well is likely to have falling profits and a falling share price. Managers' payments may be directly related to the share price, creating strong profit incentives. If the firm performs so badly as to go bankrupt, then both the owners and incumbent managers face a loss. In this sense, capital markets provide an external check on private firms and a source of managerial incentives that is not available to government-owned corporations.[14]

The provision of numerous goods and services … is best achieved through competitive markets with private firms. Most of the time, competition and private ownership provide an excellent way of organising production and distribution throughout society.

3.3 The naïve theory of privatisation

If private firms in competitive markets operate more efficiently than equivalent publicly-owned firms, and this leads to allocative and productive efficiency, then private ownership seems like a good idea. This simple logic provides a naïve theory of privatisation, and it is undoubtedly true for a vast number of markets in a modern economy. The provision of numerous goods and services, from cardboard to computer chips and haircuts to houses, is best achieved through competitive markets with private firms. Most of the time, competition and private ownership provide an excellent way of organising production and distribution throughout society.

But this naïve argument misses the point. The public debate about privatisation in a developed country like Australia is not about the huge number of areas of the economy where private provision works well but about those sectors where, for some reason, the private sector *does not* currently operate appropriately. Government ownership, in transport, energy and other infrastructure industries, may reflect that competition is unviable, so that private ownership means a monopoly provider. In areas of pollution management, waste disposal, incarceration and health services, externalities may mean that private incentives are not aligned with public welfare, even if the market is highly competitive. It is these areas—where private ownership need not be socially desirable—that are the key to the privatisation debate. And it is these areas where the naïve theory of privatisation is inapplicable.

Two examples can help to illustrate these points. In the United Kingdom, the railways began as private firms. But with their large fixed costs and relatively low marginal costs, railways represent a classic 'natural monopoly' where competition can be both socially undesirable and can result in an unstable market. In the 19th century the railways were regulated, first directly through parliament and then through regulatory commission. Gladstone suggested nationalising the railways as early as 1865, and the Government eventually took over control and ownership of the railways throughout the early to mid-20th century. Nationalisation was the end result of failed regulation and chronic unprofitability as automotive competition grew.[15]

The public debate about privatisation in a developed country like Australia is not about the huge number of areas of the economy where private provision works well but about those sectors where … the private sector does not currently operate appropriately.

While large fixed costs may render competition and standard competitive behaviour unviable, when there are externalities competition may be feasible but undesirable. For example, the safe disposal of toxic medical waste involves costly high-temperature incineration. But private firms seeking to maximise profits have an incentive to 'cut corners' on disposal to reduce costs. In the extreme, private firms may simply dump the waste at sea. This occurred in both New Jersey in 1987 and Los Angeles in 1996, creating major public health problems when the waste began to wash up on local beaches.[16]

The naïve theory of privatisation is sometimes used to justify privatisation[17] but it is inappropriate because it fails to recognise that government intervention is required in some parts of the economy. In these areas the government can intervene through a variety of combinations of regulation and ownership. Privatisation is about designing an optimal mix of ownership and regulation to achieve the best outcomes for society.

The naïve theory of privatisation is also used to criticise government ownership. GBE performance, in terms of commercial outcomes, is compared with private firms. For example, the Australian steering committee that monitored government business performance used financial measures such as 'return on assets' and 'sales margin' in its 1993 report.[18] But government ownership is only required when the pursuit of profits is socially undesirable. In this situation we do not want a GBE sto pursue profit-maximising activities, so judging a GBE's performance by profit-related measures has little validity.

3.4 The economics of privatisation

The theory of privatisation and government ownership is intrinsically linked with the theory of regulation. Government ownership only needs to be considered if there is a conflict between private profit-maximising behaviour and social welfare.

> *Lesson 1. Government ownership is unnecessary if private market interaction is reasonably competitive and there are no significant negative externalities associated with profit-maximising behaviour.*

In most markets, private ownership, guided by general trade practices laws, leads to socially desirable outcomes. Government ownership in such situations is at best benign and at worst harms social welfare. For this reason, privatisations were clearly desirable in banking and insurance in Australia, and steel production and the car industry in the United Kingdom. There is little if any justification for the government to be an active participant in these competitive industries. But if there is a significant market failure, the government needs to step in, and ownership is one of the tools in the government's regulatory arsenal.

If governments always acted in the long-term interests of society, if regulation could perfectly control private sector behaviour, and if GBE managers were completely guided by social interest, then any market failures could be rapidly eliminated by a judicious mix of government ownership and regulation. In fact, in this utopian world, there would be no need to balance regulation and government ownership, as either could be used to perfectly control any undesirable market outcomes. Unfortunately, none of these three conditions holds true in reality, creating a need for second-best solutions to problem markets.

Government ownership only needs to be considered if there is a conflict between private profit-maximising behaviour and social welfare. … Government ownership, however, is not a perfect solution to market failure.

> *Lesson 2. The potential need for direct government ownership arises because the regulation of private firms is imperfect.*

If governments could perfectly regulate private market behaviour, then direct ownership would be unnecessary. Any socially desirable outcome could be achieved through regulation. But the regulation of private firms is imperfect. Regulatory systems such as price cap regulation or rate-base regulation may lead to distorted outcomes, such as over-capitalisation and muted incentives to lower costs and adopt state-of-the-art technology. While regulation can alter private incentives and reduce any social costs of profit-maximising behaviour, it also reduces the social benefits that flow from private ownership. In this situation, government ownership might better achieve society's objectives.

Government ownership, however, is not a perfect solution to market failure. There are two main sources of failure of government ownership. Government ownership may lead to political interference that is socially undesirable. Alternatively, government ownership may lead to imperfect outcomes because the incentives of GBE managers are not perfectly aligned with social interests.

Politicians sometimes find it in their political interest to interfere with the operations of a GBE in a way that is detrimental to the broader social welfare. For example, politicians with interests in certain geographic areas or 'marginal electorates' might require a GBE to over-employ staff or maintain redundant facilities in that area in order to gain political support. This is particularly likely to be the case if the direct costs of such intervention are dispersed, delayed or concentrated in areas where they are not seeking electoral support. Political interference can undermine the social benefits of government ownership and privatisation can be a commitment device by government to reduce such interference. It is generally easier for politicians to intervene in the day-to-day operations of GBEs than to interfere in privately-owned firms.[19]

Even if politicians seek to act to maximise social welfare, the task of managing a GBE falls to delegated public managers. While these managers might be motivated by the public good, they also face private incentives that distort GBE performance. For example, GBE managers can face limited incentives to reduce costs, fire inefficient workers or set appropriate prices for the GBE's products. Because these managers do not face any profit-based market test of their actions, a GBE will not create the operational benefits associated with a competitive private firm. Corporatisation, the use of private-sector-type benchmarks to monitor the performance of GBE managers, can help to achieve more efficient outcomes but, like regulation, corporatisation is imperfect.[20]

When private profit-maximising activities conflict with social welfare, governments face a trade-off between private ownership and regulation—with its distortions—and public ownership with corporatisation. Both of these solutions are imperfect ... This is the fundamental privatisation trade-off.

When private profit-maximising activities conflict with social welfare, governments face a trade-off between private ownership and regulation—with its distortions—and public ownership with corporatisation. Both of these solutions are imperfect and the choice of ownership/regulatory regime is always an imperfect choice for government. This is the fundamental privatisation trade-off.

Lesson 3. Government intervention involves a trade-off between private ownership together with imperfect government regulation, and government ownership together with imperfect public sector incentives.

When judging privatisation policy we need to consider the mix of ownership and regulation chosen by the government. Did the government investigate any source of market failure that led to initial government ownership or that can be used to justify its continuation? If a market failure was identified, did the government consider alternative strategies of ownership and regulation to deal with this problem? For example, did the government consider reforming the relevant GBE, say through separating part of the GBE under government ownership while privatising the remainder? Was a regulatory regime clearly designed along with the privatisation process? Or was privatisation an ill-conceived 'grab for cash' that has led to a diminution of public welfare?

4. Three cases of privatisation

Performance in privatisation must be judged on a case-by-case basis. Three key privatisations in Australia have been the Commonwealth Bank, the partial privatisation of Telstra and the privatisation of the Victorian electricity system. How do these privatisations 'stack up' against the theory?

4.1 The Commonwealth Bank

In the 1940s and 1950s the Commonwealth Bank was the central banker for Australia. The Reserve Bank of Australia took over this role in 1959, placing the Commonwealth Bank in a similar position to a number of highly regulated private banks. Deregulation of the Australian banking sector in the 1980s meant that there was little if any special role for State-owned commercial banks, and the Commonwealth Bank was privatised in three tranches during the 1990s. The first sale of 30 per cent of the Bank in 1991 was the first large privatisation by share float in Australia and it set the benchmark for future sales, such as the sale of GIO and Qantas. Overall, it is likely that the Government sold the Commonwealth Bank at a discount to its true market value (Harris and Lye 2001). But in terms of economic welfare it seems clear that the sale of the Commonwealth Bank made perfect sense. The Bank operated in active competition with private banks and its functions were essentially identical to those private competitors. In fact, given the tendency for politicians to seek short-term electoral kudos by railing against the banking system, it is likely that continued government ownership of the Commonwealth Bank would have opened it up to political exploitation in the 1990s. In economic terms, the privatisation of the Commonwealth Bank was clearly sensible policy.

4.2 Telstra

Telstra was formed in 1992 by the merger of Telecom Australia and the Overseas Telecommunications Corporation (OTC). Both of these were fully owned by the Commonwealth Government. Telecom Australia controlled Australia's domestic telephone network while OTC controlled overseas telecommunications. In the late 1990s, 49.9 per cent of Telstra was sold by the Government in two tranches. This partial privatisation is the largest by value in Australia, reaping over $30 billion for the Commonwealth.[21]

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At first blush, the sale of Telstra might appear similar to the sale of the Commonwealth Bank. After deregulation in July 1997, Telstra competed vigorously with privately-owned carriers. Since then, Telstra has lost market share in both domestic long-distance calls and overseas calls. Telstra also currently faces vigorous competition in mobile telephony.

Unlike banking, however, telecommunications involves a key natural monopoly element, the customer access network (CAN) that provides the 'last link' in the telephone network between a switch and a customer's phone. Telstra owns the CAN and its private competitors rely on Telstra providing them access to the CAN in order to compete. Telstra could eliminate its private competitors outside the CBD areas of Australia if it refused them the right to either originate or terminate calls using the CAN.

Telstra faces a wide range of regulations, including retail price controls, procedures for setting wholesale access prices and rules to prevent any anti-competitive behaviour. This regulation has been modified over the past five years and in 2001 the Productivity Commission recommended further reform of Telstra's regulatory regime (Commonwealth of Australia 2001). In 2002 the Federal Government investigated and rejected reforming Telstra by accounting separation to 'isolate' the CAN.

The partial privatisation of Telstra failed to adequately recognise the source of market failure—the natural monopoly CAN. Neither did it establish appropriate procedures to deal with this problem. One solution might have been vertical separation of the CAN from the rest of Telstra. The CAN could have remained in public ownership with open access while the remainder of Telstra could have competed with other telecommunications companies. Alternatively, the management of the CAN could have changed. For example, the CAN could be jointly owned by a number of licensed carriers. These carriers would have a mutual obligation to maintain the CAN but otherwise would compete. The sharing of infrastructure facilities between competing firms sometimes occurs with gas pipelines.

Discontent with the partial privatisation has made it politically difficult to sell the remainder of Telstra. In the absence of a restructured approach to the CAN, further privatisation will simply mean ongoing costly regulation. Such regulation will continue into the future as the CAN grows in importance for data rather than voice telecommunications traffic.

4.3 The Victorian electricity system

The creation of a National Electricity Market (NEM) was a key part of the Hilmer reforms. This market involves generators competing to sell power into a grid connecting South Australia, Victoria, New South Wales and Queensland. The proposed construction of BassLink will connect Tasmania to the NEM.

Privatisation is not required under the NEM but private generators are able to compete with government-owned facilities. The Kennett Government in Victoria decided to sell the State's electricity assets to the private sector. Privatisation was preceded by vertical and horizontal restructuring, including the creation of five distribution/retail companies, five competing generation businesses and a single transmission business. The total proceeds of the privatisations in the mid-1990s were approximately $22.5 billion, second only to Telstra in terms of total revenue raised.[22]

By separating competitive generation from natural monopoly elements … the Victorian electricity privatisations avoided the issues of access and competitive abuse that have dogged telecommunications … However, both transmission and distribution have limited scope for competition and these prices need ongoing regulation. … this regulation has been contentious.

By separating competitive generation from natural monopoly elements, like transmission and distribution, the Victorian electricity privatisations avoided the issues of access and competitive abuse that have dogged telecommunications. Further, some measures of performance, such as the reliability of the distribution system, have significantly improved.[23] However, both transmission and distribution have limited scope for competition and these prices need ongoing regulation. As noted earlier, this regulation has been contentious.

Political interference still occurs, as both generation prices are capped under the NEM and maximum prices for power to households are set. For example, in 2001 the Victorian Government rejected recommended increases in household power prices, leading to comparisons with the Californian electricity crisis and concerns over the long-term viability of distributors/retailers if they are unable to pass on increased wholesale electricity prices to customers.[24] The shift to a national market has also required modifications, for example, in the face of claims of price rigging by generators.[25] Further, it is not clear that long-term competition between State-owned electricity systems and private systems is viable.

While generation and retailing can be open to competition, a preferred approach might have been to retain public ownership of transmission and distribution lines. Rather than heavy-handed profit-based regulation, the ongoing operation and maintenance of these facilities might have been handled through private contractors, with the relevant governments setting transmission and distribution charges to cover cost. At the same time, electricity experience shows that privatisation is not a cure for short-term political interference in key infrastructure assets.

5. Is privatisation dead?

The privatisation process has slowed in Australia. But this is to be expected. Most of the obvious privatisations have been completed and both politicians and bureaucrats are realising the limitations of a naïve approach to privatisation. Public pressure against privatisation has grown. Despite the Federal Government's preference for privatising the remainder of Telstra, such a policy is currently unpalatable to the electorate. Similarly, in New South Wales attempts by senior politicians to push for electricity privatisation have been thwarted by public opposition. While privatisation in Australia is not dead, it is 'on the nose'.

The current public backlash against privatisation is a direct consequence of its naïve application. Some privatisations have not worked. While these sales have raised short-term revenue for the government, they have not resulted in improved social welfare because they have not carefully considered any sources of market failure and dealt appropriately with these failures.

At the same time, the underlying motivations for privatisation remain relevant. Government still feels the need to reduce fiscal pressures, and public–private partnerships (PPP), where the government ties the private development of infrastructure assets to long-term government funding, represent a new face of privatisation. Thus privatisation continues, but under another name.

Australia requires an integrated approach to privatisation and regulation. Private ownership with regulation is simply one of a number of options for dealing with market problems and public policy needs to recognise the costs and benefits of alternative options. This means that some previous privatisations might need to be radically re-evaluated. For example, it might be desirable to restructure Telstra with current private shareholders owning the potentially competitive assets, while the government retains the CAN. It also means that some privatisations should proceed, such as the sale of the New South Wales electricity generation facilities, while some other assets, such as the Victorian electricity transmission system, might better be returned to government ownership. Finally, it means that governments should not be allowed to use privatisation as an expedient source of funds. An alteration to government accounting is required so that privatisation revenues cannot be used to prop up a government budget. While this reform has already started, with analysts focusing on 'underlying' deficit figures that remove privatisation revenues, it needs to be formalised. Privatisation and regulation are all about incentives—and the first incentives that need to be fixed are those facing our politicians.

Australia requires an integrated approach to privatisation and regulation. Private ownership with regulation is simply one of a number of options for dealing with market problems and public policy needs to recognise the costs and benefits of alternative options. This means that some previous privatisations might need to be radically re-evaluated.

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Endnotes

1 See Walker and Walker (2000, p.8) with the addition of more recent sales.

2 See Vickers and Yarrow (1988) for a survey of the UK experience in the 1980s.

3 Megginson and Netter (2001) provides a wide-ranging survey on the theory and empirical research on privatisation around the world.

4 Commonwealth of Australia (1993).

5 Commonwealth of Australia, 1990, p.30

6 See also Commonwealth of Australia (1991) and (1992). It has been argued that this perception of poor performance was overstated. For example, see Dowrick (1993).

7 'Revenue' in Australia, 'negative expenditure' in the UK.

8 There is an ongoing debate about whether revenues from privatisations equal the value of the assets sold by the government, or are either less or more than the value of the assets sold. See for example chapter 9 by Quiggin in this volume.

9 Newbery (1999, p.16) notes the same phenomenon in the UK privatisation program. 'The case for privatising British Airways, British Steel, British Aerospace, holdings in oil companies, and other industries exposed to local and international competition was clear, and it needs little defense. But the privatisation program did not confine itself to selling industries whose market power can be handled by normal competition policy'.

10 See Reserve Bank of Australia (1997) and Harris and Lye (2001) for more details.

11 A natural monopoly technology exists if it is more efficient—in terms of reducing production costs—for one firm to supply all market demand for a product than to have multiple firms supply this demand (Panzar, 1989). This will most often be the case when production involves large, unrecoverable fixed costs and low ongoing or marginal costs. It has long been recognised that in industries such as railways, telecommunications and electricity, where part of the production process involves a natural monopoly technology, competition is unlikely to develop and may not be desirable (Spulber 1989, chapter 1).

12 See 'Deep heat: California tackles power crisis', *Wall Street Journal*, reprinted in the *Australian Financial Review*, 20 July 2001.

13 See M. Dickson 'Byers, Railtrack and the great train robbery of 2001', *Financial Times*, 12 October 12, 2001.

14 Related to this, Schmidt (1996) argues that privatisation can provide government with a credible threat not to bail out a financially distressed firm, unlike government ownership.

15 See Foster (1992) for details.

16 See 'Medical-waste mess leads to fees for health professionals', by Shelby Grad, *The Los Angeles Times*, 29 December 1996, Metro p.1.

17 See Walker and Walker, 2001, p.75.

18 See Steering Committee on National Performance Monitoring of Government Trading Enterprises (1993).

19 Boycko, Shleifer and Vishny (1996) provide a model of privatisation based on political interference.

20 Laffont and Tirole (1991) and King and Pitchford (1998) present models based on imperfect monitoring of public and private firms. King (2002) considers the economics of corporatisation.

21 See Harris and Lye (2001) and Walker and Walker (2000) for details and for alternative views of the success of the Telstra sale in terms of revenue raising.

22 See Reserve Bank (1997) and Fearon and Moran (1999) for more details.

23 See R. Myer (2002) 'Promise of cheaper power falls short', *The Age*, 12 January.

24 See B. Clegg (2002) 'Energy sector in turmoil', *Australian Financial Review*, 11 March; and S. Bartholomuesz (2002) 'Power sale gives insight into deregulation', *The Age*, 5 February.

25 See P. Hopkins (2002) 'Gererators extract up to $1b more', *The Age*, 26 February.

2. Future directions in the private provision of public infrastructure

Jamie Carstairs

1. Introduction

In this chapter, possible future developments in the private provision of public infrastructure in Australia are considered. It looks specifically at two routes private provision can take:

- Private investors buying government assets, or making new investments, in markets where they earn their revenues direct from consumers; and
- Private investors entering long-term contracts, where at least part of their revenues are dependent on continued government funding.

Past experiences and future prospects of both these routes are briefly summarised, with the conclusion that while there are still prospects for privatisation of government assets, the role of long-term contracts for private sector participation may increase.

While there are still prospects for privatisation of government assets, the role of long-term contracts for private sector participation may increase.

Before looking at experience, it is worth considering why that should be so, and why it matters.

Privatisations of electricity, gas and other sectors have ensured that consumer interests are protected through competitive markets or, where the infrastructure has natural monopoly characteristics, through independent regulation. The interests of investors are also protected. They are able to identify and charge customers. Competition should ensure that prices reflect costs—at least over the long term. And regulation should, in theory, allow efficient investors to earn a reasonable return.

There are many sectors where these pre-conditions do not apply. In sectors such as defence, it is impractical to identify and charge users. In sectors such as public transport, the desired level of supply is loss-making. And in health and primary and secondary education, equity objectives are met through ensuring the publicly provided service is largely free at point of use.

There are still major government assets which could be sold into competitive markets with cost-reflective pricing, continuing the privatisation agenda of the 1990s. However, the scope for efficiency gains through private sector participation in water, public transport, health and education may be much greater. To varying degrees, these sectors are likely to be more amenable to contractual routes for private sector participation rather than to divestment.

Why does this matter? These approaches to private sector participation differ with respect to the financial implications, the way decisions are taken on the quantity and quality of production, and the impact on dynamism and innovation in the market. Understanding those differences is important for the design, implementation and ongoing success of increased private sector participation.

The financial gains from increased private sector participation can appear to be a zero sum game. Under privatisation the stream of income that comes from owning an asset is swapped for a lump sum on selling it. And under long-term contracts, the government faces a stream of contract payments or a stream of debt repayment (if it increases overall debt by financing the activity itself).

In one sense, divestment and contracting are the same: they minimise costs through auctioning an asset (or a right to provide a service) and they should only improve the State's financial position if efficiency gains are capitalised in the sale or contract price. However, in another sense they are very different. The gains from divestment are locked up after the sale. The gains from contracting depend on subsequent performance.

While this article was being drafted the press was reporting the proposed sale of Loy Yang power station in Victoria. It is clear that the Victorian Government achieved a strong sale price, and that any subsequent loss of value would be borne by those who hold equity in the company, not by taxpayers. The position on say the La Trobe hospital contract was sharply different. The Victorian Government may have received a strong bid, offering a significant discount to case-mix. However, the failure of that contract meant that taxpayers were faced with a higher price for future provision of hospital services. The apparent financial gains were not sustained.

The route for private sector participation also has a major impact on how decisions are taken on the quantity and quality of supply of infrastructure-based services. Under one model these are provided through market prices, which guide both consumption and production decisions.

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Electricity provides an example. Prices for retail consumers have to reflect the costs of supply (since otherwise retailers become insolvent). Those costs of supply in turn reflect generation prices, the cost of using the transmission and distribution networks, and retail margins.

There are plenty of debates about how far electricity prices are cost reflective. Time-of-day price signals are close to non-existent for many consumers, locational price signals are highly averaged, and security of supply (a key aspect of quality) is largely mandated rather than being market-based. However, these debates tend to be conducted within an assumption that cost-reflective prices enable consumers to take the right consumption decisions, and enable producers to take the right production decisions. To lapse into jargon, economists have convinced policy makers that cost-reflective prices encourage allocative efficiency.

Public transport provides an example of the approach taken where private participation is through contract. Public transport services tend to only partly recover their costs, and tariffs are not cost reflective. The rationale for subsidising loss-making transport is a mix of an economic decision (subsidising public transport is a second-best solution to pricing road transport correctly) and a social decision (it is desirable to ensure that people of all incomes have equitable access to employment and recreation).

There might be a market-based solution in time: congestion pricing might be introduced on roads, fuel taxes could incorporate environmental externalities, insurance costs could reflect the death and accident toll from car use, and access to whatever transport solutions emerged could be guaranteed by Community Service Obligations. In such a world, public transport might be profitable. But in the absence of these changes there is still going to be a case for public transport; the desired level of public transport is going to be loss-making, and the supply of services will be decided to some extent by what the government is willing to pay for, rather than simply the interaction of providers and consumers of public transport.

Unlike the electricity sector, decisions on the quantity and quality of public transport do not rely primarily on price signals. The total level of public funding emerges from the budgetary process. The decision on how to allocate funds within the sector relies on planning within the public sector and—regardless of how fashionable the term—is strongly affected by how well that planning job is conducted. As discussed below, contract design also affects the ability of private providers to vary services in response to demand.

A final question is how governments ensure innovation and dynamism in sectors based on infrastructure. Under market-based solutions, this relies on competitive pressure. Again, electricity provides an example. Generators have gained a competitive advantage from their speed to market and from securing low-cost gas; retailers are pursuing economies of scale through combining electricity, gas and telecommunications; and innovation in the demand side is emerging (slowly).

If governments are to continue using private sector participation … they will have to attract private capital into sectors that are not fully financially viable. And to do so well, they will … need to improve their skills in allocating finance, designing contracts and managing them.

Where governments are contracting for the service, the scope for innovation depends largely on contract design. Simply standing back is not a solution—many of the services governments want to contract for are loss-making, and the contract needs to specify what is provided. On the other hand, detailed specification may squeeze out the room for innovation. Ensuring that contract specifications are output-based is clearly desirable—but often not so easy in application.

In practice, good contracts leave scope for innovation. An example is the contract with Transurban for CityLink in Melbourne. Under a 34-year lease Transurban was free to design a relatively innovative service level, with smart cards, improved traffic information and safety measures. However, designing good contracts is not easy. More recently the contract for redevelopment of Spencer Street station also in Melbourne has allowed innovation in design and in sources of finance, and contracts for waste water treatment have allowed technological innovation in meeting EPA discharge standards.

So what are the implications of this discussion? I think simply this: that if governments are to continue using private sector participation to achieve efficiency gains and to innovate, they will have to attract private capital into sectors that are not fully financially viable. And to do so well, they will also need to improve their skills in allocating finance, designing contracts and managing them.

2. Privatisation into competitive markets

The last decade has seen a substantial increase in the private provision of public infrastructure. This has been dominated by the twin agendas of liberalisation and privatisation. Liberalisation has sought to protect consumer interests and enhance consumer choice through establishing competitive markets. This has seen the reduction of legislative or other barriers to entry, the separation and regulation of elements of infrastructure with natural monopoly characteristics, and the establishment of competition in sectors such as electricity generation and retailing, and telecommunications.

In a number of cases, liberalisation has been accompanied by privatisation. This has varied by sector and by State. Total revenues from privatisation during the 1990s were $85 billion.[1] Around 40 per cent of that was for sales of electricity and gas, and 33 per cent was for the sale of shares in Telstra. Privatisation revenues were dominated by the Commonwealth, with its sales of airports, 50 per cent of Telstra shares, and the Commonwealth Bank. At State level, Victoria's revenues from privatisation exceeded those of all other States put together, and were dominated by the electricity and gas sales.

Despite privatisations over the last decade, governments in Australia continue to own and operate companies which own significant infrastructure assets. Examples, drawn from the Productivity Commission's *Financial Performance of Government Trading Enterprises, 1996–97 to 2000–01,* include:

- *Electricity:* 23 government trading enterprises are listed, with total revenues of around $16 billion in 2000–01;
- *Ports:* 15 enterprises and authorities, managing over $3 billion of assets and with revenues of $650 million;
- *Water and sewerage:* 14 enterprises and authorities, managing $39 billion of assets and with revenues approaching $5 billion;
- *Urban transport:* four enterprises, with assets exceeding $1 billion and revenues of $680 million; and
- *Railways:* three enterprises (following recent sales of freight businesses), with around $14 billion of assets and $4 billion of revenues.

Despite privatisations over the last decade, governments in Australia continue to own and operate companies which own significant infrastructure assets.

Other possible Commonwealth sales, in particular T3 and Australia Post, would be large, but remain highly political. Similarly sensitive are the electricity assets still in public ownership in New South Wales, Queensland, Western Australia and Tasmania. The position of these governments on divestment of existing generation, transmission and distribution assets has either been unclear, or it has been clear that they are not for sale.

In recent months the New South Wales Government sold PowerCoal to Centennial Coal, and Pacific Power International is in the market. However, there has been no indication of a change of position on the sale of the core assets. Instead, the focus has been on reducing the risk arising from owning businesses in very volatile markets. There have been two major approaches to this:

- The Independent Pricing and Regulatory Tribunal (IPART) has established price caps to apply to the franchise load. Since that limits retailers' ability to pass through pool prices, it creates a risk to their profitability. That risk has been limited through the electricity tariff equalization fund (ETEF). This is effectively a swap (or contract for differences), whereby generators pay if pool prices exceed the reference tariff, and retailers pay if it falls below it. The main difference from other contracts of this kind is that it is imposed by the owner, rather than negotiated by the managers of each company, and achieved through administrative decision rather than mediated by the finance sector; and
- Trader model. The electricity sector provides the New South Wales Government with around $650 million annually through dividends and tax equivalent payments. However, revenues are highly risky. The Government has been exploring the possibility of converting a potentially volatile revenue stream into a more certain one by selling off the right to trade its electricity output.

It is possible that if the risks associated with ownership can be reduced in this way, then governments will be more willing to bear any continuing efficiency losses, and, in particular, higher manning levels due to public sector operation. However, the draft report of the Parer review of Australia's power and gas markets has made clear, if it was not already, that this will be an area of contention between the Commonwealth and some State governments.

In Queensland new power plants have been financed on a build-own-operate (BOO) basis. This will also be the case in Western Australia (judging by recent decisions), and has not been tested in New South Wales in recent years because of its substantial generating capacity. As new capacity additions are required, there may well be a gradual increase in private generation in these States. There have also been BOO investments in gas, although with increasing concerns about the impact of access regulation on the investment climate.

Private finance of new capacity has been one route to take for increased private participation. Another route has been the contracting-out of public provision … In some cases this has been accompanied by the introduction of new pricing structures to enable the private sector to recover costs from users … In other cases … the contract has required a continuing subsidy.

In the rail sector above-rail freight operations are now largely private, other than Queensland Rail's Coal and Freight Services business unit. Passenger services are under contract in Victoria, and publicly provided in New South Wales, Queensland and Western Australia. It seems unlikely that these are candidates for sale, although they might be candidates for long-term contracts of different types. BOO contracts for new infrastructure and services remain possible, although they will mostly require public funding.

Water and sewerage largely remains publicly funded. Provision is through a mix of public provision, BOO contracts for new water facilities, and the long-term contract in South Australia. This remains a sensitive sector. Again, it seems a candidate for private sector participation through long term contract rather than sale. Finally, the ports sector has also seen a mix of approaches—sale, contract and public provision.

3. Private participation through contract

3.1 Activity to date

Liberalisation combined with divestment, or private finance of new capacity, has been one route to take for increased private participation. Another route has been the contracting-out of public provision in areas such as public transport, hospital care, prisons, roads and water. In some cases this has been accompanied by the introduction of new pricing structures to enable the private sector to recover costs from users, for example, on toll roads. In other cases, where revenues for the service do not fully cover costs, the contract has required a continuing subsidy.

There are fewer sources of aggregate information on long-term contracts than on divestment. However, examples include:

- *Water:* in January 1996 United Water entered a 15-year contract with the South Australian Government and SA Water to manage, maintain and operate Adelaide's water and waste-water system. The objectives were cost reduction, improved quality and levels of service, and facilitating export opportunities for South Australian businesses;
- *Roads:* over the last decade the New South Wales Government has entered into contracts totalling around $2.5 billion for motorways and toll-roads (excluding the recently announced contract for the Western Sydney Orbital). In Victoria, CityLink was constructed against a 34-year concession period;

- *Public transport:* in 1999, the Government of Victoria entered 10–15-year deals which entailed the provision of defined public transport services, maintenance of fixed assets and procurement of new rolling stock. The expected total value of subsidy under the contracts was around $3.6 billion; and
- *Social sector:* the Kennett Government also entered into long-term contracts to build and operate two hospitals (La Trobe and Mildura), and to build and operate three prisons, mostly under 20-year contracts.

More recently, four State governments have put out policy statements on future policy for private sector participation. The key elements of those policies include:

- the possibility of private provision of infrastructure in all sectors, including schools and hospitals;
- retaining core services in government, while relying on the private sector for financing, construction, maintenance and some non-core services;
- whole-of-life contracts, to ensure the optimisation of up-front investment costs and life-cycle maintenance and operation costs;
- ensuring value for money, through comparison with a public sector comparator; and
- protecting the public interest through an assessment against a broader set of public interest criteria.

A number of projects are proceeding under these guidelines.[2] In Victoria, in June 2000, the Bracks Government signed the contract for the County Court, worth around $140 million over 20 years, and the project was completed in 2002. The contract has been let for the Spencer Street Station redevelopment, a $700 million project over 30 years, supported by $300 million of government finance and significant revenues from property development. The Berwick Hospital contract has come down to two preferred bidders, and two new correctional facilities are proposed as partnership projects. In New South Wales, a contract to build and maintain nine schools is well advanced, although there are concerns about delays in the contract award.

3.2 Lessons to date

What lessons have been learnt from the contracting experience to date? Again, there is a literature setting out qualitative gains, and cost savings, from entering long-term contracts. I do not intend to rehearse that. As a summary, it appears that contracts can deliver efficiency and financial gains, but that a lot depends on how it is done.

What lessons have been learnt from the contracting experience to date? … There is a literature setting out qualitative gains and cost savings from entering long-term contracts … As a summary, it appears that contracts can deliver efficiency and financial gains, but that a lot depends on how it is done. Overall success in long-term contracts for private provision has been varied.

Overall success in long-term contracts for private provision has been varied. The financing of toll roads on long-term BOO or build-own-operate-transfer (BOOT) contracts in both Victoria and New South Wales appears to have been successful—in the sense that the projects were completed, the cost of delays or over-runs were mainly borne by the developer and the contracts appear sustainable. However, in other respects, the Kennett Government's contracting experience was mixed. Of two contracts to build and operate hospitals, one reverted to public sector operation due to financial difficulties. Of three contracts to build and operate prisons, one was taken over by the Government after the prison had difficulty meeting operational performance requirements. And although there have been performance improvements and cost savings in public transport, press reports indicate that the five public transport franchises have been encountering financial difficulties.

One of the key elements of any contracting exercise is the allocation of risk. The mantra—a sensible one—is that risk should be allocated to the party best able to bear it, although the practical application can raise problems. Under a typical private finance deal this has developed into a somewhat arcane art, with the risk allocation tables sometimes being wheeled in on a trolley—indeed, it is questionable whether the cost of investigating and allocating the risk might on occasion exceed the cost of bearing it! However, there is undoubtedly value in putting a spotlight on risk, in clarifying how it is to be allocated, and in considering carefully who best can bear it.

One lesson of experience is that the *government bears the residual risk.* If a contract for the provision of water, a hospital, or public transport fails, the government has a policy—not a contractual—obligation to ensure the service continues, and to bear the higher costs. Failure of the hospital and prison contracts obliged the Government to pick up the increased costs of providing these services—simply allowing the contracts to terminate was not an option. As discussed above, this is sharply different from who has borne the risk on the value of privatised assets.

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What practical responses can government take to bearing this residual risk? Several spring to mind. The first is obviously to put in place safeguards. In some cases access to the infrastructure assets themselves provides some security. In others, financial security through performance bonds or other mechanisms plays that role.

A second response is to put heavy emphasis on the financial viability of the proposal at the time of bid award, and to reject bids that appear financially strong but that may be unsustainable. There is plenty of evidence internationally that contracts may prove unsustainable. Unpublished research from the World Bank shows that 75 per cent of water concessions required re-negotiation outside of any contractual processes for price revision or reset. This could illustrate that firms intentionally underbid, seeking to then re-negotiate; that the 'winner's curse' means that the strongest bid is also likely to be an unrealistic bid; or that governments are prone to change their minds about what they are trying to buy. Whatever the cause, it reinforces the importance of long-term financial sustainability being an element of bid award.

A third response is to recognise the risk and ensure it appears in the government accounts. At present, for example, the Victorian Government accounts for contingent risks under its contracts, but nowhere does it state the much larger financial risk it faces if contracts fail. While public provision also faces risks of increasing costs, the lower information when buying services across a contractural divide increases the risk of cost shocks. The problem is clear but the solution less so. Accounting for the likelihood of termination, and the expected costs incurred following termination, would not be straightforward.

Another lesson from experience is that, within the constraint on residual risk described above, *risk can be transferred on the financing, procurement and provision of services from infrastructure,* provided contracts are designed to achieve this. However, performance in managing operating costs only shows up slowly—managers need time to understand the business, make changes, possibly encounter initial difficulties, and then reap the benefits. Performance in investing in long-lived assets is revealed over a longer period. As a result, contract length and the responsibilities of the contracting parties need to be consistent with the desired risk transfer.

The French, with over 200 years' experience of contracts for private provision of water, have developed a taxonomy of contracts which illustrate the degree of risk transfer that can be achieved under different contract types. This shows the progression from contracts for specific services, to management contracts, operations (or lease) contracts, and concessions which transfer investment risk over a 25–30 year period.[3] (As an aside, it seems somewhat puzzling that in the international consulting arena, the French tend to be ignored in favour of the British, who seem to have become converts to long-term contracts—giving them a new name—in the 1990s. This may illustrate that English is an international language, or simply that that the British are better at marketing).

A third lesson is the *need to balance risk with control.* Contract design within government can easily become a struggle between treasuries, that want to transfer risk to the private sector, and line departments, that want to retain control. The worst possible solution is if both succeed and a contract transfers a risk but is also highly prescriptive on how it will be managed.

Contract design within government can easily become a struggle between treasuries, that want to transfer risk to the private sector, and line departments, that want to retain control. The worst possible solution is if … a contract transfers a risk but is also highly prescriptive on how it will be managed.

As an example, the La Trobe hospital contract in Victoria transferred substantial risk to the contracting party, getting them to assume risk on the demand for health services (from a defined population), and on future trends in case-mix. However, it combined this with a fee for the facility which incorporated an expectation for the kitchen to be painted in year 5, at an (indexed) cost of $10 000.

In one sense this example is unfair—the cost of painting the kitchen was simply used to estimate a reasonable budget—but in another it is indicative of the continuing desire of departments to seek to control the behaviour of contractors. Governments have to decide whether they are willing to trust contracting parties to bear major risks, and, if so, to give them the space to do so. Transferring a significant risk—such as overall revenue risk, or the risk associated with major investment—needs to be accompanied by a transfer of the necessary control for the contracting party to manage that risk. If governments are not willing to do that, or if they value highly the flexibility to change their mind on investment requirements or policy settings with strong revenue or cost impacts, then less ambitious contracts should be designed.

A final lesson is the *importance of contract management.* A friend of mine, who has managed the private side of international water concessions, likens them to a wedding. A dramatic build-up and a party with champagne at the time of contract signature is succeeded by the need to live together without (to mix the metaphors) the presence of the large numbers of highly paid advisers present in the run-up to the transaction. To return to the original metaphor, the hangover can be prolonged.

Managing that relationship is not a skill that comes naturally to government. But simply buying in contract managers from outside is not a solution either—the approaches to accountability and to contract enforcement in government are different from those in the private sector. As a result, there is a need to develop contract management skills within the public sector.

3.3 Future prospects

What are the prospects for additional private sector participation under contract? As discussed above, water and sewerage, ports and public transport are areas where there is significant infrastructure, but divestment may be unattractive. They could therefore be fruitful areas for contractual routes for private sector participation.

In addition to 'traditional' areas of infrastructure, governments make substantial expenditures in the social sector. To varying degrees, these expenditures include infrastructure. Government recurrent expenditure on services is shown in Table 1 below.

Table 1: Recurrent expenditure on services, 2000–01[4]

Education	$24.0 billion
Health	$18.7 billion
Community Services	$9.5 billion
Justice	$6.8 billion
Housing	$3.1 billion
Emergency Management	$2.2 billion

The present position of State governments in New South Wales and Victoria is that private provision in the social sector will be limited to buildings and non-core services.

The present position of State governments in New South Wales and Victoria is that private provision in the social sector will be limited to buildings and non-core services. In part, this may be a healthy response to problems encountered under earlier contracts, and a sensible way to develop and test a new policy. However, if there is evidence that the private sector can innovate, improve quality and reduce costs it would be preferable to achieve this in health services rather than hospitals, or education rather than school buildings.

Is there any sign of a trend in that direction? The answer to that may be a little, rather than a lot. Possible signs of more radical change are:

- the emergence of the programs for failing schools and failing hospitals in the United Kingdom;
- the increased use of vouchers in the education sector in the United States, and the removal of remaining constitutional obstacles; and
- consideration of new governance models, such as self-governing schools, which may reduce the constraints on models for provision of education.

Nursing homes, aged care, and public housing may also be areas where there is a possibility of exploring more radical models of private sector participation. However, the signs are that this will be a gradual and cautious development, if at all. Effective management within the public sector, as well as across contractual divides, will remain an enduring requirement—and one that remains rather unfashionable and neglected.

References

1 This summary of privatisation experience draws on Alan Moran, 'Privatisation in Australia', *Privatisation International*, July 2000 at http://www.ipa.org.au/pubs/Moranwebpapers/amprivint0700sum.html. Activity since then includes the finalisation of the SA electricity sales, and the recent sale of National Rail Corporation and Freight Corp, and airport sales.

2 Details for Victoria and New South Wales can be found on www.partnerships.vic.gov.au and http://wwg.premiers.nsw.gov.au/wwg/index.asp

3 There are plenty of sources on the web that discuss different contract types. An example is the discussion at http://www.worldbank.org/html/fpd/water/wstoolkits/Prospectus/pros1.html of the World Bank's views on water contracts.

4 Steering Committee for the Review of Commonwealth/State Service Provision, *Report on Government Services 2002, p.6.*

3. Accountability in privatisation and contracting-out

Tony Harris

Privatisation used not to have the political odium it carries today. In the past, transfers of assets and functions from the public to the private sector merely added to assets that pre-existed in the private sector. Governments had initially invested in these assets as a 'trail-blazer', to induce private sector investment in the same industry. That job having been achieved, the government was able to privatise its own investment without political fuss.

Today, governments have started to transfer to the private sector whole functions which, in Australia, have typically been delivered only by the public sector. These privatised monopoly functions—often those which had been delivered by government utilities—require a higher and different level of accountability than is needed for the privatisation of other public assets.

Sometimes these functions are not privatised but are contracted out. Companies have been awarded franchises, or the right to provide a service for a specified time which governments had previously delivered. On other occasions, governments have contracted out part of a service which they had previously undertaken in-house.

Governments are grappling with the need for a new or extended accountability model as they try to convince the public that these community functions can be delivered efficiently and safely by the private sector.

Today, governments have started to transfer to the private sector whole functions which, in Australia, have typically been delivered only by the public sector … [and they] are grappling with the need for a new or extended accountability model.

1. Privatising competitive businesses

Most Australians do not know that the petroleum firm trading in Australia as BP emerged from a business that carried the trading name COR—an abbreviation for Commonwealth Oil Refineries, a government trading company. Neither would most people know that COMALCO, the Commonwealth Aluminium Company, was once a business of the Federal Government.

These businesses were successfully privatised after World War II by the Menzies Government. They carry no residual signs of their government parentage, and there are no particular accountability arrangements that apply to their activities. At the same time, there is no public call to enhance accountability because of their former government ownership.

Privatisations by the Hawke Government in the 1980s that mirror these earlier sales include the disposal of the Belconnen Mall—a substantial shopping centre in the northern suburbs of Canberra—and the Canberra brickworks. There was local opposition to the sale of these assets at the time but today's shoppers and homebuilders neither recognise nor care that these facilities were once in public hands. And there is no special accountability regimen that applies to their activities.

The sale of the first tranche of the Commonwealth's interests in the Commonwealth Bank was contentious. That sale was linked to the Commonwealth Bank's absorption of the failed State Bank of Victoria, but the public had a lingering affection for a financial institution which had deep and close links with Australian communities, especially in the bush. Similarly, the Fahey Government in New South Wales encountered opposition to the sale of the State Bank of New South Wales in the early 1990s because that bank—once known as the Rural Bank of New South Wales—was regarded warmly by its customers.

Now only the name of the Commonwealth Bank gives a clue to its origins and neither it nor the former State Bank has particular accountability requirements that can be distinguished from those applying to any other Australian bank.

Qantas remains an Australian business icon, notwithstanding the change of ownership from the Commonwealth to private hands. This helps explain why the Federal Government recently rejected suggestions to remove foreign ownership restrictions applying to the airline. But these ownership limits were not caused by the airline's privatisation. They apply to other businesses—in the print and television industries especially—because of other sensitivities.

All of these businesses and other former government trading concerns such as ANL—the Australian National Line—operate in a competitive market. The public seems to have accepted that this feature means the normal accountability arrangements applying to those businesses in those industries suffice, even though they have been transferred from the public to the private sector.

The accountability provisions that … apply to … competitive business entities formerly in the public sector, have broadly been accepted by the community.

But the accountability regimen to which these businesses are subject is extensive. The Commonwealth Bank, for example, is regulated by the Reserve Bank, the Australian Prudential Regulation Authority, the Australian Securities and Investments Commission, the Australian Stock Exchange and a number of State bodies, such as fair trading departments.

Banks are obliged to produce annual reports and to have their financial statements audited by persons licensed by regulators. They are subject to continuous disclosure rules and their ownership is subject to agreement by the Commonwealth Treasurer. The Commonwealth Bank is also subject to the industry ombudsman, and its activities, along with those of other banks, are scrutinised from time to time by parliamentary committees. On top of this, there is the minute-to-minute scrutiny of the banks afforded by the financial market.

More importantly, bank customers also hold banks accountable for the competitiveness of their services.

Notwithstanding this extensive web of oversight, sections of the community have asked governments to hold banks accountable for the delivery of their services, especially in rural and remote parts of Australia. But these calls, which illustrate the sensitivities in the community when 'essential' services are threatened, are not related to privatisation or ownership issues. The accountability provisions that affect the privatised Commonwealth Bank, and that apply to other competitive business entities formerly in the public sector, have broadly been accepted by the community.

2. Privatising monopolistic businesses

By contrast, when a monopoly business activity is in government hands and privatisation is being pursued, members of the public apply rather more stringent accountability tests. Indeed, public opposition to the sale of the Federal Government's majority ownership of Telstra and to the sale of the New South Wales Government's electricity generation plants has forestalled their disposal.

From World War II until the 1990s, New South Wales electricity generation was almost wholly under the ownership and control of the NSW Electricity Commission, known as Pacific Power. Although it enjoyed monopoly powers—

or perhaps because it was a monopoly—Pacific Power was an inefficient electricity generator. Its inefficiencies were hidden by its access to cheap coal. But its indifferent reliability and massive over-investment in generating capacity in the last decades of the 20th century imposed considerable costs on the community and marked the electricity generator out as a good prospect for restructuring and privatisation.

A further factor adding to the benefits of a change of ownership, one which Pacific Power shared with all of its State counterparts, was the significant cost burden placed on electricity generation by the union movement. In most public sector electricity-generating businesses, unions controlled day-to-day access to electricity-generating plants. Contractors could not maintain generators without union consent, and union activity significantly reduced the productivity of electricity plant.

Partly because of the need to remove or ameliorate union control, the State Electricity Commission in Victoria went through a privatisation process in the 1990s. The sale of its components by the Kennett Government opened up electricity generation to competitive pressures from within Victoria and from New South Wales. That competition massively reduced union control and employment numbers, and allowed significant productivity increases.

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The sale proceeds contributed to a marked reduction of Victoria's public debt and to the revitalisation of that State's economy, which had been badly affected by the failure of the government-owned bank. But the public seemed to be unimpressed by these benefits and they dismissed the Kennett Government in 1999.

The New South Wales Government under the Labor Party Premier, Bob Carr, embarked on the same process of dismemberment and privatisation in the mid-1990s. The Government even formally agreed to the sale of a dismembered Pacific Power. But it avoided the political fate of the Kennett Government when the peak union movement vetoed the Government's plans.

Subsequently, the sale of the State's electricity generating plants was a point of difference between the NSW Australian Labor Party and the Liberal Party in a general State election. The Government committed itself to maintaining electricity generation in the public sector; the Opposition promised to sell the generating businesses and to provide shares or a dividend to voters from the sale proceeds.

The Opposition's loss in the 1999 general elections caused a change of policy. Neither major party now has any expressed intention to privatise the State's electricity sector. The Government has, however, allowed the private sector to compete with government generating plants and its distribution entities. There has been some modest growth in electricity generation, especially via co-generation, but the community's resistance to privatisation of electricity can be seen in its reluctance to move its custom from the government monopoly distribution entities to private sector competitors. Even though the government-owned network to supply electricity to households would remain, on some reports less than a few hundred household customers have switched.

The Commonwealth Government was able to sell 49.9 per cent of its holding in Australia's telephone monopoly, Telstra. But it has seen formidable public resistance to its plans to sell its remaining majority holding. The public has happily embraced the competitive supply of mobile phone services, but opinion polls show strong resistance to the Government giving up its majority ownership of this utility. The public has also resisted switching its custom for the local telephonic network from Telstra to the major competitor, Optus, and Optus' penetration of the local call market has faltered at a low percentage.

Apart from Victoria, other State governments have been unable to privatise their monopoly business ventures. It seems that the public does not have sufficient faith in the adequacy of government accountability frameworks to support the transfer of monopoly powers to the private sector.

The sale of Sydney's Kingsford Smith Airport (KSA) to a private sector consortium managed by the Macquarie Bank provided further evidence of public suspicion of the disposal of monopoly facilities. KSA was the last major airport owned by the Commonwealth to be privatised. According to the Productivity Commission, all of the metropolitan airports have characteristics that are monopolistic, but KSA is the key and dominant airport in Australia.

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Under the light-handed approach to price regulation adopted by the Government, city airports have upped their fees by as much as 100 per cent. It is not unexpected then that the private sector has called on the Government to re-enforce its regulatory oversight of fees to ensure that city airports do not abuse their market powers.

The public—unhappy with the cost and quality of Telstra's services in rural and remote Australia—has also asked the Government to oversee the provision of those services. The Government has responded with a number of initiatives, including the conduct of two inquiries which will enable movements in quality to be measured. The Government has also financed a number of programs aimed at reducing the cost of rural telephone services and at supplying services that were uneconomic to Telstra.

3. Accountability and monopolies

Although the community—especially the rural community—may be using its electoral power to extract concessions from the Government on Telstra's services that are uneconomic, it seems the Australian community generally is diffident about the privatisation of the Government's monopoly functions. That diffidence is supported by the 'essential' nature of the services—including power and communications—which Australian governments have provided.

The generally applicable accountability mechanisms that apply to all businesses have their weaknesses. But they seem adequate for privatised government enterprises which operate in a competitive market. But the public seems to have concerns about the adequacy of government measures that hold the private sector accountable for its use of monopoly powers.

Even when monopoly regulations are heavy-handed, intrusive and detailed, as Telstra complains is the case for the regulation of its services and powers, this is insufficient to gain public support for privatisation. This explains Government plans to detail the levels of service that Telstra must achieve before and after its planned full privatisation.

Australian governments also face difficulties in convincing the public that their interests have been protected when a service or function provided by a utility has been privatised. The New South Wales Government funded an advertising campaign aimed at convincing electricity customers that they faced no great risk should they purchase their electricity from licensed private sector providers. But when consumers contemplated switching from the regulated to a contractual relationship, they were faced with a large contract which many must have found incomprehensible. Accordingly, most consumers believed that maintaining the accountability mechanisms inherent in a political system was preferable to substituting those for the accountability mechanism available under contract law. While political agitation need not produce the results sought by the agitators, at least it is understandable and it has passed the test of time.

New South Wales residents also face little gain from surrendering their political powers in exchange for a contractual relationship. The savings available by switching to private electricity providers are of the order of $1 a week. There were significant savings in breaking up Pacific Power into competing units, but these advantages were obtained without the need for privatisation.

Similarly, the Commonwealth offers the public only minimal and unquantified gains from the full sale of Telstra. Economists might think it is important that the Government's regulatory interests be separated from its ownership interests. And the Government might think it important that the small residual of Commonwealth public debt be repaid. But none of this has persuaded the public that the Government can hold Telstra—or other private sector utilities—effectively accountable for its use of its monopoly powers.

Even when monopoly regulations are heavy-handed, intrusive and detailed … this is insufficient to gain public support for privatisation.

4. Contracting-out

Governments have fared better when they retain control of a public utility but contract out some or all of its operations under tightly defined arrangements. The Victorian public appears to have accepted the franchising arrangements which led to public transport—metropolitan trams and metropolitan and country trains — being operated by private firms. The public and the Government hold these firms accountable for the standard of their operations, including the timeliness of their services, and the Government applies a range of incentive and penalty payments to reflect company adherence to contractual conditions.

However, it seems that the contractual arrangements might be insufficient in circumstances when the private sector faces financial difficulties. Recently, the Victorian Government supplemented the payments required by the franchise agreements. It is not entirely clear that these additional payments were made because the companies supplying public transport faced financial problems or, as the Government has suggested, they were the result of initial teething problems in the contract.

In New South Wales, the Government has franchised to a private firm the operation of for-profit public hospital services in the Port Macquarie region. The adequacy of the provision of public hospital services can be assessed both by patients and the Government, and the public understands that the Government can step in if the hospital fails to meet the standards required of hospitals under the Government's licensing arrangements.

The New South Wales Government maintains, at least in theory, a similar 'step-in' right should the private water filtration plant at Prospect fail. This plant supplies the bulk of Sydney's filtrated water under arrangements that closely specify the quality of water delivered to the Government's distribution authority by the plant.

The contract was tested when Sydney water consumers were warned to boil water for drinking because health-threatening giardia and cryptosporidium appeared in delivered water at unacceptable concentrations. The contract provided no criteria for the latter and the company declined to allow the Government to take over the plant, as it is entitled to do in situations where there is a catastrophic failure by the company. Because there was no observable increase in public illness, these contractual weaknesses went unnoticed by the public. But they demonstrated the difficulty of reflecting in contracts with the private sector the accountabilty issues to which the government itself is subject.

Governments have fared better when they retain control of a public utility but contract out some or all of its operations under tightly defined arrangements.

4. From Stockdale to stocktake: privatisation and deregulation of the Victorian electricity industry

Paul Fearon

Privatisation and the deregulation of the electricity industry have had a profound impact on Victoria. The proceeds alone, at over $30 billion (for all energy assets) were able to pay down nearly 90 per cent of State debt as a proportion of State Gross Product. This cash infusion underpinned a huge turnaround in Victoria's economy and continues to drive solid economic growth. Customers have generally experienced better reliability, improved customer service and lower prices since 1995.[1]

The industry has seen significant efficiency and productivity improvements and has benefited greatly from the infusion of international expertise and private equity.[2] Most significantly, all Victorian customers now have a choice of electricity retailer.

Not all stakeholders have benefited, however. Achieving greater efficiency has caused significant structural dislocation in some communities. The process sometimes involved other costs, for example, CitiPower's 1997 Enterprise Bargaining Agreement dispute that lasted 15 weeks and saw Electrical Trade Union (ETU) membership within CitiPower drop from 130 to 38.

The industry faces some big challenges, most importantly, whether the new market and industry structure will continue to deliver the infrastructure to meet anticipated increases in demand.[3] As demonstrated in California, the impact of supply failure on society far exceeds the actual cost of generating and supplying the product.

Concerns over supply and prices are, of course, not restricted to deregulated markets. Governments, central planners and public utilities have failed at times to deliver reliable electricity supply. Few people would also remember the annual electricity price increases of 16, 17, 16, and 10 per cent from 1980 to 1984 under the SECV.

Today electricity reform remains incomplete and most politicians will (privately) agree that it is appropriate for private equity to assume the new risks implicit in the deregulated national electricity market. However, there is no agreement on any timetable or priorities, and there is a question of what is now required—refinements or fundamental change.

1. The path to privatisation

The original vision for a national grid was established under the auspices of the Council of Australian Governments (COAG) and a Federal Labor administration in 1990. The National Grid Management Council, which was formed in 1992 as a creature of COAG, worked diligently but was often frustrated by State governments, and at times by the big State-owned utilities.

Around the same time, a series of studies—culminating in an Industry Commission report in 1991—documented a comprehensive case for electricity reform based on a deregulated, national and privatised model. It said that ownership did matter.[4]

It was the election of Jeff Kennett in Victoria in 1992 and the driving vision of his Treasurer Alan Stockdale that saw electricity reform become a reality. Armed with a clear and urgent plan, the new Government implemented the basic disaggregation of the industry, a comprehensive privatisation program and established the foundations for a competitive retail and wholesale electricity market.[5] As Stockdale put it: 'We took it out of the hands of bureaucrats' and 'in effect, privatised the process'.[6]

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A key objective of structural reform was to separate the potentially competitive elements of the industry (retailing electricity and wholesale generation of electricity) from the monopoly of poles and wires (distribution and transmission). Retail and wholesale electricity prices would be subject to the competitive disciplines of the market. Distribution and transmission tariffs would be subject to ongoing regulatory oversight and review.

In 1993 the SECV was disaggregated into three corporatised businesses covering transmission, retail/distribution and generation. Between 1994 and 1997 the Government further disaggregated these businesses into five distribution/retail companies (including merger with the 11 former municipal electricity undertakings), three brown-coal generating companies[7], one hydro-generation business, one gas-fired generation business and one transmission company.[8]

The first three years to 1998 was a period of great liberation and confidence for the privatised distribution companies. Leveraging off the initial acquisitions, the Victorian private companies pursued a variety of strategies designed to achieve growth and profitability.

CitiPower saw opportunities in related non-regulated infrastructure including telecommunications.[9] Investments were made in private networks, stadiums, rural water-treatment facilities and central energy facilities for hospitals. Many of these investments would not have been made if CitiPower had not been privatised. Not all were financially successful, but private shareholders were taking the risk and the community still benefits from the assets put in place.

Solaris (now AGL) strongly marketed its service territory, in particular its industrial areas to the north of Melbourne, with energy packages and other incentives to successfully induce overseas businesses to relocate their manufacturing/process operations to Melbourne. Other electricity distribution companies built up or spun off their construction businesses, meter and data management operations and made investments in new technologies and businesses. This is estimated to have benefited Victoria an additional $300 million.[10]

Other companies pursued very aggressive retailing strategies. Taking advantage of surplus generation, the initial contestable markets for large customers saw significant market share change hands and huge but unsustainable electricity price reductions achieved initially by business customers.[11]

2. The reform process stalls

By the end of 1998 the first regulatory review of distribution prices was under way and the logistical challenges of introducing full retail contestability (FRC), whereby 2.1 million small customers could choose their own retailers, were fast approaching. The costs to business of underwriting the development of this, while at the same time dealing with Y2K and then GST, would ultimately see the cash burden for the distributor/retailers run into hundreds of millions of dollars.

Worrying signs soon began to emerge on the likely outcome for the first regulatory review of the tariffs for the distribution (monopoly poles and wires) companies. Ninety per cent of the privatisation values for distributors were driven by assumptions of what level of tariffs the regulator would allow into the future. The competitive trade sale process run by the Victorian Government ensured that bidders were more than optimistic in their assessments.[12]

The subsequent controversy and debate was predictable. Throughout 1999 and 2000 businesses were vigorously pointing back to the earlier 'assurances and promises'. The regulator (a new one) was unswayed and instead adopted an interpretation of the legislation that saw tariffs set at levels substantially lower than purchasers had assumed.

As the recent Epic decision has demonstrated,[13] the debate over economic regulation continues to be clouded by the legacy of the sale processes and the controversy surrounding asset values, the weighted average cost of capital (WACC)[14] and sharing of efficiency gains.

The first independent regulatory review, post-privatisation, was completed in December 2000.[15] It was always going to be controversial. However, in going forward the challenge now rests with regulators as to how they choose to incentivise distributors to achieve dynamic efficiency (innovation, new technology, environmentally sustainable solutions), rather than just cost-cutting and inevitably then building assets beyond an efficient level.

Better forms of network regulation exist that will align the interests of customers and business and create a more predictable and stable environment for network investment.[16]

After years of frustration, delay and massive effort, December 1998 finally saw the establishment of the national wholesale electricity market.[17] However, the combination of policy exhaustion and some waning of interest by the Victorian Liberal Government saw a hiatus reached on retail market issues, especially FRC development.

The surprise election of Labor in 1999 saw additional time lost as it tried to make sense of what had happened to the electricity industry. Like the greater public, the reform had been so fast and profound that the new Labor Government was hardly able to conceive what it needed to do, what challenges lay ahead and how to deal with an industry of which it had lost control. After some delays a national system was also finally established to allow the opening of FRC in January 2002. So far, customer switching rates have been relatively low at the residential level but are gradually increasing.[18]

In retrospect, Kennett and Stockdale were blessed with a remarkable conjunction of perfect timing and natural advantages. This included cashed-up and keen overseas utilities, and, most importantly, a significant surplus in generation capacity—now largely gone as a result of strong economic growth and the emergence of 'needle peaks' in demand, reflecting the significant take-up of residential air-conditioning.

But as California demonstrated in spectacular fashion a year or so ago, tight markets expose flaws very quickly, be they market design, industry structure or institutional/regulatory in nature. The model put in place by Stockdale and his advisers was never predicated on the presumption that the perfect model had been achieved, but it did assume that properly functioning and supervised markets would deliver the optimum result for society.

As already noted, much of the spare (particularly peaking) capacity had been used by 2000. However, other structural issues and political circumstances were conspiring to create a sudden surge in the wholesale cost of electricity, at the very same time that FRC was being delayed.[19] The New South Wales Government had not only abruptly stopped its privatisation program,[20] but had introduced a form of tariff equalisation fund. This essentially removed an important source of hedge contracts for Victorian retailers—hedge contracts being the principal mechanism by which retailers manage a volatile spot price and therefore determine their 'cost of goods sold'.

In 2000 CitiPower was largely fully hedged and able to agree on voluntary 'safety net' tariffs with the Victorian Government for the small customers who would not be able to choose a retailer for another 12 months. One significant event in February 2001 substantially altered the financial position of CitiPower. In peak summer conditions a planned shutdown of a major generating unit led to the main Victorian/New South Wales interconnector being constrained.

The impact over just a few hours cost CitiPower many millions of dollars and the company was forced to seek an increase in its residential tariffs from the Government.[21] This was followed by a number of requests for tariff increases from all retailers, each seeking to pass on the significant increases in peak energy costs. This highlighted two structural flaws that continue to exist today, namely, an inability to write 'firm' hedges across the interconnector and the almost complete removal of a competitive source of electricity contracts from New South Wales.

In December 2001 the Victorian Government effectively capped prices for the incumbent Victorian retailers.[22] The urban retailers—Pulse, AGL and CitiPower—were hit the hardest. Rural retailers were cushioned by a special subsidy to be paid by the State Government for 2002. This outcome played a significant role in accelerating the consolidation of retail energy businesses in Victoria—from eight original incumbents to three (Origin, AGL and TXU).[23]

Today the principal retail strategies are achieving critical scale, necessary to amortise the significant information technology and back-office costs over large numbers of small margin customers and dual fuel marketing. The ability to integrate systems and processes will determine how successful these energy retailers will be into the future.

3. Outstanding issues

For government and customers, what does the future hold? Customer choice is laudable but will the light come on when the switch is flicked?

Surrounding this question are a number of very complex public policy and market design issues. Concerns about the bidding behaviour of generators and the manner in which new transmission interconnectors are installed continue to challenge policymakers, the industry and regulators.

Electricity is an essential service and commodity. Unlike most other products, electricity cannot be stored—save for a few exceptions—and this also makes the electricity systems complex to operate in real time. Overlaying deregulated markets adds a level of complexity, especially since electrons don't conform to the law of contract or financial rules. It is one of the reasons that the more natural form of organisational structure in the industry has been one of vertical integration.

However, this is certainly not an argument for central planning and government ownership. Recent regulatory reports conclude that the performance of our wholesale electricity market does not warrant radical redesign.[24] The energy-only market[25] does create new risks.[26] But it has been successful in attracting over 3000 megawatts of new capacity and at least 8000 megawatts of proposed or potential capacity. Nobody can guarantee that capacity and no one ever could. However, Victoria does now have three large and substantial retailers competing in the privatised Victorian market and they all have the capability and strong commercial incentive to write the long-term contracts that will underwrite the construction of new generating capacity. They also have significant gas interests that, among other things, will support investment in new, efficient, combined cycle gas generating plants.

Getting price signals through to customers is an essential element of completing electricity reform. For example, a higher price should be paid when a customer uses air-conditioning at 4 pm on a 40-degree summer day. Consumption might then better reflect its true cost and achieve other conservation goals.

Government price caps continue to slow this process. Regulators should also require distributors to install bulk low-cost smart metering, at least at the replacement and installation stage.

Fierce competition at the retail level will ultimately drive required investment back into upstream gas and electricity supply. The pre-condition for this will be uniform competition, economic and environmental regulation and uniform low-cost customer transfer systems to facilitate new entrants.

State governments will, however, continue to be reluctant to make changes in these areas as long as they retain an equity interest in their electricity businesses. Governments have a legitimate public policymaking role but over the longer term the conflict of interest is untenable.

Letting go is not going to be easy or without risk. For example, generating reserve margins will naturally be tighter in this new market, an outcome which is not necessarily bad. Pricing and demand management will, and already does, play a role in managing the tighter margins. As with the SECV, there may even be rare occasions where voluntary restrictions are required and sought.

The current design of the electricity market must be given the chance to work. Intervention might be unavoidable but the slide back to central planning is slippery. Some businesses will prefer the Government to take the risk. For others already in the competitive market, the intervention simply destroys incentive and shareholder value.

The genie was let out of the bottle in 1992. It can never be put back. Only a rejuvenated commitment to a deregulated, national and privatised electricity industry will achieve the optimal outcome for customers, employees, shareholders and society as a whole.

CASE STUDY

References

1 Regulators' comparative performance reports at www.esc.vic.gov.au

2 Further information can be found at http://www.ipa.org.au/units/EnergyForum/energyforum.html

3 $40 billion of additional generating, transmission and distribution is estimated to be required over the next ten years.

4 Industry Commission, *Energy Generation and Distribution*, Report No 11 AGPS. Canberra, May 1991.

5 The way it was done has been well documented in *Privatisation International* No.134, London, November 1999. Another perspective can be be found in Robert Booth, *Warring Tribes: The Story of Power Development in Australia*, Bardak Group 2000.

6 A. Stockdale, 'The Politics of privatisation in Victoria' in *Privatisation International.*

7 The previous Victorian Labor Government had already initiated the 40 per cent sale of a fourth brown-coal generator: Loy Yang B. The Kennett Government subsequently increased the interest being sold to 51 per cent and ultimately 100 per cent.

8 All were privatised by 1999 except for the Victorian Power Exchange, whose wholesale market and system control functions were ultimately assumed by the National Electricity Market Management Company which became responsible for managing the wholesale electricity market in December 1998 for NSW, Victoria, South Australia and later Queensland.

9 CitiPower participated ultimately in a three-way joint venture with Energy Australia and Energex to create the now publicly-listed telco new entrant Powertel.

10 'Electricity Distribution Price Review: Achieving a Balanced Outcome' Joint Submission to the ORG by the five electricity distribution businesses 2000.

11 Price reductions of over 40 per cent were common.

12 The level of ambiguity that also surrounded the due diligence process seemed to be conveniently accepted by all parties including purchasers, banks, governments and their advisers—everyone except the regulator who, despite some contribution to the confusion, was also heard to say 'Don't come crying to me if you pay too much'. Office of the Regulator-General, *Annual Report* 1995–96.

13 The Epic Decision, 23 August 2002 (Dr Ken Michael AM; Ex Parte Epic Energy (WA) Nominees [2002] Western Australian Supreme Court 231) concerns the interpretation of the National Third Party Access Code for Natural Gas Pipeline Systems and its application by the WA Gas regulator.

14 The rate of return that the regulator assesses as being reasonable and efficient given the monopoly characteristics of the businesses.

15 On 4 December 2000, following completion of a series of appeals, the Office of the Regulator-General (ORG) released its re-determination of the distribution price controls which determined, inter alia, the charges that the five Victorian distribution businesses could levy for the period 2001–05. The review commenced formally in June 1998. Over the subsequent two and a half years the review consumed a huge amount of public and company resources and time, leading to probably the most comprehensive and detailed examination of distributor costs, capital programs, prices and reliability undertaken by any regulator in Australia.

The review delivered financial outcomes, both for business and consumers. On one hand, private investors had acquired from the State of Victoria the five distribution businesses for $8.3 billion when their underlying regulatory value was $3.8 billion. Investors were not likely to easily acquiesce to returns being determined without reference to the basis upon which the actual investment had been made. Against this was a public and consumer expectation that the regulator would deliver the largest possible short-term price reductions without compromising service standards.

A detailed review of the outcomes of the first Victoria Electricity Distribution Price Review and a commentary on economic regulation is contained in 'Pricing and Competition in Electricity and Gas: Impact of Regulation', 5th Annual Queensland Power Conference, May 2001.

16 The theory and practice of these forms of regulation in other jurisdictions is outlined in 'Incentive Regulation and External Performance Measures: Report to Utility Regulators Forum', CitiPower June 2001.

17 Called the National Electricity Market (NEM), it constitutes the electricity spot market—whereby generators bid in and get dispatched according to a merit order of bid offers—all generators running get paid the half-hourly clearing price for the energy they generate; wholesale settlement between retailers and generators and the real-time operation of the power system and its security.

18 In NSW, customers have a choice between the regulated tariff (which is below economic cost) and a competitive tariff which is generally higher. It is not surprising that most customers prefer not to switch. In Victoria the Essential Services Commission has recently undertaken an investigation into the effectiveness of full retail competition and has identified price caps, inter alia, as having a dampening impact on the level of competition, see http:www/esc.vic.gov.au

19 Originally planned to occur in January 2001.

20 Largely due to NSW union opposition in spite of initially very strong support from Treasurer Egan.

21 The event was argued by CitiPower to be a significant and unforeseeable event.

22 The Government sought 'independent' advice from the regulator, advice which was largely constrained by the reference and scope defined by the Government. Retailers vigorously criticised the benchmarking approaches required to be used by the regulator, e.g. the use of NSW comparators for operating costs and margins—themselves regulated. See also Access Economics, 'Assessment of the Draft Report by the ORG on Proposed Victorian Retail Electricity Price Amendments', Canberra 2001.

23 The surviving retailers also retail gas, each having acquired directly or indirectly the three gas retailers privatised earlier under the Kennett Government. Five electricity retailers/distributors were privatised between 1995 and 1996.

24 'Capacity Mechanisms—The Options', prepared for the National Electricity Code Administrator by Tavis Consulting, August 2002.

25 All electricity—capacity and energy—is traded through a half-hourly spot market. The volatility of the energy spot price has been questioned as an efficient signal for investment and competition.

26 At the wholesale level, half-hourly prices can reach $10 000 MWh (a thousand times the selling price).

5. Privatisation and employment patterns

Grant Belchamber

Privatisations in the Australian economy over the past 15 years have contributed to growing job insecurity and widening income distribution.

In this discussion I take a broad definition of 'privatisation', encompassing:

- the sale of previously public sector financial and trading organisations (such as the Commonwealth Bank, Qantas, Telstra, railways, airports, and power and water utilities);
- outsourcing of previously in-house functions and services by all levels of government through 'compulsory competitive tendering' and similar strictures (including local road maintenance and construction, garbage collection, building maintenance, leisure and recreation facilities, issuance of building permits, and the like); and
- so-called 'public–private partnerships' involving the provision and delivery of public infrastructure under long-term contractual arrangements (such as the CityLink project, correctional facilities, and public transport).

In all instances, the effect of the changes has been to shift the employment of the workers who actually do the work from the public sector to the private sector.

Quantifying the magnitude of this shift on overall employment levels is fraught with difficulty. Definitional issues aside, separating the impact of privatisation from all other influences in an employment time series raises many tricky conceptual and practical issues:

- What portion of the overall change in employment levels is due to privatisation and what portion to technological change?
- What fraction of the rise in casual and temporary employment has been due to privatisation and what fraction is due to changes in labour market regulation more generally?
- To what extent have the job losses and the associated measured productivity increases in privatised industries been offset by job increases in other sectors that use the output of those industries as inputs to their own production?

Since November 1984 (when the ABS data series commences), employment in the two industry categories 'Electricity, Gas and Water' and 'Communication Services' has declined by almost 20 per cent, while employment in all other industry sectors has risen by more than 40 per cent.

However, most of the fall in the combined employment in these two sectors occurred between 1984 and 1992. Since that time communication services employment has risen by 50 000, reflecting the ICT revolution, while employment in electricity, gas and water has fallen by a further 30 000.

In aggregate terms, Australia's jobs growth in the 1990s (and in the 1980s) was right at the top of the OECD league tables. It is far-fetched to attribute this to privatisation policies alone. It is similarly far-fetched to assert that the phenomenal growth over that period in part-time employment, the near stagnation of full-time jobs growth, the burgeoning of casual and temporary jobs, and the rise and rise of subcontractors as a share of total employment, are wholly due to privatisation.

Privatisations in the Australian economy over the past 15 years have contributed to growing job insecurity and widening income distribution.

The rapid escalation of executive and managerial salaries following privatisation is notorious, as executives of former public enterprises seek to match and exceed the levels set in traditional private sector enterprises. Chief executives in the Commonwealth Bank, Qantas, and CityLink have all recently been reported to receive multiples of millions of dollars in salary, bonuses and stock options in the past year. Their share prices appear to bear an inverse relation to announcements of job shedding.

To take just one example, in 1996 no Commonwealth Bank executive received $1 million dollars or more in salary; in 2001 there were nine. In 2002 the CEO, David Murray, received $7 million in salary and bonuses and his outstanding share options are estimated to be worth $80 million. The Bank has closed 870 branches and shed 17 760 staff since 1991. The basic teller's salary at the Commonwealth Bank is $32 000 per annum, and the 4 per cent annual pay rise they recently received came after long and difficult negotiations by the Finance Sector Union.

The distribution of market incomes and working hours has become markedly more polar … and … work-related stress and job insecurity are on the rise.

Meanwhile, the private individual contractors engaged by not-for-profit organisations to provide leisure services at municipal baths and gyms, today receive the same hourly rates as their predecessors ten years ago when employed on wages by the local government. But whereas yesterday's leisure workers enjoyed holiday and sick leave entitlements, today's contractors receive no casual loading and must make provision for their own annual and sick leave.

This is labour market fragmentation. At the top end, working hours are long and the competitive remuneration cycle is upwards ever upwards; at the bottom employment is precarious and part-time, and workers compete one against another in a wages variant of the Dutch auction where the lowest bidder wins the job.

While the precise figures are subject to debate, casual employment as a proportion of total employment has roughly doubled over the past two decades, from one in eight employees to one in four. Here, in a world of atomised subcontractors, union organisation and maintenance of minimum standards are a daunting challenge.

Prior to privatisation, the employment of the workers concerned was secure, mostly full-time and with leave entitlements, in large workplaces with wages and conditions set by collectively bargained agreements. Having been shed through 'downsizing' after privatisation, many displaced workers, out of necessity, have taken new jobs on a casual or temporary basis with no leave entitlements, in part-time positions, on individual employment contracts, and often as subcontractors in small workplaces.

Is this the consequence of privatisation, or is some larger force at work?

What is certain is that privatisation was vigorously pursued in Australia by Federal and State governments of both political colours over the past two decades. It is also clear that the distribution of market incomes and working hours has become markedly more polar in that time, and that work-related stress and job insecurity are on the rise.

Whatever can or cannot be discerned from aggregated time series data for the economy as a whole, the clear inference is that the former has had something to do with the latter. This inference accords with popular perception and case study assessments.

Since the privatisation process began, the Commonwealth Bank has eliminated more than 18 000 career positions and employed thousands of part-time workers in their stead, mainly as temporaries and casuals. Meanwhile, the growth in the salaries paid to its executives has blown the lid right off any notion of restraint. The Bank's profits have soared, while the fees and charges paid by its customers have increased even more than the length of the queues they wait in pending the next available teller, and the workloads weighing on the remnant staff give no respite.

Since garbage services were contracted out, the garbage is still collected but the departing truck leaves in its wake a street strewn with capsized bins and a wreckage of escaped litter. With so many streets to service, the collectors simply do not have the time to spend chasing small items along gutters when they blow free, and are under constant pressure to get the bin from the kerb to the truck and returned as quickly as possible.

Privatisation has played a part in these trends, but is only one in a suite of causal factors.

A corporate profit from a privatised service can be achieved for many years by running infrastructure to the absolute end of its economic life, replacing preventative maintenance programs with 'fix-on-failure' rules. Ask the companies about this and they deny it. Ask consumers (ask yourself) how long it takes these days compared with in the past to have a phone line connected or a fault investigated and repaired or a water leak in the road attended to, and there is no doubt about it.

When the service is finally performed, it is a contractor who does it—often the same character who used to do it on wages as a Telstra or Board of Works employee. Today's rectifier is someone who has bought the tools and the truck and who not only fixes faults, but also collects GST for the Federal Government and achieves personal income adequacy by working long hours and minimising tax through creative expensing.

The hidden costs fall on the worker through increased stress, on their family through reduced contact time, on the local community when the individual no longer has the time for the school council or the church choir, and on taxpayers at large, who must make good the consolidated revenue shortfall.

Can it be proved? Quite probably in time, but how long has it taken and how difficult has it been to prove that smoking is bad for your health? Do executives of privatised companies have a material incentive to demonstrate that privatisation does you no harm? You bet they do, all the way to their stock options.

Privatisation has played a part in these trends, but is only one in a suite of causal factors. It is simply nonsense to think that today's social and workplace stresses can be cured by nationalisation, by putting everyone on the public payroll. But the claim that privatisation is entirely wholesome and as good for you as muesli is poppycock.

6. Privatisation: the impact on consumers

Louise Sylvan

'Mixed success, some failures. Insufficient attention to consumer outcomes.' That's the verdict that consumers would give to the results of various privatisations in Australia. It's a verdict that derives from looking at traditional consumer concerns—issues such as price, service and quality. If one added in broader 'citizen' considerations, such as the cost to government revenue, the costs of regulation, transparency (and access to freedom of information), accountability, and socially just outcomes, the verdict in some cases would be much harsher.

The scale of privatisation of public assets in Australia is awesome—one of the larger programs among the OECD nations and 'in dollar terms … second only to the UK.'[1] Despite this, the consumer view of privatisation in Australia has been rather pragmatic. Not surprisingly, most consumers are not primarily concerned about who owns a particular product or service. And it's not simply a case of consumers being narrow in their consideration. Australia was not tempted, like many other governments around the world, to own industries such as steel production, oil exploration, car production or ship-building (though many of these have benefited and continue to benefit from substantial corporate welfare from the government). So Australian consumers, in the dawn of the privatisation frenzy which began in the late 1980s, mainly had experience with institutions like the Commonwealth Bank, the government insurance offices, Telecom and transport providers such as railroads and airlines. Their experiences with these institutions, no better or worse than with private sector counterparts, didn't really provide a great impetus for consumer activism in seeking to protect government provision or ownership.

From a consumer perspective … a well-regulated private provider can be as good as … one with direct government ownership. Such a position is quite reasonable [for] services which are not 'essential' … [but this] argument is less applicable to an essential service.

From a consumer perspective, a private owner can be regulated, and provided that governments are taking their jobs seriously, a well-regulated private provider can be as good as (sometimes better than) one with direct government ownership. Such a position is quite reasonable to apply towards services which are not 'essential' like an airline,[2] or mowing the government lawns, or products like steel. It goes without saying that such an argument is less applicable to an essential service like water—where consumers by and large do not support privatisation.

Despite a certain level of complacency about privatisation generally, Australian consumers get quite agitated when, with stunning lack of sophistication, governments proceed to a privatisation without recognition of the specifics of either the type of system involved or the existing industry structure. Two particular considerations are critical here: one is whether the system is a network where, quite predictably, problems will arise with a break-up—public transport being the classic example; the other is a competition issue—whether the privatised provider-to-be is a 'big hairy incumbent' with monopolistic tendencies.

Networks, which have received too little academic attention in Australia, are by definition not simply the sum of their parts. A road system, for example, is a network that as a unity works better when all the bits are being managed as a whole. As soon as some bits belong to different private providers, with different goals and priorities, trouble is bound to result (problems result even with a variety of state owners of networks). The problems in Melbourne's public transport system are a good example,[3] as are the UK railroads, the subject of volumes of consumer complaints in that country. Service problems are not the only issue with privatised network systems; the fragmentation of ownership can easily make some bits more profitable than other bits. A number of the privatised UK train feeder lines became unprofitable, closed, and created severe viability problems for the trunk lines—on any analysis, a mess.

A similar set of problems is emerging with the privatisation of Australia's electricity system: industry players are selling up and leaving an unprofitable market, others are failing to invest appropriately in infrastructure for the future (thus inflating profitability in the short term), spot pricing is leading to under-utilisation of efficient base-load power stations, and in a number of cases, prices for consumers are higher than they should be—for example, South Australian consumers are facing price hikes of 30 per cent but with no noticeable improvement in service. These are classic problems of governments having failed to understand the network characteristics of a system, and where caution should have been the byword of a possible privatisation. While governments might privatise to 'privatise the problems', guess on whose doorstep the ultimate consumer and industry problems will land? For key services like energy, privatising doesn't absolve a government from its responsibilities to its citizenry. The lesson for politicians is to be very careful when considering the privatisation of a *gestalt!*

> Governments ought not to do something as silly as privatising a monopoly. This occurred in many developing countries … The immense harm of this misguided policy … is only beginning to be counted.

The second key consideration in privatisations is to ensure that the free market mechanisms so central to the smooth operation of our economies are not severely impacted by a privatisation. Much more simply, governments ought not to do something as silly as privatising a monopoly. This occurred in many developing countries, under pressure from the World Bank and International Monetary Fund (IMF) structural adjustment programs, which have now seen energy, water, transport and telecommunications fall into private monopolist hands—and this, in countries with no competition or access laws. The immense harm of this misguided policy, not only through a decrease in consumer welfare from monopolistic pricing, but also the tragic social costs of withdrawal of services from the most vulnerable of consumers, is only beginning to be counted.[4]

In Australia, despite being a developed country with appropriate understanding and key institutions governing market operations, privatising of monopolies has not only occurred but there is more in the wings. Sydney's airport facilities are the most recent case—and virtually overnight, price increases of 100 per cent were seen. The more alarming situation, however, is Telstra. One can plausibly argue that the natural monopoly characteristics of telecommunications have largely been altered by new technologies—but not entirely. The infrastructure is still a natural monopoly. While competitive retail urban telecommunications are a reasonable candidate for privatisation, the network itself certainly shouldn't be. Recent OECD work, reported in the *Australian Financial Review,*[5] shows how Australia's telecom prices are already a bit above the average. The comparison, more importantly, also provided a scorecard on how liberalisation has affected prices—the effect can be very positive or very negative for consumers. Countries that did the job badly—either through their own misjudgements or at the behest of the IMF and World Bank—have punished their consumers severely. In addition, the whole economy has become less competitive as a result of a private monopoly successfully engaging in predictable rent-seeking behaviour.

Australia is a sophisticated, developed country with no excuse for making an error of this magnitude. All of the evidence suggests that attempting to control a private monopoly—through such things as accounting separation or pricing scrutiny or even a vigilant regulator—is less than successful. This is a case where the government's obsession with reducing its debt allows it to attempt to rationalise its conflict of interest in seeking the highest sale price, even where the cost of this is significant damage to consumers (including, of course, business consumers). Separating wholesale and retail Telstra—which would enable urban retail to be sold off into a competitive market—is a difficult task (but then, maybe Ministers should have thought about that earlier on).

One major argument made to support the privatisation push generally is that the private sector can do it more efficiently. The claim is very open to debate. Does anyone really believe that a government could have done any worse than the banks in 'picking winners' in the late 1980s? And given HIH, One.Tel, Enron, Worldcom, are there really many who would now stand up—as they did to propel the privatisation thrust—and say the private sector provides far better management? There is no inherent reason for management skills to be any better or any worse in the private or public sectors. The difficulty is more related to the ambiguity of working for political masters; private managers have a bottom line to look at—it's nice and simple in comparison to the public sector management, and probably results in far more focused and competent financial management. But any government business enterprise (GBE) which is not subjected to political interference and ambiguity could probably do as good a job. The fact is that many GBE managers are very keen to progress privatisations, in their own interests. Remember the Commonwealth Bank? In the year after its partial privatisation, the number of executives on salaries over $100 000 doubled. (And isn't talk of senior executive remuneration in the $100 000 range terribly quaint now? The Commonwealth Bank currently has 11 executives paid more than $1 million each including its CEO who is paid $7 million—his previous salary of $2.3 million may have been considered low for the banking sector but $7 million isn't). But a GBE executive, knowing that executive salaries in the private sector increased between 15 and 20 times over the last ten years—not that consumers are getting 15 to 20 times better products or shareholders better management—would hardly be looking to stay out of that particular less-scrutinised private framework.

One major argument made to support the privatisation push generally is that the private sector can do it more efficiently. The claim is very open to debate.

As taxpayers, consumers also have views about government privatisation being driven by ideology rather than commonsense. Governments have a responsibility to be aware of the reasons when governments should become involved in provision. Based on a quite conventional economic assessment, government involvement is required in the cases when provision, if left to the market, would result in no provision, economically inefficient provision, or intolerable inequities in provision. Government intervention is not only possible but quite likely preferable in all the following areas: cases of natural monopoly (to avoid the inevitable problem of deadweight loss),[6] 'pure' public goods, such as meteorological services; 'impure' public goods like search and rescue; essential supplies, such as defence production; and in areas of social justice where an equitable distribution of services would never be achieved by a private sector picking the eyes out of a market, for example, Internet services to remote areas. When these conditions apply, trying solely to rely on private provision is, from much past experience, a poor strategy.

Finally, consumers—again as taxpayers—have some reasonable claim that governments will not be incompetent in their privatisation activities. The Federal Government's sale of a huge swathe of government buildings (under a totally unrealistic hurdle rate of 15 per cent) has been severely criticised by the Australian National Audit Office,[7] and means that taxpayers end up paying more in future—for no good reason—for the spaces the public service inhabits.

To conclude, consumers are somewhat neutral about who owns a range of products or services—but note that neutrality means either a public or a private owner is fine by them, as long as the price and service are good. Thus, consumers were not particularly pro or con most privatisations, though much more caution (and perhaps serious re-thinking) needs to attend the privatisations of critical services like energy. But at minimum, consumers should be able to expect governments also to be sensible rather than ideological about privatisation. Worse, when ideology trumps basic commonsense—like privatising the monopoly telecommunications infrastructure provider—then consumers (and voters) need the opportunity to tell a government to shape up.

Consumers are somewhat neutral about who owns a range of products or services … as long as the price and service are good.

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1 Bob Walker and Betty Con Walker, *Privatisation Sell off or Sell Out? The Australian Experience*, ABC Books, Sydney, 2000.

2 Although it is worth noting that government ownership of airlines was a strong case in the 1940s, time and technology change the equation.

3 Paul Mees, 'A public solution to city transport', *Dissent*, Autumn/Winter 2000.

4 See, for example, Joseph Stiglitz, *Globalization and its Discontents*, Norton NY 2002, as well as a range of papers from Oxfam or Community Aid Abroad. For an Australian description, see Walker & Walker, op cit.

5 Alan Mitchell, 'Telstra split deserves thought', *Australian Financial Review*, 29 May 2002.

6 See the arguments in the Australian Consumers' Association Submission to the Review of the Trade Practices Act, July 2002, at www.choice.com.au.

7 ANAO, Audit Report for 2001–02, *Commonwealth Estate Property Sales*, 2001.

7. Australian public opinion on privatisation, 1986–2002

Jonathan Kelley and Joanna Sikora

Privatisation has long been one of the key issues in Australian politics. Until the late 1980s government enterprises accounted for more than 10 per cent of GDP and employed about 5 per cent of the labour force (Marsden 1998). The beginning of the 1990s saw the launch of a controversial public sector reform agenda incorporating contracting-out, corporatisation and privatisation[1]. Similar controversies arose in many other nations (see Blank 2000; Crew and Kleindorfer 1995; Pollitt 1995). Australia is now seen by some as a leader in a worldwide trend towards economic liberalism (Argy 1998:xi).

To assess public opinion on these controversial issues, the International Social Science Survey/Australia (IsssA) asked about them in 11 large, representative, national sample surveys which began in 1986, with more than 20 000 cases in all. Two questions were asked, as shown in Table 1.[2]

Table 1. IsssA survey questions and responses 1986–2001

There has been some talk about privatisation – about selling government-owned industries to the private sector. Should the government...

Sell the rest of Telstra to private industry? ...Australia Post? ... Commonwealth Bank? ... Qantas? ... the railways?

	Telstra %	Australia Post %	C'wlth Bank %	Qantas %	Railways %	Points %
Yes, definitely	10	8	7	10	10	[100]
Yes, probably	24	17	18	26	25	[75]
Mixed feelings	13	13	17	14	14	[50]
No, probably not	34	40	39	34	35	[25]
No, definitely not	20	22	20	17	17	[0]
Total (%)	100	100	100	100	100	
Nr of cases (1986–2001)	20 581	20 581	17 485	20 580	20 575	
Mean (points)	43	37	38	44	44	

Over this period, strong support for selling Telstra to the private sector was rare: just 10 per cent would do so. Another 24 per cent were lukewarm supporters. Some 13 per cent sat on the fence, having mixed feelings about the matter. A total of 34 per cent thought that Telstra probably should not be privatised, and 26 per cent thought definitely not.[3] The mean was a chilly 43 points out of 100, well below the neutral point of 50.[4]

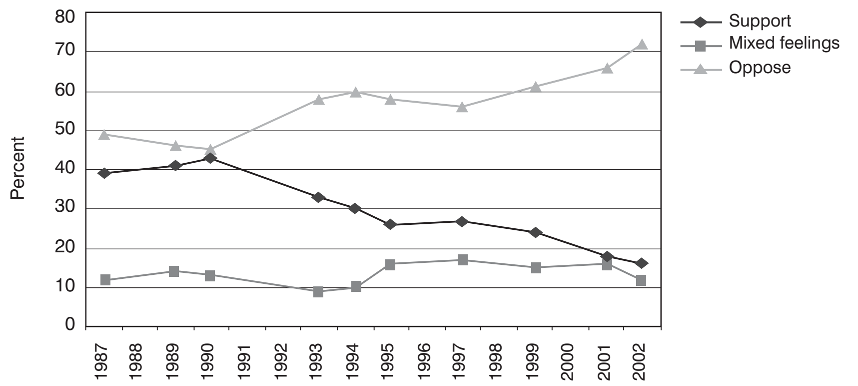
There was even less support for privatising Australia Post (37 points) and the Commonwealth Bank (38). Views about privatising Qantas and the railways (44 points) were about as chilly as for Telstra.

1. Changes over time

If government is to continue with privatisation under these circumstances, it will definitely be a case of elite leadership rather than of government representing the current views of the average voter. The chances that the government can bring the populace around to its point of view are difficult to estimate, but we can gain some insight into the issue by looking at time trends to see if support has been growing or declining since 1986. Let us begin with Telstra.

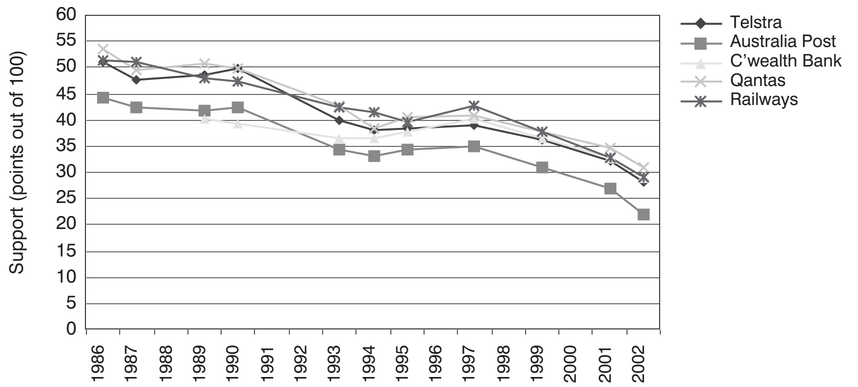
Support for privatising Telstra has eroded steadily since 1986 (Figure 1). At first, opinion was pretty evenly split.[5] But by 2002 only 16 per cent were in favour and 12 per cent were neutral. Fully 71 per cent were opposed.

Figure 1. Privatise Telstra?



Support for privatising Australia Post, the Commonwealth Bank,[6] Qantas and the railways has followed much the same pattern (Figure 2). In 1986 opinion was fairly evenly split, with means around the neutral point of 50. Then it declined slowly but steadily. There was a bit of a revival of support in the mid-1990s but then the decline resumed. By 2002, support had dropped to just 25 or 30 points out of 100.

Figure 2. Support for privatisation



It can be seen from this that public opinion on privatisation is one area of ideological combat that the pro-market forces have not been winning, despite their success in implementing substantial privatisation in the Australian economy in the last decade. To win over public opinion in the future they would have to make a very strong case indeed.

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2. One issue or many?

The general public sees privatisation as a single, broad issue (Table 2). That is, it is not one distinct argument about telecommunications, a second distinct one about the post, yet a third about banks, a fourth about airlines, and a fifth about railways. Instead, people who support privatisation in one domain tend very strongly to support it in all the others; conversely, those who oppose privatisation of one government enterprise tend to oppose all privatisation.

Thus, it is quite sensible to talk about the public's view about 'privatisation' in general. That also means that special stories—for example, stories about Telecom and support in the bush—are unlikely to be important to the big picture.

Table 2. Correlations among views about privatisation, Australia 1986-2001. N=20 581 [1]

	Telecom	Post	Bank	Qantas	Railways	Factor loading[2]
Telstra	1.00					0.87
Australia Post	0.77	1.00				0.86
Commonwealth Bank	0.61	0.62	1.00			0.73
Qantas	0.66	0.62	0.65	1.00		0.77
Railways	0.69	0.67	0.55	0.62	1.00	0.79

[1] N=17 485 for the Commonwealth Bank question, which was not asked in earlier surveys.
[2] Factor loadings from a maximum likelihood factor analysis. Only one factor had an eigenvalue >1.

3. Social differences

Social differences in support for privatisation are modest:[7] there are neither strong demographic pockets of support nor strong pockets of opposition (Figure 3). According to Figure 3, regression analysis shows that, other things being equal:

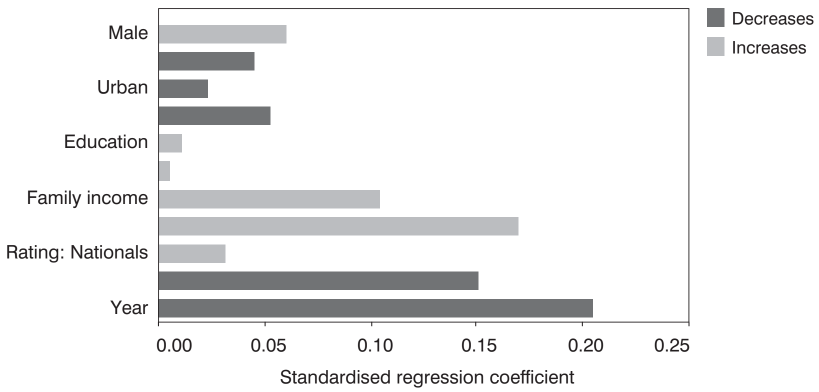
- men are fractionally more supportive than women, but only by three points out of 100;
- older people are slightly less supportive than the young. The difference between a 60-year-old and an otherwise comparable 20-year-old is just three points;
- rural/urban differences are minuscule;
- union members are only three points less supportive than non-members, once their political party preferences are taken into account; and
- education and occupational status are irrelevant.
  (For details, see technical notes).

As we have seen, there have been very real changes over time: other things being equal, support is declining by a little over one point a year, on average. If this trend persists over the next decade, support will drop from the present modest level of 42 points out of 100 to a cold 29 points.

The other big differences are political: other things being equal, Liberals tend to favour privatisation, the Nationals are mostly neutral, and Labor opposes. The differences are real and important but not enormous:

- Someone who is very favourable to the Liberal Party is, other things equal, likely to be 17 points more favourable to privatisation than someone who detests the Liberals.[8]

Figure 3. Influences on support for privatisation



- Views about the National Party hardly matter, only a difference of three points between strong supporters and strong opponents.
- Someone who is very favourable to Labor is likely to be 15 points less inclined to support privatisation.
- At the extreme, a very partisan Liberal supporter who hates Labor is likely to be 33 points more supportive of privatisation than an equally partisan Labor supporter.[9] But this is an extreme case; the difference is more typically around 10 points.[10]

Future research on privatisation could usefully go beyond these partisan differences. One possibility is to investigate the links between views on privatisation and more general views about government ownership, redistribution, subsidies and welfare—matters about which Australians have clear and distinct views (see Kelley 1988; Sikora and Kelley 1999; Sikora 2000).

Technical notes

Data are from the pooled IsssA surveys for all the years when the privatisation questions were asked: 1986, 1987, 1989, 1990, 1993, 1994, 1995, 1997, 1999, 2001 and 2002. The 2002 survey, still in the field, is used only in Figures 1 and 2. Details on the IsssA survey methods, comparisons with the census, and the exact definition of variables are in Evans and Kelley (2002, 296–310).

Estimates are by ordinary least squares regression. The equation (with standard errors in parentheses) is:

Privatisation attitudes =	55 (1.55)	+3.2 Male (.42)	–.075 Age (.015)	–.17 Urban (.06)	–3.3 Union member (.49)
	+.09 Years education (.09)	+.004 Occupational status (.010)	+ .07 Family income (.0055)		
	+.17 Rating Liberals (.011)	+.04 Rating Nationals (.012)	–.15 Rating Labor (.008)		
	–1.24 Years since 1980 (.048)	+ e (R^2=.14; N=20 636)			

Male is scored 1 and female 0; age is in years; urban is the natural log of size of the place of residence; education is in years of schooling and university; occupational status is the score described in the text, ranging from a low of 0 to a high of 100; family income is in $1000s, adjusted for inflation to the year 2000; ratings of the Liberal, National and Labor parties are Michigan feeling thermometer ratings (Sudman and Bradburn 1982, 158–9) ranging from 0 ('very cold or unfavourable feeling') to 100 ('very warm or favourable feeling'). Year is the survey year (scored so 1980=0).

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Endnotes

1 See Brown (1997), Chu (2001), Davies (1995), McElhinney (2001), Scales (1995).

2 Question wording varies somewhat in different years according to circumstances. For example, early surveys asked whether the government should 'sell Telecom' rather than the current 'sell the rest of Telstra'. The results given in text are for 1986 to 2001. Preliminary results for a further 948 cases from the 2002 survey, which was still in the field as this chapter was being written, are given in Figures 1 and 2.

3 This is an easy question with only 3 per cent of respondents unable to answer. They have been excluded from the results shown in the text.

4 For clarity and convenience, items are scored in equal intervals from 0 to 100, as shown in the text. Any other equal interval (Likert) scoring would lead to identical conclusions, differing only by a scale factor.

5 The 1986 results are not shown because the answer categories are slightly different than in later years.

6 We first asked about the Commonwealth Bank in 1989.

7 Measured by an additive scale averaging answers to the five individual questions. Scale scores range from 0 to 100. The scale has a very satisfactory alpha reliability of .90.

8 The comparison is between someone rating the Liberal Party 100 on the thermometer scale ('very warm or favourable') and someone rating it 0 ('very cold or unfavourable'). Similar comparisons are made about the National and the Labor parties, based on separate questions about them.

9 The effects are additive, so someone who rates the Liberals 100 and Labor 0 will be 33 points (=17.5 + 15.4) more supportive of privatisation than their opposite who hates Liberals and adores Labor.

10 A typical Liberal supporter rates that party about 65 thermometer points and Labor 33, so the difference is around 32 points, not the extreme 100 points used in the example.

8. The politics of privatisation

Kenneth Wiltshire

Laggard in the 1980s, leader in the 1990s; that is the story of privatisation in Australia, and politics provides the main explanation.

Following the election of the Thatcher Government in the United Kingdom in 1979, a new international era of privatisation began. Only a decade later more than 70 countries had privatisation programs, and most international financial bodies had adopted privatisation as a condition for their lending. In Australia, for most of the 1980s, privatisation was a no-go area. There were Labor governments in Canberra and almost all of the States; the major exception being the Greiner Coalition Government in New South Wales, which dabbled in privatisation; however, its few experiments produced a good deal of political flak and the momentum slowed.

Political attitudes to privatisation in Australia generally follow the ideological divide of labour versus capital, but there are some important refinements. Although the Australian Labor Party does not favour privatisation, this is not always true of Labor governments. Indeed, the most notable example is the Hawke Government which tried to have privatisation accepted by national Labor Party conferences, only to be outflanked by an alliance of the trade union movement and the left factions, which together formed a small but sufficient majority on the conference floor. The only major instance of privatisation which slipped through this roadblock was the sale of the Commonwealth Bank, and that was only because of the promise that a privatised Commonwealth Bank would bail out the State Bank of Victoria and hence give the Labor Government in that State a chance of survival. As the caption on the Patrick Cook cartoon of the day said, ‘I have seen the light on the hill and I wonder how much we could get for it.’

Political attitudes to privatisation in Australia generally follow the ideological divide of labour versus capital, but there are some important refinements.

Another refinement to the generalisation relates to the National Party, which, although predisposed to free enterprise and hence private ownership, will fiercely oppose policy initiatives that would threaten service delivery in the bush—the debate over the sale of Telstra being the prime example. The same goes for the Australian Democrats and the Greens, who on the face of it are predisposed to public ownership, but can obviously be tempted to support privatisation if they can have some say in the use of the proceeds. The same is certainly true for the independents in the Senate if they can channel a good slice of the proceeds into their State, which is their electorate.

As Paul Kelly has observed, the 1990s was a very different decade to the 1980s in very many respects, economically and politically, particularly regarding the focus of economic policies.[1] The appearance of more Coalition governments is an obvious manifestation, especially the Howard Government and its support for privatisation, but in many ways the enormous increase in the sale of public assets was as much a feature of more broadly based changed public attitudes to the best way to achieve economic growth. This was evident in a raft of macro- and micro-economic reforms, of which privatisation is only one. At any event, during the 1990s Australia was a pace-setter in privatisation around the world. By December 1997 the Reserve Bank was reporting that Australia had had one of the larger privatisation programs among OECD countries, with proceeds estimated at about $61 billion coming roughly equally from privatisation by State and Commonwealth governments in three main sectors—financial services, electricity and gas, and transport and communication.[2] But it has been the partial sale of Telstra in 1997 and 1999, and to a lesser extent the sale of airports from 1997, the national rail freight operations, and now the mooted sale of Medibank Private and the rest of Telstra, and the plethora of sales and contracting-out during the Kennett era in Victoria, which have dominated the political debate over privatisation. The much smaller-scale privatisations in Queensland, South Australia and Western Australia, some of them under Labor governments, have not given rise to the same intensity of political debate, except perhaps for energy, especially electricity, which has been the scene of turbulence as the industry has been restructured while being privatised, and the east coast grid has come to fruition.

There have been some fundamental aspects of Australian political **culture** which have been encountered by governments which have sought to privatise. One is the sense of national identity which has been attached to many government business enterprises (GBEs). Qantas, the Commonwealth Bank, Telstra, Medibank, for example, are household names and they symbolise Australian nationhood. In a similar vein, some of the State banks, insurance companies and public utilities are also symbols of statehood. Playing around with cultural symbols is bound to generate waves.

There have been some fundamental aspects of Australian political culture which have been encountered by governments which have sought to privatise. One is the sense of national identity which has been attached to many government business enterprises.

It is also true that many of Australia's GBEs have had a good record by international standards. Their efficiency makes the case for privatisation in Australia much weaker than it was in the United Kingdom or other countries, where the obvious inefficiency in the public sector aided the cause of the privatisation. To some extent this has reinforced the cause of those Labor governments who corporatise rather than privatise these entities. Interestingly, there are now two opposite views of corporatisation: some say it is a poor person's privatisation, and others say it is the ultimate extension of efficiency in public ownership.

It may well also be true that many Australians equate public ownership of such icons with the 'public interest', since they believe that public ownership will deliver their basic goods and services in an equitable manner to all Australians. Government ownership does provide a unique capacity to cross-subsidise across the nation and across the socio-demographic groups, and although the average citizen may not comprehend all of the mechanisms by which this takes place, he or she may feel more assured that government ownership can deliver this objective better than can private ownership.

It is also true that, prior to the big floats, e.g. Commonwealth Bank, Qantas and Telstra, the level of individual share-ownership in Australia was one of the lowest in the world, and of the 12 per cent or so of the population who did own shares, most of it was through institutional rather than direct investment. So for the vast majority of Australians, their sense of ownership of infrastructure or basic commodities has been through public ownership, and they attempt to shape policies and influence service delivery through the ballot box, not the sharemarket. And if public ownership equals public interest, then for many Australians the obverse must be true; that private ownership will see sectional interests triumph over public interest. This aspect is present in all countries but perhaps more entrenched in Australian history where a sparse population across a large continent saw governments having to establish industries, especially in transport and communications, which, in other smaller, more densely populated countries, were founded by private enterprise. Nowadays, with individual share ownership approaching 40 per cent, it may well be that this attitudinal hump has been over-ridden, but it seems odd that the Howard Government has not sought to reform the taxation system to give incentives for share-ownership, especially by employees, when the evidence is clear from other countries that privatisation has created popular capitalism which, in turn, appears to have broken down ideological divides and weakened trade union influence.

There are also some **structural** elements of the Australian political system which have served as hindrances to privatisation. One is the three-year election cycle at the national level and in some States. The lead time for privatisation is typically at least one and a half to two years and, given the instability which the surrounding debate causes, it is a policy that requires immensely careful management. It contains substantial risks should the process falter in any way. Another hindrance is the peculiar dichotomy which results from the voting system for Senate elections, whereby no national government has controlled the Upper House since the early 1980s and is not likely to in the foreseeable future. It seems generally true that Australians deliberately use the proportional voting system to ensure that the Senate provides a check on the power of government in the Lower House. So minority parties and independents hold the balance of power and this gives rise to a clash of mandates. A Coalition government obtaining a majority in the Lower House can claim it has a clear mandate to privatise, but a minority party or independent holding a balance of power in the Senate can also claim to have a mandate to block or control such privatisation. Compromise becomes the only solution unless the government is prepared to risk a double dissolution (and none has been so prepared in relation to privatisation, despite some threats). Such compromise takes time, and again the short electoral cycle comes into play with the next election just around the corner. Also, even in those States that now have four-year terms, the exigencies of privatising enterprises with such mammoth infrastructure as in electricity, ports, railways, water or roads, mean that electoral misfortune is always near, as some States have discovered and hence back-pedalled or even dropped privatisation programs.

There are also some structural elements of the Australian political system which have served as hindrances to privatisation. One is the three-year election cycle at the national level and in some States.

Many of these structural/attitudinal elements might not be so pervasive if Australians had more confidence in the independence and effectiveness of the regulatory system. In many other countries it has been possible to sell the equation: public ownership = private ownership + regulation. But with a few exceptions such as the ACCC or the APRA, the regulatory frameworks are not well understood in Australia. The powers of the regulators are often tepid, and the visibility of the regulatory bodies low. This is all the more so following two decades of a shift to deregulation in Australia at both national and State level. Broadcasting is the quintessential example where self-regulation by the industry has seen a loss of faith by the public in the regulatory oversight bodies that remain, but the same could be said of so many other industries. Many studies have revealed how ineffective Australia's regulators are perceived to be, and the irony is that the power of the regulators has rarely been enhanced following privatisation, as should happen to ensure maintenance of the public interest, despite the simultaneous introduction of National Competition Policy, which was meant to be accompanied by stronger regulatory frameworks. No wonder Australians still tend to look to public ownership rather than regulation to protect the public interest.

1. The issues

Apart from these more structural aspects, there have been a number of recurrent political issues surrounding privatisation in Australia in recent years. The **motivation** for privatisation is one of them. Of course, the purest motive for privatising is the economic argument regarding competition. Shifting activity from the public to the private sector should subject it to market forces and hence improve resource allocation and efficiency. Not much of this argument appears in Australian political debate these days; perhaps it is more in evidence in relation to State government utilities rather than national enterprises. All of this is somewhat surprising given that there has been relatively little increase in the degree of competition surrounding these bodies after they have been privatised; indeed, often there is less competition.

> In Australia … the motivation [for privatisation] appears to be mainly threefold—to reduce government indebtedness, to use the proceeds for various economic and political purposes, and to shift contentious areas of service delivery away from the responsibility of the government.

Of course, in all countries the competition argument is not the only motivation and there are both economic and political reasons for privatisation. The United Kingdom is the classic case in point, where the reduction of trade union power, reducing the size of the public sector, the gaining of international competitiveness, and many purely ideological motives, were well to the fore. In Australia of late, the motivation appears to be mainly threefold—to reduce government indebtedness, to use the proceeds for various economic and political purposes, and to shift contentious areas of service delivery away from the responsibility of the government.

Peter Costello has announced his preference for the **proceeds** from any full privatisation of Telstra to go towards debt reduction. Clearly there are economic arguments favouring debt reduction but there are also powerful political elements. Governments these days are judged by the public, the media and the credit rating agencies, on the amount of public debt they accrue. So it is only natural that all governments would seek to reduce the Public Sector Borrowing Requirement statistic, and privatisation is a quick way to do it. As for the use of the funds generated from the sale, we have witnessed an unholy scramble from all political parties and interest groups for a share of the spoils. Indeed, it is now history that the major national asset sales only passed through the Australian Senate when the minor parties and independents were able to have a say in the use of the funds. Such is the nature of political compromise, where issues of principle turn into ones of pragmatism and political advantage. The full sale of Telstra and possibly Medibank Private will be no exception. The turkey will be carved up in the red chamber with the minor parties and independents getting a good helping of the meat and the gravy.

Undoubtedly the major political issue which has arisen in Australia relates to **community service obligations** (CSOs) or, in the case of Telstra, the Universal Service Obligation. All government enterprises, Commonwealth and State, have long had cross-subsidies imposed upon them, or accepted by them as part of normal business life. For the most part the CSOs remain hidden while the enterprise remains in public ownership, but privatisation certainly flushes them out. The major Australian CSO is the provision of services to the bush which are often uneconomic but are mandated because of the fundamental Australian ethic that every Australian is entitled to the same standard of government services wherever they live. Other key CSOs have often related to the way business customers subsidise domestic ones (and sometimes *vice versa,* especially in State government arenas), and also concessions for the aged, the young and the disadvantaged. The refusal of the National Party to sanction the full sale of Telstra until telecommunications in the bush reach an appropriate standard is the quintessential example of this political force at work; hence the Besley inquiry which scoped out the lift in regional telecommunication services that would be necessary, and now Son of Besley, the Estens Report, to assess whether this has been achieved.

A somewhat related issue is that of the **standard of services** following privatisation. This is often translated into an issue of whether privatised bodies set out to please their shareholders rather than their clients or the public at large. The most visible examples of this relate to cost-cutting measures by privatised bodies. Their price levels usually remain in the spotlight for quite a while after they are sold, and the use by regulators of the CPI-X formula in effect caps price rises, and so produces efforts to cut costs. The main flak in this area seems to have been directed at State government bodies, including electricity authorities, rail, trains, emergency services, prisons and welfare services, where media reports contain a large number of instances of a perceived fall in standards of service, and occasionally even failure. This is especially the case regarding electricity privatisation, where the complex separation of generation from transmission and reticulation has often been seen as a result of privatisation, not just of industry restructuring. When the service fails or the prices rise, and both have occurred in some jurisdictions, the argument strengthens. At the Commonwealth level, a paradox seems to reign in that the criticism of nationally privatised bodies, like the Commonwealth Bank and Qantas, for winding down services to rural areas does not always attribute the blame to their privatised status, although this is not the case for Telstra whose sins are usually blamed upon the desire to please shareholders.

All of this immediately produces a focus on the **regulatory framework** surrounding privatisation, which has been a controversial aspect of privatisation in virtually every country where it has occurred.[3] In Australia, our most spectacular contest is not the State of Origin or the AFL Grand Final, it is the Telstra versus ACCC heavyweight contest. This battle between regulator and privatised entity is played out in many other areas including State governments. There have been instances where privatised bodies, especially former natural monopolies, have sought to abuse market power, squash new entrants, disguise price rises and lower standards. National and State regulators have not always received the full backing of governments in their endeavours to reveal and outlaw these practices.

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The resourcing of regulators is often inadequate and the penalties they can deliver are often weak in relation to the wealth of the bodies they seek to regulate. Australia is also yet to have a proper debate on the merits of generic regulators versus industry-specific ones, and there is evidence supporting both models from other countries. Also, the regulatory framework is often jumbled up in the policy melange that surrounds a privatised body, all of which is supposedly to protect the public interest, including licensing, ministerial directions, over-rides, industry ombudsmen and legislated access to various appeal mechanisms. For an aggrieved client of a privatised body it is a jungle, and the redress of grievances is often a daunting path indeed. For example, the vast majority of Australians would never have heard of the State regulatory bodies that were established following the introduction of National Competition Policy, yet which oversee many of the necessities of daily life like water, electricity, gas, train and tram travel.

Privatisation usually results in short-term **unemployment** as newly sold entities seek to reduce overheads and costs. This has certainly been true in Australia as falling employment in almost all privatised bodies will show. Of course, the advocates of privatisation say that this trend will be reversed as the enterprise becomes more efficient and grows, and there is some truth in this if overseas experience is any guide. But it is somewhat surprising that this has not become more of an issue in Australia. It certainly accounts for a good deal of the trade union opposition to privatisation, although the potential for reduced coverage is just as powerful a force. Maybe it is just part of the very unfortunate way in which the Australian electorate has come to acquiesce to constantly high rates of rural/regional unemployment.

Most of these issues become bundled up into ones of **accountability** and there has certainly been a welter of political attacks on the lack of accountability of the privatisation process itself, the performance of the privatised bodies, and the lack of government efforts to protect the public interest throughout and beyond privatisation.[4] Various auditors have questioned these aspects, none more strongly than the former Victorian Auditor-General, who produced a complete accountability framework to be applied to the privatisation process.[5] Issues which have arisen most often in this context include the determination of the sale price of public assets, especially given the rapid escalation in share prices that has often occurred following a sale, thereby giving rise to accusations that governments deliberately set low sale prices to make sure someone comes to the party.[6] Occasionally the reverse scenario occurs, as with the sale of the Sydney airport, a trade sale, where the unexpectedly high price tendered by the successful bidder has given rise to fears that the airport owner will now have to charge inordinately high charges and fees to airport clientele to recoup its outlay. The battle with Virgin Blue over access to the former Ansett terminal has been cast in this light.

There has … been a welter of political attacks on the lack of accountability of the privatisation process … the performance of the privatised bodies, and the lack of government efforts to protect the public interest.

This accountability dilemma is part of a wider concern in Australia regarding many aspects of government/business relationships at both State and national level, whereby ‘commercial in confidence’ rules are invoked to prevent scrutiny by the full range of accountability regimes in the parliamentary, executive and judicial branches of government. Not even Freedom of Information laws, the powers of the Auditor-General, or the probing of Parliamentary Committees seem able to penetrate the veil of secrecy that often surrounds the process of privatisation. It is said that the thing that most galls Telstra senior management is having to appear before the Senate Estimates Committee.

Somewhat surprisingly, the issue of **foreign ownership** has not loomed as large an issue as was forecast, despite the fact that there has been a significant degree of investment from offshore in the privatised entities. Admittedly it is not usually a majority ownership, largely because of the operation of the ‘golden share’ arrangements. It may also be that the general opening-up of the Australian economy has caused foreign ownership to be less of an issue in general, despite the fact that in the case of privatisation it is the ownership of key elements of the nation’s infrastructure which is involved.

2. Some unanswered questions

Like all arenas of privatisation, Australia has provided a case study where some of the theories surrounding the drive for privatisation can be tested, yet to date there has been little research to answer these questions:

- Has the motivation of the management and staff of these enterprises changed with the shift to private ownership? Is the pursuit of profits and market share a greater force for performance than the serving of 'the public interest' and the direct accountability to governments?
- What difference does the emergence of a share-owning public make to perceptions of, and attitudes to, further privatisation, and has their voting behaviour been affected?
- Does the attitude of workers towards industrial militancy change when they come to hold shares in the newly privatised entities in which they are now employed?
- What can governments achieve by owning enterprises that they cannot achieve by regulation and the policy/legislative framework?
- Is ownership superior in achieving the public interest?
- Is it valid to allow privatised entities a monopoly position in the domestic market to enhance their international competitiveness?
- Why cannot Telstra and other enterprises continue to exist as hybrid, mixed enterprises, serving both shareholders and governments, when in other countries (especially in Western Europe), such bodies have prospered and provided the backbone of economic growth and development?
- Could the logical starting point to the debate be that, whatever the industry, the government will most probably need to own the infrastructure, and it will be the value-added components that will provide the main scope for private ownership, hopefully with the maximum degree of competition?
- What is the modern-day definition of a 'public good' and do the classical economics textbooks need revision on this score?

The debate about privatisation remains a very uneven one. The advocates of privatisation often have hard quantitative data at their disposal … The opponents generally have to rely on qualitative arguments.

For the moment in Australia, the debate about privatisation remains a very uneven one. The advocates of privatisation often have hard quantitative data at their disposal—successful growth rates, profitability, market share, dividends, etc. The opponents generally have to rely on qualitative arguments—falls in standards of service, market failure, job losses, avoidance of community service obligations, regulator capture, etc.—all of which are hard to measure and hard to attribute directly to privatisation *per se.*

Endnotes

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9. Privatisation and nationalisation in the 21st century

John Quiggin[1]

1. Introduction

In economic terms, the dominant policy trend of the 20th century was that of nationalisation. In almost all countries, and on almost all measures, the range of economic activities undertaken by governments was substantially larger at the end of the 20th century than at the beginning, as was the ratio of public revenue and expenditure to national income.

During the last 20 years, however, there were sustained, and to some extent successful, attempts to roll back the growth of government. Centrally planned economies collapsed and began a transition towards a market-oriented model. In the developed OECD countries, privatisation of publicly-owned enterprises took place on a large scale, beginning with the sale by public float of British Telecom, undertaken by the Thatcher Government in the United Kingdom in 1985.

Although privatisation reduced the role of government in the provision of marketed goods and services, throughout the 1980s and 1990s the general government sector (health, education, community services and social welfare) continued to grow in absolute terms.

These developments popularised a 'triumphalist' analysis, in which it was claimed that 'capitalism' had triumphed over 'socialism', inaugurating the 'end of history' (Fukuyama 1992). This claim was clearly correct insofar as 'capitalism' referred to the set of economic and political systems prevailing in OECD countries, ranging from the United States to Norway, and 'socialism' referred to the systems prevailing in the Soviet Union. However, as was made clear by Fukuyama and subsequent writers such as Friedman (1999), a much stronger claim was intended. The claim was that history had shown the inevitably of a free-market system similar in broad terms to that prevailing in the United States, but with reductions in the role of government along the lines of those proposed in the Republican Party's Contract with America (Gingrich 1994).

Such claims were premature. Although privatisation reduced the role of government in the provision of marketed goods and services, throughout the 1980s and 1990s the general government sector (health, education, community services and social welfare) continued to grow in absolute terms and, in many countries, as a proportion of GDP. Moreover, by the late 1990s, the pace of privatisation had clearly slowed. For example, whereas before 1995 almost all proposals for privatisation in Australia had been successful, in the period after 1995 most were rejected.

In the first few years of the 21st century, the rate of privatisation has slowed even further, particularly in Europe and Latin America. More significantly, a countervailing trend has emerged in the English-speaking countries. For the first time in decades, nationalisation or re-nationalisation has taken place on a significant scale. Notable examples include the nationalisation of airport security in the United States, the effective re-nationalisation of the railway system owner Railtrack in the United Kingdom and the establishment of a new publicly-owned bank in New Zealand.

2. Transfers

Privatisation and nationalisation frequently involve substantial transfers of wealth. Analysis of these transfers is useful for several purposes. First, it is important to distinguish between transfers of wealth and efficiency gains or losses arising from privatisation or nationalisation. Second, analysis of wealth transfers is an important part of any evaluation of welfare effects. Finally, the political economy of privatisation and nationalisation is largely determined by the direction and magnitude of wealth transfers.

2.1 Underpricing and buyer over-optimism

The most obvious transfers associated with privatisation by public float, as with private sector initial public offerings (IPOs), arise when the offer price for shares is set at a level below the market value of the shares, as revealed in early trading. In both the private and public sectors there are incentives for the organisers of IPOs to set prices below the expected market price, thereby allowing those participating in the float to benefit from first-day 'stag' profits.

First, the negative consequences associated with a 'failed' float (one in which not all shares on offer are taken up) are generally greater than for a float that is oversubscribed. This is particularly true in relation to politically controversial privatisations, where a failure to purchase shares can be represented as a lack of confidence in the government.

Second, the allocation of underpriced shares provides opportunities to give favours to individuals and groups whose goodwill may be valuable in the future. Such favours were a prominent and controversial feature of the recent stockmarket bubble in the United States. The allocation of discounted shares to employees and others has been a common feature of privatisation in Australia and elsewhere.

Transfers have also arisen in relation to privatisation by trade sale. In many developing and transitional countries, privatisation by trade sale has been the occasion for large-scale expropriation of public wealth. Australian experience has been more favourable, from the viewpoint of the public. Although some assets, such as the NSW State Bank, appear to have been sold at unreasonably low prices (Walker and Walker 2000), there have been other instances, such as the sale of Victorian electricity distribution enterprises, where the price paid appeared unreasonably high in the light of the regulatory regime that determined subsequent earnings. In some cases of this kind, such as the privatisation of airports, regulations have been relaxed to allow higher profits, retrospectively validating high sale prices.

2.2 Prices and service quality

The impact of privatisation on prices and service quality has varied, depending particularly on the nature of regulatory changes introduced at the time of privatisation. In general, direct impacts on prices have been small, except where governments have sought to increase the sale price of assets by raising costs to consumers. The most notable recent example was the leasing of Australian airports, which was accompanied by large increases in landing charges (up to 100 per cent), increases in other charges, such as parking fees, and the introduction of a range of new charges, such as taxi levies.

Privatisation of monopolies when combined with price regulation has typically led to a reduction in service quality as monopoly firms seek opportunities to reduce costs and raise profits. Over time, the introduction of steadily more intrusive regulation has reduced both the incentives for lower service quality and the differences in operational efficiency between private and public monopolies.

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In some other instances, privatisation has led to the adoption of a more business-like and 'customer-focused' approach. This has typically been associated with an increase in the quality of service for profitable customers, but also with attempts to discard unprofitable customers and uncompensated community service obligations.

2.3 Safety and reliability

Privatisation has generally been accompanied by a decline in the safety and reliability of infrastructure services, particularly when account is taken of exogenous technological trends, which have generally improved the reliability of equipment of all kinds. The cost reductions associated with privatisation and, to a lesser extent, corporatisation, have focused particularly on reductions in overstaffing in areas such as maintenance and on the elimination of redundant capital capacity, frequently referred to as 'goldplating'. Other things being equal, cost savings achieved in this way must involve some loss of reliability and, in some cases, safety.

Like other aspects of microeconomic reform, privatisation has imposed costs on workers in the form of increased stress and a faster pace of work.

The shift from public to private ownership reduces incentives for safety and reliability. The political costs of failures in infrastructure systems can be severe. By contrast, the costs to private infrastructure owners of occasional breakdowns is relatively modest. Hence, if such outcomes are to be avoided, intrusive regulation is likely to be necessary.

Another possible response is the introduction of a legal regime based on strict liability of infrastructure providers for economic losses associated with system failures. A current class action against Esso in relation to the consequences of the Longford explosion and system failure in Victoria may set a precedent in this respect. Surprisingly, relatively few supporters of the adoption of the US model of private provision of infrastructure services seem to welcome the arrival of a system of regulation in which the threat of litigation plays a central role, as in the United States.

None of the discussion above establishes whether the net impact of reductions in maintenance expenditure is positive or negative. Terms like 'goldplating' and 'redundancy' tend to imply that there is too much reliability, but goldplating makes sense in some contexts (computers) and redundancy in others (aircraft control systems).

2.4 Wages, conditions and work intensity

Like other aspects of microeconomic reform, privatisation has imposed costs on workers in the form of increased stress and a faster pace of work. Although anecdotal evidence of increases in work intensity abounds, statistical evidence is limited. The Australian Workplace Industrial Relations Survey undertaken in 1995 found that a majority of employees reported increases in stress, work effort and the pace of work over the previous year, while less than 10 per cent reported reductions in any of these variables (Morehead et al. 1997).

Dawson et al. (2002) examined the increase in working hours for full-time workers and concluded:

> *For many Australian workers, their families and communities, extended working hours have led to increased levels of fatigue and decreasing levels of social support. This in turn has the potential to compromise safety and the long-term health and wellbeing of workers and the organisations that employ them.* (p. 4)

Another source of evidence comes from the supply side. The combination of increased work intensity and longer hours of work has rendered full-time employment increasingly unattractive. The full-time participation rate (full-time employment plus those seeking full-time work as a proportion of the population aged between 15 and 64) fell during the 1990s for both males and females. The decline in female participation in the full-time labour force represents the reversal of a long-term trend towards increased participation.

3. Efficiency gains and losses

If all transfers to and from workers, consumers and taxpayers are netted out, the impact of privatisation can be assessed by comparing the value of the enterprise in private ownership, measured by the sale price, with its value in continued public ownership, measured by the present value of the earnings that would have been realised under continued public ownership. The starting point for any such assessment is what may be called the 'equivalence hypothesis', namely, that in the absence of some specific source of efficiency gains or losses, the value of the asset will be the same in public or private ownership. Hence, in the absence of transfers such as those discussed in the previous section, privatisation will have no effect on the net worth of the public sector (Forsyth 1993).

One of the strongest claims for privatisation is that it will increase the operating efficiency, and … profitability, of the enterprises concerned. Empirical studies have yielded mixed results, although the balance of evidence favours the hypothesis.

In this section, a range of possible sources of efficiency gains and losses are considered. Although it is difficult to assess them individually, a market test is provided by a comparison of sale prices with earnings foregone through privatisation.

3.1 Operational efficiency

One of the strongest claims for privatisation is that it will increase the operating efficiency, and therefore the profitability, of the enterprises concerned. Empirical studies have yielded mixed results, although the balance of evidence favours the hypothesis that privatisation increases operating efficiency. Borcherding, Pommerehne and Schneider (1982) surveyed the literature on municipal services and reported that in most studies either the private sector was found to be more efficient or no significant difference was observed. However, in studies of electricity and water services, either the public sector has been found to be more efficient (Pescatrice and Trapani 1980; Bhattacharyya, Parker and Raffiee 1994) or no significant difference has been discovered (Byrnes, Grosskopf and Hayes 1986).

Historically, public enterprises have had a wide variety of objectives and it is reasonable to assume that many of the enterprises in the studies surveyed by Borcherding, Pommerehne and Schneider (1982) had neither a profit-maximisation objective nor a cost-minimisation objective. One result of this diversity of objectives is the common finding that the variance of performance measures is higher for public than for private firms (Bhattacharyya, Parker and Raffiee 1994).

A central feature of public sector reform in Australia has been the attempt to replace the diffuse objectives of traditional public enterprises with an objective of profit maximisation subject to the satisfaction of clearly defined community service obligations. This has most commonly been achieved through corporatisation. Corporatised government business enterprises (GBEs) have competed effectively with private firms in many industries, suggesting that any differences in operating efficiency must be modest. It should also be noted that many of the wealth transfers associated with privatisation, such as uncompensated increases in the intensity of work, also arise in corporatised government business enterprises.

3.2 Regulatory risk

In some instances, such as cases where governments have owned firms trading in competitive markets, privatisation involves no changes in regulation. However, such cases, typically arising from public 'rescues' of failing firms, have been relatively infrequent. As public ownership expanded during the first 80 years of the 20th century, nationalisation was used primarily as a method of regulating industries that were, or were seen to be, characterised by market failures such as natural monopoly or externality.

In these circumstances, privatisation creates a regulatory risk that did not exist under public ownership. Small differences in regulated rates of return imply large transfers between consumers and private monopolists. By contrast, under public ownership, this risk is internalised, since, for most regulated infrastructure services, consumers and taxpayers (or, more precisely, residents of the relevant jurisdiction) are the same people.

The costs of regulatory risk are substantial. The failure of private buyers to take regulatory risk into account led to the over-optimistic prices paid for Victorian electricity assets.

This analysis directly contradicts a widely held view of public policy in Australia, that there is, in some sense, a conflict of interest in governments both owning and regulating business enterprises. This view lacks any analytical basis. It is analogous to an argument that a conflict arises when a private company contracts with or directs the actions of a wholly-owned subsidiary.

The costs of regulatory risk are substantial. The failure of private buyers to take regulatory risk into account led to the over-optimistic prices paid for Victorian electricity assets. These purchases have been followed by re-sales and lower prices and by vigorous rent-seeking activity aimed at validating the original purchase prices by securing more favourable regulatory treatment.

3.3 Cost of capital

The crucial efficiency difference in favour of public ownership arises from differences in the cost of capital. The return demanded by investors in private equity in the average large company includes a risk premium of around 6 percentage points to compensate for the company's exposure to aggregate economic risk. That is, if the rate of interest on government bonds is 5 per cent, investors in a typical stock will expect a return of around 11 per cent. The equity premium is smaller for companies with stable returns or for those that are only weakly correlated with the economy as a whole, and larger for those with highly cyclical returns, such as companies involved in construction.

The market's aversion to risk is reflected in the difference between the return demanded by investors in private equity and the rate of return on government bonds or good-quality corporate bonds. This difference is called the equity premium, and its size represents a long-standing puzzle for economists. Most economic models imply that, if capital markets spread all relevant risks efficiently and at low cost, the equity premium should be no more than one percentage point, and probably less. A variety of explanations for the 'equity premium puzzle' have been offered, most of which incorporate the failure of private capital markets to spread risk as well as is assumed in neoclassical models of the financial sector.

As Grant and Quiggin (2002) observe, if the demand for a high rate of return on equity arises from failures in private capital markets, there is no reason to apply this rate of return in evaluating public investments, or determining the present value of income streams flowing from GBEs.

3.4 An assessment of Australian privatisations

As has been argued in this chapter, the effects of privatisation can be assessed by examining the difference between the sale price realised for an asset and the present value of earnings foregone under public ownership, after netting out transfers to and from workers, consumers and buyers of assets. Such analyses of actual and prospective privatisations have been performed for the Commonwealth Bank (Quiggin 1995), Commonwealth Serum Laboratories (Hamilton and Quiggin 1997), Telstra (Quiggin 1996a), the NSW State Bank (Walker and Walker 2000) and the Victorian electricity industry (Quiggin 2002a), among others.

In all cases the analysis indicated a net welfare loss from privatisation. In the case of Victorian electricity, however, the loss was borne by the buyers (mainly US electricity companies) who paid prices which were, at least in retrospect, excessive. Hence, the net impact on Victorian residents was roughly neutral, with gains to taxpayers being offset by losses to workers and consumers.

Based on this evidence, it seems unlikely that privatisation of efficiently run government business enterprises in 'core' areas of government activity such as infrastructure is ever likely to be beneficial, except during market 'bubbles' when buyers may be willing to pay prices that exceed the long-run private market value of assets.

It seems unlikely that privatisation of efficiently run government business enterprises in 'core' areas of government activity such as infrastructure is ever likely to be beneficial, except during market 'bubbles'.

4. The case for re-nationalisation

4.1 Thinking the unthinkable

Until about 1980, the idea of a substantial reduction in the scale and scope of public sector economic activity lay outside the realm of acceptable public debate. Cockett's (1995) classic study of the British thinktanks, such as the Institute for Economic Affairs, that first advocated privatisation, was aptly titled *Thinking the Unthinkable.* Such is the power of conformism in human affairs that within a decade of its entry into the public debate, the insurgent idea of privatisation had become an orthodox dogma, and the concept of nationalisation was, literally, unthinkable for many.

This point may be illustrated with reference to the Australian debate. Criticisms of privatisation, such as those by Quiggin (1995) and Walker (1994), have been the subject of vigorous debate (Hathaway 1997; Officer 1999), but until recently, arguments that the appropriate response to the failures of privatisation is a return to public ownership (Quiggin 2000) have simply been ignored.

This position is slowly changing, although the public debate is lagging behind events in the real world. Re-nationalisation in various forms has taken place in numerous countries, sometimes as a deliberate attempt to offset excessive privatisation, but more frequently in response to the failures of privatised firms and the associated regulatory structure. Notable examples include Railtrack in the United Kingdom, airport security in the United States, electricity in California and the re-establishment of a publicly-owned bank in New Zealand.

In Australia, the Minister for Small Business, Joe Hockey, recently suggested that it might be necessary for State governments to re-enter the insurance business following the collapse of HIH Insurance and United Medical Protection.[2] The unthinkable is becoming thinkable once again.

4.2 The mixed economy

In most OECD countries, governments and GBEs produce around 30 per cent of total output. This proportion has tended to grow over time, reflecting the increasing economic importance of the sectors in which government activity is concentrated, such as health and education. Large-scale privatisation has offset or reversed the increasing trend in a number of countries, including the United Kingdom. Nevertheless, it seems clear that for the foreseeable future OECD countries will have 'mixed' rather than 'free-market' economies.

In a mixed economy, even supporters of further privatisation should welcome the availability of nationalisation as a policy option. If privatisation is, as is sometimes supposed, irreversible, it should be undertaken with great caution. By contrast, if both privatisation and nationalisation are feasible, it is possible to adjust the boundary between the private and public sectors optimally in response to new information and changed circumstances.

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Nevertheless, the policy relevance of nationalisation is greatest in cases where privatisation has already gone too far. The evidence cited in this chapter suggests that this is the case in Australia, and that a number of privatisations already undertaken have reduced both public sector net worth and the welfare of the community as a whole. It follows that, in the absence of transactions costs, re-nationalisation would improve welfare.

4.3 Targets for re-nationalisation

The strongest candidate for re-nationalisation in Australia at present is Telstra. Even supporters of privatisation, such as Treasurer Peter Costello, agree that the present state of partial privatisation is highly unsatisfactory. When the current Government's proposal for partial privatisation was under consideration, the same view was expressed in Quiggin (1996b) and derided by members of the then Government. On the other hand, given Telstra's monopoly power, full privatisation would be acceptable to other market participants only if it was accompanied by more stringent regulation. The implied regulatory risk reduces the market value of Telstra, which is well below any reasonable estimate of the value of future real earnings, discounted at the real bond rate.

Privatisation of Telstra could be financed in part by the sale of peripheral assets, such as Telstra's pay-TV interests and joint ventures in Hong Kong. This idea, along with proposals for more extensive structural separation, has been discussed by Quiggin (2002b) and Tanner (2002), and criticised by Eason (2002).

Re-nationalisation of infrastructure assets that have been fully privatised is further off, except in cases such as that of Railtrack where the private operator has failed completely. Nevertheless, it would be highly desirable to restore full public ownership of the road system and to replace the present arbitrary patchwork of tolls with a rational system of road-user charging. Less urgent, but still highly desirable, is the re-nationalisation of natural monopoly infrastructure, such as water supply in South Australia and electricity distribution in South Australia and Victoria.

5. Concluding comments

The limitations and failures of privatisation are widely recognised, but the obvious implication that at least some privatised enterprises should be re-nationalised, remains unthinkable for many. Thus far, re-nationalisation has occurred primarily as an emergency response to the failure of private firms to provide essential services. As instances of this kind break down the notion that privatisation is irreversible, it may be possible to undertake a more systematic and rational reconsideration of the appropriate roles of the public and private sectors.

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Endnote

1 I thank Nancy Walker for her helpful comments and cricitism of this chapter.

2 ABC interview, reproduced at http://www.abc.net.au/am/s566044.htm

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