

Privatisation Perspectives

What makes some privatisations work, but others fail? Ross Clark reflects on what can be learned from rail and other transport-sector privatisations as played out in New Zealand and Great Britain. It turns out that the structure of the industry in which the privatised firm operates has a crucial bearing upon the likelihood of privatisation succeeding.¹

In the 1980s and 1990, the Governments of both New Zealand and Great Britain privatised many transportation businesses. The track record of these firms post-privatisation has been somewhat patchy. Some have become extremely successful. Others have failed, necessitating repurchase and recapitalisation by the successors of the Governments that sold them.

Many privatised firms have become successful commercial businesses operating in competitive markets – an example is the Intercity bus group, once part of government-owned New Zealand Rail before it was separated out in 1991. These successes are examples of businesses which face competition *in* the market. However, many of the privatised businesses are subsidy-dependent: they face competition *for* the market. Examples of this are the former municipal bus operations in Auckland and Wellington now owned by Infratil. They rely on public subsidy (contract income, as distinct from fares) for over forty percent of their annual income. There are no real public-policy issues arising from the privatisations of these businesses: this is probably because the bus and coach industry faces reasonably straightforward entry and exit, which in turn is a consequence of the transparent competitive tendering processes as well as the industry deregulation that occurred at the same time as privatisation (and removed protections previously enjoyed by the government-owned operator).

Privatisation has tended to become more problematic (and especially contentious) when the business concerned is a natural monopoly such as a telcoms company or an airport. New Zealand examples include Telecom and the Wellington and Auckland airport companies. Privatisation of these businesses has occurred in the context of a transparent regulatory regime which by and large seems to have facilitated the creation and operation of successful privately-owned firms while limiting consumers' exposure to the most egregious consequences of exertion of market power (although rapid technological change in the telcoms industry has rendered the regulatory task increasingly more complex). A New Zealand example of this sort of firm – which could have been privatised, but which hasn't been – is the Airways Corporation. Its equivalent in the United Kingdom is partially privatised, with the private share held by a number of the larger airlines.

So far so good. But, when it comes to privatising railways, why has this policy frequently failed to result in economically sustainable businesses? Addressing two

¹ This article is based on: R Clark (2010) 'Full Circle: rail industry privatisation in New Zealand and a new theory of its fundamental conceptual weaknesses' (available at www.iscr.org.nz/f630,17980/17980_ETC_2010_paper.pdf).

fundamental questions provides some insights: to what extent can a business cover its costs and – separately – to what extent can the business be considered monopolistic?

The X factor(s)

Plotting these dimensions on a two-by-two matrix gives the four cells in Figure 1. Cell 1 contains businesses which are both profitable and operating in a competitive market. These firms (such as Intercity) are ‘competing in’ the market. Cell 2 contains the subsidised firms ‘competing for’ the market (one example is Infratil; others are given in the equivalent cell in Figure 2). Cell 3 contains profitable firms that have monopoly status but are subject to regulation. Their monopoly status suggests they could be compared with the rail firms – yet, as Figure 2 shows, many firms in cell 3 have been successfully privatised. The crucial difference is in the dimension of profitability: this is what places rail firms in cell 4 and distinguishes them from the regulated monopoly firms in cell 3. (Figure 2’s cell shows business which share with rail the characteristics of monopoly provision and the need for subsidies.)

The conclusion is that while privatisation of a business which is either subsidy-dependent or a natural monopoly (or neither) is likely to succeed, the privatisation of a business which is *both* subsidy-dependent *and* a monopoly supplier will generally not work.

Tranz Rail and Railtrack show why: the fundamental issue is business risk. First, it is too risky for a government to have a subsidy-dependent monopoly in private hands, because it faces the possibility that the private operator will ‘hold up’ supply in order to obtain greater subsidies. Second, it is too risky for a private business to be beholden to a Government for its funding because the government can ‘hold up’ the private operator by withholding subsidies, leaving it with stranded assets unable to be deployed elsewhere. Third, both governments and businesses alike face risks from whatever independent regulatory regime is in place. This was a major issue for both sides in the British situation: the presence of a regulator did not stop the old Railtrack going bust, and arguably contributed to its demise.²

Choo-choo no-nos

So how does Figure 1 help us understand the Tranz Rail issues? Tranz Rail was privatised on the basis that it would be commercially viable. However, for all sorts of reasons – fundamentally related to long-term trends within the New Zealand economy – the freight business proved to be commercially unviable. This became evident within five years of privatisation. The problem for the Government was not that Tranz Rail was a monopoly supplier of freight services (because it wasn’t: most of the freight services it offers can be duplicated by private sector truck or coastal shipping companies). However, it was *definitely* a monopoly supplier of the external benefits to society from having a railway network – notably the road safety benefits arising from moving freight on rail rather than on the state highway system, but also regional-development and environmental benefits.

² ‘The costs of running scared of running late’ *Competition and Regulation Times* issue 4 p4.

Whatever was said in public, it is highly unlikely that a Government of any political persuasion would have allowed the old Tranz Rail to engage in a systematic culling of the network in order to make itself profitable or at least solvent. (And the financial difficulties associated with peripheral parts of the system are well documented.) Faced with a private owner threatening to shut down much of the system, as Toll was threatening to do after 2005, the then Government opted in 2008 to secure the continued flow of external benefits by returning the firm to direct public ownership. Likewise, in the UK, Railtrack was eventually returned to de facto public ownership after it went bankrupt. However, its replacement (the ‘not-for-dividend’ company Network Rail) has proved difficult to regulate – leading to the possibility of its return to the core public sector, as this offers much clearer government control.

A distinction must also be made between the privatisation of *operations* and the privatisation of the *networks*. The railway operations in Great Britain have mostly remained in private hands – railway franchising is an excellent example of competition for the market. Likewise, in Europe, there is increasing private involvement in railway operations, but the *networks* have remained consistently in public hands. While a separation of operations from the network was considered for New Zealand, it was not carried out until 2004 – which is when the Government repurchased the network, forming Ontrack. However, Toll failed under these arrangements ultimately because it *wasn't* subsidised: Ontrack charged Toll for track access on the basis that the Government received a commercial return on investments made in track upgrades, even though Toll was, in effect, required to provide unprofitable services in order to generate external benefits.

Up in the air

The model also explains the Government’s continued ownership of Air New Zealand. This firm faces significant competition in the market; and if it wasn’t there, other suppliers such as Qantas and Emirates would continue to provide services. Yet the Government continues to own the company, because of the strategic benefits its continued New Zealand ownership is meant to provide – presumably, a continued visibility for “New Zealand” in a variety of overseas markets (although how this can be valued is another matter).

Into the future

So what does the model suggest about the proposed partial privatisations of Solid Energy and the electricity generator-retailer SOEs? Despite some scale economies, none are true natural monopolies and all appear to be commercially viable without subsidies. As they occupy cell 1 in Figure 1, the risks of privatisation appear low – unless, of course there is some yet-to-be-identified ‘hidden social benefit’ that cannot be obtained without subsidies.

Ross Clark is Rail Performance Manager at Transport Scotland. He was formerly employed by Tranz Rail and Transit New Zealand.