

# Privatization of Utility Assets: An International Perspective

NARUC Annual Meeting  
Chicago, Illinois

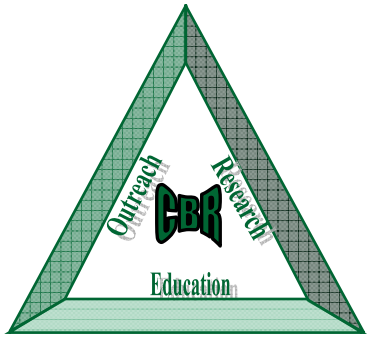
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November 15, 2009



# Introduction

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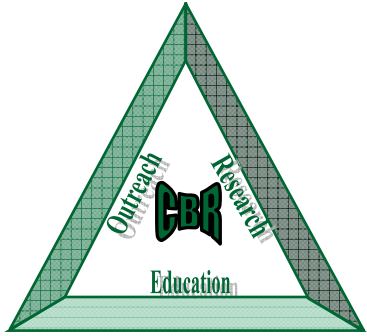
- Reasons
- Goals
- What is privatization?

## ▼ Economics

- What does privatization do?
- Private v. Public Production

## ▼ Issues

- Pre-privatization
- Post-privatization and regret



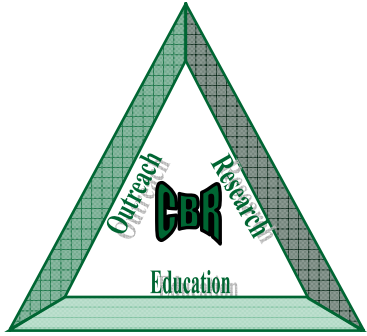
# Capitalist economies

## ✓ Competition

- Forces firms to behave efficiently
- Provides for transparent signals in economy

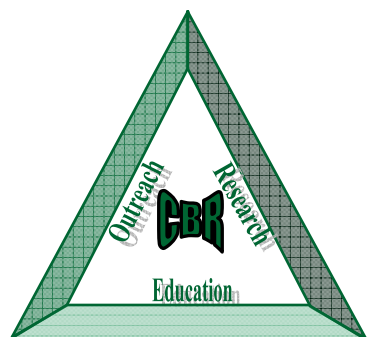
## ✓ Private ownership

- If property rights are clearly defined and there are no transactions costs, any allocation of property rights will produce an efficient outcome
- If property rights are not well defined and transaction costs exist then the allocation of property rights matters



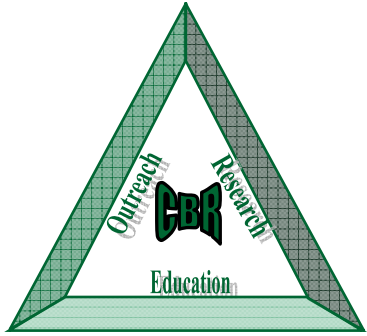
# Goals of privatization

- ✓ Increased production efficiency
  - Traditionally state-owned enterprises (SOE) have not produced at an efficient level
- ✓ Proper price signals and incentives for investment
  - Evidence that SOE do not invest in on-going maintenance (depreciation costs not recovered)
- ✓ Stabilize industry
  - Many formally centrally-planned economies have unstable industries in terms of investment and pricing
- ✓ Provide macro-economic benefits



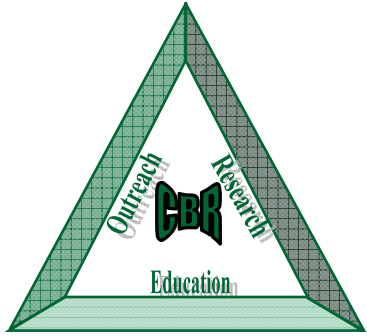
| Country                      | Consecutive years of output decline | Cumulative output decline (percent) | Real GDP, 2000 (1990=100) |
|------------------------------|-------------------------------------|-------------------------------------|---------------------------|
| Central and Southeast Europe | 3.8                                 | 22.6                                | 106.5                     |
| Albania                      | 3                                   | 33                                  | 110                       |
| Bulgaria                     | 4                                   | 16                                  | 81                        |
| Croatia                      | 4                                   | 36                                  | 87                        |
| Czech Republic               | 3                                   | 12                                  | 99                        |
| Estonia                      | 5                                   | 35                                  | 85                        |
| Hungary                      | 4                                   | 15                                  | 109                       |
| Latvia                       | 6                                   | 51                                  | 61                        |
| Lithuania                    | 5                                   | 44                                  | 67                        |
| Poland                       | 2                                   | 6                                   | 112                       |
| Romania                      | 3                                   | 21                                  | 144                       |
| Slovak Republic              | 4                                   | 23                                  | 82                        |
| Slovenia                     | 3                                   | 14                                  | 105                       |
| Russian Federation           | 7                                   | 40                                  | 64                        |
| Moldova                      | 7                                   | 63                                  | 35                        |
| <b>1930-1934</b>             |                                     |                                     |                           |
| France                       | 3                                   | 11                                  | --                        |
| Germany                      | 3                                   | 16                                  | --                        |
| United Kingdom               | 2                                   | 6                                   | --                        |
| United States                | 4                                   | 27                                  | --                        |

Source: Adapted from World Bank (2002, Table 1.1)



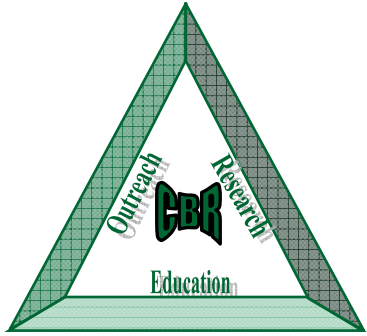
# What is privatization?

- ▼ Changing ownership
  - Asset sales
  - New enterprises are set-up (bottom-up)
  - SOE ownership changes (transformational or top-down)
- ▼ Privatization of management
  - Management contracting and contracting out
  - Leasing



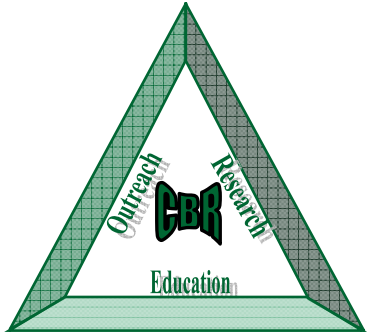
# Economics

- ✓ Rationalizing control mechanisms
- ✓ Creating competition (although privatization is not required)
- ✓ Creating commercial companies
- ✓ Creating appropriate incentive structures



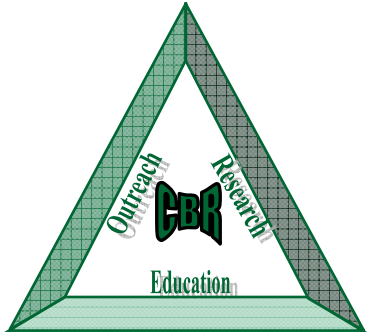
# Private v. Public Production

- ✓ Public production and private production are similar in that controlling bodies (shareholders and parliaments) have little ability to control and monitor managers (principle-agent problem)
- ✓ Public ownership may have incentive problems
- ✓ Private ownership may not produce efficiently
  - ✓ Rent-seeking behavior
  - ✓ Destructive competition



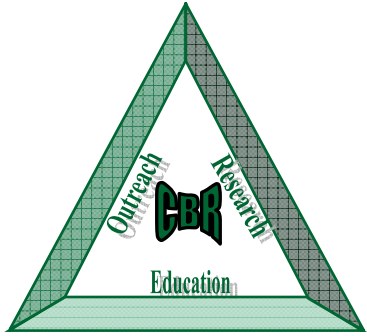
# Is there an economic argument for privatization?

- ✓ Incentive problems
  - Soft budget constraint
  - Attracting employees
- ✓ Commitment
  - Government often cannot commit to policy (e.g., not to subsidize a SOE, competition, etc.)
  - Same is true with private firms (automakers, banks, etc.) but the cost of obtaining subsidies may be higher



# Is there an economic argument for privatization?

- ✓ Internalizing Externalities: Why? Not clear could be incentive to innovate, costs of non-compliance, political capital
- ✓ Selection effects
  - Hard budget constraints facilitate the selection of those companies that should survive.
  - Government has little ability to select the “right” companies to succeed.

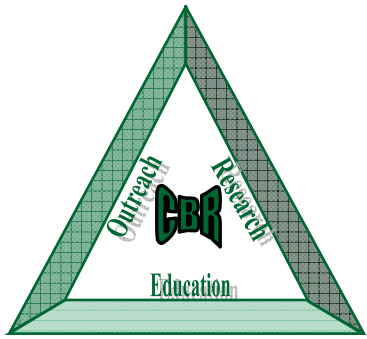


# Issues – Pre-Privatization

## ▼ Objectives

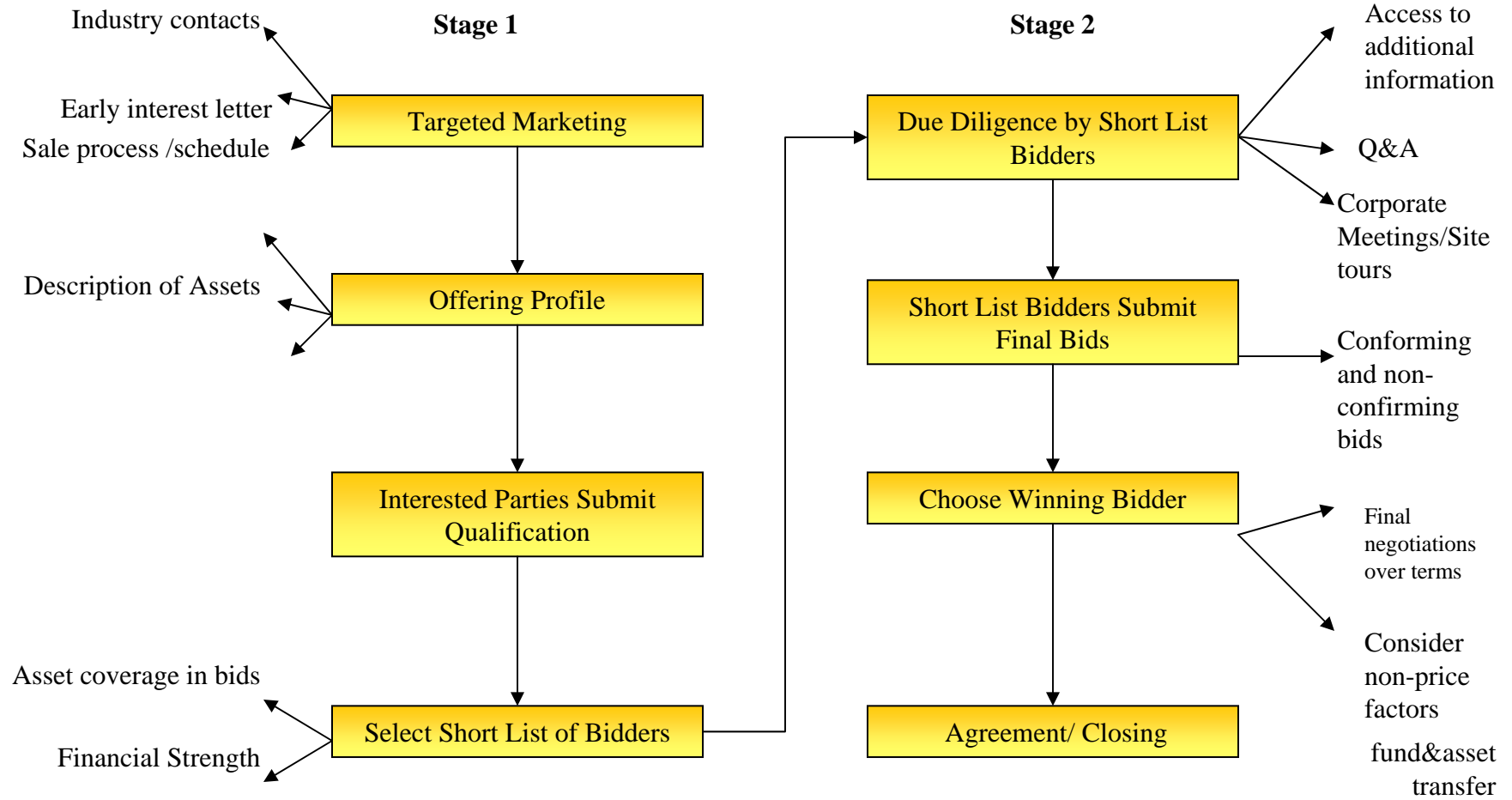
- Increase efficiency
- Lower losses (electric, gas, water)
- Maintain strong utility sector (e.g., attract modernization investment)
- Raise cash for government

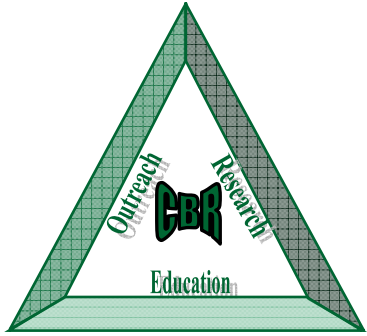
## ▼ Order of Privatization



# Issues – Pre-Privatization

## Tender v. Negotiation

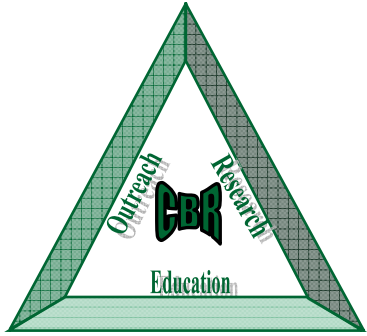




# Issues – Pre-Privatization

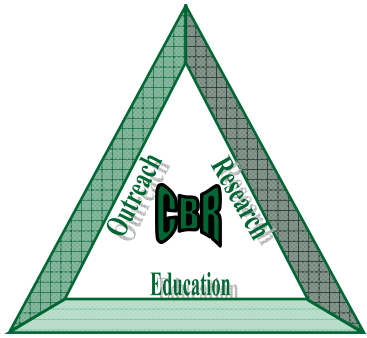
## ▼ Due diligence

- Asset valuation: fair market, book, or replacement? Regulators may want to keep prices low initially, but allow prices to increase over time → affects the value of the assets
- Asset values can be complicated by ownership disputes
- Lesson learned: pre-privatization analysis is necessary



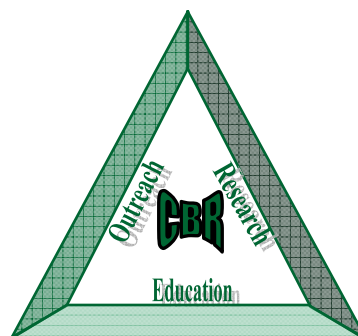
# Issues – Pre-Privatization

- ✓ Past Bills - Solve this prior to privatization
- ✓ Regulatory Commitment
  - Tariff methods (OPEX and CAPEX)
  - Investment terms and conditions



# Post-Privatization investment issues

- ✓ How do we value assets that remain publically owned in an illiquid market?
- ✓ Regret
  - England with price caps
  - Bulgaria with service quality
  - Macedonia with market and tariff rules



# What influences the pace (i.e., exit) of investment in the post-privatization market?

**TABLE 1**

**Canceled infrastructure projects with private participation in developing countries, by sector, 1990–2006**

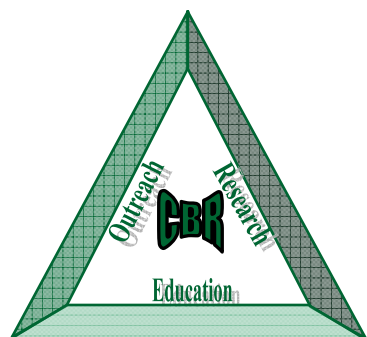
| Sector   | Projects reaching financial closure |  | Projects canceled |  | Canceled projects as % of sector total |                           |
|--|-------------------------------------|--|-------------------|--|--|---------------------------|
|  | Number                              | Investment commitments (US\$ billions) | Number            | Investment commitments (US\$ billions) | By number                              | By investment commitments |
| Energy   | 1,498                               | 322.8                                  | 49                | 11.5                                   | 3.3**                                  | 3.6**                     |
| Electricity generation                           | 836                                 | 190.2                                  | 23                | 9.7                                    | 2.8**                                  | 5.1                       |
| Electricity distribution or integrated utilities | 328                                 | 76.8                                   | 20                | 1.2                                    | 6.1                                    | 1.6**                     |
| Natural gas                                      | 334                                 | 55.8                                   | 6                 | 0.6                                    | 1.8**                                  | 1.1**                     |
| Telecommunications                               | 797                                 | 537.3                                  | 35                | 11.2                                   | 4.4                                    | 2.1**                     |
| Transport  | 994                                 | 180.2                                  | 47                | 15.3                                   | 4.7                                    | 8.5**                     |
| Airports   | 118                                 | 25.6                                   | 4                 | 0.9                                    | 3.4                                    | 3.6                       |
| Ports  | 298                                 | 33.1                                   | 4                 | 0.5                                    | 1.3**                                  | 1.5**                     |
| Railways   | 101                                 | 36.8                                   | 7                 | 4.6                                    | 6.9                                    | 12.6*                     |
| Roads  | 477                                 | 84.7                                   | 32                | 9.3                                    | 6.7                                    | 10.9**                    |
| Water and sewerage                               | 546                                 | 53.9                                   | 48                | 15.3                                   | 8.8**                                  | 28.4**                    |
| Treatment plants                                 | 257                                 | 11.0                                   | 23                | 1.1                                    | 8.9*                                   | 9.8**                     |
| Utilities  | 289                                 | 42.9                                   | 25                | 14.2                                   | 8.7*                                   | 33.1**                    |
| <b>Total</b>                                     | <b>3,835</b>                        | <b>1,094.2</b>                         | <b>179</b>        | <b>53.4</b>                            | <b>4.7</b>                             | <b>4.9</b>                |

Source: World Bank and PPIAF, PPI Project Database.

Note: Data refer to projects reaching financial closure in 1990–2006.

\* Difference significant at the 5 percent level.

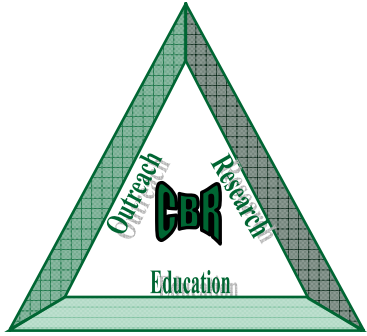
\*\* Difference significant at the 1 percent level.



## World Bank Staff Evaluation of Kazakhstan Privatization Process

| Privatization Indicators                                 | Grade    | Rationale   |
|--|----------|---|
| <b>Results:</b>  |          |   |
| Raising revenue for the public exchequer                 | Poor     | Proceeds from the privatization were not substantial—less than 100 million USD              |
| Reduction in government borrowing and public liabilities | Moderate | Build-up of future liabilities was restrained—government took on past liabilities           |
| Efficiency gains from commercial incentives              | Good     | Most indicators of sector performance have improved where the private sector was brought in |
| Efficiency gains from competition and market discipline  | Poor     | Structure implemented was not open to competition   |
| Broadening or boosting domestic capital markets          | Poor     | Privatization transactions were all based on foreign strategic private investment           |
| <b>Process:</b>  |          |   |
| Level of transparency in privatization process           | Poor     | No public information disclosure, during or after the process                               |
| Level of competition between potential investors         | Poor     | There was no competitive evaluation of bids based on clearly defined criteria.              |

Source: World Bank (1999, Table 1, p. 101)



# Conclusions

- ✓ Privatization has not always worked as we expected (the details matter)
- ✓ Lessons learned have improved privatization process over time
- ✓ Institutions matter! Get the regulations and the law right first