

THE EFFECTS OF PRIVATIZATION OF PUBLIC SERVICES: THE CASE OF URBAN WATER

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The World Bank and The International Monetary Fund have been pushing client countries toward privatization. In Latin America these organizations have advocated the “Chilean Model” of radical and rapid privatization. In the Chilean case, the sudden privatization of water resources resulted in a high degree of monopolization of water supply by the national hydroelectric generating companies to the detriment of the agricultural sector and cities that must pay exorbitant prices for added water supplies.

The program of privatization of public services in the United Kingdom provides us with the most extensive record of privatization and its consequences. This program was pushed dogmatically by the Thatcher government, starting with British Telecom in 1983, British Gas in 1986, British Airways in 1987, the water and wastewater treatment sector in 1989, electric production and distribution in 1990-91, and the railroads in 1994. The results have been quite mixed, from outstanding success in the gas, electricity, and telecom sector to chaos in the railroads, and great public dissatisfaction in the water sector.

The motivation for water sector privatization (besides the market philosophy held by the Tory government) was a backlog of maintenance and repair estimated to be 24 billion pounds that the government didn't want to bear and the obvious need to raise water charges for which the government preferred not to take the blame. Prior to privatization in 1989, the water sector consisted of ten major river authorities that provided water supplies, waste water treatment, and ambient water quality management in the major river basins, supplemented by 25 historical water supply companies serving local areas. Ownership shares for these entities were created and “floated” at quite advantageous prices to be sure that buyers would be found. The offerings were heavily oversubscribed and the successful buyers were mostly the three large French water companies: Compagnie General des Eaux, Compagnie Lyonnaise

des Eaux, and Societe d' Amenagement Urbain et Rural. Some of the companies remained under British control.

The water sector is the closest approximation to the ideal “natural monopoly” of economic texts. The required infrastructure is costly and specialized. Duplication by potential competitors would be prohibitive. Thus one cannot count on competition of the usual sort to maintain reasonable prices and levels of service. The British solution has been to establish (for each of the privatized public service sectors) a very strong regulatory office—the Office of Water Services (OFWAT) in the case of water. OFWAT exercises its control through “price cap” regulation, “yardstick competition,” and public pressure through citizen advisory groups.

The major result has been a strong (and outspoken) public discontent with the private companies. Water charges have increased from 100 percent to 200 percent. The salaries of company directors have been very high in comparison with similar industries, while the prices of the company stocks (large numbers held by company officials) have increased tremendously in anticipation of continued high profits. (The average stock price for the 25 water supply companies has increased by a factor of ten!) The number of service shutoffs has increased dramatically – a social issue of great concern.

Evaluation of the companies' performances has been confounded by the occurrence of two severe droughts since privatization. The companies clearly have invested heavily in repairs and capacity expansion. A major issue has been reduction of water losses through leaks. Residential users typically are not metered because of the age of the systems and the earlier plenitude of raw water, so that isolating leaks has been difficult. Because of the severe control by OFWAT, the operations of the industry are more transparent and, to some extent, more accountable. Eventually, after the great backlogs of investment have been filled, there will be more effective control of water charges. What will

be the ultimate equilibrium of the industry? Consolidation of companies is already underway.

What have we learned? Clearly, although privatization doesn't work magic in the public service area, it has been quite successful in those industries where the technology is more "flexible" in the sense of permitting multicompany use of facilities. In the water sector, a loosely regulated public service has been replaced by a heavily regulated private service. The natural monopoly problem has not been overcome. "Price cap regulation" and "yardstick competition" have proved more feeble instruments than anticipated. The new equilibrium of the industry will probably be superior to the situation

prior to privatization, but the costs of the transition to equilibrium are quite significant and should not be ignored in weighing the privatization decision.

Chuck Howe is an economist specializing in natural resource and environmental policy issues. Much of his research deals with the role of water resources in the development process and the human welfare implications of different management systems. During his 1997-98 sabbatical leave in the United Kingdom and France, he studied the effects of the privatization of public service industries, especially urban water services.