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Agenda

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25 years on: markets transformed and the European ethos

Markets, politics and business have changed almost beyond recognition since the early 1980s, with the privatisation, regulation and liberalisation of major sectors, and issues such as security of energy supply and climate change coming to the fore. In the first in a series of articles to celebrate Oxera's 25th anniversary, Professor Dieter Helm, Oxera founder and Director, looks at how the economic environment has changed in the past 25 years, and considers what the future holds

The first 25 years of Oxera have coincided with a transformation of the UK's (and indeed Europe's) economic landscape. Back in the early 1980s, the first signs of what was to be a revolution in the economic borders of the state were already in evidence. At the end of the 1970s, the Labour Party had started selling off its shares in BP, and the newly elected Conservative government was grappling with the problems of how to finance BT's plans for the new 'system X' exchanges. However, all of this was small beer compared with what was to follow.

As the years pass, the fog of detail begins to clear, and the really important steps can be detected. The first two phases of the transition have now largely been completed—the first phase of privatising virtually all the main state-owned assets, and the second phase of working out how to regulate them to ensure that natural monopolies deliver the public interest and to limit market power.

Bits and pieces are yet to be sold, and there remains quite a lot of regulatory detail to fill in. But from a broader perspective, it is the next phase—the return of policy and the shift to Europe—that matters.

Looking back

It is remarkable how a small number of individuals and organisations made most of the running back in those early days of the 1980s. One of them was the then Secretary of State for Energy, Nigel Lawson. In two little-remembered Acts, the 1982 Oil and Gas (Enterprise) Act, and the 1983 Energy Act, he started out on a road which would see all the great state monopolies broken up, and the principles of separating out generation, supply, transmission and distribution into distinct entities two decades later. The Acts themselves were both relative failures, but the underlying ideas promoted by Lawson—what he called 'the market for energy'—have endured. Indeed, it is ironic that it was Tony Blair, who was Shadow Secretary of State for Energy when the electricity industry was privatised, who did much to bring Labour to terms with the historic defeat by the Conservatives of Arthur Scargill during the miners' dispute of 1984/85 and the privatisations.

Professor Dieter Helm, Oxera Director

These politicians swam in a sea of new ideas. At one extreme was the Austrian economics school, who argued a narrow sort of economics but were really deeply political. Building on Hayek's political philosophy, they saw the state as an obstacle to economic efficiency, and held a radical optimism about markets. There was almost nothing that markets could not achieve, and the task was to drive markets as far as possible into the heart of the utilities. The early pioneers had depth to their intellectual case—later it was to fall into the hands of regulators and administrators whose understanding was not always as penetrating. Some of these promoted what Sir John

The views expressed in this article are those of the author.

Mogg, Chairman of the Gas and Electricity Markets Authority in Great Britain, has called 'the gospel of markets'.

While the other extreme—the Statists on the left—was largely discredited in its outright opposition to privatisation (although Network Rail did end up effectively back under state control), it was left to the pragmatists to try to work out how to make the new regulatory state actually work—ie, working out the crucial building blocks, such as how to design new market structures, what rules competition should operate under, how to calculate the cost of capital and where to fit in the regulatory asset bases, and so on.

Inevitably, not everything worked out as intended, although it took time for the fault lines to emerge. It turned out that the 1980s and 1990s offered remarkably benign economic circumstances. In the energy sector there was (massive) excess supply, and fossil-fuel prices fell to historically low levels. A regulatory system, which was in effect an asset-sweating one, was right for the time, but it left a difficult legacy after 2000. The combination of RPI – X and commodity markets such as NETA (New Electricity Trading Arrangements) yielded what the politicians wanted—low prices—but at a long-term cost. Although it suited the times, it has gradually dawned on both politicians and regulators that in infrastructure utilities it is investment and the quality of the capital stock that is significant—and having enough of it.

It was therefore not surprising that, by the end of the 1990s the cracks were beginning to emerge. Britain did not emerge from the 1980s and 1990s with infrastructure that was the envy of the world. Few in Europe would choose to travel on Britain's trains in preference to those on the Continent, and foreign travellers arriving at London Heathrow could be forgiven for thinking that they had arrived in the Third World. The apparent benefits of the electricity and gas markets and regulatory regime looked less appealing in the winter of 2005/06 when prices spiked (in effect placing a tax on consumers and business) and supply interruptions were prevented only because the weather was relatively mild. In the water industry, the situation looked better on the investment front, but less so with respect to the costs and bills required to finance it, and the failures on leakage of Thames Water in particular and the hosepipe bans must have looked odd to other Member States that have much less rainfall and natural water resources to supply their populations.

In the end, privatisation and regulation—the first two phases of the transformation of the utility sector—delivered much, but much less than the advocates predicted, and continue to claim. Since 2000 these weaknesses have increasingly been revealed. The search is now on—in phase three—to resolve these problems. Unfortunately the benign background context is very different now.

Looking forward

So what is different now? What are the next 25 years going to bring? Some of the themes are already apparent—in infrastructure and utilities, we are the prisoners of past decisions. We inherit the assets.

There are two fundamental differences between the 1980s/90s, and the post-2000 period. These are: climate change and security of supply. A third might also be added: the enormous increase in gearing—as the private sector borrowed on an unprecedented scale; the government offloaded public borrowing onto private sector balance sheets; and the government itself significantly increased its own borrowing and share of the economy. These have created a mortgage on future generations, which they may struggle to pay—through higher bills and higher taxes.

Climate change policy has many dimensions, but at its heart is a massive investment requirement—to replace a carbon capital stock with a low-carbon one, and quickly. At the same time, external pressures have grown. This applies not just to energy, but also to transport and even water. The easy policy givens of switching to gas from coal, allowing road traffic to continue its upwards path, squeezing the rail sector through even higher fares, and expanding air traffic significantly now all look just wrong. None is sustainable.

Add to this the fact that security of supply is now a real problem in energy, and the requirement that the rivers of Britain reach good ecological status, and suddenly the idea of simply leaving the utilities to the market, and treating them just like the commodities that the Austrian school imagined looks stunningly naive. Trying to make the market do everything is likely to pull the whole edifice down.

The new agenda is about externalities and the public goods of networks provision and security of supply. These are the market failures that now matter most, not just monopoly and market power. Yet what we have is a set of policies and regulatory regimes focused overwhelmingly on this one market failure. Competition has been elevated from an extremely important means to the end of the public good to an end in itself. Sir John Mogg's 'gospel of markets' goes too far. What it has delivered is very low operating costs, an orgy of M&A, but not infrastructure networks fit for purpose.

That now is the challenge—how to harness markets to deliver on externalities and public goods. This requires a recognition that politics matters, and that markets operate within policy frameworks, which, in a democracy, must come from the political process rather than administrative bureaucracies. The new landscape is beginning to emerge, and it is very European. We have the EU 20% carbon-reduction target, the EU Emissions Trading Scheme, the EU Water Framework Directive, and we are about to see much more EU regulation of electricity and gas networks and markets. The challenge is to create an EU set of energy grids, an EU set of transport networks, and an EU environmental framework.

Of course not everything will be fixed at the European level, but much will be. Natural monopolies have moved from the national to the European level, and national efforts to tackle climate change can have only a limited impact on a global problem.

Dieter Helm is an economist, specialising in utilities, infrastructure, regulation and the environment, and concentrates on the energy, water and transport sectors in the UK and Europe.

If you have any questions regarding the issues raised in this article, please contact the editor, Derek Holt: tel +44 (0) 1865 253 000 or email d_holt@oxera.com

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