SET THE BUSES FREE?
CAN PRIVATIZATION SOLVE ALL TRANSPORTATION PROBLEMS?

GUEST COMMENTARY BY IAN SAVAGE

During the past twenty years, private operation of urban transit services has been transformed from a radical experiment to almost the norm. Today the cutting edge is the introduction of competition into rail services. Private operation of urban bus services has become almost passé. However, there is an exception to the transit privatization trend—the major cities in the United States.

What is Privatization?

Privatization can take many forms, ranging from the transfer of a public monopoly to private ownership to complete deregulation with no controls on entry, prices, and levels of service. Many people advocate the middle ground, known as competitive contracting. This is particularly applicable to bus services. Under this system, monopoly rights to operate individual routes for a period of three to five years are put out to bid. Depending on the type of contract used, firms bid on the basis of the cost or the amount of the subsidy required to provide service. Typically the public authority specifies the level of service to be provided, the fares to be charged, and arranges for the marketing of the network of services and the sale of system-wide passes. The best-known example of such a system is London.

Competitive contracting is usually associated with breaking up the operating capacity of the existing public transit agency into smaller units, and then selling the units to the private sector. Frequently, the agency retains some small amount of in-house operating capacity to protect against the forming of private cartels, and to act as a back up in the event of sudden default by a contractor. The newly privatized units then compete against each other and against existing private sector firms to win route contracts. The publicly owned "transit agency" continues to exist in the public sector, but as a marketing and procurement organization, rather than a combined planning and operations organization.

While these proposals may sound very radical to an American audience, they would be regarded as rather conservative by worldwide standards. Many advocate total freedom in deciding what services to offer and what fares to charge. I personally believe that competitive contracting promises greater long-term benefit than complete deregulation for three reasons.

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A MOVE TOWARD REGULATORY CERTAINTY
THE FERC REPORT ON CALIFORNIA REFUNDS

COMMENTARY BY LYNNE KIESLING

The Federal Energy Regulatory Commission recently issued its staff report on price manipulation in western wholesale markets. The report, and the likely FERC actions to arise from it, accomplishes some goals that will reduce regulatory uncertainty and improve the investment prospects in this industry, and in the rest of the nation, if not in California.

The FERC report analyzed whether wholesale prices were "just and reasonable," and its findings will lead to estimated refunds of $3.3 billion, instead of the $1.2 billion estimated in December. Otherwise, the findings largely support FERC Judge Birchman's preliminary findings in December.

Most of the findings of direct electricity market manipulation revolve around Enron, particularly Enron's ability to use its proprietary online trading platform to give it an information advantage. This advantage, which exploited the lack of price transparency across the market, enabled Enron to profit from its trading strategies, from trading in illiquid markets, and from using wash trades–which occur when companies swap the same amount of power at the same price–to create the appearance of liquidity.

Separating Enron's widespread perpetration of fraud from the flawed market rules that they exploited in California has been a challenge. One thing that FERC staff did was analyze such behaviors, by Enron and others, on the basis of rules included in ISO and PX tariffs. Some of these actions did violate rules in the tariffs, and therefore can and should be pursued. Enforcing such rules is one important step in restoring regulatory certainty in wholesale markets. FERC staff recommend that some companies substantiate the integrity of their bidding. They comprise both private generators and public power companies, including AES/Williams, Dynegy/NRG, Mirant, Reliant, Bonneville Power Association, Los Angeles Department of Water and Power, Idaho Power, Powerex, and Enron. Interestingly, although Enron's actual California market share was low, its apparent share of the market manipulation that violated existing rules was high.

So what are the major implications of the findings in this report?

- Bad rules are still primarily to blame. To quote the *Findings at a Glance*, "staff concludes that supply-demand imbalance, flawed market design and inconsistent rules made

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(1) Riders seem to prefer integrated ticketing and easy transfer between bus routes and between bus and rail, and across municipal boundaries within a metropolitan area. It would be impossible to maintain such a coordinated system in a deregulated environment.

(2) Riders prefer a predictable system. Riders make long-term decisions on residential locations and workplaces based on a known system of public transportation. The upheaval of complete deregulation, with unpredictable entry and exit by different companies on different routes, combined with unpredictable fares, would encourage people to use automobiles. There is evidence that this has occurred in the wake of deregulation in British cities outside London.

(3) A rolling program of relatively small bundles of work coming up for bid encourages small firms to compete for contracts. In London there is still active competition when contracts come up for bids, but in the rest of the country, which was completely deregulated, large holding companies have emerged that dominate areas and can stifle potential competitors.

Of course, there is a downside of competitive contracting compared with complete deregulation. It is possible, at least in the short term, that the lack of on-the-road competition may not be as effective at eradicating cost inefficiencies. It is also possible that the full entrepreneurial spirit in providing innovative service patterns and methods of operation will be lost. A competitive contracting system is still one where public-sector planners determine what services will be offered.

Despite these disadvantages, my opinion is that on balance competitive contracting brings about greater net social benefits than full deregulation. But is it a panacea?

Privatization Can Help: Removing Cost Inefficiencies

Without doubt the major attraction of privatization is the prospect of reduced operating costs. Experience elsewhere in the world suggests that cost efficiencies from privatization have come from both wage reductions and from increased flexibility in the use of labor. In Britain in the early years of deregulation, the wages of bus drivers declined by 15% in real terms compared with other blue-collar workers, and the number of vehicle-miles per employee increased by a quarter.

It is clearly a political decision whether the reductions in operating support are used to reduce the tax burden, to fund the capital program, to allow lower fares and greater levels of service, or some combination of the three. My own analysis in Chicago suggests that after cost reductions, there are social benefits from spending the savings on lower fares, and additional service in some off-peak periods.

Privatization May Help: Innovating Service

A feature of deregulation and privatization in other parts of the world has been the introduction of smaller vehicles operating more frequently. This was certainly a feature of privatization in Britain. Even though the size of the small vehicles used in Britain has increased over the years, there is still potential for North America to learn important lessons. Evidence has shown that the largest benefits have occurred in the off-peak and in low-housing-density markets where previously there was quite infrequent service (every fifteen to thirty minutes). The effect that privatization will have on innovative service provision and also on the structure of existing routes is debatable. To some extent the radical changes may cause planners to question some long-standing assumptions. In addition, private bidders may have innovative ideas for service provision and be freed of labor constraints that fossilize operating practices and traditional methods of service delivery. A lot will depend on the nature of the contracting process. The public authority will need to "think outside the box" and allow for some feedback in the bidding process for the firms to suggest alternate methods of service provision, while at the same time having enough uniformity in the bidding process so that informed comparisons can be made between the various bids.

Privatization May Not Help: Balancing Fares and Service Levels

Many observers of the industry point out that transit has tended to produce an inappropriate "balance" between fares and levels of service. The underlying economics of this issue is that transportation firms are unusual in that they can choose both their price (fare) and the level of output (vehicle-miles). This contrasts with many manufacturing firms who can only choose one of these variables with the other being determined in the marketplace. For a given level of subsidies, transit firms can either provide a high level of service at a high price, or a lower level of service at a lower price. Riders prefer high levels of service but low fares. At some combination, public benefits maximize given the subsidies available. Evidence from North America, Europe and Australia has consistently found that "too much" service is provided, primarily in peak periods, at "too high" fares. This means that riders would be better off if service levels were reduced, and the money saved was channeled into reduced fare.

The main reason for the current imbalance is that agencies have tried to maintain service levels in the face of falling demand, and have increased fares in real terms to correct any resulting budget deficit. Service cuts provoke vocal opposition from staff and specific groups of riders. The opposition to fare changes is a lot more diffuse, and hence less politically effective. Privatization may induce planners or operators to deal with this imbalance. In addition, privatization may or may not aid in righting one of the obvious shortcomings of transit pricing—the ubiquitous flat fare, which is a significant deterrent to short distance trips, especially on buses.

In Conclusion

There is ample evidence that considerable cost inefficiencies were introduced into transit operations in the late 1960s and 1970s. Competitive contracting has proved to be an effective method to reduce inefficiencies. The lowered operating costs can be used to reduce taxes and/or provide improved transit service. However, privatization is not a complete panacea for all of transit's ills. There are open questions as to the appropriate methods of service provision in lower density areas, whether peak capacity should be reduced, and whether there should be differentiated fares based on time and distance. These are also pressing policy issues for transit, and ones that are not directly tied to the privatization debate.

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possible significant market manipulation as delineated in the final investigation report. Without underlying market dysfunction, attempts to manipulate the market would not be successful." This finding, importantly, and correctly, recognizes that market manipulation arose from the existence of a flawed design, and firms should not be held responsible for responding to the incentives in that flawed design, but should be held accountable for violations of explicit rules in tariffs.

- This thorough analysis can help us move on. The economic limbo and regulatory uncertainty that has hampered this industry is to the detriment of both consumers and the industry. This staff report is so thorough and analytically rigorous that it is unlikely to fall prey to the oft-heard criticism that FERC is not really paying attention to California's plight. Hopefully this report and subsequent FERC actions will enable California to shift to a forward-looking focus.
- The sanctity of contract remains inviolate. Based on these findings, FERC is unlikely to support nullifying the state's long-term contracts signed in early 2001. This stance is crucial for maintaining a stable legal framework for ongoing activity in this industry. Furthermore, the state has had success at renegotiating the terms of these contracts.
- Prices above short-run marginal cost signals scarcity and the need for investment in the industry, and refunds should not interfere with that. The care that FERC staff took in establishing a refund rule that preserved the scarcity rent component of prices should indicate the prospect for investment-friendly regulatory certainty. Ex post refunds raise the possibility of expropriation and can stifle investment. The refund rule in this analysis is careful to take that into account as much as possible, and to preserve scarcity rents in tight markets.
- FERC's estimates of the dollar amounts in the affected transactions suggest that, Enron aside, the largest magnitude manipulation was in the natural gas input market, not in the electricity market.
- Price transparency, and legal and regulatory simplicity, stability and enforcement, are crucial for the growth of liquid markets that create value for suppliers and consumers.

There are a few more steps in resolving these refunds, but this report and its recommendations are a substantial step toward shifting focus to the future potential value propositions that a market-based electricity environment can deliver to California's residents and to entrepreneurial firms that could profit from creating that value for them. ■