

## HOW BRITISH AIRWAYS WAS PRIVATIZED

**Sir Colin Marshall**

Chief Executive of British Airways

### THE STARTING POINT

I have been asked to talk about British Airways and its change from a rather unhappy and depressed statutory corporation into a company with more than 400,000 shareholders: a company which has turned a substantial profit for more than five years and one which looks forward to competing effectively in the decades ahead in the increasingly integrated world markets of the travel tourism and transport industries.

#### **The spadework**

Privatization has become a word with a considerable cachet. One which implies avoiding bloated bureaucracy, achieving profit, and finding better ways to compete. However, I assure you that it is not merely the act of moving from the public to the private arena which may cause these things to happen. It requires long hard work at every level of a company to ensure that they do. Becoming private is in itself no immediate guarantee of improvement. In fact, if unaccompanied by anything else it may well result in additional travail, since quite often the personnel of public corporations find themselves ill-equipped to move efficiently into sections of business that are very different.

At British Airways it took us five years to achieve what we had hoped would happen in eighteen months. Much of this was due to some vicissitudes which almost no one could have anticipated. Even with this lapse of time we still have more work to do internally to get the company to the point where I would like to see it as a cost-effective business, eliminating the last vestiges of a statutory unit.

We are still encouraging changes in attitude, in response mechanisms, and in ways of working, both of the management and the staff level -- which will take some time yet to bring to fruition.

Privatization is something not to be lightly undertaken. The major problems of finance, restructuring and dealing with images in transition, are only the beginning. Beyond these are the uncharted areas of management/staff relationships, customer awareness, and responsiveness, the whole question of accepting risk and chance as part of everyday life rather than something to be avoided at all costs. These are a few of the things which anyone thinking about taking a company private needs to review. Without a top management totally dedicated to the concept and willing to withstand a long hard grind

with all kinds of unforeseen eventualities, privatization is not something to be lightly undertaken.

### **Government and management**

Some companies may see it merely as exchanging one master for a set of masters with big business continuing much as before. I assure you that under even the most benign circumstances, this cannot be the case.

It is important to understand that being owned by Government is not all bad, nor is being in the private sector all good. We are obviously dealing with human beings in both cases, many of whom are very dedicated, able and determined to discharge their obligations just as well as they can. The distinction is that there is a major difference in goals between companies in the private and those in the public sector.

Private-sector companies must respond to the marketplace, to the efforts of competition, to the desires of customers and to the need to be able to expand on a profitable basis over a period of time. A company in the public sector responds to a totally different set of signals. The need to satisfy all the potential constituencies, even when some of the requirements may not make commercial sense. For example, British Airways at various periods in its statutory career was required to purchase aircraft for its fleet not because they matched our needs but because they satisfied Government requirements.

Governments also have sensitivities about people and places which are quite different from those of a profit-motivated organization. The results may often work to the detriment to the overall wellbeing of the company: however, they may be seen as contributing to the public benefit in some form or other. The really major damage is that the people inside the companies develop a point of view about what their aims and ends should be as well as what the expected outputs may be, a point of view which is at variance with what the objectives should be if the company were concerned principally with competing successfully in the marketplace.

For many people in nationalized businesses, the idea of seeking profit is seen as almost dishonest -- as milking people of monies which are more properly theirs. The idea that one must generate profit in order to create the capital to buy new equipment, repair and refurbish old equipment, expand the business, or even raise the salaries of those people who have done work good enough to merit it, all these are not ideas which come easily to people who have been trained in the mould of a government-owned corporation.

### **The management agenda**

Therefore, I would suggest that any management seeking to move from the public into the private sector must do a number of specific things.

1. Look at the goals and objectives of the company as they may be today.
2. Create those aims as they think they should be for success in the private sector.
3. Test the suggestions in No 2 with a number of managers in companies already engaged in that industry, and see how they fit with their own impressions.



4. Create an amended list of targets which will give them specific guidance as to what they must expect from the company as it moves out of public ownership.

Then one has to create a series of further tests. What is the gap between what the company's managers are doing today and what they may be required to do in the future? Can they cope with the difference? If not, what steps need to be taken? What are the resource changes which will have to be made? What is excess that must be reduced? What is not on hand that will be needed, whether in terms of people, money, facilities or any other aspect of the business?

Then there is the need to consider more strategic issues. What kind of company is it today? What areas can it best compete in? What changes have to be made to permit all this to happen?

Lastly, there must be reviews of risk. What are the things that might beset us during or before the transition? What can we do to be prepared for them?

#### **The political challenge for BA**

In the case of British Airways, our managers and staff had to endure four long years of problems for reasons which had nothing to do directly with them, their output, or the company's overall capabilities, but rather a considerable series of what can only be called political events.

Take some of the most important. The first thing was that the Government instructed the Civil Aviation Authority, our regulatory body, to carry out a review of the British airline industry. This was engendered in part by some of the smaller British airlines who felt they were entitled to a piece of the pie. Some of that feeling was also found among some of the regulators, the bureaucratic view that egalitarianism is superior to business capability as a social outcome. There was a wrangle which went on for many months as to whether parts of the airline should not be taken from it and given to others. In the end, after a massive protest, not just from our very determined staff members, but from the public too this effort was frustrated with the exception of the donation of our then very profitable Saudi Arabian routes to one of the less financially sound British airlines.

A good part of the reason for the staff concern was loyalty to the company plus the fact that they had lived through the pain of years of poor results culminating in 1981 with a loss of almost half a billion pounds, only to see the turnaround within the space of two years to becoming one of the most profitable airlines in the world. A second cause for delay was some very complex and protracted litigation brought against twelve defendants by the liquidator following the collapse of Laker Airways. The Government felt this had to be settled before the Company could be moved into the private sector. This was followed by yet another delay when the United States and British governments got into a protracted struggle having to do with the bi-lateral treaty governing air travel between the two countries. All British Airways could do was to stand helplessly to one side while the arguments waxed and waned.

Throughout all this, our people -- staff and managers -- kept driving steadily to improve the Airline. To get its performance, its ability to satisfy its customers, at a higher level with each oncoming season of the year. I am proud of what they did and of their ability to stand up to four years of considerable



uncertainty while we went through all the trauma of the continuing delays and the changes in structure and style that it was necessary to make to improve our capability to function successfully in the competitive marketplace.

A key effort in this direction which we started in 1983 and which continues today is a whole series of programmes which began with one called 'Putting People First'. The purpose was to get all of us to understand how better to relate to other people and that our first obligation was to our customers, not to a series of practices and rules laid down in a manual.

In effect, many of our managers and staff brought up in the public sector felt that their prime responsibility was to make a set of processes work well. We had to persuade ourselves that this was not the business we were in but really we were there as a service business, not just an airline; that we had to be concerned with making passengers feel that they would enjoy their travel with us more than they would with any other airline. To do this we had to meet people's requests and to anticipate them. Aircraft, check-in stands, reservations, telephones, all these had to be seen as a part of a chain of seamless service which would deliver passenger rather than just airline satisfaction.

It sounds easy as I say this but endless hours, weeks, months of effort by everyone at every level of the Company have gone into making this part and parcel of the way people think. In other words, we didn't want this to be something they did because they were supposed to but something they did because of how they reacted with everyone they met.

It wasn't easy and we were not always successful in every case. It was especially difficult since it was obvious in 1981 that with 58,000 staff we were grossly overmanned. Lord King, then as today our Chairman, ordered that a massive reduction should take place. Numbers came down to 36,000 by the Autumn of 1983 and have now risen 4,000 above that to reflect the substantial increase in business in the meanwhile.

### **Competitive pressures**

Obviously this change was a cause of considerable stress and strain to everyone in the Airline. It was expensive but it was achieved with little disruption and it proved that a public sector company could be brought down to something resembling competitive fitness without going through destructive strife. This was important to achieve. While the public utilities, which are natural monopolies, can move into the private sector without too much strain, British Airways was moving in an industry with enormous competition. Further than that, it was having to cope with a government competition policy which still saw the airline as having a national focus, and which, therefore, wished to strengthen other British airlines by awarding them routes and destinations even if these conflicted with British Airways' ability to stand up to its international rivals with much larger bases of domestic business.

Our real competition does not come from the smaller British operators but from the big American airlines, the Far Eastern companies and several of the European airlines whose governments do not require the same return on capital employed as is expected by private investors. We still have much work to do within the Airline to make even clearer to all of our managers and all of our staff just how all-pervading the requirements of being successful in the marketplace can be.



We are currently having a very good travel summer, after one during which the fears of terrorism and nuclear contamination dropped our key North Atlantic business by as much as 25%. As witness to the successes of oncoming privatization, our competitive flexibility was such that within a matter of a few days we had designed a marketing response in the United States which was so well received that British Airways' rate of recovery in terms of speed and volume was much more than that of most other airlines on the North Atlantic.

I could cite all kinds of examples of the steady build-up of competitive pressures, some of which have been government-created, some of which are just a natural outcome of the ever-changing market place. We are trying to make sure everyone in the airline understands that you cannot depend on past success nor present achievement but must always be concerned about what the future may bring and how best to take advantage of it.

### THE MECHANISM OF CHANGE

You may have noticed that I have spent a good deal of time talking to you about the 'people factor' in privatization rather than going into considerable discussion of establishing a balance sheet, assuring oneself of capital, promoting the stock floatation itself or any of the other major business elements which are of key importance in a transition as complex as this. The reason for the preference is simply this. It has been my experience in a variety of businesses that if you wish to achieve important change, all of the brilliant planning and staff work will be to no avail if your managers and your staff do not understand what needs to be done, why it has to be done, how to do it, (and most important of all) do not want to do it.

Looking back, in a sense British Airways was perhaps fortunate in some of the delays; not all, by a long shot, but they gave us more time to get our house in order, to understand the full implications of putting people first and to stand up to the changes we had to make. This is why I have not given you a long detailed menu of precise steps to take in order to make sure that a company moves successfully from the public to the private sector.

The three sets of queries I suggested at the outset are extremely important and they must be answered fully, in great detail, and with total honesty. Even more important is to make everyone in the company into believers, to identify the reasons why their own wellbeing as well as that of the company as a whole will be much improved in the future if they go through the sweat and trouble of the change. For -- make no bones about it -- achieving change such as this is hard work. It is a long slog for everyone involved; it requires consistent support and continuous physical presence on the part of all of top management if it is to come off.

There are obvious questions of timing when it comes to the financial elements of such a transfer. Picking the right time to appear on the stock market takes skill and experience and perhaps some luck. Preparing the volumes and volumes of documentation required for listing on any of the world's exchanges is exhausting for the lawyers and managers alike.

It of course does not hurt to have a public symbol of the company as effective as our Concorde supersonic aircraft, a technological marvel which is a joy to watch in the air and still stops hardened mechanics in their tracks every day when it takes off. Concorde gave us a marvellous insignia, standing for what



soaring into the private sector meant for all at British Airways.

### **Staff involvement**

We find ourselves operating one of the most successful and complex networks in the world. Serving customers ranging from the big cargo shipper to the small child going home alone from school, watchfully cared for by our cabin crews as well as our special ground staff.

We are going into our sixth successive year of profit with major orders placed to renew, expand and refurbish our aircraft fleet now that we are out from under the public sector borrowing requirement. We see the vistas ahead of us as challenging but we also see ourselves as quite able to cope given the considerable difference between what we are today and what we were before the long complex drive started towards privatization. It isn't that our people then were not good: most of them were technically superb, very loyal with great experience of the airline industry and all its requirements. The difference is that today we all understand that being good airline people is not nearly enough. We have to be good at rendering service, continuing service, service which is given every day under all kinds of conditions with a smile and extra effort even at the end of the long tiring periods many of our staff encounter at peak travel times.

One question often asked of me is: 'What arguments were put to your staff to persuade them that working for a privatized company was better than doing the same for a business controlled by a government?' In all honesty, there were no suggestions put to the staff that were nearly as convincing as what their own considerable experience told them -- that the airline could not fail to operate more effectively working for itself and its shareholders than it could working for the government. Not only did they agree with the proposition, many thousands of them became shareholders themselves. In fact, 94% of our employees worldwide are now shareholders in British Airways.

We did make a conscious effort to bring home to all of our staff the meaning and importance of profits through the introduction of a simple-to-understand profit sharing plan for all employees which is now in its fifth year. To me, all of the staff communication was a key element in the whole process that what we were attempting to do was seen as eminently sensible by our customers as well as by our staff and managers. Without their energy and enthusiasm it would have been very difficult to make the transition as smoothly and successfully as it has been.

Another question put to me is: 'What are the improvements accruing to the airline from privatization?' They are manifold, and yet simple. We are our own bosses free to succeed or fail on our own.

### **Regulation and the environment for growth**

There continues to be regulation and it will be no surprise if I say that there is too much of it. The minimum regulation consistent with safety and the legitimate demands of more open markets should be all that is necessary. The Government has wisely given up market manipulation at the macro level and should not be tempted to reintroduce it at the micro level. Particularly it should license the British airline most able to compete successfully against our large international competitors, not seek to achieve some specious equality between British airlines.



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Most of all we are free, with the flexibility to act immediately on our own decisions. Free of the stigma which inevitably attaches to government-owned businesses. It is not reasonable nor acceptable for government to be both owner and regulator. Governments have proven that they can run public utilities but not competitive businesses in the world market- place. Since we are in the latter category, I delighted that we are not any longer one of the former.

## CONCLUSION

The key to making the transition is to remember not to let yourself get buried in the detail of the process but keep your eye firmly on where you have to end up, the kind of shape in which your business needs to be when you arrive, and that most of all you have the managers and the staff who can help you get there. If you are going to be in a service business you will have to embark on a long complex process of persuading everyone involved that they are working for their customers not the other way round. You will have to require that your managers understand that their job is to teach and motivate, not to give orders and demand the perquisites of their rank. You will have to show everyone involved that operational excellence may sound well but it cannot allay the fury of a mishandled customer who feels that he or she has been mistreated in the business process. Your profit lies in your people and their desire to do well. They are the real resource which makes privatization work.

## QUESTIONS AND DISCUSSION

**Tim Fergusson (The Wall Street Journal):** You made a remark about the Government licensing the carrier most able to compete internationally. Ought it to be a restrictive licence or do you favour an open license with your competitors, auctioning off of landing slots and gates?

**Sir Colin Marshall:** Our position is one of believing that the British Government's policy on competition does not fully recognize what has happened in the world marketplace in the interim period -- with the onset of the mega-carriers in the United States and the disappointingly abortive attempts at liberalization in Europe, or with the tremendous growth that is occurring among many carriers in the developing countries and especially out in the Far East and the very large Asian markets. We are not saying that we do not want competition from British airlines. What we feel is extremely important for the whole future of the British airline industry for the future, that is that we should not have shackles put upon us that prevent us from getting out there and fully competing in the world market-place.

Anybody coming from the private sector has some bewilderment as well as some concerns that the thing which was making £177 million per year for our Company, which we had spent all of the time and effort in developing to that level of profitability, is at the stroke of a pen taken away and given to somebody else. (We got back in return some routes to other areas of the world which the other airline was losing money on.) It does create a degree of bewilderment, surprise and concern, particularly to those of us who have been brought up in the private sector. But how would we do it differently? Well the fact is that for many years now this country has had a multi- airline policy, the other airlines have, generally speaking, been able to acquire routes to fly in competition with British Airways as well as with the foreign carriers;



and we believe that that was the proper way for the business to continue to develop.

**Jalil Shoraka (Center for Privatization):** You mentioned that the major concern in developing countries is the displacement of labour force. You mentioned that British Airways had a staff of 58,000 and that over a two year period it was reduced to 38,000. What did you do with them? Put them on the street? What are they doing now?

**Sir Colin Marshall:** What we did was to put together a financial severance package for the staff, agreed with the trades unions and offered on a voluntary basis to the staff. Virtually all of those who took the severance package, close to 22,000 people, did it on a voluntary basis (though there may have been a relatively small handful of people who were encouraged in that direction). In quite large numbers they used the money to set themselves up in other businesses. In fact we have been the instigator of many small businesses, particularly in the vicinity of Heathrow and in the area of West London where the large majority of the reductions in staff took place.

**Question:** Sir Colin, governments are very peculiar organizations when it comes to giving away authority. As Chief Executive of British Airways, have you experienced government influences directly, or indirectly, in your operations since the privatization? If so, how have you avoided them or treated them?

**Sir Colin Marshall:** I agree with you -- governments can be very peculiar organizations from time to time. We have had no pressure put upon us by our Government either directly or indirectly, other than in the context of the regulatory framework within which we and the rest of the airline industry inevitably have to operate, but that is I think a pressure which is certainly not relative to our having moved from the public into the private sector. I have to add that since Mrs Thatcher came to power in 1979, our Company really was never put under pressure by the British Government to select specific aircraft or specific engines to go with the aircraft. We have largely been free to take our own decisions for the last almost eight years now.

**Fouad Hussein (Egypt Investment Finance Corporation):** Would it be possible for the experience of BA going from state-owned to privatization to be embodied in a book or a report for the benefit of other people who are interested? Many people would certainly like to know more about the management development programme that you undertook and how you reduced the red tape, reformed the financial structure, the legal structure, the marketing picture, the production costs, the labour costs, the accounting, the management, the evaluation and so forth and so on.

**Sir Colin Marshall:** We do have some literature available now which deals at least in part with the points that you were making, Mr Hussein, Our Chairman, Lord King, delivered a lecture to the Institute of Directors here in London recently which was all about privatization. Although it was more general, it contained within the lecture some specific illuminating references to the way in which we went about it in British Airways. We have made ourselves available on request to talk to parties from all over the world who have wanted to discuss what are the implications of privatization in respect of airlines, and we are quite happy to continue to do that where possible. I am not sure that we have yet determined actually putting together a complete and comprehensive report but it is a thought.



**Anthony Maxwell (Canada):** Could you tell us whether there were any Board changes at the time it was announced that British Airways was going to be privatized? Could you tell us about the role of the Board during that preparatory period?

**Sir Colin Marshall:** The original announcement of British Airways' privatization was made within weeks of Mrs Thatcher being elected to govern in 1979. In fact the announcement of the Airline's privatization was the very first, or certainly among the first, that were targeted for this particular purpose. Lord King, or Sir John King as he was then, joined the Board of British Airways in late 1980 and assumed the Chairmanship of the Company in early 1981, with the specific mission of getting the Airline ready for sale into the private sector. At that time he did make, with the full approval of the Secretary of State, several changes in the Board of Directors; but Board changes have been very minimal indeed subsequently. So we have had a considerable consistency.

The Board is made up primarily of non-executive members and they have essentially carried out the responsibilities of a normal Board of Directors doing what you would expect Boards of Directors to do under usual trading and business circumstances of a company. Because we had to prepare ourselves for the private sector, almost all of the new Board members came from the private sector. The principal difference from being private-sector was of course that on any major issue, particularly major items of capital expenditure, when the Board had taken its decision, that decision then had to go for endorsement or otherwise by the appropriate Secretary of State, originally Secretary of State for Trade and then Secretary of State for Transport, and once the Secretary of State had given his blessing it also had to have the approval of the Treasury; and this was one of the more frustrating aspects of being in the public sector. Even given all of the good intentions of Mrs Thatcher's administrations, we found ourselves delayed for as long as five months in getting government approval on major items of capital expenditure and that impeded our ability to compete properly out in the world marketplace.

**Yildirim Akturk (Interbank, Turkey):** You seem to be sharply critical of the regulatory agencies handing out profitable routes to your potential competitors in a weaker financial status. How would you have gone about disciplining the sector and introducing some non-monopolistic approach?

**Question:** You said that the management must organize its personnel; but how do you re-orientate them towards market objectives?

**Sir Colin Marshall:** It is vitally important that the top management lead the organization, and lead it from the front. They must make sure that the direction in which the company is to go is well communicated and well understood by all of the people throughout the organization. Certainly, in the public sector, finance tends to become the overriding factor, at least at the very highest level. On the other hand, of course, it isn't a minor factor when you are in the private sector either, because you certainly want to ensure that your finances are in good shape and that you are well prepared for what your capital requirements are going to be. We determined that we were very strong from an operational standpoint and that we were also strong in terms of our financial management and it was essential for us to change the philosophy of the Company to one of being much more caring, much more people-orientated. We went out and we hired the services of an outside firm to come in and work with our own people in developing the specific courses.



The first one, which I referred to earlier, entitled 'Putting People First', took two years to get every member of our staff throughout the Airline, all over the world, through a two-day seminar. To begin with, the people were quite cynical and very skeptical as to what all this was about and as to whether it was going to work. After about eight weeks of concentrated effort -- which included me personally going to most of those two-day seminars and actually closing them by talking to the hundred and fifty staff we had gathered there -- we began to get a change of attitude on the part of staff.

**John Hallaq (United States):** Do you see privatization creeping into the EEC, into Airbus Industries for example?

**Sir Colin Marshall:** It has happened already to some extent, though it hasn't gone all the way in a number of the European countries. There are others where the governments have already stated that they are going to privatize a part of the state airlines and there are a few where they are suggesting that they might take those decisions. There is a degree of private ownership in the state airlines, certainly of Scandinavia, of Holland, of Germany to a small extent, of Switzerland to a considerable extent, of Italy. It is our view that all of them should get into the private sector because we think that then, everyone will be operating on a fully competitive basis.

As to what is going to happen in terms of Airbus Industries itself, Airbus Industries is essentially in the private sector at this point in time through its various shareholdings. What it does have, of course, is the benefit of government financial support to assist in the launching new aircraft. The British interests in Airbus Industries are held by British Aerospace Plc, which of course was one of the early privatizations that took place in this country.

**Question:** Would the BA method work to privatize a railway, for instance?

**Sir Colin Marshall:** Quite honestly I don't see that it is necessarily all that different from an airline, except that British Rail (in this country, for example) is larger, and as a result is much more complex. That is no reason to stop the effort to motivate the staff to recognize the importance of the customer for the staff's own livelihoods for the future.

The Government must determine if there are certain sectors of the railway that must be maintained for social purposes and those sectors have got to be effectively split out, for financial purposes, from the rest of the railway system in order that the degree of any subsidization that is required is very clearly identified. British Rail is certainly moving in this direction. But British Rail is dealing with three trades unions, whereas we had to deal with some seventeen trades unions in the Airline; so I think that it can be done. It is a question of time, dedication, and tremendous leadership.



## MAKING THE PORTS PRIVATE

**Sir Keith Stuart**

Chairman of Associated British Ports

I would like to use a few themes to demonstrate the effect of privatization on Associated British Ports, as an example of the effect of privatization within the UK as a whole.

### The problems

I think it's quite a good example, because ABP is a company which, while it runs part of an essential industry, is not in any sense a monopoly. The Company controls approximately 25% of the port transport industry in the UK. So although it is the biggest single player in that market (and has been for many years), it is not a monopoly. It is a company which has always been faced with tough competition. Privatization was not necessary as a means of introducing competition, which of course is not the case in a number of the other privatizations. The second point to bring out is that ports in the United Kingdom suffered for many years from both real problems and images of not so real problems, which produced a very considerable burden of incredulity, at the time when privatization was mooted some five or six years ago.

The general image of the industry was that of lot of men in cloth caps, badly equipped, not working terribly hard, too many in number, very highly unionized, very old fashioned, and so on. Not, you might think, a particularly promising ground in which to sow the seeds of privatization.

The reality had actually been something like that twenty or thirty years before privatization. In the 1960s and 1970s, the Company (already operating in a competitive environment, but still owned by the State) had moved forward, as indeed the rest of the port industry had, to establish a totally different reality.

The third problem was that the company, quite apart from being in the state sector, and thus subject to Treasury controls, was also subject to a particularly penal regime set by the 1962 Transport Act of the then Conservative Government. That regime in effect limited the Company to using its assets for the purpose of running ports -- handling ships and cargo and employing people to do those two things -- and not for any other purpose, even if some additional profit could be made by so doing.

### The privatization

On 1st March, 1983, when the company was offered for sale, we were one of the early cases of privatization. The price of the stock was fixed at 112p per share, which put the princely valuation of forty four point five million pounds



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The general image of the industry was that of lot of men in cloth caps, badly equipped, not working terribly hard, too many in number, very highly unionized, very old fashioned, and so on. Not, you might think, a particularly promising ground in which to sow the seeds of privatization.

The reality had actually been something like that twenty or thirty years before privatization. In the 1960s and 1970s, the Company (already operating in a competitive environment, but still owned by the State) had moved forward, as indeed the rest of the port industry had, to establish a totally different reality.

The third problem was that the company, quite apart from being in the state sector, and thus subject to Treasury controls, was also subject to a particularly penal regime set by the 1962 Transport Act of the then Conservative Government. That regime in effect limited the Company to using its assets for the purpose of running ports -- handling ships and cargo and employing people to do those two things -- and not for any other purpose, even if some additional profit could be made by so doing.

### The privatization

On 1st March, 1983, when the company was offered for sale, we were one of the early cases of privatization. The price of the stock was fixed at 112p per share, which put the princely valuation of forty four point five million pounds



on the company: about one quarter of the asset value of the company in the books. Much of the reason for that low market capitalization was the poor image of the industry, although that image was in fact far removed from the reality.

The other reason why the price was low was that the immediately previous privatization, Britoil, had gone badly on the market. It was a complicated tender-type of offer, most of the stock was left for the underwriters and the City of London was extremely suspicious of the Government as a vendor and said that the next sale had better be a better bargain than Britoil.

### **The effect**

As soon as the company moved into the private sector (and it did move, once the Government had sold the stock to the underwriters, long before the public had decided whether to buy the stock), as soon as that transfer had taken place, the whole image and perception of the company on the market was transformed. The result was, that the offer for sale of fifty-one and a half percent of the stock at 112p per share, was oversubscribed thirty three times.

The reaction of employees -- highly unionized employees in an ancient industry with ancient labour practices -- was equally enthusiastic. Not only did they take, of course, the small free issue, they also heavily oversubscribed the matching offer under which they paid for one share and got one free, and they heavily subscribed for shares at the full market price. This was despite strong opposition from the leaders of the trade unions of which they had been loyal members for many years.

The other major change which took place at that time, was that all those restrictions in the 1962 Transport Act were swept away at a stroke.

We were very successfully floated on the market. On the first day of dealings we were at 1.37 and the stock progressively moved up in the weeks and months thereafter. In our first eighteen months, we used our private-sector freedoms partly to step up the investment programme because previously, although all our capital investment for port operations were self-generated, it was still regarded as part of the public sector investment programme and therefore restricted by the Treasury. That, of course, ceased on the moment of privatization. We doubled the capital investment programme in the first two years of privatization, spending for example about five million pounds on a new roll-on, roll-off ferry service at Hull, container cranes and so on.

We also began, tentatively, a programme of diversification. It was very tentative in those early stages because our management had not been trained or recruited for diversification, they had been trained and recruited to manage the ports. We put our toe in the water through joint ventures with companies with which we already had a good relationship and who could bring technological benefits to the use of our existing assets.

By April, 1984, thirteen months after the initial 112p price of the stock the Government then sold the remaining forty-eight and half percent at 270p on a tender, the price having reached 290p on the market. So it had more than doubled in the space of twelve months.

The year 1984, as George Orwell predicted, proved a difficult year for us. In that there was the coal miners' strike which lasted about twelve months and quite seriously affected part of our revenue because we do handle quite a lot



of coal. There were other problems associated with that strike which had the effect of depressing our results in the second year of privatization. The first year it moved from a profit of five million pounds to a profit of nearly three times that; in the second year of privatization that profit was down to just two or three million pounds because of the effect of these various problems. This reinforced a message which was already very familiar to us, the need for further diversification. We had one very clear area in which our effort should be concentrated, namely the very significant land holdings which we had at the ports, which could be now redeveloped for purposes other than port operations.

The port of Southampton in the late 1970s was home to a few ships which used to ply between there and the French coast on a regular twice-daily ferry operation. But the Channel ferries ultimately merged with each other and were transferred to Portsmouth, so two years after privatization we had a totally empty dock. Using our private sector freedoms, we forged a number of joint ventures with property companies to redevelop this and other parts of the company's land holdings. In a large part of the Port of Southampton, you can now see a thriving marina, a number of shopping malls and the beginning of a major residential construction on each side of the water.

The process of moving heavily into property, where we already had an existing asset, has now been taken further. At the end of last year and the beginning of this, we became one of the very first examples of a privatized company to use its own shares to buy into another company, Grosvenor Square Properties. That new expertise is being used not only to develop our own land areas, but the company is also heavily involved in property development in and around London and the South East.

The market capitalization of the company in 1983, was forty-four point five million; now it is nearly five hundred and fifty million. In other words, in the space of four years it has moved up twelve times.

If ever you wanted an example of the impact of privatization on performance, on perception by the market, on employee participation, on managements' freedom to manage, I think that it must be this company. Rooted in the past as it was, a very ancient industry with some terrible traditions which had to be got rid of, it provides a very interesting example of the impact of privatization.



## THE MANAGEMENT BUYOUT

**Dr Madsen Pirie**  
President, Adam Smith Institute

There are many different methods of privatization. The total used in Britain already exceeds twenty. A variety of techniques can be deployed to involve the various interest groups in the particular package which is devised. Depending on the method of transfer the management, the work force, the customers and the investors can all be taken on board if involvement is built into the process.

Sometimes the sale is of the whole equity to private buyers; this is among the most difficult politically, as was evidenced by the furore aroused in Britain by the attempted sale of Leyland Bus and Leyland Truck early in 1986. It has proved easier to attract popular support for public stock issue, either at fixed price or by tender. The sale of the British Airports Authority broke new ground by using a combination of both methods of sale.

The sale of British Telecom illustrated the technique in which enough of the equity is sold to transfer ownership to the private sector. One advantage gained is that more cash might be raised by the residual public holding at a later stage than by the original sale. The privatized companies tend to prosper and to raise their share valuation.

### **The unsung story**

In many ways the unsung story of privatization has been the sale to a management-led consortium. Usually the package includes an allocation for the work force and participation by banks. In many cases the initiative for the sale comes from the management team itself. The story is to some extent unsung because it does not generate the international headlines of the gigantic stock issues such as Telecom and British Gas. Yet it is no less typical. There have been hundreds of management-led buyouts.

One aspect of current interest to the momentum of privatization is the extent to which the stock market slide of October 1987 has an effect on the ability of governments to attract buyers. After all, most of the sales since 1979 have taken place on a rising stock market. Does the slide make a difference? The answer is that it must.

The Chancellor of the Exchequer received his money from the sale of the final tranche of British Petroleum, but from the under writers rather than from the public. The novel buy-back offer sufficed to stabilize the sale, helped by the action of Kuwait in taking a large investment in BP. The Chancellor's short term luck has been matched by his long term fortune. Very few public sales



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are scheduled to come within the next two years. By the time that Water and then Electricity come to the market, he can hope that the fluctuations of the stock exchange will have steadied.

In the meantime the question arises as to who might buy on an uncertain market. The answer very often is management. They are in a unique position to know the value of their company, and the steps which can make it more efficient and more profitable. They know its strengths and its weaknesses, and what it will take to turn it around. Management can lead a buyout which is insulated in some degree from the rise and fall of shares because it is not quoted. The average time between buyout and public quotation in the private sector is about three years. This, too, allows time for an upturn in share values and buyer confidence.

### **The early experiments**

The first major use of management-led buyout as a privatization technique occurred with the sale of National Freight in 1982 to a consortium of its employees, NFC pensioners and four banks. This took place after a firm offer from within NFC in May 1981. About 9,000 employees and 1,300 pensioners took part, at an average of about 700 £1 shares.

The sale augured well for the technique because it was an instant success. Productivity has since jumped by 30 percent, and the value of the shares was estimated to have risen more than fifty times over by the summer of 1987, when the first NFC tax exile, a former chauffeur, received wide publicity. Public flotation is now planned.

On a smaller scale, the privatization of the British Rail hotels, including Gleneagles, had featured management and worker buyouts and had also met with success. The plastics company Victualic was similarly sold, and after mixed fortunes emerged triumphant by 1987.

### **A landmark case**

The sale of Vickers Shipyard in 1986 was interesting because of the lessons it involved. The consortium included strong participation from the work force. The yard had enjoyed a distinguished history and had built 320 submarines and 200 warships. The bid accepted was for £100m, of which £60m was due on purchase, with further payments in 1992 and 1993. Interestingly, the successful bid from Vickers Shipbuilding and Engineering Employee Consortium was not the highest. A larger bid from Trafalgar House was passed over because the management-led bid offered a smoother transfer.

The management team took considerable trouble to educate the work force and encourage participation. Videos showed how to apply for shares, and each employee was given access to a £500 interest free loan repayable out of subsequent wages. Workers were allowed to buy at £1 a share, whereas institutions, pension funds and banks had to pay £5.

A further novel feature was the involvement of the communities of Barrow and Birkenhead where the yards were located. Relatives of the workers and local residents were eligible to participate, and this brought to 300,000 the number taking part.

The National Bus Company with 50,000 workers and 14,000 buses was first exposed to competition, then privatized in its constituent companies.



Overwhelmingly, with most of the 60-odd sales already completed, the sales have been to management-led teams at a rate of several per month.

The privatization of Leyland Bus, which had created such a storm in 1986, took place smoothly by management buyout a year later. A further BL subsidiary, Unipart, went to a similar buyout at the same time. In the latter case the workers were allocated 12 percent of the shares, and management given the right to raise its stake from 10 to 20 percent if targets were met.

British Transport Advertising passed almost unnoticed into the private sector early in 1987. A buyout of eight senior managers headed institutional investors, with a price tag of £50m, by no means untypical of management buyouts.

### **Both private and public**

An interesting feature of this type of privatization is that the increase in public sector sales matches a similar rise in private sector management buyouts. When Mrs Thatcher took office in 1979 there were 52 buyouts with a total value of £26m. By 1986 there were 261 buyouts at a total value of £1.21b. By September 1987 this had already been exceeded by buyouts totalling £1.36b.

If there is a size limit, the view of it is constantly increased by new sales. 1987 saw a proposed buyout four times the size of the previous record in Britain, but this is dwarfed by examples from the USA. The management buyout of the Beatrice companies was at \$6.26b. The pace is such that there is now a freefone number in Britain which management can call to obtain advice on how to prepare a buyout bid.

A striking difference between British and US buyouts lies in the gearing. The debt-equity ratio in Britain is typically three of four to one, as against the American levels of eight or nine to one. Britain would be well advised to stick to its conservative levels if it wishes to see this type of buyout succeed. Given a cautious approach such as this, there is no reason why much more privatization should not take place by management buyout. It can be done on an unsteady market, even on a bear market, in the knowledge that flotation can take place years later when the firm has established itself and the stock market has once again taken an upward track.

The government would be well advised during the period before the next big public issues are due to reach the market to concentrate its privatization programme on management-led buyouts, especially on those which offer opportunities for substantial participation by the work force. There is a large number of state operations which make good candidates for this specialized approach.

### **The immediate candidates**

In January 1988, the Secretary of State for Scotland, Malcolm Rifkind MP, confirmed that the Scottish Transport Group would be an early candidate for privatization. Management-led buyouts would be a completely appropriate strategy for this, since the success of bus privatization in England has indicated the opportunity and the techniques. There is little justification for denying to Scotland some of business opportunities which have been so eagerly seized in England. Also in Scotland is the Forth and Clyde Ports Authority, also ready for this kind of buyout. The lesson should not be lost from the successful privatization of the other British ports that land, even in



docks long disused, can provide part of the asset basis for a viable private company.

Following the start made with station buffets, the catering services on the trains themselves should now be subject to early privatization, again with substantial opportunities for teams led by current management to take part.

The transfer of British Coal to the private sector will obviously come at some stage as the industry is led toward profitability. A start could be made on the Nottinghamshire coalfields. Already dominated by the independent Union of Democratic Mineworkers, the Nottingham pits constitute the basis for a management and worker-owned company.

The privatization of the elements of the Post Office is similarly in view. While the girobank is a candidate for sale to a private sector purchaser, the parcels service of the Post Office would be a viable private sector operation. Just as both productivity and efficiency jumped in National Freight, so would the quality of service provided by Post Office Parcels be expected to improve once the management and workers owned the company and had a stake in the profits and any capital appreciation.

Parts of some of the New Towns have already gone to the private sector; now the remainder could be made into viable packages and offered to management-led teams. There are opportunities here to involve residents of the communities, just as locals were given the chance to participate on attractive terms when the Vickers sale took place. Innovative share-buying techniques could be put together for New Town residents as well as for management teams.

The remaining ports could also be privatized to management groups but only after the Dock Labour Scheme had been dealt with in some way which removed its diseconomies on their operation. This would involve government action to cancel the scheme, or some package which included compensatory payments to those affected by its removal. No privatization could hope to succeed with it in place; indeed, its operation has been in large part responsible for the decline.

The shipyards remaining in the public sector present no problem other than that of arriving at a deal which recognized the state of the world market. It might be necessary in some cases for the government to put money into the deal, as opposed to realizing cash from the sale. This would not be a totally new idea.

The English Industrial Estates Corporation is basically a company which manages property. It has 16 offices and employs 320 staff, and has already received a management-led buyout offer. By far the easiest course for the government would be to proceed on this basis, especially since City investment is already lined up.

Polytechnics and other colleges presently under local government control could become private institutions under the leadership of their current management. The government is already trying to increase their participation with private firms and the marketing of their operations and services. Fixed term agreements between the colleges and government could launch many of them into the private sector with direct state financial support tailing off after initial grants.



More controversially there are selected state hospitals which could be surrendered to the control of their current management in order to market their services to the private sector as well as the NHS. This is by no means suitable generally, but there are some institutions which could be managed more cost-effectively if they were freed from outside political controls and allowed to operate on a commercial basis.

The success of the National Bus privatization to management-led groups gave politicians a clear indication that similar benefits could be spread to London Regional Transport. Although London was originally treated as a special case, there arose a growing body of evidence that new private companies could be more flexible and responsive. Already, the more efficient small bus is becoming a familiar sight in British cities. It is quite likely that privatized bus services in London would abandon the congestion-causing and widely detested one-man buses in favour of the more manoeuvrable minibuses, and that they would be both competitive and successful. This and other innovations will soon be made easier: in January 1988, it was announced that London Buses would be divided into fifteen units for individual sale, possibly to management buyouts.

### **Local government services**

Within local government services there is vast scope for buyouts by management of the existing operation. The new Bill to require tendering for a range of services will bring private contractors to provide some services. It also brings a natural opportunity for direct labour organizations to move into the private sector and seek elsewhere the additional work which DLOs cannot perform. The Merton architects have already been floated as a management bought company and now perform contracts for Merton council. The same has happened with the North West Thames Regional Health Authority's design services. Westminster's refuse department is going through the same process. The same could be encouraged in many sectors of local services and in all parts of the country.

On a much larger scale government should look very seriously at the prospect for a management buyout in British Rail itself, as well as in its ancillary activities. This could be done in many different ways, with regional companies or route profit centres serving as the basis. Trains and track could be separated, with a national trust responsible for track leased by private companies providing train services. Since the writing is on the wall for a continuation of nationalized rail services, the management might well be ready to step in with a pre-emptive bid.

The conclusion is that privatization will continue and that while Britain waits for the next big public flotations, it will proceed by a technique which has already proved itself to be versatile as well as successful. The management-led buyout will probably bring as much study by countries overseas as the public flotations have done. It lends itself to application across a wide range of sizes and to a variety of operations. At the heart of its success there lies the elemental truth that people work with more commitment when they have a direct stake in the outcome.



## THE BUYOUT AT NATIONAL FREIGHT

**Sir Peter Thompson**

Chairman, National Freight Corporation

National Freight was a company that was mentioned in the original Conservative Party Manifesto in 1979 -- in fact I think it was one of only two that were mentioned as targets for privatization and when you think about all the other much bigger companies that has come along since, it's really quite surprising.

However, when the merchant bank advisors looked at us and our performance, they concluded that it would take at least two to three years for the stock market accept NFC, and two to three years of rapid improvement. This worried us a bit and we were worried that we might be sold off in job lot. So we thought up the original scheme of buying the Company from the Government on behalf of the employees.

### THE POWER OF OWNERSHIP

Let me remind you perhaps of the magic moment some five years ago when the then Secretary of State for Transport, David Howell, actually handed the shares over to me as the keeper, on behalf of the employees. It was a ceremony which took place in one of our depots, and at that time David Howell made quite a prophetic statement. He said: 'There is nothing so powerful as an idea whose time has come'.

At the time of our privatization, whilst many of the advantages of pushing back the frontiers of the state had been seen, perhaps what had not been fully realized was what advantages there could be in the motivation of people from the share-ownership perspective, particularly in terms of employees owning shares in the company that they work for.

So we decided right from the start that we had to have certain objectives. The first was to keep the business together. One of the big fears that we had was that if we did not successfully privatize the company, it might in fact be split up. We have seen that happen where some of the enterprises which are not suitable for bringing to the market have actually been auctioned off.

### Workers as owners

I suppose the other fear that we had was that if we were auctioned off we wouldn't know who our next bosses would be, and we quite liked ourselves as bosses. So the next basic principle that we put forward was that we wanted to majority of the equity, the majority of the shares in the company, to



be owned by the employees. We were quite adamant with all the financing institutions that we did business with, that we really wanted all the equity to be owned by the employees. We didn't quite succeed, we finished up giving seventeen per cent away. But that objective meant that we had to take on a tremendous amount of debt. We didn't believe that our employees would be able to raise more than five or six million. If we wanted all of the equity sitting on that five or six million, we had to gear the company up.

We also insisted on equal opportunities for all employees, with no preference given to directors or senior managers, everybody having the equal right to subscribe for shares. There was no restriction, though, in fact, we actually gave preference in share allocation to the smaller shareholder. Obviously the scheme we put forward had got to be viable because we, as managers, were worried about a failure because we would be regarded as bad managers and would have persuaded people to put their money into a bad deal.

We were determined the Company should be professionally managed, not a cooperative. The employee shareholders would appoint us to run the business but it would be a business which was run in a normal managerial sense. We were not to be consensus managers.

Also, we made a commitment to the Government that we would not go to the stock exchange for five years. At the early stages of the privatization programme, and even extending right the way through to today, there was this worry about accountability, worry about whether the right price is being asked for state assets and so on. One of the concerns that the Government had about an employee buy-out is that in fact we would buy the company and re-sell it again: make a quick profit and then get out. We said we were not in that game, but in the game of managing the company for the long term. We gave a commitment for at least five years. Those five years have gone by, we asked the shareholder employees whether they wanted to go to the market at the last Annual General Meeting, they decided not to. But each year we will be talking with them about whether and how we should go to the market.

### **The art of persuasion**

Then we moved into the phase of being persuaders. The first people we had to persuade were the Government. We didn't have much problem in persuading the Secretary of State for Transport, once we had a viable scheme, so it all rested on finding a legal way through, and the bank finance.

**Financiers:** We also had to persuade the financiers. We had hawked the idea round to one or two merchant banks and been turned down flat, but Barclays Merchant Bank picked it up at an agreed purchase price of fifty three and half million pounds. On top of that we had to borrow another seventy million to fund the debt. So altogether we were looking to borrow around one hundred and twenty million pounds. The bank agreed, but imposed some conditions: a major one was that the fourteen top executives in the business had to come in with sizeable stakes (and the minimum stake they were talking about at the time was thirty thousand pounds, I suppose the bank had the theory, that if they are going to lose one hundred and twenty million, then we should be personally exposed to risk as well.

Then they insisted that the next thousand managers had also to contribute six hundred and fifty thousand between them. Finally, if we couldn't raise four million then the deal was off. Plainly, the bank wanted involvement. They had assets, we had good people.



**The workforce:** Another thing that we learnt in this exercise was how to communicate with the workforce, and we have never stopped communicating since with our staff. We offered the deal to the employees and their immediate families with a minimum subscription of one hundred pounds and we prepared a prospectus, the reason being that the lawyers and the City men fully understood all the right words and legal definitions that should go into a prospectus, but the lorry driver in Stockton on Tees, really had only the vaguest knowledge of what latin tags and jargon phrases meant. So we argued that we were trying to address a group of people who have never bought a share before in their lives. So we resolved the problem by filling the first half with simple words and pictures and the back half with the usual legal terminology the City people understand but my drivers wouldn't.

### **Industrial democracy**

Seven and half million pounds was raised and away we went. Only something like forty-five percent of our employees had invested at that early stage. There were no free shares, no deals, everybody had to buy the one pound share for a pound. If this was going to work, we had to re-focus the company onto the concepts of industrial democracy. It was their company, they owned the shares, they also had a right to take part in the critical decisions of the Company.

The first year we had our AGM we expected about five or six hundred people to turn up. In fact one thousand eight hundred turned up and had to go into an overflow room. Every year we have used that Annual General Meeting as the centre of our decision-taking process and it's like a mixture of a party political conference and a normal AGM in which motions are debated. The Board are defeated occasionally, but on the important issues we usually get our way. The AGM decides whether I and my fellow directors have got a job for the following twelve months, but it's rather different than being faced up with City investors. Our guys actually do know whether you have run the company well or not.

We took the strategic direction of the business to the worker-shareholders and part of that strategy was to take twenty-five percent of the investment that could go into the UK and put it overseas for five years. We expected opposition, but by the time we had finished and had taken them through the whole reason of why we wanted to do it, they were there behind us. We have merged two loss-making companies. It involved a loss of a thousand jobs and caused a great debate, and of course you can imagine the anger at the Board from those who were going to lose their jobs. At the end of the day, despite the trade unions demanding a strike to protest against what we were doing, we effected that merger without losing a single hour's productive work.

The AGM decides our policy on donations. They do give to charity. They don't give to politicians, they don't regrettably give to culture. But at least its their money and we ask them how we should spend it. We also invited them to give up fifteen percent of their pre-tax profit so that we could start a share scheme so that the new generation of managers and workers who were not in right at the beginning could actually build up a stake in the Company. To their credit they agreed with that.

### **THE RESULTS**

In 1981, the year that we bought the company, we had a bottom-line profit of



one million pounds. By 1986 that had gone up to thirty-seven million and the turnover has increased accordingly.

In terms of the numbers of staff employed, when NFC was first put together by Government in 1968, there were sixty three-thousand people employed. By the time we came to buy the company, that had gone down to twenty-three and half thousand. In the first two years we made it part of our mission to increase employment opportunities. In the first year or two, we stabilized employment, and we now stand at twenty-nine thousand employees. In terms of growth in share value, we trade amongst ourselves and shares are changing hands now at roughly nine times P/E so those of you in the City will know that they are not over-valued, but at the moment we are trading the original one pound share amongst ourselves at forty-six pounds. This year, dividends will give them back what they originally invested gross at the beginning of the exercise. When we started, there was a cynicism about which suggested as soon as worker shareowners had made a buck they would run. But we have started with ten thousand and we now have twenty-seven thousand. A concept has grown, they have come to like it they have come to accept it. They want to be part of it and the numbers have grown to the extent that about eighty-five percent of our employees now own shares.

#### QUESTIONS AND DISCUSSION

**Dr Eamonn Butler:** National Freight was a company which before privatization was losing about twenty five million pounds a year on a twenty five million pound turnover. Some people on the right then said that it ought really to be closed down. What is the secret to get the company in shape so that you can sell it successfully and make it prosper?

**Sir Peter Thompson:** One of the things that I observed in our business was that for the whole of the fourteen years that we were state-owned, we somehow became accountant-dominated. Don't ask me why but all the time, in trying to meet government objectives (which were not to lose money) we concentrated on bringing the cost line down for the time. The process of bringing the cost line down in a service industry is all about redundancy.

When we took the company over ourselves, we recognized, fairly early on, that if all that we could do was to offer our new shareholder employees redundancy, then the scheme wouldn't work anyway and so we then started to concentrate very much more on how we could actually create new business, create new employment opportunities, and start to grow the company.

We became market-dominated. In the companies I have worked for in the private industry, marketeers were kings -- the guys who went out and produced the new business and did the new developments. In the two state industries I worked, National Freight and British Steel, it was the accountants, the production cost guys that were kings, the I don't know whether one can draw conclusions from that. But certainly, in our own case, in the space of fourteen years before the buyouts, we actually got rid of forty-two thousand people. In the space of five years since we have owned the company ourselves, we have actually found new employment opportunities for six thousand. I think it is that different type of management focus takes over.

**Sir Keith Stuart (Associated British Ports):** Our experience since



privatization in the ports industry has been that to achieve change -- whether it's a matter of getting a reduced manning improved productivity, moving into a new market area, or using assets for different purposes from those from which they were originally designed -- that process of change is radically different and radically quicker, in the private sector. Part of that is to do with the attitude of one's employees to a private company. They simply expect change in the private sector and ultimately come, of course, to welcome it; whereas in the state sector, our experience has been that change is resisted as long as it possibly can be -- which often, of course, has the result of creating enormously greater problems. So where change is necessary, our experience, and I am sure this is shared by many other companies now in the private sector, is that it is much more easily accepted.

**Yildirim Akturk (Interbank, Turkey):** In the case of the National Freight Corporation example of staff buyout, I believe the merchant bankers were not all in agreement. Who instigated on the successful model, who initiated it, what were the arguments that were carried in the day?

**John Redwood:** Like all good things in life there was a happy element of chance in the whole thing and I think it's a great credit to Sir Peter and his team that they came forward at the right point with this proposal. There were discussions about all kinds of options for selling National Freight. In this country if something is written in the Conservative manifesto, they try to deliver the promise however difficult that may be. There was such a pledge in 1979 to sell National Freight. A number of options were put forward against the background of it being a loss-making, declining, difficult business.

When the idea of a management buyout came up many of us immediately saw the charms of this solution and a fair wind was given to it and people saw its value.

If you then ask, why it hasn't happened more often, the answer is that in part it has. The case-histories haven't been written up so much and they haven't yet been up and running for as long as National Freight, so we cannot yet say how successful they have been. The story gets more interesting four or five years out when you can go back and see what impact it has had. There has been an enormous buyout in the ship-building industry and there have been buyouts in part of the motor industry and the bus industry.

The reason the buyout has not been used for some of the very large and glamorous sales, is quite simply that the employees couldn't afford them. The British Telecom employees bought as many shares as they felt able to do but there was no way they were going to be able to put up several thousands of millions of pounds to buy the whole of British Telecom; similarly with British Gas. So in the very large sales, it isn't an option. All you can do, which the Government has done, is to encourage as big an employee stake as possible. A number of special inducements like free shares and cheap shares, become a standard part of the procedure to build that solid vested interest amongst the employees in the privatization and in the success of the privatized business.

**Sir Peter Thompson:** There were two problems that we encountered anyway. The first one is the problem of accountability. At what price to should an asset be sold? It seems to me the Government gets in trouble when it has to go to the market and determine the price. Certainly the spectre at our feast was this inability, or unwillingness, of the civil servants to recommend the price that we were offering was a fair price because the



company wasn't being put up for auction.

The other element which does worry me is that, whereas management buyouts in the United States go in for incredibly high levels of gearing, people in the UK they are much more conservative. There is a great fear that if you actually do a management buyout with a ten to one gearing, or something of that kind, the risk of failure is fairly severe and the last thing that any government wants is to have a failure in its privatization programme.

**T de Saint Phalle (Privatization Council):** Are there tax advantages given by the government when there are employee buyouts?

**Sir Peter Thompson:** There are, but they are nothing like as generous as your ESOPs and those kind of schemes in the United States. We had one of your senators over preaching how we should get these tax breaks to a much greater extent.



## **PRIVATE FINANCE AND MANAGEMENT OF INFRASTRUCTURE**

**Patrick de Pelet**  
Director, Kleinwort Benson

The provision of a country's essential infrastructure has long been regarded as a duty of Government, although in recent years the scale of that commitment has been steadily reduced, largely from financial pressures. While there are a number of infrastructure systems which because of their size, complexity and economic importance need a large degree of central planning and control, there is nevertheless a growing acceptance that these need not necessarily remain the exclusive preserve of the state. Indeed the UK's highly successful privatization programme, has already resulted in the transfer of major utilities such as British Telecom and British Gas to the private sector, and these are now to be followed by the water industry and electricity.

### **ISSUES IN INFRASTRUCTURE FINANCE**

There is, however, a further general area where the private sector can make a significant contribution to the process of privatization and this is in the financing of individual large- scale infrastructure projects. There are many possible candidates, and these include motorways or major roads, tunnels and bridges and other river crossings (I will be talking in some detail about the Dartford Bridge financing which we have recently concluded), and also mass transit systems and power generation projects.

Chronic capital shortage is a continued problem in the public sector and is exacerbated in the UK by the present Government's commitment to reducing both public sector borrowing and the proportion of GNP spent by the state.

In such circumstances the scope for replacement or extension of the infrastructure network becomes more limited. One solution is the introduction of private enterprise and finance into the works of restoration and expansion of the infrastructure which can relieve the burden on the public purse, benefitting the country at large without further burdening the taxpayer.

### **Risk and reward**

Private finance will, of course, be forthcoming only if there is an anticipated positive return to be earned. If the return is guaranteed by the government then, of course, this is merely disguised public expenditure and will count as public sector borrowing; and nothing therefore, would have been gained. What is required is a scheme which rewards the private sector for the risk it accepts, based upon the projected use of new or re-built parts of the



infrastructure network.

The introduction of risk has two great benefits: it allows the required finance to be regarded as private sector finance and not as public sector borrowing; and it encourages private funds to flow into those projects that are needed most, that is, those projects most certain of demand usage.

The attraction for legislators of bringing private capital to the aid of a traditionally public network is that it enables work to be done with a minimum of public outlay. It is often noted how infrastructure suffers when there is a squeeze on public money. With this type of approach, however, an infrastructure can be maintained and extended without massive outlays of public funding. The cost is spread more evenly by linking repayment of private sector loans and the return to private sector investors to usage.

The criteria formulated by the Government to judge whether or not a private sector scheme is acceptable in the UK were outlined in 1981 by Leon Brittan, who was then Chief Secretary of the Treasury. He stated that: 'market pressures' should be brought to bear on the public sector; and that the 'funds for investment should be taken under conditions of fair competition with the private sector's that is, that the latter should not obtain a normal equity profit without accepting a normal equity risk.

### **Black Country setback**

The first infrastructure system to be studied for private finance was the road network and, in particular, a scheme to privately finance and maintain a proposed new route in the 'Black Country' in the Midlands. In this instance, the investors would have received income over a 25 year concession period based upon a 'phantom toll'. That is, they would have been paid a set sum per vehicle using the new road by the Department of Transport, based upon a measurement of traffic volume. Of course, a weakness of this scheme was that it failed to link the payment from the Treasury to the private sector to usage. There was a lack of a nexus between payment and usage. The taxpayer, essentially, would be subsidizing the motorist.

This resulted in the Treasury rejecting this project on economic grounds, but the time spent in negotiations did highlight the difficulties of gaining acceptance for private-sector finance. The main stumbling blocks were the rules drawn up by the Treasury which became known as the Ryrie Rules. These emphasised that 'the improved efficiency and profit from the additional investment should be commensurate with the extra costs of raising risk capital from the financial markets'.

In other words, the Treasury sought to offset the increased cost of private sector finance with efficiency gains only, and sought to ignore the premium for risk.

In practice, this requires the total cashflows involved in direct public sector investment and in the alternative private sector method under consideration to be fully set out and then discounted at the Government's perceived, risk-adjusted, opportunity cost of capital to arrive at comparable Net Present Values.

However, persuading civil servants to grasp the concept of risk and the implicit negative value attached to it, let alone attempting to calculate an exact figure for the risk-adjusted opportunity cost, proved to be a lengthy task.



## THE DARTFORD PROJECT

We then move forward to March 1986 when the Department invited civil engineering contractors to bid for a large infrastructure contract and allowed them to offer one of three methods of finance, including private-sector finance. This is the case of the Dartford River Crossing which I would like to dwell on in some detail.

At Dartford, there are presently two tunnels providing a tolled crossing over the River Thames joining the M25 orbital motorway. With the growth of traffic generated by this motorway the Department of Transport realized that the existing crossing would soon become inadequate and they therefore decided to provide additional capacity in the form of a third crossing. The form of that third crossing was not determined but it was originally anticipated to be either a tunnel or submerged tube.

### **The mandate**

In September, 1986, after sensitive negotiations resulting from the tender, the Department awarded a mandate to a consortium led by Trafalgar House, with Kleinwort Benson acting as financial advisers. The winning bid was on a consortium basis and with private sector finance. This provided for the purchase of existing tunnels at a cost equal to the outstanding debt, relating to their original construction; the construction of a new bridge (and this turned out to be one of the advantages of this tender since it finally emerged that a bridge would be the most competitive solution for the third crossing): the maintenance and operation of the tunnels and the bridge during the concession period; and the collection of tolls for a period sufficient to cover costs including finance costs, up to a maximum of twenty years. At the end of the concession period or when all accumulated debt from both the original tunnels and the new bridge has been repaid, whichever is the earlier, the combined crossings revert to government free of charge.

This bid won because it met the objectives of both the Government and the bidding consortium, in that the Government wanted a new crossing as quickly and as cheaply as possible and Trafalgar House wanted to secure profitable construction work and it also met the financial criteria acceptable to the private sector.

There were, however, important secondary considerations. A series of unsuccessful attempts at financing infrastructure had left the private sector uncertain whether the Government was committed to the concept of private sector finance, or whether the Ryrie Rules had been drafted deliberately to frustrate success. Dartford became widely regarded as a test case. For the private sector, it was essential to demonstrate clearly that there was indeed a genuine transfer of risk to the private sector, and that this was on a commercial base which could be accepted by Government. For the Government, the decision would bear heavily on whether the scope for privatization would indeed be extended into the field of infrastructure, or whether a further unsuccessful attempt would extinguish interest in this type of arrangement.

### **The financial package**

The proposal was to form a company, the Dartford River Crossing Company, with a single purpose of constructing the new bridge and owning and operating the combined crossing, financed through a novel package. The



total of this package was some one hundred and seventy million pounds, and I will spell out its constituent parts.

Firstly, it was capitalized with purely nominal equity of one thousand pounds. Secondly, there was a tranche of twenty years subordinated loan stock and a further tranche of thirty million pounds of sixteen-year loan stock. Thirdly, there was an eighty-five million pound term loan, provided by a consortium of banks and, in addition, the package provided for contingent bank loans to meet overrun finance and working capital requirements totalling some twenty million pounds.

The equity risk is borne effectively by the subordinated loan stock holders. The key to the bid's success was that, unlike previous private sector schemes of this kind, there is no equity profit. The nominal equity attracts no dividends, thus the Concession can revert to the Government, at no cost, once sufficient surpluses have accrued to meet the cost of all debt. On present projections this is likely to happen in year sixteen of the twenty-year Concession period, but it could well happen earlier if we have underestimated traffic projections.

I would like to elaborate further on the finance package. The subordinated loan stock earns a fixed rate of return set on drawdown against the redemption yield of a reference gilt, but bears the equity risk, which has no upper limit except total loss of the loan stock subscribed.

This you might feel on first sight is a somewhat unattractive proposition, which would have been unlikely to attract many subscribers.

The loan stock was in fact saleable and was fully underwritten before we submitted our bid to the Government, because it was possible to reduce the equity risk to manageable levels, where the subscribers were compensated for the risks borne by the relatively high margin on the loan stock, but were shielded from those which were unacceptable.

This was partly possible because of features peculiar to the Dartford project. There are two existing crossings, earning toll income from the start of the concession. Not only does this mean that the project enjoys an immediate cash flow, thus reducing the initial financing requirement and providing comfort to lenders, but it also allows payments to be made to investors from day one of the concession.

Traffic over the crossing, and hence toll income, is predictable with a high level of comfort because there is a history of traffic over the crossing, from which future traffic levels can be extrapolated.

Although tolls are fixed in real terms for the whole period of the Concession, at the beginning of the Concession they are linked to the retail price index. Another important feature is that there is no argument over the market need for the crossing. There is hard evidence of traffic levels mounting on the M25, of which the Dartford Concession is part; and furthermore, motorists are accustomed already to paying tolls on the crossing. The Concession therefore is founded on an existing and profitable base.

#### **Practical issues**

If it was reasonable to expect the loan stock holders to bear the commercial and operating risks of the venture, it was clear that they were less able to assess the construction risks involved in a new large-scale bridge. It was



therefore concluded that the design of the new bridge should be agreed between DRC and the Department of Transport and that thereafter it should go forward without any significant design changes.

Further, the Construction Group, which consists of Trafalgar House subsidiaries Cementation Construction and Cleveland Bridge, has contracted to build the new bridge for a firm price, which is subject only to increases relating to inflation and, if appropriate, subsequent design changes. These of course, would be paid for by Government in the event that they were prompted by Government.

An important aspect of the construction contract was that almost all normally accepted risks were eliminated, including in this case the unforeseen ground conditions risk of placing bridge piers on the river bed, a risk not normally taken by contractors.

It is important to note that as both the construction price and the tolls are to be indexed to inflation, the major cost to the concession and the income to meet that cost will of course be linked.

I have been discussing the allocation of risk amongst the various parties to the DRC Concession. The principle is that each element of risk should be borne by the party best equipped to assume it -- thus the construction risk has been assumed by the contractor and the revenue, and operating and financial risk by the various categories of debt in a descending order. Insurance also has played its part. I would emphasize however, that the full risk has been assumed by the private sector, thus complying with an essential requirement of the Ryrie Rules. It is important that this should be clearly understood by those seeking to promote comparable schemes, since they are otherwise likely to fail.

#### **Lenders' security**

I now wish to deal briefly with the question of security, the means whereby lenders enforce their rights over the DRC Concession Company. This is another area where the Dartford package broke new ground.

It of course, of fundamental importance that there should be no interruption to traffic over the crossing at Dartford. For this reason, should DRC fail, all physical assets, the bridge and the tunnels, will revert immediately to the Government so that Government can ensure that the crossing remains open.

This means that conventional forms of security available to lenders are valueless. Should the lenders exercise their normal rights to appoint a receiver, or to wind up the company, the assets upon which they would rely are taken by Government and passed beyond their grasp.

Instead, other than a conventional charge over any residual assets of DRC, the principal security for lenders takes the form of a charge over the shares: such as, if their interests are at risk, they may replace the Board of DRC with their own nominees in an attempt to rescue the situation.

This is effectively the only tangible security available to lenders. Indeed, they have entered into an agreement between themselves not to individually exercise remedies that would be normally available in law, where to do so would jeopardize the interests of other lenders and thereby entitle Government to revoke the Concession without compensation.



Essentially we are talking about a project financing based on future cash flow generation.

The Dartford project is now subject only to passage of the necessary legislation. The construction and financing contracts have all been agreed, and the Concession agreed with Government. It is expected that Royal Assent will be received in Spring 1988 and construction will commence shortly thereafter.

Dartford has broken new ground in that it is the first major infrastructure development in the UK to be financed in the private sector since the Second World War, and should now pave the way for other comparable projects.

### **Risk and competition**

It also represents a new kind of investment for financial institutions. The subscribers to the Dartford loan stocks were principally insurance companies who have demonstrated their willingness to invest in long-term fixed-rate instruments which rely for both interest and repayment of principal solely on the cash flow of the individual project. This, of course, was unfamiliar territory for them both in terms of the risks they were being asked to assess and the nature of the security they were being offered. The implications should not be underestimated and provide a good example of the willingness of City institutions to take a long-term view.

It is important however, to note that Dartford does not solve all the problems. The particular circumstances which applied, including the objectives of both Government and the DRC consortium, made possible a solution which is not necessarily easily applied to other private-sector financing of infrastructure projects.

In particular I draw your attention to four main points.

1. The loan stock holders and lenders are substantially protected from cost- or time-based construction overruns. These have been off-loaded to the construction group.
2. There is an existing revenue stream from the tunnels.
3. Future revenue can be projected with a reasonable degree of accuracy.
4. There is a clear, unambiguous need for the new crossing.

In projects where similar circumstances do not prevail, other means would need to be found to reduce the risk, if it is to be borne by fixed rate debt instruments. Equally, more conventional equity-based deals do have a role to play, providing the Government is prepared to accept that the private sector should be able to benefit from a return commensurate with the risk assumed.

Lastly, I would like to deal with the issue of competition. In some instances, Government will determine that a particular piece of infrastructure, which it is already committed to building, could be successfully transferred to the private sector. In these circumstances the sponsoring department is likely to set out detailed guidelines and invite the private sector to tender on a fully financed basis for its design, construction and operation. This procedure was adopted for Dartford and follows from the fact that the Department had already planned a new crossing.



However, since Dartford, ministers have encouraged the private sector to take their own initiatives and to bring forward new schemes. Where these fall outside the current Government plans or where schemes proposed are sufficiently different to those envisaged by Government, then I believe a new approach is required. If these initiatives are to be credible, and withstand the scrutiny of both Government departments and other interested bodies, they will need to have been thoroughly researched and costed.

It will have been necessary for promoters to accept that they will need to deliver the scheme on the terms proposed, and this in turn will require a commitment to a firm price on their part and an underwritten finance package on the part of the financiers.

The costs of preparing a comprehensive and credible scheme are necessarily high. If the scheme is to be credible, it will involve the promoting group in being willing to submit its best offer in terms of design, construction, operation and management; and the financiers will have to provide underwritten commitments for finance at the time the bid is submitted.

If the private sector is to be encouraged in this way, I believe that Government will need to accept the principle of negotiated contracts. If Government takes such proposals initiated by the private sector and merely uses them as a base line for a competitive tender, I believe the consequence would be that the flow of valuable sources of new ideas for modernising infrastructure of the UK, coupled with creative financing packages, will be cut off. There is, of course, an interaction between the design and structure of a project and its financing.

In conclusion, we believe that Dartford has established a sound precedent for the extension of privatization into the field of individual infrastructure investments, and in its wake has created a new market for funding such investments. Although the particular financing techniques used for Dartford cannot necessarily be repeated on each occasion, we believe that financing schemes can be successfully developed for a wide variety of infrastructure investments.

#### QUESTIONS AND DISCUSSION

**Patrick Wendell Cox (Wendell Cox Transport, USA):** On the Dartford Bridge was the cost escalation permitted limited to the retail price index or some construction index that is a part of that index?

Secondly, are there aspects of that project that make it easier to provide that kind of cost guarantee that are not the case in other projects?

**Patrick de Pelet:** The answer is that the escalation for the tolls is limited purely to the retail price index. The arrangements between the Dartford River Crossing Company and the contractor is a matter entirely for itself.

On the second question, I don't think there were any special circumstances. Indeed, the estimate of costs is complicated by the fact that we are talking about a relatively large span bridge in a constricted area in conditions which have not yet been totally explored. There is of course experience of the river bed, both through the PLA and existing crossings, but those were for tunnels rather than for bridge piers. So there is a degree of risk, and I think it is worth emphasising that the private sector is taking risk.



**Yildirim Akturk (Interbank, Turkey):** What are the arrangements for repairs on the existing two tunnel crossings that are earmarked for this project? Is the maintenance of the two tunnels the responsibility of the company that is undertaking the construction? Thirdly, what is the expected rate of return on the equity investor?

**Patrick de Pelet:** The Dartford River Crossing Company will be responsible for all maintenance and repairs for the duration of the concession. On the question of the return, there is only a fixed return to the loan stock holders. So we have a fixed rate instrument on all the subordinated stocks and a floating arrangement for the banks. The margins on all of them are fixed by reference to corresponding gilts in each case so the pricing will be the yield on that gilt at the date of the fixing plus the fixed margin.

The revenue on existing crossings will accumulate for the benefit of Dartford River Crossing Company from the date of the takeover.

**Adhemar Byl (World Bank):** In a contract where your investment returns to the state after sixteen or twenty years, how do you guarantee the proper maintenance of the work in the later years? There are some examples around the world where things have reverted to another government in the last years; and where before that happened, while discussions were going, on there was practically no maintenance and then the investment deteriorated considerably.

**Patrick de Pelet:** There is a hierarchy of allocation of revenues throughout the concession period and maintenance has a prior call on revenues ahead of all service of debts. There will be provision for the close monitoring of the performance of the Dartford River Crossing Company by government and its advisers. So there will be a continuous monitoring of our performance. We have agreed standards of maintenance and renewal and a renewal programme which will have to be adhered to. In the event we fail to comply, we risk losing the concession.

**Ronald Lillejord (Bechtel Financing Services):** In the case of a power station, you would have operating contracts where you would be contractually committed to the operations of the facility and in the case of Antrim, the whole payment is tied up based upon how the facility is operated. So there is enormous incentive to operate the facility at a high standard. There is an ultimate termination provision for being unable to provide plant availability.

**Question:** Many countries in the developing world have overborrowed from the international markets. What would you advise? Nigeria is a country thinking of privatizing an agency like power supply. In many cases they cannot raise this capital locally. Would you say that they should not privatize because they can no longer raise capital funding on the international market? In many cases they cannot raise this capital locally.

**Ronald Lillejord (Bechtel Financing Services):** First of all there has to be an environment that will attract foreign equity investment. In some cases that is a political problem but it also has to do with the regulations that pertain and government approvals that are required so it is a facilitation process.

Also, there needs to be a commitment at the highest levels to support privatization efforts. One of the features of today's overborrowing is that there are additional equity sources through equity swaps; so in a way you can take advantage of the current situation by converting debt to equity.



## PRIVATIZATION IN THE DEVELOPING WORLD

**Ronnie De Mel**  
Finance Minister of Sri Lanka

The age of liberalization and deregulation has certainly dawned. Not only in the developed countries of the West, not only in the developing countries in the Third World, but also in some of the socialist countries. The age of nationalization which swept the 1940s and 1950s and spilt over into the 1960s and 1970s in the Third World, seems to be on the decline.

Sri Lanka is no exception to the general rule -- though, of course, as George Canning said long ago, each country for itself and God for them all. So privatization must take its own course in every country in the world and there is no unequivocal example or model for any country to follow.

### **The political background**

In Sri Lanka we have had 450 years of Colonial rule from 1505 to 1947, when we obtained independence. We have had a strange political history, a strongly democratic country with universal suffrage, women's suffrage, an eighteen-year-old suffrage, even before Britain, with the first woman Prime Minister in the world, long before Britain. We also had a very strong socialist tradition and an even stronger Marxist tradition. We have had the strongest Trotskyite party in the world; about 20% of the Members of Parliament belong in the Trotskyite party, we have had Trotskyites and Communist Party Members in the Cabinet, we have even had a Trotskyite Minister of Finance. In the first election after independence more than half the Parliament were Marxist oriented. This has all presented a difficult psychological background in which to go for privatization.

I think when Aristotle once said that man is a political animal he was speaking of a Sri Lankan, because in every election more than 90% of the people vote of their own free will, walking to the polls. We have had nine elections and several changes of government since 1947.

But in 1977, when our Government came into power with a resounding majority, with four-fifths of the seats in Parliament, we decided to embark on a completely different course. We had had twenty years of a completely controlled economy from 1956 until 1977. More than 70% of all economic activity in the country was either state-owned or state-managed. The state-owned, controlled and managed all the commanding heights of the economy: the plantations, banking, insurance, transport, the ports, the airports, the big industries, textile mills and even some hotels.

We have never had a strong private sector. We have not had a strong capital



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market. We have not had a strong stock exchange. So it was with this difficult background that we started to liberalize our economy in 1977. In 1977 the first budget which I introduced (I have been introducing these things called budgets for eleven years now -- a thankless task) we abolished almost all the controls. We had at that time exchange controls, price controls, import controls, export controls and various other controls that hung like a millstone round the economy, grinding it down.

As a result of the liberalization policies which we inaugurated in 1977, we have reaped many benefits from an economic point of view. We have almost trebled our growth rate from less than 2% in the period of the controlled economy to over 6% per annum. We doubled investment as a percentage at GDP. We reduced unemployment by exactly half, from 26% of the workforce to 12% of the workforce and above all, we brought inflation down to zero in 1985. Even now with tremendous defence expenditure causing deficits in the budget, inflation is still within single digits.

So I think our liberalization policies have paid off. Most importantly, it abolished all the shortages, scarcities and queues that used to be an endemic feature of the controlled economy of the past. People had to queue for everything, their rice, their bread, their textiles, their building materials, their clothing materials, their school books, their shoes, everything. We have abolished all that and people seem to see the advantages of a free economy.

We had great difficulties. In fact, the biggest obstacles I faced when I liberalized the economy came from two sectors which you may think would have supported it. The greatest came from the private sector at that time. A private sector that had fattened itself on licences, permits, quotas and controls. The favoured few of the last government had got all the licences, permits, quotas and monopolies, and this private sector opposed us very strongly. We were also opposed by the bureaucracy -- naturally they felt that they would lose all their powers, privileges and patronage.

The mass media were heavily imbued with this idea of state control, and were also against us. Even more difficult was the resistance from the trade unions and from our political opponents. The psychological war to change people's minds is still going on. It is still a big public relations job, and in this area we certainly welcome the support of Britain and other countries that have been able to mount a successful privatization programme. I don't think people in Sri Lanka are even now convinced that privatization is a good thing or that it is a way of life for the future. There is much public relations work still to be done if we are going to achieve success.

Even the Government party, which is a centre-right party, has no great ideological commitment to privatization. Privatization is considered only a drive towards greater efficiency, for a better allocation of resources, as a drive towards lower budget deficits, covering the losses of corporations, a drive towards fewer losses.

### **The objectives of privatization**

We feel that privatization is not a panacea for all ills. We feel the magic is not in the ownership but in the management; and certain countries, certainly, have shown us that even state enterprises can be well managed, for example Singapore Airlines. Privatization is seen as part of a general process of liberalization and deregulation in Sri Lanka, not an end in itself. It is part of a general programme of economic reform in which we are trying to give a new



place to market forces and reduce the role of the state in economic life.

The second objective of privatization in Sri Lanka is to improve management and efficiency, particularly in those corporations which are now hopelessly mismanaged by the state. We have nearly two hundred state corporations, and the Treasury has doled out to them a tremendous amount of money both as original capital and as further loan capital and further subsidies afterwards. The return over the last thirty years has been less than one and a half percent on our investment in the public sector. So there is a great need to improve management and efficiency.

Third is stopping losses, which are a tremendous burden on the budget and ultimately on the people because losses mean higher taxes for them.

The fourth objective is try to spread ownership, creating a shareowning, property-owning democracy. We feel that a strong middle class is as essential for political stability in a developing country as it is for political stability in the West. Many countries in the Third World lack a strong middle class and we feel that privatization is one method of achieving a share-owning democracy, a property owning democracy, which will produce a strong middle class as a force for political stability.

The fifth objective is worker participation. If the workers can be brought in to participate in the ownership of some of these companies, at least a certain percentage of the ownership, we will be very happy.

We also need, in certain areas, foreign expertise, foreign management skills, foreign technology, foreign marketing, and foreign capital. That is one of the reasons why we wanted the privatization of our telecommunications system -- because we are keen to introduce foreign capital and foreign management and technological expertise.

### **Progress**

I will go on to the progress we have achieved. We started rather slowly. We had to get out of this Marxist, Trotskyite syndrome after nearly twenty years and get into a free economy.

We had also to abolish the monopolies.

**Food:** One of the first sectors we privatized was the key sector of food. Food imports and food distribution were entirely done by the state from the time of the War. The British started the habit and our politicians perfected the system of the state being the ultimate arbiter of whether the people got food or not.

We liberalized the entire food trade. Rice is the staple food of our people, though the import procurement and distribution was entirely in state hands. We liberalized it and as a result today Sri Lanka (which was importing 30% of its rice requirement in 1977) is now completely selfsufficient in rice production. Then we liberalized sugar. Sugar import and distribution was also entirely in state hands. We have invited foreign capital into our sugar plantations and into our sugar mills. A British firm is doing a joint venture; the factory has already been opened and twenty thousand acres of land has already been cultivated.

In other sectors like milk foods, flour, wheat, all the state monopolies have been abolished. As a result, all the scarcity, shortages and queues have



vanished. Fertilizer import and distribution, again, was entirely state-owned and state-controlled, as was the import of tractors and agricultural implements. All have now been opened up to competition.

**Banks:** For twenty-six years after 1951, no foreign bank was allowed to open a branch in Sri Lanka. Only a few British banks which had been there before independence had a few branches and three Indian banks had branches. Apart from that the biggest banks in Sri Lanka were the Bank of Ceylon (which used to be a private sector bank but was nationalized in 1960) and another state bank called The People's Bank. So the banking sector was almost 90% nationalized. We opened up the banking sector to the private sector, and to foreign banks; and fourteen new foreign banks opened branches in Sri Lanka. A new Sri Lankan private-sector bank has come into operation and these banks operate in competition with the two state-owned banks.

**Insurance:** Insurance, both general and life, was completely nationalized in the 1960s. We have now allowed private-sector firms to start insurance companies in competition with the state sector insurance companies and since they know something of the efficiency of the state sector insurance corporations, I am sure very soon the private-sector insurance companies will have a powerful competitive effect.

**Transport:** Transport was considered a state sector function which was almost sacrosanct, like the coal mines in Britain. It was considered outrageous even to talk of private sector participation in transport. Yet now, we have allowed the private sector to compete with the state sector in bus transport all over the country (very important in Sri Lanka), and today about 50% of all transport is in the hands of the private sector. As a result, the bus queues which used to be endemic in the old days are gone: there was a time when politicians used to be frightened to go on the roads their cars because they used to get jeered from the bus queues on the road.

**Textiles:** The biggest textile mills were all state-owned from the very start. We first handed them all to private sector management, and now we are in the process of floating them as public companies.

**Other industries:** We are in the process of privatizing our Telecommunication network. Some other smaller industries have also been privatized. We are privatizing the State Distilleries Corporation, a most profitable cooperation (It used to go on increasing its profits every year because people were drinking more and more). I wanted to break the tradition in Sri Lanka where people think that only loss-making things should be privatized. I wanted to privatize a profit making thing and give the lead from my own Ministry, and that is why we decided to privatize the State Distilleries Corporation.

**The difficulties:** After so many years of Colonial rule and then of a controlled economy, to suddenly liberalize the economy and go into a privatization programme is not an easy thing. At least two or three generations of people who have come out from the universities in Sri Lanka, who have come out from the schools, who teach in the universities, who teach in all the schools, who write in all the newspapers, who report on the TV or the radio of Sri Lanka -- about 95% of them have been indoctrinated with Marxist and Trotskyite dogma. It is very difficult to break this. That is the greatest difficulty: how we change people's minds.

**Capital Shortage:** The lack of a strong capital market is another difficulty. The British established a thing called The Colombo Sharebrokers Association



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a hundred years ago, but after 1956 when the socialist government came into power, the share market became almost dead. There were no transactions at all.

We have revived it. We have created a Stock Exchange -- though we have also brought in legislation for a securities council, because we don't want to start off on the wrong foot having the type of insider dealings that are now common place even in Wall Street and the City. So the lack of a really strong Stock Exchange was a great difficulty, as was the lack of big institutional investors and big pension funds.

**Unemployment worries:** The third difficulty is the great fear of retrenchment leading to large-scale unemployment in a country which has no unemployment insurance. We have a great deal of social welfare, we have free education, we have free help, we have food stamps for half the population, we have milk, bus transport, railway fares, fertilizer, all at subsidized prices, but we don't have unemployment insurance -- we can't afford it. So in a country which has no unemployment insurance, the fear of mass unemployment as a result of privatization is a serious problem to face. Accordingly, we will have to proceed slowly and cautiously. The pace of privatization is sensitive.

**Lack of ideology:** The lack of strong political and ideological commitment to privatization is another barrier. My own Cabinet colleagues have the general feeling that the Minister of Finance is at liberty to privatize anybody else but not their own personal concerns.

**Communication:** Then there are problems of public opinion, of the mass media, of changing people's minds. We need a lot of help in this area because I think we have to create a new sense of feeling towards free market processes in the country after so many years of Marxist and Trotskyist indoctrination.

**Politicians and unions:** The opposition politicians are all against privatization -- all parties. Politicians, even of our own party, are not fully for privatization, because privatization brings a loss of political power (and political patronage, because most of the public sector corporations are very useful employment agencies for politicians and even for ministers).

We have opposition from the trade unions. The trade union movement in Sri Lanka is probably the strongest trade union movement in the whole of the Third World. There were times when the entire country came to a stand still as a result of a general strike. So we have to contend with the trade unions, even within our own party workers. And above all, we still get a great deal of opposition from the bureaucracy: from the chairmen, directors and managers of state corporations who naturally don't wish to be privatized. We have to overcome all these problems.

### **Overcoming the problems**

To overcome these problems, it is vital to have a sound legal and legislative framework for privatization and for this we have introduced and passed two Bills in Parliament for which allow the conversion of all public sector corporations into peculiar Sri Lankan animals called Government-Owned Business Undertakings. These two Bills enable the Government to privatize any of the public sector corporations, or Government-Owned Business Undertakings, by converting them into public companies, the shares of which



will be held at the start by the Secretary to the Treasury, but of which can be thrown open to the public in due course.

The second thing that is needed is a proper organizational and administrative framework for privatization, which we have lacked in Sri Lanka to date. It has been done more or less on an ad hoc basis due to strong pressure from the Ministry of Finance and the President of Sri Lanka.

So we have now established a clear organization of privatization. We have done so under the President himself so that it has greater strength than if it was under the Minister of Finance who is only one of several ministers in the Cabinet. We have created a Presidential Privatization Commission, consisting of three public sector officials, the Secretary to the Ministry of Finance as Chairman, the Secretary to the Ministry of Industry, the Secretary to the Ministry of Trade; and three private-sector individuals, the chairmen of three of the biggest private sector firms, best-run and best-managed private-sector firms in Sri Lanka. The Presidential Privatization Commission has terms of reference to prepare a programme of privatization, procedures of privatization, of valuations for floatation, of compensation for workers, and to lay down principles for worker participation where possible.

To service this Presidential Privatization Commission, we have a special privatization unit of officials in my Ministry.

### **Helping the process**

We also need foreign experts, we have already made a request to the UK's Ministry of Overseas Development. We have also made a request to USAID and to the World Bank and to the Asian Development Bank. We hope we will be able to get the necessary foreign experts to help us with our work. What we need is not somebody to come out and give us an academic report, but people who have been involved in the nuts and bolts of privatization, people to help us with the actual procedures and with the public relations side, which is equally important. Formulating a proper strategy. Proper procedures of valuations, floatations, advertising and disclosure of all information. Also the pace of privatization, the proper timetable - all that is important.

Foreign involvement, especially capital, is a volatile issue but the government is prepared to be very flexible on the subject. We have to meet a certain amount of opposition on the ground that we are handing all our ventures to foreigners once again. But we have not hesitated to ask for foreign participation where we think it is necessary, both from the management angle, the technological angle and the capital angle.

The help needed is largely connected with the matters of which I spoken already, getting the personnel, the capital, foreign expertise, foreign technology, help of the IFCD, the World Bank, institutions like the Commonwealth Development Corporation, the DEG in Germany or in the Netherlands the ADB, will be very helpful because there will be less opposition from capital coming from such institutions than if the capital came directly from foreign multinationals.

I think the greatest help that our friends abroad can give the process of privatization and liberalization in Sri Lanka is to support us to keep our economy as a whole buoyant and growing despite the ethnic conflicts in the North and the East which are taking so much of our revenue from the budget. We want more aid, more trade and more investment.



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