

## TRADITIONAL, PLANNED ECONOMY, AND POLITICS

## Regional patterns

Urban

## PART 4 - PRIVATIZATION IN NON-MARKET ECONOMIES

During the 1990s, the process of privatization in non-market economies was characterized by a number of key features. First, the pace of privatization was rapid, with many countries completing the process within a few years. Second, the scope of privatization was broad, covering a wide range of sectors and enterprises. Third, the methods of privatization were diverse, including the sale of state-owned enterprises to private investors, the creation of new private enterprises, and the restructuring of existing state-owned enterprises.

The challenges of privatization in non-market economies were also significant. These included the need to establish a legal and regulatory framework for private enterprise, the need to attract private investment, and the need to ensure that the process of privatization was transparent and accountable. Despite these challenges, the process of privatization in non-market economies has been largely successful, leading to the emergence of a new private sector in many countries.

## The process of privatization

Privatization is the process of transferring ownership of state-owned enterprises to private individuals or companies. This can be done in a number of ways, including the sale of shares to the public, the sale of the enterprise to a private company, or the creation of a new private company. The process of privatization is often a complex one, involving a number of legal and regulatory steps.

There are a number of advantages to privatization. These include the potential for increased efficiency, the potential for increased investment, and the potential for increased competition. However, there are also a number of disadvantages to privatization, including the potential for loss of jobs, the potential for increased inequality, and the potential for loss of control over the economy. The process of privatization is therefore a complex one, and the results can vary significantly between different countries and different sectors.

## TRADE SALES, FOREIGN INVESTMENT AND POLITICS

Krzysztof Stupnicki

Warsaw

After a fierce debate the Polish Senate passed that country's privatization bill on July 26th, without any amendments to the version approved by the lower house. The vote remove the last significant legal obstacle to creating a legal framework for privatization in Poland.

Voting was overwhelmingly in favour: 328 for and 2 against with 40 abstaining in the Diet and 60 for and 8 against in the Senate. The vote did not reflect the debate which lasted since mid-April and which was rich in minority proposals by radicals from the right and the left. In the end the government bill presented to the Parliament by Deputy Prime Minister Leszek Balcerowicz and Government Plenipotentiary for Ownership Changes Krzysztof Lis emerged basically unchanged.

The bill allows for both the sale of equity and the sale of assets, although the authors clearly prefer the former method. Privatization of an individual enterprise will be implemented by the Minister of Privatization on the basis of a request by its worker's council with the approval of the relevant ministry. The privatization minister can privatize a firm if his decision is approved by the Prime Minister. He also will carry out all procedures involved in the privatization.

### The proces of privatization

Privatization is divided into two steps: first, transformation of the state enterprises into a Treasury joint-stock company; second, sale of the Treasury shares to private investors. After the first step the employees get the right to elect one-third of the Board of Trustees. They keep this right only as long as the shares can be sold through tender, fixed price offer or private placement. They should be sold within two years from transformation of the state enterprises.

Foreign investors can buy up to 10% of shares on general terms. Larger purchases require permission from the chairman of the Foreign Investment Agency. It is understood that the foreign investors' share will be determined on a case by case basis. In the case of the healthiest enterprises it will probably be limited to a minority stake in the initial sale, while in other cases it can be up to 100%. Dividend transfer is allowed on the same terms as in the foreign investment law of 1988. The Minister of Finance can grant additional profit transfer upon request of the Minister of Privatization. This provision

suggests prompt abolition of profit transfer restrictions, which will probably take effect at the beginning of the next year.

Employees get the right to buy up to 20% of all shares on preferential terms. They will be offered a 50% price discount from the price for individual domestic investors. The total amount of price discount for employees is limited to one year's average salary for the national economy. They will not get any preferred voting rights. Shares bought by the general public can be paid for in instalments.

Shares can be also purchased for 'vouchers', but it will be a long time before these appear. They will be issued only if Parliament votes for them on a request from the Council of Ministers. It will ask for 'vouchers' if demand from the general public turns out to be too weak to support the planned pace of privatization and if institutional circumstances guarantee that 'vouchers' will not disrupt capital market operations.

Sale of assets is another method of privatization allowed under the law. It will mainly be used in the case of liquidated or broken up monopolistic trade organizations and will be used as a tool to encourage the growth of small private firms. If a sponsoring ministry decides to liquidate an enterprise and transfer its assets to a new company the same rules will apply for subsequent share sales.

After a prolonged battle the government succeeded in defending its version of the bill and supporters of employee share ownership lost their fight to use employee ownership as a primary method of privatization. Liberals who called for immediate privatization through a massive give-away also failed to convince the deputies. The bill remains a general framework, which gives the new Privatization Ministry a relatively free hand in shaping privatization policy. Individual privatization will require consent within the relevant enterprise, but will not need individual authorization from Parliament. The bill therefore should lead to a successful, conventional privatization without attempts to experiment with totally untested 'creative' schemes.

Preparations are now underway to sell at least 7 medium size enterprises. All but one, a construction company, are industrial enterprises. Two weeks after Minister Kuczynski's nomination seven Treasury companies were established and registered completing their transformation into joint stock companies. The enterprises included five prepared by London based consortia:

- **Exbud Kielce** (prepared by Coopers & Lybrand). A construction company run by aggressive manager W Zaraska. For the first 7 months of 1990 it had \$8.4 million profits on sales of \$58 million mainly in the Middle East and Western Europe. Its fixed assets are \$3.7 million and employment 11,000.

- **Warsaw Rolling Mill** (prepared by Barclays de Zoete Wedd). Nationalized after the Second World War it has operated for 180 years under the name of Norblin. In the first half of 1990 it had \$29 million of sales and unaudited after tax profits of \$3 million. It has 870 employees and manufactures a variety of copper and other non-ferrous metal products which are sold mainly in Western Europe.

- **Krosno Glass Works** (Schroders and Moore Stevens) has sales of \$23 million and after tax profits of \$4.7 million with fixed assets of \$19.5 million. Employing 6,600 it exports 35% of output to Western Europe, mainly Scandinavia. In addition to a variety of standard glass products it makes handmade artistic glassware.



- **Fampa Pater Machinery Factory** in Jelenia Gora (prepared by N M Rothschild with Arthur Anderson) had sales of \$5 million for the first 7 months of the year, profits of \$1.43 million and fixed assets of \$6 million. Employees number 950 and 55% of sales are exported.

- **Gourmet Factory Prochnik** in Lodz (Morgan Grenfell) has sales of \$5.4 million, profits of \$3 million before tax and exports 45%. The company manufactures quality coats with 2,800 employees.

The two other transformed enterprises are:

- **Silesian Cable Factory** in Czechowice Dziedzice (prepared by Sankt Annae Bank from Copenhagen) which has \$15 million of sales, \$4.7 million profits and 560 employees.

- **Meat Factory** in Inowroclaw.

Transformation of two other enterprises was delayed but is expected to take place shortly. These are:

- **Tonsil** in Wrzesnia (prepared by Ernst & Young, Samuel Montagu and T Goddard), loudspeaker manufacturer with \$14 million sales, \$2.2 million after tax profit, \$5.6 million fixed assets and 3,000 employees. It manufactures 9 million speakers a year making it the third largest manufacturer in Europe and exports 30% of its output to West Germany, France and the UK.

- **Swarzedz Furniture Factory** (prepared by the International Finance Corporation) which has sales of \$15 million, \$2.4 million profit and 3,300 employees and makes solid wood quality furniture entirely for the German and Scandinavian markets.

The transformed enterprises including Tonsil are expected to be ready for sale soon. Except Fampa, all will be sold in a public offering. The lead receiving bank is likely to be Pekao SA, a Warsaw based bank which acted in the Universal issue last summer and the sale of government convertible bonds last autumn.

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## SPREADING OWNERSHIP THROUGH BUY-OUTS

Dr John Howell

Ernst & Young

I want to examine a few of the critical ingredients for a buy-out as a method of privatization and then look at how those apply to the challenges faced in Eastern Europe.

First, a buy-out will not succeed without the **support of the banking community**. There is a clear need to draw on the aid of the local banking community, though a contribution has also to be made by the workforce and management team. Local governments have a clear political need to avoid the criticism of selling the state assets too cheaply -- criticism which we hear in this country as well -- so the buy-out price has to be realistic. This means the sum to be raised can be sizeable, which sparks off two problems: one is that **bankers are cautious people** by instinct; and the other is that there may be **insufficient local money** in the right currencies to support the buyout.

One of the more imaginative solutions to the banking problem is the use of a number of the **venture capital funds** in Eastern Europe as a means of financing management buyouts.

Perhaps, though, the most important ingredient that any financier would look for is the need for the buyout to be led by a **quality management team**: and management expertise and management skills are qualities which have, by and large, been absent in Eastern Europe. What is required, clearly, is a management team that has the confidence, the commitment and the skills to convert their vision of where their business wants to go into a future reality. The absence of management skills training in Eastern Europe is clearly a disadvantage for this; indeed too often in our experience the management teams' vision is restricted to gaining nothing more than an additional source of personal income.

Clearly, for positive growth to happen, **the business must have some potential** and it would be a folly for management to think that they can make a success of a buyout when there is declining demand for a product that is out of date, or obviously unable to match competitive products. This is a particular problem for Eastern Europe, where many of the products are clearly uncompetitive, and for many of which there is no demand outside the rather artificial demand created from supplying to other members of the bloc, particularly the Soviet Union. Production technology is often out of date, and

this is again an area where Eastern Europe will be weak for a while until industrial rationalization occurs.

A fourth factor is that **support is required from employees**; if the buyout is to succeed the management must have the general support and goodwill of the workforce. To achieve a level of support amongst the workers the right incentives will be needed to motivate the workers -- bonus and profit sharing schemes for example. Through owning shares in the business they work for employees are likely to be keen to see the value of their investment grow. But is this really likely to be effective in Eastern Europe where often there is no confidence in the basic business which owes more to Stalin's industrial masterplan than to any economic rationale?

The final success factor is clearly an **appropriate** exit rate from the market for the investment. Employees, having put their life savings into their workplace, will want to draw the rewards when the value of their stake has grown substantially. In Eastern Europe the investment market is somewhat restricted by the problems of convertability of currencies and exit rates need to be planned with care.

With these in mind I would like to look in more detail at how employee participation is being viewed in Eastern Europe.

## EMPLOYEE PARTICIPATION IN EASTERN EUROPE

### Poland

In Poland, the Parliament has proposed that 20% of the shares should be sold to employees at a discount, calculated on the basis of employees' salaries, length of service etc.

The Government is seeking to have the Board of Directors of the Joint Stock Company that is created out of the state enterprise comprise two-thirds directors appointed by the State, and one-third directors appointed by the Workers Council. Opponents of the Bill have reacted that if the State still has more than 50% of the shares after the creation of the Joint Stock Company this should be countered by the Workers Council having more than 50% of the directors on the Board.

The key issue here is that workers fear that they are going to have less say in the running of their companies than before. After 44 years of a controlled economy the workers feel that they should be left with at least something for their toil. The thought of having lived through 44 hard years only to see the country's assets (which under the ideology of that time was said to be 'theirs') sold off to, among others, foreign investors, was not appealing.

Understandably there is concern that foreign investors will 'buy up' Poland. This concern is felt particularly in respect of German investment which is significant.

Attached to this concern there is a genuine fear of unemployment, as Krzysztof has mentioned, a phenomenon not encountered up to the beginning of this year. However, faced with the prospect of unemployment or their factory being bought by a foreign investor, many workers in traditional industries would prefer the latter.



There is a considerable doubt whether the Polish people either have sufficient money to purchase shares in their companies or would want to invest their money in the purchase of shares in their own company.

The Government is considering a voucher scheme (employees would be issued with vouchers which may only be exchanged for a limited number of shares in their own company); consideration has also been given to providing loans for employees to buy shares or to allow employees to buy in instalments.

On the other hand, Polish industry is badly in need of additional foreign capital which would not necessarily be forthcoming in abundance if the buy-out route was chosen. Clearly, foreign capital will still be required.

Other issues affect the prospects of a buy-out such as the valuation of the company. This is a sensitive area for employees believe they have the best idea of the value of their company, but they look at the issue in isolation from the market.

### **Hungary**

In Hungary there have been few management/employee buy-outs of any size that have been completed and it seems there are only a few possible transactions being considered where employee involvement is of any great significance. Management as such will, it seems likely, comprise only a part of ownership. Funding will be mainly international in source.

The issue of management buy-outs or employee ownership has not been warmly welcomed by the general public and the government in Hungary. There is a feeling of injustice about the process, that a small number of individuals may benefit while the general public could be worse off having lost a State asset.

The process that has occurred has seen Hungarian enterprise management criticised at times for entering transactions which benefit them but are detrimental to the State -- that is the price has been too low.

This feeling is tied to what has been a fundamental and recurring issue in Hungary, what is the 'fair' value at which State assets should be sold. Moves have been taken to solve the valuation problem. Moving from a relatively unregulated procedure for privatization, the process is becoming more structured with the establishment of the State Property Agency in March 1990 to review significant transactions involving foreign investment.

As a result of changes in the 1970s a number of State enterprises became co-operatives with management in the hands of all the employees. In these enterprises for a change of ownership to occur employee support will be required. This may be difficult where one in three may subsequently face job loss.

Management buy-outs and employee ownership have not been widely discussed or encouraged in Hungary. Perhaps this reflects an awareness that outside (foreign) investors are required for the management and expertise they bring. It is likely that management/employee ownership will increase as local expertise and experience encourages greater involvement. In our own company in Hungary, for example, there already is an employee ownership



scheme. Shares are issued to senior management whom they would make partners if they were in one of our conventional practices.

Another fundamental issue is the lack of internal funds, the high interest rate, which makes servicing loans difficult, and the lack of a convenient institutional structure to provide funds. In the short-term it is thought that local funds will play a minor role in the privatization of the economy.

In the recent privatization of Ibusz, which was the first Hungarian offer and partial privatization since the war, there are facilities for employees to receive a loan for purchasing shares, but I understand that an employee transaction has yet to occur.

## **Czechoslovakia**

The privatization programme in Czechoslovakia is very much in its formative stages. Privatization is a high priority of the new government; however, they recognise that to move too quickly without the necessary framework in place, may not achieve the desired result. Therefore the approach adopted is a cautious one.

Two pieces of new legislation were enacted with effect from May 1, 1990, which are the government's first steps toward privatization. The Act on State Firms enables state firms to be transformed into Joint Stock Companies. The Act on Joint Stock Companies allows such companies to be formed by any Czechoslovak or foreign legal entity or individual with an authorised capital of at least 100.000 korunas with similar requirements to that of a western corporation (i.e. incorporated by memorandum and articles of association).

Initially it is envisaged that the State will purchase 100% of the shares in the joint stock companies and then divest ownership of these to the company management, employees and the public at large. Exactly how this is to be done is yet to be formally determined.

The minister in charge of the privatization team in the Czechoslovak Ministry of Finance, Dusan Triska, has suggested one possibility of making the transition to privatization could be to distribute vouchers to all persons in the country which are then used to purchase shares in the newly formed joint stock companies. This is not the only method currently under discussion within the Ministry of Finance and a firm decision is not expected at least before the end of the year.

## **Soviet Union**

In the Soviet Union consideration is being given to joint stock company law. In the draft outline of the law it is envisaged that employees will be given priority in purchasing shares. It is far too soon to judge how the question of employee ownership will be viewed by the workers and the man in the street.

The new law regulating the relationship between and within Soviet domestic businesses, which was passed by the Supreme Soviet on June 4, 1990, envisages a situation where part of the profits of a business can each year be used to purchase shares in that business for individual employees. Although these shares do not in themselves appear to entitle the employee to participate in the management of the company (this is regulated through the wor-

kers' collective contract) they will be entitled to participate in future profits in the form of dividends and capital growth on redemption of the shares.

## CONCLUSION

In conclusion, if you believe that buy-outs of some size are unlikely to ever occur in Eastern Europe, take heart.

In this country the shining example of what can be achieved is National Freight Company. After suffering from general recession and after the loss of a substantial contract, the management bought NFC. They persuaded the banks to lend them £51 million and the employees themselves subscribed £6.2 million. Those who invested their savings saw a growth in their investment of more than 70 times. The company has now been floated and many of the employees are considerably better off than they were before the buy-out. The company is expanding and profitable. All this was built on a participative management style; high quality communications; first class consultation machinery with trade unions; a profit orientated remuneration structure which extended to wage earners to replace quantity-related bonuses; ability to measure profitability in relatively small units and a workforce which, given the opportunity, was prepared to take a share in the business. Where there is a will, there is a way.

It is early days in Eastern Europe and as the economies evolve, the contribution of the sole trader and the small businessman, the worker-owner, should not be forgotten. He will play an important role. As for the larger state-owned businesses, I believe that employee ownership will be a crucial factor in motivating the workforce and in helping the economic revival of Eastern Europe. I look forward to the next few years with great interest.

## OPENING - CAPITAL MARKET

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## PART 5 - PRIVATIZATION AND ECONOMIC STRUCTURE

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## CREATING A CAPITAL MARKET

John Burnham

J Henry Schroder Wagg & Co Ltd

I have been set a challenge by the Adam Smith Institute: to create a capital market in 15 minutes.

I suppose it could be done: we could sit down and select an enterprise together; we could issue free share certificates (we would have to issue them to a readily identifiable group, perhaps the consumers, the employees, or the enfranchised citizens of the nation); we could give them each a certificate and they would then be shareholders. And we could hire a venue, the town hall, and we could tell them that if they wish to sell their shares they could go to the town hall where they might find people wishing to buy them. I suppose there would develop at the town hall an open outcry system, which is how most capital markets in places such as London originally developed, and buyers would seek sellers and vice versa.

I suppose a capital market would then develop and intermediaries would start to grow up; they would greet you at the door and tell you that they already knew the prices and why didn't they take your shares from you rather than you have to push through the crowd yourself. Indeed, after a while there would be no need to go to the town hall at all because the intermediary would come to you, or he would make his services available through advertising and so on: prices would become clearer and the capital market would be underway.

In practice, of course, life is not quite that simple. You would need to charge for the shares -- very few governments are willing to give them away free -- and soon as you wish to do that you have an **obligation to provide information** on the company's track record and on its prospects in the future. It has usually, therefore, proved better to **commercialize** companies before issuing their shares so that you can really check where they stand: that too is a major exercise.

The market would be unregulated in my town hall and there might be a lot of insider trading; a lot of people might be deceived by some of the intermediaries. There would be no **legal framework** around the deals that were struck, and the capacity would be limited by the **administrative systems**.

It is quite impossible to cover all those points in any degree of detail and the City, as you have doubtless discovered, is well stocked with accountants and management consultants and bankers, anxious to sell you their services



to implement exactly all those detailed measures needed to set up the market.

So what I am going to do instead is to comment, from the base of my experience and also that of Schroders, on the purpose of setting up a capital market, in the hope of making those of you who are faced with that challenge sit back and think for a while about what you are trying to achieve and how best to achieve it. If you do that before you embark upon it you should avoid a lot of the pitfalls and have a greater probability of success.

On that note I need to say that there are very few of you who are going to create a capital market. I travel widely and I have yet to come across a country that doesn't already have a capital market. It might be a group of money lenders, sitting next to each other on the street, setting up a debt market; it might be the black market in foreign exchange; but almost any country has a capital market and what we are really talking about is a matter of degree. Very few of you need to create one from scratch but many of you will be interested in formalizing it, in deepening it or broadening it.

### **Be clear in your objectives**

The first thing in doing that is to be clear whether setting up a capital market is in itself your objective; whether it is going to be a consequence of something else you do, or whether it is a tool that you are going to use to achieve other aims. It often becomes an obsession pursued for its own sake, but I contend it should very rarely be an objective in itself.

There are rare exceptions: one is probably Singapore. Far be it for me to pre-judge or to guess the mind of Lee Kwon Yew but he has got a privatization programme running despite the fact that his government-owned companies are extremely well run and the envy of many other countries. So, what is his motive in privatizing them? I think in that case the chances are that one of the main motives is precisely to broaden and deepen his capital market. He had lost listings with Malaysia (the two exchanges have just separated, although you can in some respects still trade Malaysian stocks in Singapore), and perhaps he realized that without the Malaysian stocks his market was very limited. And my guess is that he decided that if he sold some of the government-owned companies then he could deepen and widen his stockmarket because he wants Singapore to be the leading financial centre of the region. and, therefore, with that objective it is logical for him now to broaden and deepen his capital market for its own sake.

Yet that is a rare circumstance; in many cases development of the capital market is a consequence of privatization, and I suppose that is true of London. When we sold the water shares we had a very well established stockmarket, so we had no need to sell them to help the stockmarket; but at the same time the *Financial Times* lists ten water stocks which between them make up a really major part of the capitalization of the market. And so, as a consequence of privatization, we have a new sector in the London market: you can trade freely and in very large amount in water utility stocks.

### **Choosing the right tools**

But in most cases it is not going to be your objective solely to set up the capital market, nor is it going to be a consequence of privatization, but setting up a capital market is going to be a tool to help in a much bigger policy trend: a trend towards private ownership, towards deregulation, and towards increasingly commercial attitudes. And in those circumstances it is therefore vitally



important to establish what the job is to be done and therefore what type of tool you need. You have to design the tool according to your purpose. And you need to be pragmatic just not about the type of capital market you want but also about the speed with which you can see it develop.

As I talk about capital markets most of you will be thinking of stock markets, secondary trading of shares: but of course capital markets are widespread phenomena and they go well beyond that. The primary market for the issue of shares is a capital market in itself: of course the secondary market is another form; but then there are the **debt markets** as well as the **equity markets**. And then there are the derivatives, the trading futures, interest rate hedges and so on.

The pride of many countries demands that they try to set up a stock market as a flagship; but in many cases that is a distortion which diverts scarce resources from sound investment, and perhaps it is more helpful to commence the process by another method.

It is perfectly possible to establish private companies without a stock market. It is true that long experience suggests that an active stock market is the best way to maximize the available capital both by mobilizing domestic funds and helps institutional investors from abroad: corporates from abroad may come in readily but institutional investors are usually assisted by the presence of a stock market. It is also the easiest way of permitting wider share ownership because it is the easiest way of permitting individuals to buy and sell easily. But markets develop in response to demand, not the false calls of bureaucrats, and the fastest way to ensure the success of the markets that you create is to concentrate on creating demand to buy and sell shares; if you can create the demand, by and large the market will take care of itself. You may well at the same time want to put in place the structures and the procedures and administrative systems but it is fundamentally important that you should create the demand.

So I maintain that when you are starting a privatizing programme you do not need the maximum availability of capital or the easiest way to exchange shares. There is nothing to stop you doing it without a stock market. I understand that Poland has sold Universal in a public offering even though there is no secondary market yet in which to trade its shares.

You can do **corporate and trade sales**, you can do **management buyouts** and **employee buyouts**, you can implement **privatized projects** -- new projects which would normally have been part of the public sector but which for various reason you want the private sector to do in future. Of course lots of interim stages are possible in doing this: for example you might allow those transactions but make it a requirement on the people who purchase the companies that they are obliged to list in due course once there is a stock market.

Another interim measure which is interesting is to **set up a unit trust**. Shroders has been advising under a USAID funded project the Malawi government on the divestment and restructuring of the government holding company ADMARC, and the idea was partly to reach small investors. When we sat down to work out how to do that without a stock market we recommended that they establish a unit trust into which they put shareholdings in quite a lot of the government-held companies; and in a way that reduces the stockmarket to its simplest form. You have at the start one unit which represents a spread of companies, which you can buy and sell.



There is then of course the problem of liquidity for a small shareholder, and in that case we have proposed that the international agencies should stand behind the unit trust in providing that liquidity for the small investor while a larger investor can only trade if he can find a willing buyer. If one takes the model further one could envisage that having established one unit trust one could then set up more specialist unit trusts in different sectors. One would then have more stocks to trade, the thing would start to grow and eventually individual company stocks would separate out.

### **Primary markets and debt markets**

If we leave the steps towards a natural stockmarket behind there are measures you can take in the interim to free-up the primary placement market -- placing to funds and institutions. And that is mainly a question of unlocking resources; many countries have pension funds and government managed funds, and it is a question then of examining the regulations on whether they are permitted to invest in the sort of companies that you want to privatize.

Please don't forget the **debt market**: it is just as much a capital market as the share markets and it makes many things much easier. It makes corporate sales or trade sales easier, and management buyouts and employee buyouts are easier. So are privatization projects: you can do far more of them and they are easier to implement if you have a well-established debt market. The reason is that there is no need to provide all the equity: you can gear the company for purchase, and therefore spread the equity that is available across more companies and more privatizations.

Most countries would find a debt market much easier to establish; most have a quite well established debt market anyway; most have banking systems. Maybe the banking systems are not tuned to long-term or medium-term lending to newly privatized companies, but it is much easier to focus on adapting those systems than it is to start a market completely from scratch.

Take the example of Malaysia, where privatization has been very successful. If we look behind that and try to see some of the reasons, it is revealing. Of course there have been some stockmarket issues -- the Malaysian Airline System, the International Shipping Corporation -- but there have been corporate sales too and there have been quite a lot of privatized projects. One of the main reasons that those aspects of their privatization programme has succeeded so well is that Malaysia does have a well-developed debt market. It is possible to raise Malaysian dollars at reasonable rates. And the local currency is very important: many of the companies that you want to have listed will have only local currency income, and one of the fundamental problems, particularly for foreigners going in, is the exchange risk involved. If you can fund a large part of the purchase with local debt, then the degree of the exchange risk on the foreign investment is much reduced.

Another feature was that Malaysia had a fixed market, and here cause and effect begin to become entangled. The **fixed rate market** permits you to raise fixed rate Malaysian dollars for quite long periods, out to perhaps ten years. Malaysia's privatizations could have been done funded at floating rates, but in looking to optimize the funding, those responsible made use of the fixed rate market, and in doing so they established it more firmly; and so cause and effect became intermingled, and the capital market and the fixed rate market in Malaysia started to develop because of privatizations. And then because it has developed, more privatizations can be done more easily in the future.



And that brings me to my conclusion which is that there are, as with many things, virtuous and vicious circles in these things. In the case of Malaysia it was a virtuous circle. Any form of capital market, however rudimentary, can permit some form of privatization: and privatization itself is then likely to extend the capital market and make it less rudimentary, thus permitting more forms of privatization; and so the bandwagon rolls along. At the same time it is possible to get caught in a vicious circle; if people believe there is no effective capital market, then there may also be a perception that no privatization can be commenced.

What I would advocate is that you do the minimum to start the ball rolling. You should not exclude thorough and detailed preparation of systems and markets and regulatory arrangements; but if you do the minimum to start with and commence the privatization process, so the natural forces of the market will be working alongside you as you proceed to set it up in detail and in a more formal way.

## QUESTIONS AND DISCUSSION

**Question:** One of the selling points for privatization is the development of the capital market in the broad sense. It is a very effective selling point because most of the countries which are developing would need a strong capital market to raise resources and to generate and mobilize the savings. The experience in the UK is that there has been a tremendous increase in the number of shareholders as a result of privatization.

But another observation about the UK experience is that a very large number of shares have slipped into the hands of the institutional investors, so the advantage of involving the small shareholders has been neutralized to some extent by the shares slipping out of their hands into institutions.

I would like to ask Mr Burnham if he has any advice to give to the developing countries regarding any precautions which may have a positive impact on the developing of the capital market.

**John Burnham:** I agree on the point about the widespread distribution of shares and the popular success in selling the concept of privatization that it engenders; and on the fact that in Britain a lot of the shares have actually flowed back to the institutions. Of course that is right; but I think there are some comments to make on it. The first is that popular success itself derives from the profits that those individuals make. People go into investments to make profit and if you deny them the opportunity to make that profit then there would be no point in giving them the investment, and equally the popular success would disappear. So the two are interlinked, and it is an inevitable consequence of the popularity that you will get some throwback towards the institutions.

The second thing is that it is actually quite surprising how many of the shares have stuck with individuals. We have just been chatting to the Water companies who we worked with before they were floated, and the number of individual shareholders and consumers still on their registers is really quite surprisingly high in our view, rather than the reverse. The premiums are high, and we would expect them to take their profits.



As to measures to help achieve a wide spread of ownership, one is to demonstrate that the company has a future and is not merely about the premium on the initial sale -- that it has a future and that it is worth staying in as it trades on up. The second is actually to institute measures to stop people selling, not to physically restrain them but to give them an incentive of the sort that we have done with our consumers -- encouraging them through reductions in their bills or whatever, so that they have not only the dividends but also another incentive to hold the shares for some time.

**Mr C Njoku (Nigeria):** The problems that you have in developed economies are quite different from the ones you have in developing economies. For example, when you talk about public ownership, the basic idea is that whatever is held by government belongs to all the citizens of that country, and therefore if the government decides to sell, every citizen of that country has a right to purchase -- and should be given all the opportunities to purchase. Therefore, the principle of widespread share- ownership is paramount. That cannot be achieved without a meaningful capital market.

**John Burnham:** The principle of the ownership of public sector entities by the citizens, I have a lot of sympathy for. At the same time I think there is a logical gap there that is filled by the capitalist system. If the citizens own something and it is sold to one individual, if the price was right then the citizens were in the same position -- the public sector has received the correct price for the asset it was selling. And so we then fall back on the discussion about what the right price is, and of course if the price is perceived to be far too low then the individual has gained at the expense of the public, and if the price is too high then the reverse. But I think the fundamental capitalist system provides a mechanism to deal with the political problem you have of not actually distributing a share to each person, and that is done through the price mechanism.

**Andy Baldwin (Price Waterhouse, Africa):** What about the possibility of developing the debt market rather more in such countries? Do you see that it will go the same way that it has gone here and elsewhere? Or possibly more use of debt swaps, and other things linked specifically to LDC situations?

**John Burnham:** My only response is to say that you are entirely right, and I think there is a limit to which the experience can be transferred from one country to another. And even if one has very broad experience of many countries the next one is always going to be unique. Some of the lessons are generic and can be transferred and can shorten the learning curve, but others need to be developed on the spot to solve the particular problem.



## THE LEGAL AND ACCOUNTING FRAMEWORK NEEDED

Iain Murray

Linklaters & Paines

In privatization, the legal and accounting framework must be a realistic and practical servant of the apparent political and economic aims. But what is appropriate in Germany may not suit another country or indeed another region, systems and procedures need to be pragmatic and not uniform.

What do I mean by privatization? It is the process of transferring property, belonging to the state, to the private sector; and by private sector I mean the local private sector. And when I talk of property belonging to the state, I am mindful that if there is any dispute about title then it may be necessary to effectively nationalize it first before you sell it. The state property can be given away, it can be passed to employees on favourable terms, it can be sold to joint ventures, and it also can be sold to the man in the street if he has got the necessary savings and does not gear himself up too high.

### Minimum requirements for privatization

What are the minimum features of a privatization programme? There should be a **constitutional right to own property**: if you have a written constitution that probably takes about three lines, if you have got unwritten constitution such as in the United Kingdom, it probably takes a very large book.

It is also necessary to make sure that the **regulatory bodies** have sufficient powers to do the tasks which you will want them to do, and these may not be so obvious at the outset. The civil law gets quite complicated in realms of administration, and it is important that if you think that the key regulator, for example, is the central bank, that you make quite sure that the necessary constitutional powers are there.

The next thing is that **funds must be available** and that you can manage the transfer of ownership in order to **protect the local market**. Savings, presumably, will be at a premium, and the capacity to take on risks requires an ability to remain solvent, having regard to contingent and prospective liabilities.

A system of **exchange control** and control of capital issues at the outset is probably a sensible strategy. The old UK system of exchange controls was very effective -- you could not do anything without the consent of the Treasury or the Bank of England, although they largely sub-delegated their powers to clearing banks and even to solicitors. So if you wanted to raise any money at all, you had to get permission from a board -- the capital is-



sues committee. But by a process of development the regulatory framework was eased and consents made more general, and gradually the whole thing was run down. I think you want to have these weapons to protect the local market because I imagine that you want to protect the family silver, at last for a decade or two. It seems to me that this can all be done initially under the control of a central bank.

Then we want a **fair description of the property** and associated risks, including in the case of companies a description of assets, liabilities, financial position, profits, losses and prospects; as well as the securities being offered.

I have to say that **you do need some lawyers** but you can get it down to two: one on each side, one for the vendor and one for the purchaser. Where the man in the street is involved the purchaser is perhaps an issuing house or something like that, selling the securities on the offer-for-sale technique and acting for the private interest.

You can make much use of legal consultants, though they do not necessarily have to be local lawyers. What you have to do is to give them tight instructions and a tight control on costs and then you should be quite happy. The local lawyers can be brought in to deal with local issues. It is basically a question of applying a technique rather than fine details of law.

It is important that the public understand what it is all about and so **prospectuses should be written in plain language**. You cannot expect the public to understand concepts such as accruals or the fact that the balance sheet does not necessarily show realizable value. The main problem will be presenting the history of the business in a form which will be similar to the way that it will be necessary to present it in the future. That is where the **accountants' long form report** comes in, and that is a technique which I think everyone should be encouraged to follow. It does not have to be prepared by the local accountant, but again the terms of reference are critical and important for keeping the costs under control, whoever you employ. But the financial issues and problems must be identified at the outset, so that everyone who is concerned with the prospectus can see what the issues are. Such a long form report can evolve and change right up to the time that the prospectus is finally issued.

I do not think it is necessary for balance sheets to be presented on the basis of a 'true and fair view' as we insist on in the UK: there has been much discussion of what 'true and fair view' means, and it remains a difficult concept which needs local interpretation and local law; and it is not something for export.

It would help to have a **basic statutory book-keeping system** which was readily understood. The books should be adequate accounting records sufficient to enable a balance sheet to be drawn up at any time, and they will need to be audited and the vouchers checked against what is in the books. You cannot write up the books long after the relevant date, if you are going to have a serviceable system. You cannot have paper bag auditing, where a manager throws his invoices in a paper bag and at the end of the year tells the accountant to prepare his balance sheet; because there are no books available during the year and nobody knows whether all the papers are in the paper bag.



For this reason I think it would be helpful to have **an audit commission** to gradually develop the accounting regime. That body should have academics in a very small minority and should comprise mainly practical people.

Another facet is that we need a **system for impartial and expeditious adjudication of complaints** and the protection of private rights. Many of these issues can be dealt with by a tough and efficient regulator, especially if trading licenses can be revoked. But there will be a role for the courts, or a commercial court; it must be expert, expeditious, effective, impartial and beyond reproach. Factual disputes can be resolved on an inquisitorial basis rather than an adversarial basis if you wish. But in any event, there must be a sensible system for the speedy collection and assembly of the facts; and the judicial function will be to apply the law to the stated agreed facts.

And we need an effective, efficient and responsible **system of market regulation**. Rome was not built in a day and the market must be allowed to develop in a pragmatic fashion from small beginnings to something wider. There must be an authority which can effectively police it. It will be concerned to see that internal controls are monitored so that capital is sufficient for credit risk, position risk, settlement risk and base capital. Above all, competence and probity must be assured -- voluntary codes and practices can be of great assistance, especially if breach means loss of licence.

Care must be taken to see that there is a **sensible settlement procedure**: cash moving one way and documents or computer entries moving the other way. It is important to see that the market is properly informed and there is no false market and no manipulation; likewise to prevent insider trading.

Finally, there needs to be a **coherent system of corporate law**. There are many models, both domestic and in the EEC: the Fifth Company Directive and the European Company Statute are both guides, although the duties of directors and the powers of minority shareholders are much stronger in those than they are in UK law. There are good arguments for having a supervisory board between management and the shareholders. The ultimate risk is important, and that requires a system of **insolvency law** whereby creditors and shareholders can put an end to companies' trading.

**Insolvent trading and unfair preferences** need to be addressed. Moral hazard is the enemy of capitalism, and it is imperative that the duds go to the wall. It is vital from the outset that all concerned should realize that rescues are to be avoided in all but the most exceptional circumstances. That again argues for a deliberate and careful process of privatization rather than a mad rush which ends in tears.

## PRIVATIZATION IN AFRICA: GOOD EXPERIENCES TO DATE

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### PART 6 - NEW INVESTMENT, NEW MANAGEMENT

There is a growing body of evidence that the privatization of state-owned enterprises in Africa has led to significant improvements in efficiency and profitability. This is particularly true for the telecommunications sector, where the introduction of competition and the privatization of state-owned enterprises have led to a rapid increase in investment and a significant improvement in service quality. The evidence also suggests that the privatization of state-owned enterprises has led to a significant increase in the level of investment in infrastructure, which is a key factor in the growth of the economy. This is particularly true for the telecommunications sector, where the introduction of competition and the privatization of state-owned enterprises have led to a rapid increase in investment and a significant improvement in service quality.

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## PRIVATIZATION IN AFRICA: CDC's EXPERIENCE TO DATE

Alistair Boyd

Director of Operations for East,  
Central and Southern Africa,  
Commonwealth Development Corporation

Let me start by looking at CDC itself. In Treasury-speak we are categorized as a non-departmental public body accountable to Parliament through our sponsoring ministry ODA -- we are in fact a parastatal. That may not sound a very promising start or even particularly appropriate in this context: but we are very conscious of the need to be both efficient and cost effective. (Whilst it may not be too easy to identify any industry norm against which we can judge just how efficient we are, there are national and multinational development finance institutions with which we can compare our costs and investment ratios, and indeed the return on funds employed).

There are five factors about CDC which I would like to suggest commend themselves in advancing the commercializing process.

The organization has an **independent board**, appointed by the Secretary of State; but we have no civil servants or sitting MPs on the board, it is drawn entirely from the private sector and from non-governmental organizations.

Secondly, and extremely important, the board has the entire **responsibility for appointing the management**. And as in the private sector, I am subject to hire, fire, redundancy and to merit salary increases.

Within the overall parameters agreed with the UK government, the **investment decisions** taken by the organization are entirely those of the board acting on recommendations emanating solely from management.

Most importantly of all we have very clear targets and objectives with regard to the **type of business and country** spread with which we are involved.

And finally, our mainstream business, that of financing and managing projects, must all be **financially sound**, self-sustainable, and in addition must meet economic development criteria.

In consequence of all this, although ultimately we are owned by government and not free from nudging and pushing, it has not inhibited us from acting in a businesslike manner and in using the same tools as the private sector.



Perhaps the very fact that we know what it is like to live in that twilight zone betwixt the parastatal and private sectors, gives us some particular expertise in the commercializing process in Africa. The many constraints to private sector growth in that continent be they political factors or the all too slow emergence of an all too few number of African entrepreneurs (and even fewer with money) -- has already been well documented. And apart from Nigeria, it is not so easy to list many privatization success stories. But then it is early days. We in CDC have made some mistakes but at least we are beginning to assemble our different strategies.

Take for example two countries: Malawi and Tanzania, both struggling with the process of shifting assets out of state ownership and control. Whilst Malawi has had no particular psychological barrier to the idea of individual ownership and prosperity, it does still have to contend with the twin problems of a low economic base and too few entrepreneurs. In Tanzania, the debate has had to cope with the added complication of a long passionately held philosophical attachment to state ownership. Just about every activity was state owned and state run, whether a public utility, a production unit, a marketing board or a trading organization, even the local travel agency.

It is abundantly clear that attitudes are changing. In Tanzania, the Minister of Finance assured me that his country really had swallowed the medicine. But of course it takes time to restore the confidence of investors.

### The issues to resolve

Let us have a look at some fundamental questions that we have had to ask ourselves in connection with one particular divestment programme that we have been involved in, the Tanzanian Tea Authority.

By far the most difficult task in the process of divestment has been to determine the present physical state and hence the value of the existing assets which the government wishes to shed. It is not an easy task to verify just what exists physically for offer, particularly when it comes to extensive areas like tea. There was, for instance, no survey available of the planted area, and that gives rise to some difficulty when in East Usambara there was something like 16 million tea bushes to inspect. There was no official indication of the presence -- which of course you only discover on a survey -- of two particularly nasty species of termite nibbling at the roots of the bushes. What management records and accounts there were turned out to be grossly inadequate.

So the question becomes one of deciding whether anything at all should be saved. Why not start with a green field project rather than try to rehabilitate? So one goes through the whole valuation process once more. Fortunately in this particular instance we did in fact conclude that it was worthwhile rehabilitating; and the government was equally grateful because it is embarrassing to be stuck with an asset that is acknowledged to be worthless.

But how do you set a value on the existing enterprise? Perhaps this is the most difficult area, and it is delicate and sensitive. The sad facts common to five of the six divestiture programmes that we have been involved in were that all the enterprises were unprofitable, all lacked adequate management, all were starved of funds for working capital and new development, all lacked foreign exchange, all had far too many people doing far too little. The five all needed a new injection of money and the sad fact was that this new injection



would inevitably swamp the existing balance sheets and hence the value of the existing asset. Only one of the companies that we have been involved in was relatively profitable, and there we found extremely easy to go through the privatization process because it had assets which were earning profits and on which a value could be placed, so the potential earnings were therefore fairly easy to ascertain.

Intending vendors of the five talked hopefully about valuations based on depreciated current replacement cost. We, representing buyers, had to bring the conversation around to the potential stream of future earnings, and the return on new money. New money has its own expected rate of return -- it is, after all, new money that is going to make the thing work, so the new money should be satisfied first. So we must think about the new debt servicing, including the repayment, and about the new risk capital that is going to be put into the venture. It is only after one has worked through the long-term cash-flows to find out whether the minimum satisfaction can be provided for both your new loans and your new equity, that you can calculate what is left over for the original shareholder.

The missing ingredient in most financing packages is equity. Why is it missing? It is not just the difficulties of the perceived investment climate in many countries, but also the attitude that people have towards risk capital. risk capital is usually last to be serviced; central banks do not understand that dividends really should come at the front of the queue and not at the back of the queue; and perhaps ministers of finance also need to accept the fact that capital appreciation (even through a re-valuation of assets) is a legitimate gain for those who put up this most valuable form of capital.

It may be possible to approach the process in stages and this is something we have done both in Malawi and which we are currently looking at in Zambia. There is a halfway house: a concept which we have been looking at and which we think does merit some effort. The great value about the idea of renting the assets while everybody makes up their mind what they are really going to do, is that it postpones having to value an enterprise prematurely, while it enables one to accelerate the commercialization process.

But it remains extremely difficult to decide then how you are going to route your new money, whether into a new institution or into the old parastatal institution, and what sort of security you want for that. I would claim that the only security that anybody can have for putting new money into those sorts of assets is not the actual physical value of the asset itself but in the cash-flows that are going to be generated from an operating business. And, hence a lien on export proceeds or sales proceeds generally would be the best form of security.

#### **For whom the benefit?**

CDC is not in the business of development merely to hang on to a successful enterprise. We are fully prepared to turn over our investment. We are a sort of equity warehouse to develop assets in a businesslike manner for handing on to successor shareholders as they emerge through the system, whether they be individuals, unit trust or companies.

Their participation in the ownership pattern will tend to be more sure and sustainable when there is a local mechanism for exchanging shares, and when values are determined by the marketplace rather than by reference to a remote World Bank price index. For this reason agencies such as the IFC,

the CDC, the DFI and USAID are all looking at the possibilities of establishing financial intermediaries and institutions.

We are ready to join hands financially and managerially with the private sector in the UK, and indeed in other metropolitan countries, and with governments in developing countries themselves, in helping to make the process of commercialization a reality. Let us extend a helping hand.



## PRIVATIZING AN AIRLINE

Michael McGhee

Barclays de Zoete Wedd

An understanding of the forces shaping the development of the industry is critical for governments making decisions on when and how to privatize airlines.

Airlines have proved to be very suitable as early privatization candidates, although there are exceptions. Airlines are glamorous, high profile and, in developing countries, often among the better run businesses. That is not of course to say that implementation is easy.

I would like to begin with the investment needs and managerial skills required to achieve and sustain a successful airline, and to comment on some of the forces shaping the industry to demonstrate that the privatization of an airline cannot be considered in isolation, and that the issue of strategic alliances or even mergers with other airlines is of crucial importance. I will then make some observations on Europe in general and Eastern Europe in particular.

### Investment and managerial requirements

The world's airline industry continues to grow rapidly as a result of lower real travel costs, rising incomes and population growth. Air travel is forecast to grow at a compound rate of 6% per annum, which means that it will double in about 12 years. But **investment in new aircraft is required** to replace ageing current aircraft (many of which do not meet proposed new noise regulations) as well as to meet new demand. And the cost of new aircraft has risen reflecting the huge research and development expense incurred by manufacturers.

Boeing Commercial Airplane Company's 1990 *Current Market Outlook* predicts that nearly 10,000 new aircraft will be delivered between 1990 and 2005 at a cost of US\$626 billion in constant 1990 terms. About 30% will be in response to retirement of aircraft currently in use and 70% will relate to growth. Annual deliveries of aircraft will rise to US\$38 billion between now and the end of the century compared with US\$17.4 billion in the previous ten years. All areas of the world will need to invest heavily in new aircraft. The biggest increase in requirement in percentage terms is the Asia Pacific region.

**Selecting the best equipment** for the purpose required is vital for an airline. But under state ownership there is often pressure to select a particular aircraft or engine type for reasons unconnected with the business.



Major expenditure is also required on **maintenance facilities and information technology**. Advanced computer systems are of crucial importance. Computer reservation systems are vital tools in surplus seat and yield management as well as selling tickets. Computerized terminal services and maintenance and inventory control are other examples.

Airlines need access to very substantial sums for investment and they need to be free to manage capital expenditure programmes over several years **without bureaucratic controls** and free from public expenditure constraints. The air finance industry is well developed and willing to channel large amounts of low cost funds to viable airlines.

### **Structural challenges to management**

Outside the US, the airline industry has been, until recently, relatively stable with little evidence of structural change. **Protection and regulation** have been such that it has been possible for many airlines to be run by management on the basis that results are assessed simply by reference to operating an existing route network. There has been little external pressure for change and this, coupled with the absence of private sector financial disciplines, has made it difficult to achieve an adequate level of efficiency.

By contrast, British Airways demonstrates the impact that a high quality private sector management can have on a state airline. Under Lord King and Sir Colin Marshall, BA's service levels have been transformed; its services are well marketed; its route network has been expanded; yields have risen through sophisticated yield management techniques based increasingly on information technology; load factors are up; and aircraft utilization has improved, along with staff productivity. And the airline is run as a business, not simply an efficient operation.

But BA had many advantages before privatization; notably its size, its extensive route network, its fleet and the hub at Heathrow. Many of the world's state owned airlines operate out of relatively minor airports with ageing or inappropriate aircraft. And most are relatively small. Installing new management recruited from the private sector to prepare the airline for privatization is simply not an option for Eastern Europe, for example.

The world's airline industry is entering an era of profound change. The commercial forces unleashed by deregulation in the US and liberalization in Europe will result in more competition and lower fares which in turn will stimulate more demand for air travel. There will be a need to improve efficiency and achieve a critical mass to compete effectively. Change will, however, be influenced heavily by domestic and European Community regulatory authorities.

### **Lessons from US airline deregulation**

Much of the pressure for change in the European airline industry can be traced back to the 1978 deregulation of the US industry. Deregulation in the US was accompanied by a sharp increase in oil prices, a major worldwide recession and excess aircraft capacity. Several new low-cost airlines started up, taking advantage of the opportunities offered by deregulation. This increased the downward pressure on fares, which further stimulated traffic growth. Major carriers whose managements did not adjust quickly to the new conditions and who failed to cut costs ran into difficulties and in many cases went out of business.



Airlines developed 'hub and spoke' route systems with a system of routes channelling 'feed' into selected airports 'hubs'. This type of system offers many advantages in terms of efficiency and improved frequencies. And airlines sought to dominate individual hubs to achieve a position of local market advantage.

In the last few years of the 1980s a rapid process of consolidation took place as airlines sought to reach a critical mass as it swiftly became apparent that only a handful of major airline groups would survive.

What then did the successful airlines get right? The key factors were:

- low cost, efficient operations;
- access to a major computer reservations system;
- a major share of traffic at the airline's main hubs;
- an efficient traffic feed system into hubs; and
- a financial strength enabling new aircraft orders to be placed on favourable terms.

The competitive challenge which the efficient US mega-carriers present to European airlines creates pressure for change in Europe.

### **Western Europe's deregulation**

In Western Europe, there has only been limited liberalization of routes as a result of bilateral agreements, for example, between the UK and the Netherlands. In 1987, European Community directives set out transitional competition rules until 1992, the target date for a unified West European market. The transitional arrangements facilitate market entry and encourage cost related fares. On December 5th, 1989, the Council of Ministers agreed on a package of principles for future liberalization to be implemented in two stages, in November 1990 and January 1993. The measures are directed at market access, capacity, air fares and fifth freedom rights.

So now Western Europe's airline industries are in the first stages of restructuring. The privatization process has begun over the last few years, and tactical and strategic alliances involving cross holdings have become increasingly common as a prelude to the forthcoming liberalization.

### **Challenge for the East**

The prospect of a revitalized Western European airline industry will increase the challenge facing Eastern Europe, where local airlines have operated in a highly regulated environment. Their costs and revenues have been partly denominated in hard currencies and partly in non-convertible local currencies. Fares have been distorted and often bear little relationship to true costs, and many expense items (particularly fuel costs) have been subsidized. As these distortions unravel, inefficiencies will be thrown into sharper relief.

It is difficult to generalize but I would pick out four main problems facing Eastern Europe's airlines.

The first is the **fleet** which predominantly comprises Soviet built planes that are unreliable, inefficient, difficult to maintain and (in many cases) do not meet new noise regulations. The scale of investment required in new aircraft is immense and although this can partially be satisfied through operating leases, it is unattractive to rely solely on this form of finance: aircraft have

represented excellent investments, retaining their value well, but these benefits fall on the lessor rather than the airline in an operating lease.

The second is **infrastructure**, by this I mean the airports -- management of which is often outside the control of the airline -- support facilities (such as maintenance) and transportation arrangements from the airport to key destinations within the country.

Thirdly, **management**. Service levels are generally poor and management does not have the support of sophisticated information systems. There is a general lack of commercial motivation, incentives, business planning and financial disciplines.

And finally **size**. None of Eastern Europe's airlines approaches the size required to compete effectively in the industry.

So what can be done? The strategic choice facing the various governments in Eastern Europe is to continue to run the airline under state ownership or to privatize.

The consequences of not privatizing could be severe. At a time when each country is seeking to rebuild its economy, its transportation links are critical. By continuing under state ownership the risk is that a country's airline will continue to struggle and that its main airport will be passed over as a potential East European hub. This in turn will undermine efforts to regenerate the economy, and trade and business are likely to suffer. In a nutshell, not just the airline but the country will suffer.

In stark contrast, privatization, if handled well, gives the opportunity to create a hub, generate more revenues for the airline and improve the country's transportation infrastructure.

There is, therefore, a strong case for airline privatization to be considered as a high priority in Eastern Europe. In order to address the key issues of management, investment and size, serious consideration should be given to the sale of equity to foreign airlines. Structuring this in a way that works effectively will be a major challenge for the privatization of these airlines.

In summary, there is certainly a need for airlines to be well managed. There is also a need for massive capital expenditure on new aircraft, support facilities and computer systems. In most cases, there will be a need to forge strategic alliances with other airlines in order to be part of an airline grouping with the critical mass and resources essential to compete in the 1990s and beyond. Airline privatization should be considered as a high priority, but an understanding of industry and regulatory issues is the key to making that privatization strategy successful.



## **MALAYSIA'S EXPERIENCE IN PRIVATIZATION**

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The purpose of this paper is to share the experience of Malaysia in privatizing some of its activities and services. The paper will provide a background to the adoption of the privatization policy in Malaysia, the objectives of privatization, the various forms of privatization being considered and its implementation in Malaysia, and issues and problems of privatization.

### **Background to the privatizations**

Privatization, as you are all aware, involves the transfer to the private sector of activities, assets and liabilities which have traditionally rested with the public sector. In Malaysia, the idea of privatization was first considered during the early 1980s. The prolonged world economic recession which began in 1979 and continued into the early 1980s had led to resource constraints and growing pressure on the Government budget. It slowed down the Malaysian economy and led to government trimming its expenditures from mid-1982.

The recession caused a re-examination of the role and priorities of the government. It was found that governmental presence in various areas of the economy had become pervasive. Government was not only involved in providing basic services and infrastructure, it had also become involved in activities normally within the purview of the private sector -- such as cement manufacturing, banking services, the steel industry and others. Consequent to the growth of government in Malaysia around the 1970s the public sector budget grew at a very fast rate. The bureaucracy expanded and there was growing tendency to regulate economic activities. There were about 1,000 government-owned companies and the government directly borrowed and guaranteed the borrowing of government-owned and associated companies for the purpose of investment totalling not less than M \$29 billion (US \$10.7 billion). The problem was that many of these companies did not fare well due to, among other things, lack of managerial skills, rigidity and lack of responsiveness to market forces.

These were the 'push' factors for privatization. On the other hand the growing maturity, strength and sophistication of the Malaysian corporate sector was a 'pull' factor that was taken into consideration. It was also observed that the experiences of the United Kingdom and other countries in privatizing government-owned entities were favourable and encouraging. It was therefore decided that Malaysia should adopt the privatization policy.

## The objectives of privatization

Privatization as a policy was decided upon by the Malaysian government in 1983 when it was decided that selective government-owned services and enterprises would be privatized. In 1985 a directive was issued to all ministries and agencies to examine the programmes and activities and consider the feasibility of privatizing all or part of their activities. The key objectives of the privatization are as follows:

- relieving the financial and administrative burden of the government;
- to promote competition and raise the efficiency and productivity of services provided by government agencies to the public and to the private sector;
- to accelerate growth in the economy through greater private sector participation;
- to reduce the size and presence of the public sector in the economy; and
- to meet the targets of the New Economic Policy (NEP).

## The forms of privatization

Privatization in Malaysia takes various forms, depending on the nature of activities to be privatized as well as other factors. In its most common form, privatization is the transfer of ownership and control of an existing enterprise, activity or service from the public to the private sector. Privatization may be 'complete' in which the entire ownership (100%) is divested to the private sector, or it may be partial. In partial privatization, control of the enterprise is exercised in accordance with the proportion of government ownership. In selective privatization, only a part of an agency's services is privatized and that may be sold or leased to the private sector. Privatization can also mean using the management expertise of the private sector while the government retains complete or almost complete ownership and control of the enterprise. The contracting-out of certain services to the private sector is also considered a form of privatization.

### SOME FORMS OF PRIVATIZATION IN MALAYSIA

Form	Examples
divesting part of the equity of a government-owned enterprise to institution & individuals	MAS MISC
by private participation in industries monopolised by the government	TV3
contracting out certain services such as the construction of roads	North-South Highway contracted to United Engineers (M)
a government agency sells or leases out a part of its services to the private sector while retaining public ownership, control and management	container terminal at Port Klang



So far a total of 24 entities have been privatized. The major ones are MAS, the Malaysian Airline System; MISC, the national shipping line; Sport Toto, a gaming enterprise; and the container terminal at Port Klang. Of the total, 15 represent takeovers of existing government functions by the private sector. The others mainly involve infrastructure construction.

The setting up of TV3, the third TV channel, did not constitute a divestment; rather it was set up to provide services in addition to and in direct competition to those already being provided by the two government channels. Besides those mentioned above there are other state (provincial) government-owned enterprises that have been privatized. Notable among these is the privatization of the water supply system for the municipal area of the city of Ipoh in the State of Perak.

The Federal Government has given approval for the process of privatization to begin for 15 government-owned enterprises. These include the National Electricity Board (NEB), Civil Aviation Department, the Royal Malaysian Navy Dockyard, Malayan Railways and the Rice-Milling Complexes of the National Padi and Rice Board. Additionally, 53 projects are being considered for privatization. These include ports, the Postal Services Department, government rock quarries and the redevelopment of government properties.

The government, at this point in time, is finalizing the privatization masterplan which was prepared with the assistance of foreign and local consultants. The masterplan will set the broad policy framework, implementation procedures for privatization, the likely candidates for privatization and detailed target programmes for the first two years.

#### **The experience so far**

Privatization in Malaysia, in spite of initial problems, has been implemented successfully. It has brought about the benefits as originally envisaged. For the government, privatization is easing its administrative burden especially in terms of personnel (reduced by 31,000 so far) and expenditure. The sale of its interests in companies has added \$755 million ringgit (US \$279.5 million) to its coffers so far and it has obtained additional revenue from lease payments and corporate tax. It has been estimated that the financial relief for the government from expenditure on the construction of infrastructure facilities now privatized under build-operate-transfer (BOT) and build and operate (BO) schemes amounts to \$4.9 billion ringgit (US \$1.8 billion). There has also been a marked reduction in government exposure to loans and loan guarantees.

Privatization has enhanced economic growth through more rapid expansion of the corporate sector, greater efficiency in the implementation of the infrastructure development programme. It has also contributed to the expansion of the Kuala Lumpur Stock Exchange.

Although it may be still too early to make a full assessment of the benefits of privatization there are indications in many cases that privatization has led to increased efficiency. Some examples are the container terminal at Port Klang which had its average turnaround time per vessel reduced from 11.7 hours to 8.9 hours; the competition brought about by TV3's entry into an industry monopolised by the public sector has set new standards in television broadcasting; vast improvements in telecommunications services and facilities resulted from the corporatization of telecommunication services with the formation of Syarikat Telekom Malaysia (STM).



The privatization of the North-South Expressway has also yielded significant results. Covering 877 kms, the North-South Expressway and the Klang Valley Expressway were 34% complete before being privatized. An additional sum of 4.5 billion ringgit (US \$1.6 billion) would have been borne by the government had these roads not been privatized. This expressway has been allowed to recoup its investment through toll collection. The company is also responsible for the maintenance of the expressway and the construction of facilities such as restaurant service areas. Due to privatization, construction of the expressway is ahead of schedule than what had been planned earlier.

### **Telecommunications and electricity**

As the minister in charge of telecommunications, allow me to highlight the privatization of telecommunications services in Malaysia as a specific example. The first stage of privatization, ie corporatization, involved the transfer of the operations, assets and liabilities of Jabatan Telekom (Telecoms Department) to a corporate entity in the form of STM on 1st January 1987. The British merchant bankers Kleinwort Benson and the local merchant bank Arab Malaysian Merchant Bank were involved in the privatization exercise. This was effectively the corporatization of the government department to pave the way for the eventual divestment of shares in STM to the private sector. Currently, STM is wholly-owned by the government. The process of privatizing STM will be completed when its shares are floated on the stock exchange by the end of this year. In terms of performance, STM has done well. It recorded a pre-tax profit of \$360 million ringgit for the financial year ended December 31, 1989, thereby doubling its 1988 profits of \$180.4 million ringgit. In its first year of corporatization STM only managed a \$4.7 million ringgit profit in 1987. Although it is profit-orientated STM has also been tasked with the responsibility of improving telecommunications facilities especially in rural areas. Over the next five years it is expected to spend \$1.4 billion ringgit for this purpose. In 1989 STM spent \$60 million ringgit to upgrade facilities in the rural areas.

Besides STM, which is the basic network provider, the government has allowed private companies to compete in providing value-added services such as radio paging, trunked radio system and the operation of public telephones. In the area of cellular or mobile phones two operators have been licensed, STM and CELCOM. Thus the privatization of telecommunication services has led to an upgrading of technology and quality of service to consumers, greater efficiency, more competitive rates and the development of better infrastructure.

I would now like to highlight briefly the privatization of the largest electricity utility in Malaysia, the National Electricity Board (NEB), as it constitutes the largest privatization exercise ever undertaken by the Malaysian government. Moreover, as the minister responsible for energy matters as well, I have been personally involved in this.

Careful and detailed planning was necessary. In the case of NEB, which serves about 80% of the total population in Malaysia, privatizing it was a challenge. Of the three electricity utilities in the country NEB is the largest, covering the whole of the Peninsula of Malaysia. NEB has fixed assets of over \$11 billion ringgit (US \$4billion).

A study was commissioned in 1987 to evaluate the prospect of privatizing the National Electricity Board and several options for privatization were proposed, including the separation of the three main functions of electricity,



generation, transmission and distribution. In the event, the government decided to privatize the NEB as a whole and form one integrated generation, transmission and distribution company. Privatization would be in stages. First the government would form a new company to take over the assets, liabilities and staff of the NEB. Second, equity would be sold to local institutional investors, the public and NEB employees. Participation of foreign investors is also under consideration. The government would retain some and a 'golden share' in the new company.

The study on this is being done now, and a regulatory body is being set up for the purpose of licensing, securing electricity supply and ensuring reasonable prices for electricity supply. In addition the body would also oversee the control of electrical insulation, quality supply, plant and equipment with respect to the safety of persons and properties. It is envisaged that NEB will be corporatized before the end of the year and its privatization will follow soon after.

### **Issues in the privatization policy**

Many reservations have been raised in relation to the privatization policy, such as the fear of price increases for privatized services, that unprofitable services (especially to rural areas) would be terminated, and that employees would lose their benefits. However, the government has often emphasized that transferring its public services to the private sector did not mean the government was absolved of its social responsibilities. The government will not abdicate its role as the guardian of public welfare. Along with privatization, the government has devised and will continue to improve a regulatory system that will ensure the maintenance and improvement of the quality of services, fairness in pricing and fairness of competition among competing service providers.

Another issue arising from privatization is whether the benefits to be derived are widely shared. The interests and welfare of employees affected by privatization have to be given due consideration such that the terms and conditions of employment are no less favourable than those previously enjoyed. In this respect, schemes to allocate shares to the employees of privatized enterprises are being introduced. At the same time, the consuming public, especially the lower income groups, should also not have to pay unduly high or unfair prices for basic services previously provided by the government. This is already taken care of through the regulatory mechanism.

The magnitude of funds required by the private sector to take over the entities to be divested by the government is in many cases large in comparison to the local capital market. Therefore a decision on the timing of the flotation of shares in government-owned companies needs to be carefully synchronized with the capital market's situation. In some cases privatization also entails amendments to existing legislation, to enable the transfer of activities or assets to the private sector.

Another issue is perhaps the lack of efficient and experienced managers to manage the privatized companies. Malaysia does not yet have sufficiently well-trained, well-experienced and well-qualified managers and entrepreneurs.

The privatization of utilities such as the National Electricity Board involves a monopolistic industry. Thus there is a need to regulate these utilities such that they do not take undue advantage of their size or their near-monopolistic position. Alternatively, some of the services of the agency may be

hived- off to private companies before it is privatized, thereby effectively reducing its monopolistic position in some areas. We in Malaysia are watching with interest similar situations in other countries, particularly in the United Kingdom.

## **Conclusion**

The government of Malaysia is committed to privatization and will continue to divest its interests in services and activities which can be more effectively operated by the private sector. Of a total of 424 government enterprises which were studied under the Privatization Masterplan Study, 246 with majority government holding have been recommended for privatization. The privatization programme will require the massive mobilization of private sector financial resources, indicating a need for new and ingenious varieties of financial instrument to be developed. There are also many other problems relating to privatization which will have to be addressed such as the need for more managerial skills, training for management and staff, regulating the newly-privatized enterprises, controlling private monopolies, equitable distribution (given the multi-racial nature of Malaysia's population), meeting consumers' needs, and at the same time ensuring profitability for the enterprise.

It is hoped that in the final analysis government's presence in the economy will be very much reduced except in its policy and regulatory role. In this regard it is recognized that privatization will bring many changes. We will have to learn and adjust as we go by. It is also hoped that sustained economic growth will result with greater efficiency and higher productivity; and that Malaysia retains or even improves the rate of development experienced over the last two years.



## PRIVATIZATION IN PORTUGAL - 1

Cary Martin

Dewe Rogerson

Our own experience in the marketing of privatizations goes back to the beginning of the UK programme, and we have been involved in most of the major UK offers for sale throughout the 1980s. It was therefore with some interest that we received, some two years ago now, a call from Banco Portugues d'Investimento, who were about to embark on the first privatization in Portugal, namely that of the brewery, Unicer, and of Banco Totta and Acores.

### The marketing fundamental

I have never believed that you can take the detail of what is done in one country and apply it, without change, to another. Each country is different; and each market is different; and inevitably the way in which investors react to privatization offers is going to be different from one country to another.

What does not alter, however, is the marketing fundamental. The need to create a perception of value and of scarcity for a company's shares so that an offer is successfully over-subscribed at the best possible price applies to all markets and to all offers for sale. This effect is achieved by stimulating investment interest from the different markets, which in most cases means the indigenous institutional market, the indigenous retail market and international investors. By generating competition between these three audiences for the available stock, and by ensuring that each market recognizes that there is such competition, one builds the perception of scarcity which enables the vendor to maximize demand at the best possible price. This is a truism which, we would argue, applies to any offer for sale in any country in the world.

### Steps in a marketing programme

How one develops the programmes that deliver this perception of scarcity does, however, vary significantly from market to market. The Portuguese programme is a very good example of how, working to this fundamental, programmes were developed, the success of which launched their privatization programme.

The marketing begins with the **credibility of the company** itself. The first task was therefore to establish Banco Totta Acores as a well managed, successful, profitable company, with a good track record and excellent prospects. On the back of this, investors, both retail and institutional, then need to be given an invitation to consider buying shares in the company.

You cannot start a flotation with marketing 'hype' alone. No amount of paid-for publicity or paid-for advertising will have any impact unless the credibility of the company is established up front. Equally, investors who are unaware that there is any opportunity to invest are hardly going to be sending in applications spontaneously, so you need to inform and let them know that the opportunity to invest is being presented to them.

This latter point was particularly relevant with the retail market in Portugal because there the small investor had little appetite at the time for investing in shares. The Portuguese market had not recovered to anything like the same extent as other markets around the world after the 1987 crash. Therefore, although historically the Portuguese retail investor had been a keen investor in stocks and shares, all the evidence in early 1988 was that their appetite had gone.

Consequently, the fundamental task of the marketing was to ensure that the offer was structured and communicated in such a way as to make retail investors, as well as the institutions, feel that they were being wooed and that there was something in the offer for them.

The question of whether the perceived lack of interest in share purchase was real or not was settled by the market research programme -- which is one of the key techniques to be taken from the UK experience. In fact we discovered a very healthy level of interest in investing in the government privatization programme in Portugal -- as opposed to the stock market in general -- which very much confirmed the early experience we found in the UK prior to the British Telecom flotation. It was not difficult for the public to look upon privatizations quite differently from normal offers for sale and the marketing programme for Banco Totta reflected this fact.

The flotation was a resounding success and gave the Portuguese privatization programme, which was launched almost simultaneously through the Banco Totta and Acores and Unicer flotations, a confident start which has now been pursued through further privatizations.



## PRIVATIZATION IN PORTUGAL - 2

Jose Pena do Amaral

Banco Portuguese d'Investimento

### The background to privatization

In the aftermath of the 1974 Portuguese Revolution, heavy industry, transportation, telecommunications and the financial sector were fully nationalized overnight, without indemnity. The stockmarket was closed and remained literally dead for almost a decade.

A deep tradition of state intervention in the economy, strengthened by the previous 40 years' dictatorship, was then strongly reinforced by the prevailing socialism. But, unlike the past, the relative weight of the private sector in the economy was dramatically reduced: nationalization did not hit just single companies, but covered entire sectors, which remained closed to private ownership until a new law was passed in 1984 -- sectors such as petrochemicals, steel, shipbuilding, telecommunications, transportation and banking. The private sector, concentrated around the traditional exporting industries in the North, could take advantage of the escudo's devaluation as a growth factor, but did not have any significant power. Tax evasion and capital flight were significant while investment was weak.

As a result of massive nationalization, competition faded and innovation stopped. Moreover, in the context of long lasting international economic problems and domestic budgetary difficulties, most of the state companies soon became a serious burden for public finance and a source of social unrest. The system was gradually seizing up.

### Facing up to the facts

The recognition of these facts, along with a progressive shift in the dominant ideology created room for a change of this rigid framework. In 1984, a new law reopened banking and insurance to private investors, and ten new institutions, both domestic and foreign, entered the market within one year. Deregulation and liberalization gained momentum and some ambitious private projects started emerging. EC accession confirmed and accelerated this trend. Privatization soon became the consensus among the main political forces and was a major point of the ruling party's programme in 1987, when it obtained 51% of the vote in the general election.

Everything then seemed settled for the implementation of a privatization programme. A major obstacle remained, though: nationalizations were considered irrevocable by the constitution and this meant that the private sector could not have a majority in state-owned companies. A constitutional revision, scheduled for 1989, was crucial if a full privatization programme was to occur; but in the meanwhile a law was passed allowing for the sale of up to 49% of the equity of nationalized firms.

This law, published in the summer of 1988, had to deal with five basic problems:

- what should be the shareholding structure of the privatized companies?
- what should be the role and the conditions offered to foreign investors?
- what should be the route between the first offer of 49% and the future sale of the remaining 51%?
- what kind of incentives, if any, should be designed to attract the participation of workers and small subscribers?
- what should be the decision-making structure?

Going through these problems, first of all the decision was made to go for **widespread share ownership**, and consequently the operations were based on placements in the stock market. As lead-manager of the first two operations, BPI segmented the offers into four blocks and organized them using a 'cascade' system, where all the shares remaining from one segment could be re-offered to the following one; any shares not sold in the terminal segment should return in the first place to the small subscribers and then the cascade would flow again. The four segments involved workers (fixed price offer), small subscribers and emigrants (fixed price); individuals and mutual funds (tender offer) and all investors (tender). With such a mechanism, it has been possible to reserve specific blocks of shares to specific categories of investors; and to ensure that no demand would remain unsatisfied, as it could happen if there was no possibility of transfers being made between the different groups.

The **participation of foreign investors** was clearly limited, as they were not allowed to take more than 10% of the offer, equivalent to 4.9% of the equity, and their global participation in the company could not exceed, at any stage, 5%. This was sought to tackle increasing domestic criticism on the risk of a massive transfer of assets from the state to foreign owners, a situation that threatened to become particularly embarrassing considering that the dispute over indemnities on nationalizations has never been definitely settled.

Due to constitutional constraints, the authorities could not make any formal commitment on **preference rights** of the new shareholders for the future privatization of the remaining 51% of the equity, although such a commitment in principle was given in several political statements that supported the idea. That commitment was realized when the second tranche of the first 49% nationalized company was done with a preference right.

By way of **incentives to workers, small subscribers and emigrants**, such groups could take advantage of a **discount** -- higher in the case of workers - although they were not allowed to sell before two years. And they could buy more, with no transaction restrictions, in both of the fixed-price offers. The intention to favour a widespreading of shares has been enhanced by



massive communication campaigns, certainly among the biggest ever organized in the country for non-consumer goods.

The **decision-making process** is monitored by the Ministry of Finance, which is responsible for the organization of the whole privatization programme. The ministry is assisted technically by a special committee of the stockmarket with a permanent highly skilled staff. An independent board, chaired by a magistrate, is entitled to produce a final opinion on the reports presented to the Cabinet regarding pricing and on the basic scheme of the operation. Those reports are compiled on the basis of the work provided by the companies' financial consultants (selected after a qualification test). The law requires two independent valuations of the company, in an effort to reach an undisputed decision on the price structure of shares, and typically, one of the two institutions responsible for the valuation will be selected to design the operation and to lead-manage the sale.

### **The results**

The first privatization operations, limited to 49% of the equity, were implemented between April and October 1989, involving four companies: UNICER, a brewery; Banco Totta Acores, the fourth largest portuguese bank; Alianca Seguradora, and Tranquilidade, two insurance firms. The results went far above all expectations. Demand generally outstripped supply and the aftermarket price was in all cases substantially over the offer price of the placings.

It is also important to stress that privatizations were always seen by the investor as a special occasion; even if the market was not in a very favourable condition there has always been a good response for privatization operations.

The success of these four operations becomes even more clear when the results are put in the context of the market situation at the time. Although the weight of capital markets in Portugal has risen sharply from almost zero in 1985 to some 25% of GDP at the end of 1989, it is a fact that the 1987 stock market price collapse dragged out excessively in Lisbon and had not yet been overcome when the first privatization offer, concerning UNICER, took place in April 1989. Affected by some settlement problems in 1987, foreign investors took their time to come back and the domestic small investors, severely hit in 1975 by nationalizations, over-reacted to the crash and felt uncomfortable in a market increasingly dominated by professionals and where gains were no longer so easy and fast. Looking at the evolution of the volume of transactions since March 1989, it is fair to say that the UNICER offer can be seen as a turning point, marking the end of the post-crash crisis. Yet the global response of investors in all privatization operations has been always above the current pattern of the market, which helps to build up their credibility as good investment opportunities.

### **Recent changes and opportunities**

After the revision of the constitution that took place in July 1989, constitutional restrictions to full privatizations were removed. Accordingly, a new privatization law was issued last spring, introducing some important changes in the legal framework that regulated the first four sales. Among others we should stress the following:

- there is no unique model for the sale, which can be done through flotation in the stock market, limited auctions (or, exceptionally, direct negotiations,

when 'national interest' is at stake) and where a combination of these procedures can also be used;

- the limit for foreign investors will be fixed on a case-by-case basis, depending on the company and the sector involved; and
- indemnity bonds, issued by the state in compensation for nationalization, can be used to buy shares at par value (an interesting opportunity, since the bonds pay a very low interest and are listed below the offered price).

Although a strict programme has not been announced, it is likely that the pace of privatization will be strongly intensified until the end of the year. The remaining 51% of UNICER was sold last June and a second tranche of Banco Totta (30% of the equity) is scheduled to be offered in mid-July, followed by full privatization of the insurance company Tranquilidade, where 49% of the equity has already been taken. It is expected that the first 100% sale, involving Centralcer, the other state brewery, will take place in late September.

The next phase of the programme has not yet been officially settled, but it will probably include one of the biggest state banks and a major industrial corporation. In the case of the most significant companies, either financial or industrial, it is not clear that the government will be prepared to announce 100% privatizations. An increasing use of sale procedures other than flotation in the stock market is also likely to happen, given the wide flexibility introduced by the new law. The risk of a massive transfer of economic power to foreigners, on the eve of the 1992 European single market, is the key constraint to be dealt with at this stage, as it is feared that domestic investors could find it difficult to compete in operations that will be valued over US \$1 billion.

There is no doubt, however, that the expected acceleration of privatization will be essential in completing the market revival that has been progressively consolidated since the beginning of the 1980s and particularly the last five years.

At the end of 1989 capitalization of the share market alone was 53 times greater than the value recorded in 1985, and the number of companies listed rose from 50 to 195 during the same period. The enormous progress illustrated by these figures has been bolstered by the successful impact of the privatization programme and it certainly makes the Portuguese recent experience one of the most relevant references for all those concerned with the recovery of market mechanisms in state-dominated economies.



## CHAPTER 10: THE ELECTRICITY INDUSTRY

## Electricity Regulation

## The Electric Industry

## PART 7 - FROM MONOPOLY TO COMPETITION

Electricity is a natural monopoly. It is a natural monopoly because it is a network industry. The network is the physical infrastructure of the electricity system, which consists of the power stations, the transmission lines, and the distribution network. The network is a natural monopoly because it is a network industry. The network is a natural monopoly because it is a network industry.

The natural monopoly of the electricity industry has been a source of controversy for many years. The natural monopoly of the electricity industry has been a source of controversy for many years. The natural monopoly of the electricity industry has been a source of controversy for many years. The natural monopoly of the electricity industry has been a source of controversy for many years.

However, the natural monopoly of the electricity industry has been a source of controversy for many years. The natural monopoly of the electricity industry has been a source of controversy for many years. The natural monopoly of the electricity industry has been a source of controversy for many years.

## Electricity Regulation

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## COMPETITION IN PRIVATIZATION: UK ELECTRICITY

Malcolm Nicholson

Partner, Slaughter & May

Historically, the UK electricity industry had been divided into two. One part was the monolithic Central Electricity Generating Board, which owned all the power stations, including the nuclear stations, and the national grid for transporting electricity at high voltage around the country. The other side was the local area boards, who purchased electricity from the CEGB in bulk and delivered it to customers.

The initial major decision was whether to privatize the CEGB as a monopoly, subject to stringent regulatory control, or to split it up into separate generating companies, able to compete. There was strong industry pressure to retain the monolithic structure. But the political aim, reinforced by public criticism of the behaviour of the other privatized monopolies at British Telecom and British Gas, was to introduce competition, and that was the decision.

Further, there was government determination that the whole industry, including the nuclear sector, should be privatized.

### Structural choices

Those two decisions immediately necessitated a further decision. How many generators to create? It was considered necessary to create one very large generator, National Power, which was big enough to be able to absorb the nuclear part of the industry, with its massive costs and unattractive investor profile. That left room for only one other generator, with roughly 30% of UK generating capacity, big enough to act as some sort of counterweight to National Power: two generators, some competition, but not very much.

In the event, as the true costs of nuclear power later came out, it became apparent that it simply could not be sold into the private sector, and eventually it was decided to keep it in the public sector. The rationale for creating only two generators out of the CEGB had gone. But by then it was too late to restructure the industry further by creating five or six smaller generators who really could compete with one another.

A further major initial decision had to be taken regarding ownership of the national grid, previously owned by the CEGB. For reasons associated with competition, it was decided that it could not be owned and run by either of the generators, because they would thereby control access to distribution of



electricity, and could use that control to the detriment of new entrants into generation.

If the national grid were separated from generation, who was to own it? Eventually it was decided that it should be owned jointly by the twelve distribution companies, but under a complicated structure which left ownership with the distribution companies, while leaving a considerable measure of operational independence to the National Grid. Again this was to try and prevent the distribution side of the industry exerting unhealthy anti-competitive pressure over the natural monopoly of the high voltage wires business.

In our case, the introduction of competition in generation and supply, and separation of the national grid, led to an enormous proliferation of work as people had to create the contractual framework within which the industry would operate, and to do so starting with a blank piece of paper.

In the event, when the industry restructuring was completed, there was a two-day closing at which 1600 agreements were entered into. The key Pooling and Settlement Agreement, creating a spot market for electricity trading with a system price struck on a half-hour basis, ran to 743 pages, including several hundred pages of algorithms for calculating the spot price; while the key technical and operational manual to ensure safe and secure operation of the system ran to 800 pages.

Agreeing and documenting the terms of the industry restructuring over a period of only four or five months was a monumental achievement.

### **Regulatory issues**

It was recognized from the outset that there should be regulation and oversight of the industry by an independent publicly-funded authority established for the purpose. The Office of Electricity Regulation -- OFFER -- is headed by Professor Stephen Littlechild. It regulates the industry in accordance with duties imposed under the Electricity Act (including the duty to promote competition) and under the terms of the licences which all significant industry participants are required to have.

The initial licences were issued by the Secretary of State. A number of subsequent ones may be issued by OFFER. They are crucial to the operation of the industry. Two points serve to illustrate this:

(a) First, competition in the supply of electricity necessitates full and unrestricted access by generators to the high voltage wires owned by the national grid and the lower voltage wires owned by the local distribution companies. The licences contain detailed provisions guaranteeing this right.

(b) Second, both the areas of natural monopoly in transmission and distribution of electricity, and part of the activity of the area boards in the supply of electricity to consumers are subject to detailed price control, limiting price increases in line with inflation, minus an 'X' factor as being a co-efficient to encourage efficiency savings.

Competition and privatization are uneasy bedfellows. Competition, particularly in a newly-restructured industry, equates to risk and uncertainty. Risk and uncertainty mean lower proceeds on the sale of the industry. Stringent price control does not do much for stimulating investor demand either.



Thus, as the time of the sale approaches, as the difficulties and uncertainties become clearer, and the potential financial implications are better understood, the full bloom of competition is trimmed back in the interests of successful flotation. In our case, draft licences were laid before Parliament in January 1989. Revised licences were re-laid in draft in January 1990. They bore little relationship to each other. The latter were much less radically pro-competitive. But parliamentarians were either so bored or so confused that the fact escaped almost without notice. So did the fact that traditional RPI-X price control, with X as the efficiency factor, turned in many cases to RPI + X, permitting price rises above the rate of inflation.

The next issue is how far do you make detailed specific provision to seek to deal with potentially anti-competitive behaviour? Or how far do you try to leave this to general competition law? Why treat the electricity industry differently from the chemical industry? The approach we tried to take was not to seek to regulate every aspect of behaviour. Instead, we aimed for transparency in operation of the industry, and gave OFFER powers to call for information that are much more extensive than those which regulators of other privatized industries have, having learnt from the difficulties that the telecommunications and gas regulators initially had in extracting information. If the industry's behaviour worried OFFER, it could initiate a detailed investigation by the Monopolies and Mergers commission, a fate that has already befallen British Gas.

The one major exception to that policy relates to the detailed provision made to regulate discrimination in pricing. This is because in the absence of detailed rules, it is very difficult to determine what is discriminatory and what is a permitted pricing response to competitive pressures; and because if powers to intervene quickly were not available, the potential damage of discriminatory pricing -- say by generators trying to deter new market entrants, and thereby prevent the emergence of more competition -- would be substantial.

A further major regulatory problem (and I do not pretend we have a perfect answer) concerns nuclear electricity. How do you create a fair regulatory environment in which competition can flourish when you have a subsidized and state-owned generator, with very low variable costs of generation which, at least potentially, could be used to compete in a way the private sector generators might characterize as unfair. How far can the government be relied on to exercise its shareholder influence sensibly? All we could do was to give Nuclear Electric a licence in much the same form as the other generators, subject to regulatory oversight by OFFER.

### **Competition policy**

My final point is this. A government privatizing its industry can write its own competition regime. In the case of electricity, it has been necessary by legislation to exempt many of the 1600 initial agreements from the scope of the UK legislation covering restrictive trading agreements. This is not because they are inherently anti-competitive, but principally because they initially had to be negotiated and agreed under government supervision on a collective basis and were for that reason caught by the law.

But here in the UK, and elsewhere in the Community, the EC Commission has a very considerable role to play in monitoring and approving agreements which they consider fall within the scope of EC competition rules. They also have to approve any state aids given as part of the industry restructuring. Over a period of a year, I and officials from the Department made regular



monthly trips to Brussels to brief officials, and to seek to obtain their support and assistance.

They quickly recognized the essentially pro-competitive thrust of the industry restructuring, and were supportive, although a number of changes had to be made to meet their requirements. The bulk of the agreements have now been notified, and over the next few weeks details will be published in the Community's *Official Journal*, in what I hope is the first stage in their formal approval.

On the state aid side, a massive programme of aid to support the nuclear industry has been necessary. But given that the costs are inevitably to be incurred in de-commissioning existing nuclear power stations anyway, and are thus unavoidable, and recognizing that the aid intensity was made transparent, it was possible to negotiate a package with the Competition Directorate that they were prepared to take to the full Commission for the necessary approval.

Timetables required state aid approval by 30th March, 1990. It was scheduled for discussion at the weekly Commission meeting on 27th March. Concern, if not opposition, was voiced from some other cabinets. In London tension mounted. We prepared fall-back positions. At lunchtime on 27th March, we were told that it had not been approved. A number of Commissioners were absent; this, and some opposition, meant the requisite majority for approval of the state aid was absent. But, by the end of the afternoon, more Commissioners had been found, the matter was put to the vote, passed, and all was well.

#### QUESTIONS AND DISCUSSION

**Mr R A Halperin** (World Bank, USA): Regarding the pricing formula for electricity, I see the logic of RPI-X for telecoms but when you get to electricity there are two concerns that I would have in mind. The first relates to variations in fuel prices and how you would reflect those. Would you expect the utility to bear the risk of those fluctuations or would you have some provision that would allow the utility to transfer those fluctuations to its consumers? The second factor for the electricity industry relates to environmental standards. I think we all see or expect environmental standards everywhere to become tougher, and that means that there are going to be increasing costs that the industry will have to bear to accommodate those standards. How does a price-cap formula take that into account?

**Malcolm Nicholson:** How can you apply an RPI-X formula that takes account of the considerable variations in fuel prices? The answer in our case is that we were persuaded by the industry that it could not be done and fuel price increases pass straight through the consumer, subject only to a rather limited commitment on the part of supply companies to seek to regulate their price increases to tariff customers over an initial three-year period.

However, in electricity there is in fact a degree of predictability in fuel prices over the next three years because a major pre-condition of the privatization, has been a three-year contract with British Coal to supply 70 million tonnes for the first two years, and 65 million tonnes for the third year at a clearly set price. So the generators have a considerable degree of certainty as to their raw material input costs.

On environmental standards, that is also a problem and the generators face it in particular in complying with EC directives on noxious emissions; and they have a major capital investment programme to carry out over the next few years. In regulatory terms this is dealt with by omission in the sense that the generators who are competitive, and who are selling into a spot market, are not themselves price controlled so their capital investment requirements are not reflected in the price control. The future capital expenditure on emission controls was, however, an important element in the fixing of their initial capital structures.



## REVIVING A TIRED MONOPOLY: ARGENTINA'S ENTEL

Dr John Collings

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In discussing the privatization of the telephone company of Argentina, I am going to talk about the structure, competition, regulation, from now on that was put in place, the aim of which was to bring benefits to the buyer, the seller, and the public.

### The government objectives

The seller objectives can be categorized under three main headings: economic reform; improving the performance of the company; and obtaining benefits to the consumers.

In terms of **economic reform** there were a number of general aims for the privatization as part of an overall package of economic reforms that President Menem was instituting for the Argentine economy. One general aim was to eliminate subsidies -- typically the state industries were loss making and Entel has been no exception. Then there were some specific aims for the telecommunications sector -- introducing competition, breaking up the monopolistic monolith and so on. And the privatization of Entel was of great symbolic significance for the whole of the Menem economic reform programme. It was meant to set the pace for what was to come later. This symbolic importance meant that not only did the sale have to be seen to be extremely successful but it also had to be carried through in a very compressed timescale. The time from the President signing the decree for the privatization, through to the transfer of ownership to the new owners, was set at just over one year.

Turning to **performance improvement**, the guidance that we had was that if any one objective should take priority this was it. Throughout the privatization process those involved have made no attempt to disguise the poor performance of Entel's performance.

If you live in the north or the south of the country your phone goes wrong on average once per year; if you live in the south it takes on average 15 days to mend it, but if you live in the north it takes 24 days to mend it. If you live in Buenos Aires there is good news in that they only take 6 days on the average to fix a fault, but the bad news is that your telephone goes wrong six times per year on average.

In the different areas there are between 50 and 65 access lines (telephones) per employee. If you look internationally that is a low figure for comparable

economies. In a country of 32 million people there are only 3.2 million telephone lines. The network is extremely congested and this means that most call attempts fail to go through.

The network is also very old, particularly in Buenos Aires where over one-third of the exchanges are more than 20 years old and there is very little deployment of digital technology.

Turning to the third of the government's objectives, **benefits to the consumer**, obviously the consumer should benefit from improved quality and the other objectives being fulfilled but there were some specific objectives too.

The first was to do away with the payment of registration fees. In Argentina in order to go on the waiting list for a phone you had to pay a registration fee which for residential customers averaged about US \$1,000 which is payable in 30, 40 or 60 instalments: for business customers it was higher. There was also a desire to control the price of the basic service, to improve service quality and service availability, and the reliability of service.

### **Buyers' concerns**

The potential buyers had a number of concerns which again conveniently fall under three headings: **regulation**, the scale of the **investment and commitment** that would be required, and **the country's specific factors**. It was very important to stress from the outset that these buyer concerns had to be addressed.

Remarkably, in the last year or so the privatization of telephone companies has taken off and there are a lot of opportunities out there for the potential bidders. The telephone company in New Zealand was sold recently; Mexico and Puerto Rico are currently undergoing privatization; and all the potential bidders for those companies and for Argentina would also be looking at Eastern Europe with a great deal of interest. So it was essential, if the sale was to succeed, that these buyer concerns be adequately addressed.

**Regulation** is always a critical concern for buyers, particularly for telephone companies who tend to be quite heavily regulated in their home markets and are therefore aware that the regulatory framework, in a sense, is the main determinant of long-term profitability.

There were a number of particular concerns: first of all **exclusive rights**. The government plans for privatization had initially allowed for a five-year monopoly of basic service. But the analysis of the Entel situation showed that five years was going to be too short a time to provide monopoly rights if the necessary cash was going to be generated to pay for the investment necessary to fix the network. That was clearly a major buyer concern.

In terms of **price control**, buyers were concerned that the regulatory mechanism for prices might lead them to earn low returns, particularly in a very inflationary environment. There had in the past been a special tax put onto telecoms which was to pay for public sector pensions -- it had nothing to do with telecommunications and was just a convenient way of funding that particular government liability. There had also been a history of government imposed price freezes. And the bidders were very uncertain as to what the inherited profitability of the company was, mainly because there had been no audited financial statements for some time.



The third concern of the buyers on the subject of regulation was the **institutional framework**. Would the regulatory agency be independent of government or would it merely be an arm of government? What was the degree of regulatory risk? Was there a danger that the rules of the game would change quite soon after the purchase? And what would the burden of regulation turn out to be? US phone companies particularly are used to spending a fortune on regulation; those of us who are in the business of advising on regulation think that is no bad thing but it is something that the bidders will of course factor into their calculations.

The second buyer concern was the **scale of the commitment** that they were going to have to make. First of all, clearly, in order to improve the performance of Entel a considerable amount of resources were going to be needed; not only for **capital expenditure** but also **management resources**. Due to the political situation that had existed until fairly recently in Argentina, there had been no real stability of senior management in Entel and management resources were very much at a premium. The **systems** were inadequate, and it was quite clear that in order to get the company running properly, the systems would have to be radically improved.

There were also concerns about the **financial terms**, the possibility that the successor companies might have to take over the existing liabilities of Entel; concerns about how easy it would be to repatriate funds from Argentina; and the fact that the bid might require a considerable amount of hard currency.

Lastly, there were the **particular concerns about the country**, being a country that until recently had had a chequered political situation and a history of hyper-inflation. Those factors are obvious.

### Structuring the sale

How could you create a win/win opportunity from this situation? In brief, the first thing was the ownership structure: the way that the sale was to be structured was that 60% of the company would be sold to an investor group and the remainder would be sold to employees and to the public.

The investor group had to include a world-class telecommunications operator, and in order to bid you had to **pre-qualify** to show that the telephone operator member of that group met world-class performance standards in its own networks. Within the operator group there would be a group that was locked in for the duration of the monopoly period, which was to ensure that people did not sell quickly having bought the company and sorted it out.

The government had decided that the company should be broken up ahead of being sold and the original plan was to break it into at least three regional companies, plus an international operator, and sell them separately. Analyzing the structure of the network and the situation of the company, the recommendation which the government accepted was that basically the country should be **split into two**: Telco North and Telco South. That included splitting Buenos Aires into two. Buenos Aires counts for about 60% of all telephone lines in Argentina and therefore if you are going to create two roughly equal companies you had to divide Buenos Aires. Those two companies will jointly own and operate the international company: as with most telephone companies that is the prime source of profitability at the moment, and in order to generate funds for network investment it was essential that those two regional companies could have access to the international revenues.



Also there would be a jointly operated company to provide for those services which are being opened to competition, such as data services. The exclusive rights are limited to providing the basic infrastructure and voice telephone service over that infrastructure; in other words really basic service, everything else being open to competition.

There are also opportunities in areas that the telephone company does not currently serve, for independent operators to come in. If a telephone company is not willing to provide service then an independent or co-operative operator will be allowed to operate.

The period of **exclusive rights** is set for a two-year transition period during which the new owners will take up ownership and start to sort the company out, plus another five years. In order to maintain those exclusive rights they have to meet performance targets for the price, quality and availability of basic telephone service. If they exceed those performance targets then they will be allowed a further three years of monopoly. The aim here was to create an incentive whereby monopoly could work for the benefit of customers rather than against the interests of customers.

On the regulatory front there is to be an **independent regulatory commission**: because of uncertainties about the profitability of the company at privatization, there is a guaranteed minimum return available during the two-year transition period. However, prices are going to be controlled by a ten-year plan for limiting the rate of increase in prices. Unless the minimum return is not being earned, during the first two years prices must rise no more than in line with inflation; during the next five years they must rise 2% less than inflation; and if there is an extra three years granted, during that period prices have to rise 4% less than inflation. So over the whole of the period prices will have come down by 20% relative to the inflation rate.

So by the end of that period Argentina should be achieving world-class telephone service at prices 20% cheaper than when the new owners took over, which would be a good deal for the Argentine people. And for that reason the other aspect of regulation is that there are **service performance targets** built into the regulatory framework, and also targets for the number of added telephones in the network.

Lastly, there is the **financing**. This was not something that we were much involved with; the financial advisors to the sale were Banco Roberts and Morgan Stanley. However, the fundamental thing about the financial aspects of the sale was that there was an opportunity for a debt-equity swap. This was something that was clearly very strongly recommended by the financial advisers. The way the bid was then structured was that all bidders would be required to bid a certain fixed amount, which would be known in advance, in hard dollars. The winning bid would be the one that offered the most Argentine sovereign debt, so that the aim of the sale was to repatriate as much of Argentina's sovereign debt as possible.

### **Working of the plan**

The process is now in its final stages. It has to be emphasized that there were some fairly unhelpful developments during the process, and after a promising autumn, in December inflation suddenly started to spurt again in Argentina. At the end of February, in order to prepare the company for privatization and to get it profitable enough for the bidders to take over, a 300% price rise was announced, which was not universally popular. And at the same time the Menem government was starting to come under some strong



political pressure. For that reason there was a certain amount of unease among the potential bidder groups as to whether the sale could go ahead on the terms stated -- and indeed the terms were modified to some extent.

However, by the end of April, seven operator groups had pre-qualified: two of those subsequently joined together so that really gave us six operator groups. In the event in June there were three groups that actually bid: there were two bids for Telco South and there were three bids for Telco North. The highest bid for both North and South was from the same group which was a consortium led by Telefonica, the Spanish phone company, and Citibank. Under the rules of the bid, because they were far in excess of the other bids for South, they won South. The number two bidder in North was given the opportunity to match the highest bid, which they did; so as a result the two bidders whose bids have been approved by a presidential decree are Telefonica and Citibank in the North, and Bell Atlantic (one of the US regional Bell companies) and Manufacturers Hanover in the South. The net effect of this has been to repatriate roughly 10% of outstanding Argentine sovereign debt.

So that very briefly is the story of the privatization of Entel. Perhaps I can just finally conclude this by restating the importance of political commitment and drive. This process would not have happened in the timeframe it did if it had not been for the appointment of an individual to see through the privatization -- Maria Julia Alsogaray, whose father is well-known as the architect of the present economic reform programme in Argentina, and who herself is well-known, dynamic politician.

#### QUESTIONS AND DISCUSSION

**Mr R A Halperin** (World Bank, USA): How were the unions brought into this deal, and in particular is there some continuation for the rights that the union had achieved in its contract for after the company is privatized?

**Dr John Collings:** Similar to many of the UK privatizations, we reserved some shares for the employees; and in fact 10% of the shares have been reserved for employees. The second provision is that the labour agreement in force should be transferred to the new owners. It comes with the flexibility granted by the current applicable law, which does mean there is then scope for the new owners to re-negotiate contracts. But in the initial takeover period the old contracts would go on in force with the various privileges that they involve.

**Paul Corser** (Hong Kong): This is a straightforward question about the tender offer rules. We had a situation with one bidder putting in the best tender for both concerns, and under those circumstances the second tenderer was asked whether he could match the best tender for one of them. Had he failed to match the best tender, would one bidder have been given both companies to run or were there other alternatives?

**John Collings:** The third-placed bidder would have then been given the opportunity. If it failed to match the bid then the both North and South would have ended up in the same ownership.

## EXPORTING UK REGULATION

**Dr John Wright**

Partner, Price Waterhouse

There are now five privatized but regulated industries. The first office of regulation to be set up as a part of this process was Sir Bryan Carsberg's OFTEL in 1984, followed by the gas industry office OFGAS in 1986. In 1987 a new regulatory regime was set up for airports, under the existing Civil Aviation Authority. Last year saw the creation of OFWAT, set up for the water industry and finally this year has seen the electricity industry come under the regulatory control of OFFER.

There is one further monopoly moving towards privatization which will be regulated, that is TV and Radio Transmission. Thankfully it will not require an OFRAD or OFTRAN but will be regulated by Sir Bryan at OFTEL.

The creation of these new regulatory regimes has encouraged other countries to look at the UK experience. Our four new regulators have been giving talks and advice overseas so have our consultancies. With five industries now regulated and a sixth to be, it is worth looking at what the UK has to offer.

### **The problem and search for a solution**

Let us remind ourselves about the UK's starting point. All the newly regulated industries were under state ownership or control. The formal controls were relatively loose; broadly, they were based on a target rate of return. But the overriding control was a target for the year end cash position -- which does not necessarily encourage good commercial decisions. And these controls were coupled with the inevitable political persuasion which governments are bound to bring to bear on industries over which they have control. This framework was clearly inadequate for the control of private sector companies.

Privatization provided the UK with the opportunity to start with a relatively clean sheet of paper and devise a new system of regulation.

It first examined how other countries regulated monopoly industries in private ownership. The US was seen as the country from which the greater experience could be drawn. But from the UK's perspective, the US approach seemed to have a number of unwelcome features.



First of all it was seen from here to be very intrusive. Second, it required a large bureaucracy with which to administer the process both because of the intrusiveness and the openness of the process in terms of public hearings. Thirdly, there were concerns that the control of prices through an allowable rate of return encouraged overcapitalization rather than efficiency. (I recognize there are those who might challenge this last assumption, but that is the way it was perceived in the UK).

Generally speaking, there were no models elsewhere which were seen as adequate to the task. The UK therefore had to devise its own, starting with telecommunications. In addition as each industry came forward for privatization government had the opportunity to review what had been done in previous privatizations and to judge how that might be built on for the next industry. That does not mean that earlier industries got away lightly; but insofar as it was needed the regulatory regimes have been modified subsequent to the BT privatization.

The regulatory control exerted in each industry is different. Whilst this is partly because of the temporal order in which the different systems were established it is also because of natural differences between the industries. Nonetheless, there are some common principles and characteristics which are worth reviewing.

### **General principles**

Each industry has a **broad statutory framework** which can be changed only by Parliament. Detailed controls are then contained in a license issued by Government. Thereafter, regulatory control is the responsibility of a Director General. He has his own staff in an office separate from any ministerial government department and is legally **free from political interference**.

The licences can be modified under certain circumstances. This ensures that changed circumstances or latent weaknesses can be dealt with.

A cornerstone of the regulatory approach is to **encourage competition where practicable**. Hence each Director General has a duty to encourage and promote competition although the strength of that duty reflects the circumstances of each industry. As a consequence the regulation of monopoly is, if you like, a weapon of last resort to be applied where competition has not yet developed or where competition is unlikely to develop.

The **control of prices** is in each case through an **index-linked formula** which is reviewed after a period of between four and ten years in principle (but in practice five years). The nature of that formula, which links allowable price increases to the cost of living, is often described as RPI-X. But there are a number of add-on features --  $RPI-X+Y$  -- which depend on the industry to which it is applied. These factors usually relate to elements of cost which are passed on to consumers.

The pricing control is of course underpinned by a requirement that **service standards must be maintained or improved**. This overall approach is intended to be an effective proxy for competition but with minimum intrusion and minimum bureaucracy. It is also there to secure continuing efficiencies from the companies which are regulated and to be flexible and allow scope for the evolution of controls within the broad statutory framework.



## The differences

The industries so far regulated are nevertheless very different and the potential for competition (and the political will to see that competition evolve) have led to significantly different regulatory regimes.

In telecommunications, increased competition has undoubtedly been the driving force. The intention could clearly be seen in the original license to BT, which set a price formula for five years only. In other words, the original thought was that by the end of five years the industry might have been sufficiently competitive to have required total relaxation of any control over prices. Of course, in the event that turned out not to be the case. But the flexibility of the system has allowed Sir Bryan to negotiate a new price cap with BT.

By contrast, in the case of water, there is almost no scope for real competition. Moreover, there needs to be a heavy capital investment over the next decade to improve water quality and sewage disposal. It is not revenue earning and the cost will have to be borne by the consumer. But the scale of that investment is not yet fully quantified and adjustments to prices may be needed in addition to that allowed by the price formula. For that reason regulation is more intrusive and price control is likely to move close to a continuing rate of return.

## The lessons for others

What then can the UK offer to others? In short, we have had the opportunity to design diverse regulatory systems on a blank sheet of paper. Despite the diversity, the systems which have emerged have certain broad characteristics which have application elsewhere. The UK has chosen to inject competition where possible and in so doing has learned much about managing the co-existence of price regulation and emergent competition. But it also has some experience of regulating monopolies where competition is not emerging.

First, **price cap regulation** is already being adopted by others and there is a growing range of examples of how it can be modified to suit particular circumstances.

The control of prices and **standards of service** is essentially a top-down approach. Efficiencies are normally expressed as a global objective through the price formula, leaving management to achieve the overall result in a way which they are best placed to decide. It is this element which leads to a modest level of intervention and bureaucracy. Indeed, economic regulation in each of the UK's regulatory offices is handled by perhaps 20-30 people. The rest of the staff are concerned with consumer relations and technical issues.

The overall approach of a **statutory framework** for each industry which is difficult to change but where the details can be reasonably altered to meet changed circumstances is a useful general model. This gives great flexibility and independence from political intervention; and so far has been shown to cope with developing circumstances.

It is of course invidious to assume that an off the shelf regulatory system from one country can be taken and transplanted almost unchanged elsewhere. It seems to me that the key point throughout is **the need for flexibility**.



What I believe we can learn from the UK process is how to build designer regulation systems. But the needs and starting point in other countries may be very different from those which have been perceived here. As an example, if the reason for a new regulatory system is privatization, the form may depend upon whether the privatization is driven by a desire for competition or a desire for proceeds.

There are a number of other factors, including the extent of concern about discrimination and cross-subsidies. Whilst an economic approach would lead to prohibition there are occasions when cross-subsidies are perceived to be essential or seen as politically desirable. For example, although prohibition would normally be the case in the UK, a very explicit cross-subsidy has been safeguarded by statute for TV and radio transmission.

The next point is a political one. Wherever there is a change in the regulatory environment, politicians everywhere have a natural disposition to oppose any price increases, even when clearly supported by economic and financial analysis. However, that can turn out to be a helpful discipline, though if there is to be a price cap lasting several years it must be founded on a good business plan which takes account of reasonable improvements in efficiency. If a plan cannot be sufficiently well developed this will not produce systematic benefits. For this there needs to be good management and financial accounting arrangements. Whilst we are used to reasonably sophisticated procedures here and in many developed countries, the same is not necessarily true everywhere.

Social requirements will have a role to play. This may, for example, be simply a matter of ensuring continuity of supply from a particular industry or it may be ensuring that a supplier of last resort continues to be available, for example, in the case of a postal system. This feeds back into decisions about new entrants, protecting regulated incumbents from unfair competition, and the question of cross-subsidies.

In summary, the UK has had the opportunity to start from scratch. We have developed a system which is sufficiently flexible that the general approach can be used elsewhere to produce a designer regulatory system. The general characteristic is a top-down approach which aims to minimize intervention and bureaucracy, but those giving advice will need to take full account of local needs, including those which do not really allow full application of economic principles.