
12. GOVERNMENT OBJECTIVES AND THEIR ATTAINMENT

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The government's objectives

Let me start with the government's objectives in privatization. First of all, of course, objectives vary; they vary with economic circumstances, they vary with the political hue of the country concerned, and with the nature of the state-owned industries which it contains. But for most governments I think objectives fall into one or more of four categories.

First is **improving the performance** of state-owned enterprises. That means improving their efficiency and service, and quality of goods which are provided to customers. Where the public sector is significant in a national economy, improving the performance of state-owned enterprises means significantly strengthening the national economy.

Secondly, and associated with this, is the objective of **increasing competition** in the economy.

Thirdly comes **raising money** from public sales, either to reduce taxation or to repay debt.

And, fourthly, there is a wider political objective of promoting what might be called **popular capitalism**: wider share ownership, an awareness of property ownership, and securities ownership, in a democratic environment.

Having advised on six big UK privatizations and the same number overseas, I know that no two sets of circumstances are the same. And whilst one can generalize objectives, and one can generalize means of meeting those objectives to a certain extent, there are always specific and distinctive factors that have to be taken into account. There are general approaches and guidelines, but no simple package solutions to the problems of privatizing and commercializing particular firms.

Improving performance

Improving performance means greater efficiency, better quality of service and lower prices. We need to understand what the sources of those improvements are, because if we don't understand the sources then the policy routes adopted may not achieve the objective. In fact there are two sources of this improvement: the first is better quality of management; and the second is more freedom within which management can manage currently state-owned enterprises.

Better management is needed because in many parts of the world (perhaps most parts of the world), the public sector has traditionally been unable to attract the best management talent. That is partly because good remuneration, particularly incentive-based remuneration, has not always been readily forthcoming in the public sector. But it is also a matter of culture and image: the public sector in many parts of the world simply does not attract the best talent, because the best talent simply does not want to work in what it perceives to be a bureaucratic and stultifying environment.

One needs to be wary of taking this argument too far: I believe there are some parts of the world (I think in this category fall particularly lower-income developing countries) where the main management talent may reside in the public sector and not outside the public sector; so I don't think one should take the argument to extremes. But certainly in my view the most important change which needs to be generated by a privatization is a change in management behaviour, and that invariably means the possibility of new faces at the boardroom table.

Secondly, **freedom to manage the business** is also vital. Typically you find that state-owned enterprises are constrained as to investment. Not only is there frequently an investment ceiling over the funds which they have available, but they may also (in fact typically do) have to take large projects to government for specific approval. And so the electricity authority may find that the power station which it wants to build is on a list of priorities which includes hospitals, schools, tanks for the army and all sorts of things which have nothing to do with electricity generation. Their power station project may be an excellent project but it may not get funded simply because it is in a queue with other projects.

And also quite typically in the public sector there have been controls over prices. It is quite common to find that the prices charged by public enterprises are lower than they should be -- that is good for consumers but is not good for economic efficiency. And even if the overall level of prices is about right, very often you find considerable distortions in the way prices are paid as between different categories of consumer. In the utilities, for example, in electricity, gas, water, telecoms, it is very common to find that domestic customers are subsidized.

Furthermore, you find considerable restrictions over commercial relationships which state-owned enterprises can enter into. I think this is important and this is sometimes underestimated as a disadvantage which state-owned enterprises

face. But, for example, in the telecommunications industry more and more it is becoming realized that without the ability to enter into strategic alliances with other suppliers overseas -- alliances which may be politically unpopular if struck by a government -- it is very hard to remain competitive.

The government of Singapore, for example, is not privatizing Singapore Telecom because it needs the money, and it is not privatizing Singapore Telecom because it thinks it should be more efficient; it is privatizing it because it thinks that without the freedom to enter into international alliances (which it wouldn't have under government control), it won't be able to remain competitive as an international hub.

My reasons for dwelling on this are simply that mere change of ownership is not enough. Merely changing ownership from the public sector to the private sector without making or somehow inducing the sort of changes which I have described, takes one no further forward. So, in policy-making and in choosing options and routes for privatization, governments have to ensure that the fundamentals (and I have listed a few of them) are going to change.

Equally, of course, one might ask whether privatization is the only way to get these benefits. Why not simply make these changes within state-owned enterprises? Well, some steps can be taken. It is possible to make publicly-owned enterprises act more commercially, but the scope for improvement depends on where you start. Benefits can be considerable; giving organizations which remain in the public sector clear objectives, giving them financial targets, and giving them commercial systems all take one a long way further forward.

It is also possible (and we start to see this in the UK now) to give public sector management some sort of financial incentive, and so to gain some of the benefits I have described, without privatizing. But in some cases it is hard to, and the one thing that is most difficult to do without placing control in the private sector, is to achieve the shifts in culture and management attitudes which ultimately are crucial to some of the improvements that I have mentioned.

Increasing competition

Competition is often associated with privatization. I don't think it is truly an objective in its own right. It is a means to economic efficiency, a means to lower prices: indeed, in a market economy it is the most powerful means to these ends and any government intent on improving economic efficiency will want to look first to see whether it is possible to introduce competition. But we have to distinguish two cases, between industries which are so-called natural monopolies, and others which are merely monopolies because they have been granted a legal monopoly, or because the state has built a dominant position which no-one is prepared to challenge.

In the second category it seems to me that government policy should always look first to removing the monopoly; changing the law if it is a legal monopoly, or breaking up a dominant supplier if that is the problem. It is sometimes said that you don't need to privatize to introduce competition; you can simply allow others to compete against the state-owned supplier and see who wins. But state-owned suppliers typically have large dominant positions, and in a situation where you permit a state-owned competitor to trade against a private sector industry, private investors will never be convinced that the state-owned sector isn't taking advantage of its position, is not benefiting from hidden subsidies, and otherwise getting advantages not available to the private sector competitor.

In the case of natural monopolies, of course, the government (if it is going to privatize them) has to produce a form of regulation. That is not straightforward. It is easy enough to think of ways of controlling prices and ways of controlling quality and service standards; the problem is that if you over-regulate then you remove the very freedoms on management which privatization has set out to give them in the first place. The trick of regulation, for government, is to regulate just as heavily as is necessary to protect the consumers, but no more. If you go further then you tend to take away many of the benefits of regulation.

Raising money vs popular capitalism

The third objective which I mentioned was that of raising proceeds. Very obviously, in order to be saleable at all a business has to be viable. That will usually require restructuring. If the business is not restructured it might be unsaleable, or the government will not receive the full proceeds because some of the benefit of restructuring will go to the purchasers.

This leads to a very commonly experienced conflict. Governments find they have a choice between selling now at very low proceeds and selling later, after restructuring, at better proceeds. It is a good example of a more general problem which governments have to deal with in privatizing, namely that many of their objectives will conflict with each other. And one of the most important tests of governments and their advisers, is balancing these conflicting objectives.

To take another example, greater sales proceeds conflict with greater competition; competition is good for the customer but not necessarily good for the vendor of the company.

Or, again, sales proceeds conflict with wider share ownership, because if you are going to float a company widely it probably means that the shares must be priced rather more keenly than if they were to be sold in some other way, and there will be very heavy marketing costs.

Regulation is essential to protect customers, but if you go too far you destroy managements' freedom. Greater efficiency may involve loss of jobs and therefore

there may be a conflict between greater efficiency and greater proceeds on the one hand and the impact on employment, which may be politically very difficult.

And there are likely to be differences of view between the government and the management of the company being privatized. This could potentially undermine any privatization and means that managements have to be involved in some way in decision-making, without government losing control of the exercise. A common issue is the whole question of the industry's structure: if an industry is to be split, that will be seen to be threatening to the management and they may resist it. A great deal of diplomacy (and indeed other, possibly more vigorous means) may be needed to solve that sort of difficulty. The government needs to negotiate capital structure with the privatized industry, often the source of a considerable amount of heat in argument and debate: and of course, if it is a monopoly, will need to negotiate the regulatory structure -- this too is very often the battleground of many hard fought skirmishes.

Conclusion

So, what is the way through these difficulties for the government? There are no package solutions, and one needs to be careful about generalizing; but first of all the government must be clear about its priorities and know which objectives it attaches great importance to, and which objectives it attaches less importance to. Secondly, you must accept that there will need to be some compromises almost certainly between objectives: you cannot maximize proceeds and sell the business tomorrow; you may have to make choices.

Thirdly, and vitally, ask yourself whether the proposed course of action that you are taking really meets the fundamental objectives of privatization, namely, that it will change management behaviour on the ground. Take the management with you, if necessary by involving them in decisions in joint working groups and other sorts of machinery.

Lastly, learn from the experience of others. Obviously you must establish a competent team of your own, but you will learn by talking to other governments which have experience of privatizations, and by using advisers. Advisers who are experienced can help with the overall strategy which you adopt towards privatization -- identifying candidates for privatization, restructuring them, regulating monopolies, and indeed implementing the sale. National circumstances vary and therefore one has to be very wary of any form of generalization, and so in choosing advisors what you need to do is to choose those with lots of experience and a very open mind.

13. CHANGING PRIORITIES: RECENT LESSONS

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The UK government's objectives in privatization have changed over the ten years or so that the programme has been running.

It started largely with a view to funding budgetary deficits and giving scope for tax cuts. Thereafter, as the Tories began to gain more confidence, and as the first signs of a revival in the economy began to work their way through, we saw a change in the philosophy, moving more towards a rolling back of the frontiers of state capitalism. And then, finally, in the latter stages of the programme, stimulating competition began to come to the forefront of ministers' thinking. Overlaying all of this was a desire to widen share ownership.

Some examples

Let us see how that changing philosophy has been applied to four of the major privatization initiatives that took place during this period.

One of the very first privatizations was that of British Aerospace, in which I was personally involved. British Aerospace was privatized intact, without any attempt to restructure or to introduce more competition within the aerospace industry. To the extent that the government attempted to rationalize this at all, they pointed to the already intense international competition in the aerospace industry.

Moving on to British Gas, there was in this case an intense debate between the Department of Energy and the chairman of British Gas, as to the extent (if any) to which British Gas should be restructured or broken up prior to privatization. The end result was that Sir Dennis Rooke's views prevailed and British Gas was privatized as a monopoly.

British Telecom was privatized intact in the same form in which it was operating in the public sector, but here the government introduced some limited

competition in the form of a licence for Mercury Communications -- and this competition has become more effective over time.

In 1990-91 we saw the government's most ambitious project: the privatization of the electricity industry. The electricity industry can be broken down into two parts: the generation industry where there was a very significant restructuring prior to privatization, with the aim of promoting very significant competition; and the distribution industry which was virtually privatized virtually intact.

The role of government departments

The role of the sponsoring department has been subject to some considerable changes over the term of the UK privatization programme. These changes have lessons for the many other government departments considering privatizations around the world.

At the beginning the government departments were rather tentative in their relations with their City advisors and were very easily swayed by their advisors on the question of the final pricing of the issue, and on the need to produce a healthy after-market in the shares. As government departments gained in understanding of the process of flotations in the City of London, they increased in their confidence. The development of the electricity privatization is a very interesting example of that process.

You will recall that the first stage of the privatization of the UK electricity industry was the privatization of the distribution companies, which have an effective monopoly. In that case we saw the shares moving to very substantial premiums in the weeks and months after the initial issue at the end of 1990. By the spring of 1991 the government was ready to privatize the generators. Here too there were healthy premiums in the aftermarket, helped by the rapid resolution of the Gulf conflict, but nowhere near to the same extent as those apparent in the distribution companies. Later in 1991 we saw the flotation of the Scottish electricity companies where the government has clearly at last managed to extract the last ounce of blood for the taxpayer, and the premia in the aftermarket have been very modest indeed. There are surely lessons to be learnt there for all future privatizations through flotation.

Government and advisers

The next theme that I want to dwell upon is the government's relationship with its advisors, because the UK experience provides some lessons for other countries.

First, you must make sure that if you are not expert in selecting your advisors then you borrow expertise from somebody who *is* expert. You must give yourself adequate time for this process, which is crucial to the ultimate success of your privatization. And you must make sure that the people on your selection panel

are of sufficient authority to ask advisors probing questions that will test their expertise.

You must also decide whether the government and the company itself are to be separately advised. Interestingly, in the UK the government has always gone for separate advisors but this has produced a somewhat adversarial atmosphere into UK privatizations. It is not a route that has been adopted in many other countries.

If you are interviewing a consortium of different advisors -- investment bankers, accountants, lawyers, economic consultants -- you must look carefully at how well they interrelate with each other. Make sure that the advisors will be working for you and not treading on each other's toes.

And, finally, cheapest is not always best.

Regulation

Let me now turn to regulation. Where you are privatizing a monopoly, inevitably you are going to need regulation to ensure that the privatized company does not attempt to exploit its monopoly position. And therefore, attracting the right candidate as regulator is particularly important. It is not always an easy task, perhaps because the government has not always been happy to match private sector salaries in this regard.

Having decided on the right candidate, you then have the dilemma of whether to go for heavy regulation or light regulation, with the expected impact that those two approaches can have on the price you realize for your investment. Clearly, investors are going to suspect a heavy regulation, which can only mean bad news for future profits.

The government has found this extremely difficult to deal with, especially against a background of rapidly escalating profits from British Telecom, British Gas, and the electricity utilities. We have seen much moving of the goalposts on regulation, with the initial price-regulation formula of RPI-X now being debated. We might even be moving towards rate of return regulation, in order to give some protection against the political problem of private sector monopolies exploiting their position.

These dilemmas between competition and breaking up monopolies, and between heavy and light regulation, are two of the major pitfalls to avoid for those of you who are charged with regulating and privatizing a state monopoly.

14. THE MECHANICS OF RECONSTRUCTION

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Regardless of the specific methods of privatization, it is our experience that the majority of enterprises which are scheduled to be privatized can benefit by some form of restructuring. It is not necessarily because they are not fundamentally good businesses, it is just that restructuring will very often improve the attractiveness of those particular enterprises. And, of course, there are a number of enterprises which frankly could not be privatized in any shape or form, unless they were restructured.

We have been very heavily involved in advising governments internationally, including in particular Central and Eastern Europe. The major part of our task has been to examine critically the enterprises that we have been asked to look at, and often this has led to us assisting in creating a viable business entity. Sometimes that creation has to come out of something which is not at first blush obviously privatizable. So there are enterprises that need a bit of creativity, the basic aim ultimately being to attract purchasers.

Loss-making enterprises which seem to be producing a wrong product, perhaps also in the wrong market, can still be turned into viable entities. Similarly, well-managed enterprises which have been profitable in the past but have found that their markets have collapsed, again can be restructured in order to make sure that they are addressing issues which will enable them to conduct business over the years ahead.

Therefore the issues I want to discuss are the following:

- when is it necessary to restructure enterprises?
- what are the objectives; what does it achieve?
- when should restructuring take place: before, during, or after privatization? and;
- what does the process of restructuring actually entail?

Commercialization is a prerequisite for privatization. Restructuring is needed for all state businesses, not just those which are earmarked for privatization, though it might be particularly necessary for those which are scheduled for privatization. We have seen very few enterprises which could not be made substantially more attractive as a privatization candidate by being restructured through:

- * reviewing critically the existing organization structure and management;
- * revisiting and reviewing the strategy to produce a detailed and realistic business plan for, say, the next three years ahead;
- * determining what personnel requirements are needed to tie in with that plan;
- * establishing systems which allow for an easy production of management and other financial information, enabling management to take management decisions quickly;
- * introducing performance measures by which management performance can be judged and for which they are actually accountable; and
- * creating a commercial ethos which is part of the process of restructuring: thinking profit, thinking customer service, thinking market, thinking of ways of making sure you get the best out of your employees.

Businesses which undertake this sort of process would generally be better privatization candidates than those that don't. It follows logically, therefore, that in an ideal world without the outside pressures of politics, finance, and general macroeconomics, restructuring should logically precede privatization.

The trouble is that life is not quite so simple. The restructuring of enterprises has to be accommodated into the government's own particular privatization strategy. I have never met a Treasury department of any government whose prime objective is not to maximize the proceeds or minimize the cost of privatizing. And then the ministry of privatization, or the privatization unit, will have a general privatization programme, and therefore the privatization of one particular enterprise needs to be shoe-horned into that general programme. So there is a question of timing and conformity with the programme. Then, of course, there is the sponsoring ministry of the enterprise being privatized; it will have its own particular objectives. The employment ministry will wish to minimize the impact of any unemployment.

The enterprise management itself will obviously have their own agenda. Even if it is not interested in participating in the equity of the privatized entity, it will, nevertheless, wish to be involved in the selection of who the purchasers are going to be, particularly in the case of a trade sale.

Many of the employees' interests will be very similar; however, we have, in a number of instances, found that the objectives of the employees and the management are in conflict.

Those who are interested in accelerating the privatization programme will tend to want to leave the restructuring problems to the purchaser. If one is talking about a privatization by way of a public offering, that decision is probably not

possible to make, because in order to appeal to the public at large, certain fundamental restructuring has to take place. But there is often quite a simple trade-off decision in the case of trade sales, as to whether you let speed be the dominant objective over cash proceeds.

In many cases there is no choice: you actually have to restructure if you are trying to create a privatizable entity out of a particular enterprise. Each enterprise obviously has its own peculiar circumstances, and the question of timing of restructuring does have to be taken on a case-by-case basis.

What restructuring entails

I have already touched upon some of the areas from which enterprises can benefit by being restructured. More specifically they can be categorized as follows:

The business plan. I would divide the business plan into two parts: one is the strategy plan and the other is the financial plan, the financial translation of that strategy. This is a very difficult exercise for management if they are doing it for the first time. In many of the countries where we are operating this is further compounded by the fact that the economic environment in which they are having to devise a three-year or a five-year plan is rapidly changing. It can be very difficult to produce a plan which has any real credibility; of course you can put assumptions into anything, but there has to be a degree of realism. Nevertheless, the exercise has to be carried out.

In the case of the strategy plan, there has to be a fundamental change in attitudes for many enterprises. Again, some have already developed highly-sophisticated plans which provide the core for privatizing: but in a great many cases one has to rethink the whole basis as to where the management wish the business to be in three or four years' time. What do we have to do in terms of the structure of the business, to enable us to produce the work, develop the business, perhaps in new areas, in five years time?

Future business. The obvious area to consider first is quite clearly what future business activities we wish to be in. A very good case in point is the dynamic situation in which enterprises find themselves in Eastern Europe. Enterprises may have had a highly profitable past, having a virtual monopoly in the products in which they traded, and could only be imported and exported through these organizations. Now the monopolies have gone, foreign trade organizations, or enterprises, are allowed now to compete one with the other, and the market which was the former Comecon bloc has disappeared. So you have enterprises whose entire market has disappeared.

On the other hand you do have managements which have already been exposed to Western disciplines or involved in international trade. Here the task lies in trying to develop the strengths of these particular businesses, in putting them

forward, eliminating the weaknesses, perhaps closing down areas of business which do not have any viable future.

Management structures. The next items on the agenda include the training of staff. How do we actually make sure that they respond to the changes; not just the senior management, but how do the second and third tier of staff generally respond to the changing philosophy that needs to permeate through the enterprise?

What sort of management information systems exist? It is our experience that there is usually little shortage of financial information -- the only trouble is that it is often totally irrelevant. But new areas of information need to be provided: market research; customer demands; those sorts of areas. Management information needs to be produced from a system that enables its easy, quick production, and easy interpretation.

Financial plan. Then there is the question of the financial requirements -- working capital and capital expenditure -- which of course is the translation of the strategy plan into a financial plan. How do we ensure that we have the right amount of finance, and the right sort of finance, to develop the business? It may require a major investment into a certain business area.

The next issue is to make sure that we have the right capital structure, the right balance between share capital and debt capital. Again, debt probably existed before the enterprise was marked out for privatization, but of course there was a lot of government funding or government guarantee behind the debt. Therefore, these sorts of issues need to be addressed. It is all very easy to say that we can revise the balance sheet such that we can inject some debt into the business: but you have to be sure that that business can support the servicing requirements that such debt creates.

Valuation. One particular area of privatization which is close to the heart of most parties involved in privatization, is that of valuation. Clearly, the restructuring of an enterprise can have a profound effect on the valuation. It may well be that you are actually splitting a monopoly into different types of business units; some may be privatizable by way of a public offering, other parts by way of a trade sale. But the way in which you direct a particular business, in terms of the method of privatization, will have an impact on the question of valuation. Whether the restructuring is designed to enable the government as owner to extract as much as possible from the sale, or whether it is purely a recognition that the enterprise has to be restructured, will make the valuation very different.

15. THE MECHANICS OF CORPORATIZATION

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Corporatization is about bringing private sector disciplines to public sector activities. In my work in Australia and New Zealand I have found a very real desire to introduce private sector investment into public sector activities. And corporatization is in itself an essential step towards privatization.

The underlying objectives of corporatization are:

- * to improve the quality of services;
- * to ensure that the entity operates as efficiently as possible; and
- * to separate out commercial and social objectives, and make sure that the costs of each are identified.

Clear objectives

Clear objectives provide a direct focus for management and prevent management from using poorly specified objectives as an excuse for unsatisfactory performance. Basically, that requires us to separate out the non-commercial activities and the non-commercial objectives. And this can be done in a number of ways.

You can take those non-commercial activities and pass them back to government. In Australasia, this is happening in some of the property businesses where the business of actually setting government occupancy standards is now being looked after by the Cabinet Office, whereas the business of managing the government's portfolio is being handled by a corporatized entity.

Another route is to continue with the government enterprise providing these non-commercial services, but make sure that the government actually pays for them. This concept is known in Australia as community service obligations, and is probably more advanced in Australia than almost anywhere else in the world, because the very large size of the country means that some of these CSOs are

enormous. For example, in Queensland, which is about the size of Europe, the Electricity Commission has to provide electricity at the same price for the same tariff, to everyone in the state; even though it obviously costs much more to connect people who live very far away in the remoter parts of the countryside. At the moment exercises are being undertaken to identify what the costs of doing this are; and the government will be providing a subsidy to make sure that those costs are borne by the public at large and not by the corporatized electricity body.

The next type of area which needs covering when you split out these non-commercial activities are regulatory activities. In New South Wales the Hunter Water Board has all sorts of regulatory responsibilities. They have to look after the quality of water, they have to look after the standards of service which they provide to their own customers; and you cannot expect this body to act in a totally commercial way if at the same time it is regulating itself. So those regulatory activities are being taken away from the management of the Hunter Water Board to be carried out by government.

All of this is to try to identify very clearly commercial objectives for management so that they do not hide behind the excuse of differing and conflicting objectives when it comes to explaining their performance.

Monitoring standards

Without the discipline of a marketplace the best way to make sure the performance is achieved is to enter into a sort of contract between government (as the shareholder) and the management of the body (as the people who are going to provide the service). And this is exactly what is happening with these corporatized electricity bodies and water bodies. They agree a plan, a corporate statement of intent, with their minister, and they then have to deliver it. And if they deliver it they get rewarded; if they do not then there is a sanction, and either they will lose part of their pay or, in the final analysis, they will be sacked.

Fair competition

Fair competition is in many ways probably the most important factor of all. Essentially it means creating a competitive environment as far as possible, and whether one is looking at the electricity industry in New South Wales, or businesses like water or property services, in every case a real attempt is being made to deregulate the market and introduce competition.

Fair competition means making sure that these government enterprises do not have any special advantages or disadvantages as a result of being owned by the public sector. Ultimately there are two advantages which you really cannot get rid of: one is the fact that if the government is behind you there is an implicit government guarantee, and the other is the fact that you can borrow more

cheaply. What is being done in Australia to counteract that is to insist that the businesses pay a proper commercial rate on their borrowings, and to allow the sanction of sacking if performance is not met. That is about as near as you can get to bankruptcy.

Australian experience

The first thing which surprised me when I got to Australia was just how important are the states. The federal government raises all the money but it is the states who actually run most of the state-owned businesses and public enterprises. So it is important to look at what is happening at the state level to see how corporatization is getting on.

The federal government is a Labour government, and indeed all the state governments, except for New South Wales, are also Labour. The New South Wales government is a Liberal government which is leading the way (in terms of corporatization) by corporatizing the Grain Handling Authority, the Maritime Services Board, the Hunter Water Board, the Electricity Commission, forestry, the State Transit Authority (which runs all the buses), and last (and probably least), the Fish Marketing Authority. They are running corporatization with a very small, strong, central reform unit, which decides what is going to be corporatized and then monitors progress.

The other states are following quite closely behind and Queensland in particular is pursuing a policy of corporatization. It is beginning to happen in Western Australia and South Australia, and also in Victoria where, largely because of financial necessity, the government is looking at ways of introducing private sector capital.

There are a number of common themes throughout these corporatization programmes; in particular the idea of restructuring for competitive efficiency, the idea of looking for involvement of the private sector in helping to fund and finance new capital spending, and also the idea of seeking clear and market-driven objectives for management.

A case study

The electricity industry in New Zealand used to be a government department with a legal monopoly and an obligation to anticipate and meet the highest possible level of demand for electricity. It had a powerful trade union, with excessive costs, excessive manning, and excessive levels of generating capacity. So there was an enormous amount to do in order to introduce private sector disciplines and efficiency. But four years down the road the results are really quite dramatic.

The annual cash flows back to government, which were (four years ago) a little under \$0.5 billion are now over \$2 billion per year; and during the same time post-tax profits have risen from \$140 million to \$400 million; the rate of return has gone up from 4% to 13%; and the costs of sales have shrunk by 26%.

There has been a reorganization of staffing and there have been big changes in manning procedures and practices, and a great deal of contracting out of services, as a result of which staff numbers have fallen by one-third and productivity has gone up by 70%. In terms of the other major cost -- fuel -- the coal corporation has also been corporatized and coal costs have been reduced by 50%. The interesting thing is that the coal corporation used to provide coal at a loss; but having halved their selling price they are now selling at a profit.

These are impressive achievements, and the customer is benefiting as well. Surprisingly perhaps for a profit-driven organization, prices have declined by 16% in real terms, and customers are now being offered more interesting pricing options and packages.

There have been tremendous improvements in staff attitudes; line managers in particular are now given more authority and autonomy. And essentially what is happening is that the industry and senior management are able to tap into talent which was always there but never recognized and brought out.

Practical steps

How was all this achieved? The first thing was the creation of a task force and a number of small specialized working groups which tackled the important issues in a logical way. By working in these small groups it was possible to overcome the inertia which is otherwise inevitable in a large bureaucracy.

The second thing is that these deliberations and discussions were kept very confidential, and the argumentation was developed by specialists, and in a very robust way, to make sure that it stood up in practice.

Thirdly, having decided what to do, the government acted very quickly; and I think this was very important. Some people will say it is actually better to go slowly because it causes less trauma, but I cannot agree. Because of that inertia, which is there in bureaucracies and government, and because of the natural opposition which people have to change, if you go slowly it is all too likely that things will not happen. What is needed is strong leadership and determination to get things done, and vigorous leadership which sets an example.

The fourth thing worth mentioning is management and staff positions. Everyone had to re-apply for their jobs. This introduced competition, even into the employment base of the organization, and it also had the effect that everyone thought very carefully about why they were going to do the job they wanted to do, and has resulted in an effective pledge of support to the new organization.

A number of positive lessons have been learnt; and one the is fact that people *can* change. There is a remarkable resilience to change, and to worry too much about imposing change on organizations is perhaps a mistake. People can change, welcome change when they know why it is happening, and can see the opportunities in it for them. And we have seen plenty of examples of that here in the UK and elsewhere in Europe.

Agreement with the unions and good communication with staff is clearly very important, but success in this case depended on communication and agreement, and not negotiation. The approach to change and the development of new thinking took place on a confidential basis in the small working groups. Once change had been decided then the communication and the agreement followed smoothly.

An awful lot of time and money can be spent on asset valuations. If you are looking at what is going to be a market-based organization, it is the market which is going to set the price of your product, it is the market which sets the rate of return, and it is the market that will decide the valuation. One of the difficulties with corporatization process is that sometimes too much time is spent valuing assets, rather than opening up the whole business to the pressures and discipline of the marketplace.

From corporatization to privatization

Privatization is an essential and almost inevitable step after corporatization. This is certainly the lesson we have learnt in the UK, and what I have been describing in New Zealand and Australia is very like the nationalized industry situation which we had for many years in the UK. Corporatization is a difficult status to maintain for long, because it is very difficult to avoid these industries becoming political footballs.

In New Zealand they have found precisely the same, and the move from corporatization to privatization has actually taken place very quickly. In theory, corporatization is enough; in practice I doubt if it is. Management wish to be free of the shackles of government involvement, which can change, no matter how good the agreements between management and ministers. That relationship can change when ministers change, so managers are keen on the removal of political control and involvement. But above all, it is likely that privatization is really the only way to lock in these remarkable efficiency gains; and that if the competitive pressures of the marketplace are not there, and if privatization does not take place, it is all too possible that those efficiency gains will be lost.

16. MINIMIZING RISK EXPOSURE, MAXIMIZING VALUE

Adrian Platt

Managing Director, Special Projects, Sedgwick Group

My firm, which is the largest of the European-based insurance brokers, has been involved in many privatizations both here and in many parts of the world. But I am not going to suggest that every company should be carrying a total insurance package for all its risks. What I seek to do is to highlight the vital responsibilities of government privatization agencies, the managements of companies being privatized, and their advisors in risk management.

There are many types of liability and losses that may be faced by any company, such as:

- an explosion
- a damaging long strike
- a disastrous fire
- a computer breakdown
- the insolvency of a sub-contractor
- the effects of a ghastly earthquake
- becoming a victim of pollution

You will see how these problems could ruin a business. While some are natural disasters, which you can do nothing about, there are many other types of loss where good planning and action can significantly reduce, and in many cases eliminate, the risk. The basis of good risk management is to take action to minimize these difficulties.

While a company is in state ownership its total approach to its financial base is different to that which it will become when it is sold. Unless self-financing policies have been rigidly applied for years, it is inevitable that the state has been the vehicle to replenish funds when needed. If we think of Chernobyl, who has paid for the billions of dollars of loss which has occurred? Who has paid for the safety measures, which are supposed to prevent a further leakage? Who has paid for the loss of life; the contamination; the loss of forestation which has occurred? The answer of course is the state.

If Chernobyl had been a privatized company, who then would have paid for the cost of trying to prevent further leakage; the cost of reconstruction; and the liability losses? Needless to say, the answer is the shareholders, *unless* the board has taken adequate steps to protect against this risk. Therefore, the directors have a serious responsibility to address these issues as a clear part of their management strategies.

As you will appreciate, all these setbacks strongly emphasize the need to have a risk management policy and to consider effective ways of financing these risks, such as, perhaps, insurance. Can you afford not to have a risk management policy?

Over the long term, investment in risk improvement strategies eventually reduces the total cost of risk to the enterprises. This in itself must enhance shareholder value over the long term.

Risk management sequence

So, what can you do to implement this philosophy and achieve these benefits? The sequence is very simple:

Risk audit. It is necessary to interview the management to find out the general strategy and their perceptions of the key risks, and then to inspect the facilities physically, so as to establish the complete profile of the risks.

Risk analysis. Here we categorize the risks into small, medium, and severe, and whether they are insurable or not insurable.

Risk improvement. Once we have established the profile of the risks facing the enterprise, we need to identify the areas for risk reduction, and to produce an action plan to achieve that improvement. This will, of course, include items such as safety procedures, security procedures, and environmental issues.

Risk philosophy. From the first stages stems a philosophy of the principles and the financial criteria that the company needs to adopt to protect its balance sheet and its shareholders.

Risk transfer. Once we have established the general philosophy on the handling of risk, it leads to a decision on what risks should be transferred to, or shared with, others: this includes the insurers, but insurers are the last part of this initial process.

Risk control and disaster planning. Both these disciplines are needed to ensure that the process is monitored, and if possible improved, as the years progress. However, we believe that all organizations should have a comprehensive disaster contingency plan.

Particular risks

Let me now turn to a further item within the programme, and this is to address particular ways in which insurance and risk management can help the privatization of a the company.

Past liabilities. If a company has old liabilities which the seller insists upon the buyer absorbing, but which the buyer is unwilling to accept, a breakdown in negotiations can occur. Examples are the environmental clean-up of waste sites; past injuries to employees, such as industrial deafness and so on; or lawsuits against companies being privatized. In privatizations we have been able to transfer certain liabilities to the insurance market for a suitable insurance premium -- resulting in both the seller and the buyer being happy.

Prospectus indemnity. In UK privatizations it is quite normal for the directors and officers of the selling company, and their advisors, to be responsible for the production of an accurate prospectus. So special insurance has been available in the UK, designed to protect them against shareholders' suits for incorrect information.

Protecting key men. Occasionally (and we have certainly come across a few examples of this) the strength of a company to be privatized lies in the hands of very few people; should those key people not be available in the future (through death, disability, or migration, say) this would reduce the attractiveness of the company and the stability of the company. Insurance is normally available for this.

Pensions and employee benefits. Privatized companies know the importance of employees being happy and motivated, but any lack of clarity in pension rights creates uncertainty. Obviously, although state pension schemes may still apply in many privatizations, it is likely that a newly privatized company will need to examine supplementary pension schemes to attract, retain and motivate the best employees. The same principle, of course, implies to other employee benefit programmes.

Political risk. For a foreign investor, insurance against confiscation, expropriation and contract frustration is usually available in commercial insurance markets and under various state export credit schemes. In many cases, banks may well require this cover to support their loan facilities.

Enhancing value

What benefits will this have for those involved in privatization? I would naturally stress the improvement in attractiveness and the enhanced value for buyers. It would be a clear embarrassment to a government if a major accident resulted in a loss, not foreseen in the prospectus, to new shareholders who are still learning about investment. Indeed, it could lead to a major reduction of

confidence in the whole principle of privatization and indeed in a market economy. By contrast, the ability of a management to state publicly that they do have a risk management policy, and that they have spread some risk to the insurance market, could in itself enhance share price.

I have only touched in the briefest detail on some of these areas, but I hope it has brought home the vital need to address your risk strategy, since if not properly considered it could seriously affect the sale and the future of those companies under your responsibility. These types of losses, if they occur prior to the negotiations, could have a disastrous effect on the potential sale price, or share price, of the company concerned.

In conclusion, I would encourage you to use the risk management and insurance industry to make your life a little easier. Risk management, we believe, is good for your country, your company, and for you.

17. REFORMING THE UK HEALTH SERVICE

Dr Sabri Challah

Partner, Touche Ross

Big changes are taking place in Britain's National Health Service as a result of the publication of the Government's White Paper *Working for Patients* after a period of intensive political debate. The White Paper was published in January 1990 and the changes proposed have been implemented as of April 1991.

Touche Ross have been closely involved in advising on the implementation of the reforms, which are to date the most radical set of proposals for revising the way in which health care is delivered in this country.

Pre-1991 organization

The NHS was first established in 1948, after the Second World War, as part of a package of sweeping social reforms which were designed to create what was described at the time as 'a land fit for heroes'. The basic character of the Service, tax-funded and free at the point of use, is a characteristic that no government has felt able to tamper with in the four decades of the NHS's history. It is a characteristic that is important to the British public, and has shaped the nature and the culture of the Service.

However, since its inception in 1948, successive governments have tried to improve the efficiency with which the NHS performs, and have tried to address the variable quality of its clinical care and the enormous inequity that exists in the provision of health care in different parts of the country.

There have been attempts to improve efficiency and to raise quality, and it is fair to say that they have had some success; but despite that there remain enormous differences in financial and clinical performance in different parts of the NHS; and still quite striking differences remain in the level of provision.

The latest set of proposed reforms outlined in *Working for Patients* attempts to address these problems by changing the accountability of provider units to the most local level; and by introducing some element of competition, for the first time, into the state-funded health care sector.

Prior to April 1991, the Department of Health was responsible for determining national priorities in health care delivery. The Department allocates funds to fourteen regions, each covering around 3-4 million people, which are responsible for identifying priorities, and monitoring the performance of the operating units in the Health Service.

The actual operating units, prior to April 1991, were the District Health Authorities, which number around 190 in England, cover populations of between 200,000-250,000, and typically have a budget of between £50-£100 million, depending on whether they house a teaching hospital or not.

Previous attempts at improving efficiency have focused on cost improvement programmes at District Health Authority level, and efforts to identify and publish performance indicators of District Health Authorities around the country.

New structures

From April 1991 this arrangement altered. Of the changes, the most important and the most significant is the separation of the purchaser and provider roles. In effect, District Health Authorities are being split into two bodies. On the one hand, each will act as a purchaser, funded to acquire health care services for its catchment population; on the other hand, there are now separately established provider units whose responsibility is simply to deliver health care in accordance with the requirements of the purchasing authorities.

Contracts. The relationship between purchaser and provider will in future be governed by contracts. In the first stages of operation of this so-called 'internal market', the contracts are fairly crude and simple, but over time they are becoming increasingly sophisticated, and are starting to define specific procedures and set down specific prices for these different interventions and diagnoses.

DMUs and trusts. The provider units may take one of a number of forms. In the early stages the majority of provider units will be so-called directly managed units (or DMUs), which will remain within district health authority control, but will have an arm's length relationship with the purchaser, which is free to acquire services from any provider it chooses, and is not necessarily tied to its local directly managed units. However, in addition to that, NHS Self Governing Trusts have been established. These are essentially hospitals which elect to opt out of the district health authority control, and which in addition have certain freedoms, including the ability to pay staff in the way that they deem fit, and certain limited borrowing capabilities; but above all they are free of local bureaucratic control through the district health authorities.

Capital accounting. In addition to the establishment of trusts, the Health Service will account for the cost of its capital for the first time. In future, all providers are required to earn a return on their capital. This is already changing

people's decisions about investment in new hospitals, new plant and new facilities.

GP Fund holders. The reforms also provide for the establishment of so-called GP Fund Holders. While the majority of purchasing will be done by district health authorities, general practitioners will be entitled to contract for certain elements of care on behalf of their own patients. At the moment this means mostly planned surgical procedures, but depending on how the experiment evolves, it may be extended to include other types of care. This measure will push purchasing down to the most local level possible, namely into the hands of the individual primary care physician.

Finance. In future, Districts as purchasers will be funded on a per capita basis; in other words they will be funded simply according to the number of people that they are responsible for, with small adjustments for morbidity rates and social deprivation. This is considerably simpler than the funding arrangements from the past, and is intended to introduce greater equity into the funding that is available for populations in different parts of the country.

Quality. Finally, the White Paper places enormous emphasis on improving quality across the Service. First, there is a new emphasis on clinical quality as managed by doctors and nurses; and they are required now to put in place specific arrangements for quality improvements. And, secondly, provider units are being asked to look very carefully at the service they give to their customers. How long do people have to wait in out-patients departments? How long do people have to wait for an appointment? What is the general environment like? How consumer-responsive are the provider units?

Implications of the reforms

Because the purchasers are freed from running hospitals, they have more freedom to concentrate on the task of evaluating the health care needs of the population for which they are responsible; and then contracting for those needs in the way that they see fit. That may mean buying from any provider unit which provides services at the right quality at the right price.

It is intended, ultimately, that the performance of these purchasing bodies will eventually be determined by the level to which they improve the health status of their population. We will be seeking clear measures of improvement in health status by which to evaluate them.

For providers there will be competition on price and quality, though clearly the level of competition that different provider units will face varies across the country, and is likely to be more intense in urban areas where, typically, hospitals have been concentrated.

We have already seen the publication of limited price lists, which indicate an enormous variation in costs across the service, though this new competition may well lead to some equalization of cost, performance in different parts of the NHS.

The provider units are expected to be financially viable. The situation where hospitals are allowed to operate with deficits is no longer possible in the new environment. They must deliver services, agreed on a contractual basis, at the agreed price and quality.

Conclusion

The reforms are still at a comparatively early stage and we have yet to see what the results are. However, there is no doubt that they are already altering the nature of the Health Service. We already see provider units preparing business plans, planning competitive strategies, and evaluating the market, in a way that we have never seen before. This is leading to changes in the way health care is delivered.

It is my belief that if these reforms are properly and fully implemented, there are major benefits to be seen in the way health care is delivered; and we can move from a situation in which health care has been provision-led to one where it is needs-led; from a system which is professionally dominated by doctors, and shaped by their views about health care, to one that is responsive to patients and primary care physicians; and from a service that is hospital focused to the one which is more concerned about needs in the community and more concerned with prevention. There, perhaps, some of the greatest benefits in health status can be achieved.

18. REFORMING A STATE INSURANCE COMPANY

Lesley Watts

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Many countries are considering the privatization of state banks, insurance companies, and other financial services. The Irish government are currently selling Irish life, the Portuguese government have already sold one insurance company and are looking at some of their banks, the Italians are looking at privatizing ENA, and Czechoslovakia is considering the privatization of its two life insurance companies.

I would like to look specifically at the privatization of Denmark's state life-insurance company and to take that to illustrate some of the tensions between the interests of the various parties involved in a privatization.

The market and the company

Denmark has a population of five million, and has one of the highest per capita incomes in Europe, generally pretty evenly spread among the population. It has an insurance market that is increasing in concentration and has strong growth; there are twenty or so life companies in that market, but only a handful of subsidiaries are foreign owned companies in spite of the fact that there are no barriers to foreign entrants into the life insurance market. Both mutual and proprietary companies are active in Denmark, though they look rather similar due to the nature of the market itself.

The market was dominated (and still is dominated) by two companies -- State Life and PFA Pensions. Between them these companies control more than 50% of the total premium income. The growth in the market since 1985 has been at slightly more than 10% per annum, a good strongly-growing market. There is a state pension scheme, which employees are required to join, and people can add their own pension schemes on top of that in a tax efficient manner: about 25% of Danes currently have some sort of additional cover. As in other mature markets, Denmark has an ageing population, and there is increasing pressure on the social security system and on pension provision by the government.

Having said all of that, State Life itself was and is the leading provider of pensions and life insurance. It sells both through its own direct sales force and also through company schemes, and it currently has some 30,000 policyholders. It is probably the longest established life company in Denmark, and since 1842 the state has been involved with it. But in April 1990 the Danish parliament approved its sale, driven partly by a need to raise funds and partly also by philosophical belief that life insurance did not belong within the state sector.

The competitive position of the company itself had a bearing on the final decision by the Danish parliament that it would be more appropriate to go for a trade sale rather than a flotation. In May 1990, therefore, the Ministry of Finance, which was leading the privatization, announced that 80% of the company would be sold to a single purchaser or to a consortium, based in Denmark or outside.

In a privatization like this, there are certain conflicts inherent in the objectives of the seller (that is, the government). There is the need to protect policyholders and to protect the employees of the company, balanced against the need to obtain the best possible price. There was also, in this case, a desire to sell a majority stake to one purchaser or a consortium, but there was a desire to keep the policyholders involved in the company and to give them an ongoing voice.

Information to bidders

The first crucial element that we had to deal with in terms of the trade sale was obviously how much information to give purchasers in the first round. Denmark was not that widely understood outside the Scandinavian market. The structure of the life market itself, the way Danish insurance companies make their money, the taxation system, the likely changes in the environment, were all unfamiliar to many prospective purchasers. We had to provide sufficient information in the first stage to whet the appetite of a prospective purchaser, but without giving away too much confidential information and causing problems in the future.

We issued an information memorandum, therefore, dealing primarily with the public information on the company but also designed to be an information pack on Denmark itself and on the Danish market. From our initial discussions we selected a shortlist of bidders, on the basis of their financial strength and reputation and their reasons for wishing to acquire the company. The shortlisted bidders then signed a confidentiality letter, and at that stage we disclosed to them genuinely competitive information -- about the product mix, the profitability of the products, the reserves of the company, the administration and details on the cost structure: all of which would be of great value to other potential competitors.

A six-week period was given to those potential bidders to talk to the management, to look at the information, to discuss it with their advisors and to make a final bid. And at the final bid stage we then spent time discussing and

negotiating the contract, and giving the final purchasers a chance to consider all the details adequately.

Significant issues

Within that timetable there were a number of issues that are not perhaps immediately apparent but which turned out to be very significant.

First of all, the policyholder's interests are long-term -- 20-25 years for many of them. Secondly, as elsewhere, policyholders who move their policies suffer a severe financial penalty, and policyholders were therefore not in a position to vote with their feet when the final outcome was known. For those two reasons it was particularly important to look at the financial stability and security of the potential bidders -- particularly since the company has been owned by the state, since many people had probably taken those policies out because security was of prime importance to them, even though the company did not offer the best returns in the market.

The 20% that the state did not sell was reserved to provide policyholders with a continuing interest in the company and with a continuing voice. That was always likely to be more of a forum for communication between the company and the policyholders than any major power over the running of the company, though policyholders did consider whether they could form a committee and wield the 20% as a block to give them greater power. That came to nothing, but it did cause concern and it was in the back of the government's mind in looking at the status, the prestige, and the reputation of potential purchasers.

Another issue which arises in every privatization is the question of non-domestic purchasers. There was a concern in this case that an overseas purchaser might make it difficult for the government to realize a good price for the company. A number of the local pension funds made it known that if they did not feel the purchaser was appropriate, if they had 'no confidence' in the purchaser, they would then take their business away. On the other side of the equation is the fact that almost any Danish purchaser would potentially have a monopoly problem if they purchased the company. In fact, that came to be felt as no real obstacle: in PFA there is at least one extremely strong competitor in the market, so questions of monopoly would not be a major consideration. And over time the concerns about overseas purchasers did die down.

A major issue for everyone was the protection of policyholders, encapsulated in Danish law as the statement that the legitimate bonus expectations of policyholders must be fulfilled. That sounds straightforward enough, but of course no actuary had any idea as to what exactly the legitimate bonus expectations of any policyholder really could be. It was therefore very hard to encapsulate. It finally came down to providing that the company did not pay too much of its profits out by way of dividends. The government, therefore, put a

restriction on the distribution of dividends by the company for a period of ten years; over that period dividends could not exceed the company's share capital.

Why would anyone purchase a company where you could take out a very limited amount in dividends over the next ten years? The answer is that, in common with many other Danish financial companies there is the potential to run the company more efficiently, to reduce expenses, and to make management charges for services like investment management. There is, therefore, the potential for a purchaser to make a return by improving efficiency and extracting fees for services. But what there was not was the potential to take money out in the form of dividends, for a period at least.

There was no golden share; when the 80%+20% was sold, the government did not retain the right to veto prospective purchasers, but it did give a guarantee on all policies in force at the date the company was sold, and it did retain the right that while any of those policies were in force its consent would be required to a transfer of the business. That rule is to ensure that the purchaser can sell the company on only to a purchaser of at least equal financial standing in order to make sure its guarantee is not called on.

The company had a logo which, while not entirely that of the Danish state, was very close, and both it and its name very clearly tied the company into the Danish state. Equally, for a prospective purchaser these elements were part of the company's goodwill, part of why you would buy the company. A compromise had to be reached. The logo turned out to be pretty easy. The company redesigned the logo in a form which did not imply a close tie with the state but which was at least similar enough to the previous logo to make the clear connection between the two companies. The name of the company, it was agreed, could be used by the prospective purchaser for a period of years and then would have to be changed.

There was also an argument at one stage about the ownership of State Life. As in the case of the TSB in the UK, there was a question whether the government or the policyholders themselves were the owners of the company. That, in fact, never came to anything. There was no final litigation, and no writ served, although at one stage it looked as though there would be. And, clearly, for any country considering privatizing a life company one of the major issues to look at is whether the policies have been sold to individuals on the basis that they themselves own the company -- in other words whether the company was in essence a mutual owned by its policyholders.

Conclusions

Two conclusions suggest themselves. First, there is today a general relaxation of attitudes to foreign ownership. In the financial services industry -- banks and insurance companies in particular -- there is a great sensitivity to the ownership, more so perhaps than some of the other entities that have been privatized. But

over time it has become clear that more important than the nationality of the purchaser is its financial standing, reputation, and probity; so I think the xenophobia of past years is fading.

Second, there is a reassessment of the appropriateness of financial institutions being owned by the state, and a better recognition of the practicality of the regulator to provide comfort to depositors and policyholders when those types of companies are privatized.

19. THE TRANSPORT SECTOR

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These remarks have been prompted by work we have undertaken, not only in the UK but in other countries, particularly Malaysia. In the case of Malaysia we were asked to provide advice on how best to regulate monopoly industries which were being moved towards privatization. There were nine of these, including seaports, airports, railways, roads, and the energy, communications and water sectors. This work provided a unique opportunity to look across all the industries simultaneously and see where the similarities and differences lie.

Sea, air and road transport have two components that are normally found to exist under different ownership -- the fixed assets of infrastructure and the actual business of transportation. Commonly the first of these is public, and the second is either public or private. This separation is regarded as the norm for each transport sector, with the exception of rail where it is normal to have a single vertically integrated monopoly (although it could be argued that this does not have to be so).

In non-transport industries, privatization normally means full asset sale. That is less frequently the case for the infrastructure of the transport industry, even in countries which are simultaneously privatizing such industries as electricity and telecommunications. So this brings us to question three points:

- * the necessity of vertical integration;
- * the mode of privatization; and
- * the relationship between competition and the form of privatization.

We need to examine these three issues because governments have not always thought through the objectives of a privatization and consequently what might flow from them. In particular, it is very important to guard against abuse where a monopoly privilege is given to a private sector company.

Vertical integration

In the case of roads it is generally accepted in practically every country that vehicles are in private ownership and the roads are in public ownership. The same is true of transport by sea: ships have normally been in private ownership, seaports have very frequently been in public ownership. However, the public ownership of infrastructure dates back to the nineteenth century and before that turnpikes and toll roads were the norm. They became public assets in order to ensure rights of access and adequate maintenance.

In airlines and air transport we move into a slightly greyer area where airports have invariably been in public ownership until recent years and airlines (other than in the US) have generally started out by being state carriers. The introduction of competition to the airline market (other than in the US) is a relatively recent innovation. The rationale for this has been nothing to do with the nature of the airline industry, but lies with individual countries believing that they needed a state company as the national flag carrier, particularly in terms of international bilateral agreements. However, we can see now, particularly with the privatization of British Airways, that state ownership is not necessary to ensure the national interest. Indeed, in the US there has never been a state owned flag carrier even though its airlines dominated international travel in the earlier years.

Finally we move on to railways. In practically all parts of the world these remain fully vertically integrated monopolies. Early railways were developed by private capital with companies building the infrastructure on which to run their trains. Today, railways are almost exclusively in state ownership, with the US being the main exception. But there are growing signs of change, with moves in the UK, Malaysia, Japan and Sweden to separate out the transport business, with the rolling stock, from the fixed assets, the track and its management.

From the standpoint of government, transport raises a number of policy issues such as good national infrastructure, access, social policy in respect of the special needs of urban and rural areas, safety and maintenance. Privatization may be driven by a number of reasons but an overriding issue, particularly in less developed countries, is the funding of new investment. Where the assets are in public ownership it is the government which must take appropriate decisions. Where they are in private ownership, government has no concern unless of course the industry starts to find itself in financial difficulties. The existing nature of the transport industries very clearly demonstrates the different effects that ownership can have as between continual concern by governments over how to fund public assets, such as roads, railways or airports, and the complete lack of concern over how to fund investment in road vehicles, ships or private airlines.

Mode of privatization

This concern about the funding of investment is also important in the mode of privatization. It is worth recalling that historically the development of railroads, toll roads, canals and railways (both steam and electric traction in the cities) was financed by issuing bonds and shares to private savers and making these investments attractive.

Subsequently, many countries chose to finance public infrastructure by the taxpayer. In part this reflected an inability of the private owners to finance the necessary investment from the tariffs which were allowable or available. But we have turned full circle, and the ability to finance development through the public purse is now deemed by many countries to have reached its limit.

This is the point at which I think we need to address the reasons for privatization. So far I have spoken about the need to raise capital for investment and that is one reason for private involvement. However, governments have other reasons. In particular:

- * the thought that it is wrong for government to undertake activities which can equally well be done by the private sector; and
- * the view that the private sector is more efficient.

Against that background, it is worth looking at the ways in which so-called privatization might be achieved.

	ASSET OWNERSHIP	ASSET CONSTRUCTION	FUNDING	OPERATION AND MAINTENANCE
Full public services	Public	Public	Public	Public
Contract	Public	Private	Public	Public
Contract Construction & Maintenance	Public	Private	Private	Private
Concessions	Public	Private	Private	Private
Full privatization	Private	Private	Private	Private

There are effectively four different aspects to the running of a transport industry, each one of which may be separately undertaken by the state. Only when all four activities are undertaken by the private sector can the activity be deemed to be fully and properly privatized. The bottom line is, of course, the position in which nineteenth century development took place and to which full privatization returns. The other stages leave activity partly under government control even though that control may be exercised at arm's length.

The starting point in many cases will be the contracting out of asset construction and this has been the norm for public assets in mixed economies. But the first development which aims at securing the perceived efficiencies of private sector management is to contract out operation and maintenance. This may be done with relatively short term contracts and hence it introduces competition through regular tendering.

The next step has much greater consequences. Long term concessions are offered by competitive tendering in order that the concessionaire can raise the necessary capital and be responsible for its repayment. This is the BOT or BOOT approach. The difference between this and complete privatization in effect lies only in the ownership of the assets which return to state ownership at some point in the distant future.

Competition and the form of privatization

There is a fundamental aspect of privatization which is not often properly addressed by governments. Yet it is a vital part of the way in which an industry should be privatized if at the end of the day the key objectives of a better and cheaper service to users is to be achieved.

The issue is competition. Where there is genuine competition in the provision of a service there is no reason why full privatization should not proceed. The assumption should be that the consumer will pay the full cost of the service to be provided and that competition will ensure that the service is provided as efficiently as possible.

In reaching a judgement it is important to distinguish between genuine competition by three or more suppliers and apparent competition from two suppliers, which might in practice be a cosy duopoly. Where genuine competition is not practicable and government subsidy is seen as essential for social reasons, for example to run rural bus services, competition may still be practicable through tendering for the right to run a subsidized service.

In looking at the prospects for competition it is important to recognize intermodal competition, for example between roads and rail, and that it is possible to have competition between public sector entities. Where competition does not exist and is unlikely to develop, a form of regulation or control will be essential. In

essence, regulation is intended to mimic competition by pressing the monopolies to behave as if true competition were present.

However, even where a monopoly position is granted to a particular organization, it is still possible to create competition through the use of franchises or contracting out for fixed periods so that at the end of each period there will be a competition to regain or to take for the first time the franchise or the maintenance contract.

The strategic options

How then should the government take decisions on how best to proceed?

1. The problem of the monopoly in which competition is unlikely to develop has been the subject of serious debate in the United Kingdom. In the case of the electricity industry, everything possible has been done to maximize the development of competition in the future, including competition in the supply of electricity to individual customers. And now, the government is developing ideas on splitting up British Rail before privatization.

Nonetheless a considerable degree of regulation is necessary even in the case of those industries where competition will develop. Regulation is the means by which competition is established in an orderly way into a hitherto monopoly market. But for obvious reasons some aspects of transport will remain monopolies -- for example, railway tracks and roads. The same is true of airports and sea ports, although in some cases there can be direct competition with neighbouring facilities.

2. A long-term concession agreement is less than full privatization because ownership reverts to the state at a point in the future. The concession may run for a long period of time, so carries with it the need to regulate the way in which income can be raised by the concessionaire. Consider a toll road for which a concession agreement has been let for, say 25 years. The concessionaire will be concerned to ensure that he gets a reasonable return on his investment. By contrast, the government will be concerned that there should be no profiteering.

At the nub of this lies the difficulty of forecasting levels of traffic use and therefore the appropriate tariff regulation. In our experience past agreements have often been weighted against either the company or the government (or consumer). In the case of the work we have done for Malaysia we have recommended a mechanism by which both the government and the concessionaire would be able to get a fair deal, but without the concessionaire either losing money or making excessive profits.

An alternative approach is that used with the Dartford river crossing in the UK, where the assets return to state control once the concessionaires have recovered their costs together with an agreed return. Thus, the length of concession will,

to a large extent, be determined by the traffic flows. These can be very different to those expected (as has turned out in the case of the orbital road round London -- the M25 -- which was overloaded as soon as the last link was opened). Thus the transfer point for the Dartford crossing must be open to considerable variation from the initial estimate.

What is not clear, because the end point of Build, Own, Operate and Transfer schemes has not yet been reached, is how the transfer back to the public sector will subsequently be managed by governments. Do they then have to start all over again? Intellectually at least it would be better to separate out the construction aspect from the management aspect. If this were to be done so that the government funded the project, contractors built it and were rewarded at the time, and the management was contracted out on a shorter timescale, the whole question of ensuring a fair deal for the various players would be easier to manage.

3. Finally, moving down the scale one further step, we reach contracting out for services or for management. Generally speaking, the charge to be made by the contractor can be settled during a competition when the contract is being tendered. Therefore, subsequent regulation whilst the contract is in place is not an issue, only the management of the contract itself. By having regular retendering processes where the interval is determined by the nature of the service and the ease with which the contractor can be changed, it is possible to have a fair degree of competitive pressure at work and hence ensure a good deal for the government and a fair return for the contractor.

Against the background of contracting out, I would like to return to the purpose of a BOT or BOOT Scheme. What are its attractions compared with contracting out? If governments provide the funding for a project there can be a greater degree of competition, first in the construction process and subsequently with relatively short concessions for operation and maintenance. This approach would remove the difficulty of long term forecasts and regulation.

The main rationale for privatizing the funding of projects lies in raising capital. In the UK under the Ryrie rules, assets normally funded through the public purse should only be funded by the private sector where it is more cost effective, but is seldom met. Although the costs are normally greater in companies raising funds than governments, the BOOT approach removes the funding from the government's balance sheet.

Summary

The transport sector has pursued a different approach to privatization for its infrastructure assets (as opposed to the transport business) than other infrastructure industries such as energy and telecommunications, although there are similarities with water.

In deciding on a privatization mode, governments should start from:

- * the reason for privatization;
- * whether government can provide funding as cheaply as the private sector and whether it has sufficient borrowing capacity;
- * the need to have regard to competition, both within the industry to be privatized and in the way the privatization takes place.

In particular, in putting in place BOTs or BOOTs a government should consider the purpose of the final transfer, especially if in other privatizations transfer is absent. Meanwhile, the balance between concessionaire and government interests in this long term relationship needs very careful thought.

20. PRIVATIZATION IN TRANSPORT

Richard Lloyd
Morgan Grenfell

My job is to find answers to difficult privatization problems and when I was asked to talk about the subject of transport I thought about the two main kinds of privatization in which we have been involved.

The first was the trade sale, simply the business of selling a business; it is something we do in the corporate private sector all the time. We sold the Sealink Channel Ferries by a very similar method to the normal corporate disposal method, and we also sold British Transport Hotels by something similar.

The second method is the privatization of infrastructure, and that includes very big projects such as EuroTunnel, which is some \$10 billion, and the Malaysian highway project.

Trade sales

In selling a business through a trade sale, the starting point is a corporate auction, the whole idea being to try and stimulate competition to get people to bid against one another. (I am assuming that if it is a privatization you have done the necessary restructuring).

In the first stage a key element is dealing adequately with the problems of management. Management will be very apprehensive about having their business sold from underneath them, and if they are valuable to the enterprise you may well have to give them some special incentives to stay there -- not only to stay there but to participate enthusiastically in the sale. That is the first and biggest pitfall in this whole process.

It is vital that you have a really professional selling memorandum, a document that will do credit to you as the seller and to the entity you are selling. If you are lucky you may then have dozens of interested people. How do you deal with them in an auction process? We might suggest an indicative stage, to weed them down to the last three or four, and then really negotiate very hard with those, until you reach a final bid. If you are selling something less attractive you may very well just have one bid, as we did in fact with British Transport Hotels --

they were not all tremendously attractive. And then you move on to the negotiation phase. This whole process of bidding has got to be seen to be fair and to be transparent.

I would stress three key things in that process. The first is preparation -- and that will determine the success or failure of the whole process. The second is competition. And the third is keeping up the momentum. In the last phase, as well as fairness you must have momentum, because if the buyers sense that you are dilly-dallying and the timetable is slipping, they will either think you are a weak seller or that you are an unfair seller, and either way you will lose value.

Privatizing infrastructure

The example of infrastructure privatization that I would like to focus on is the North/South Highway in Malaysia. The length is 800 kilometres and the cost is \$42 billion plus over a construction period of seven years. Commercial debt takes up nearly half, the government has put in over one-third, and there is 17% of equity.

Such projects require a lot of commitment and a lot of trust from investors because they have to wait so long for a return; but if they do wait that long they are probably going to do quite well. It is a typical concession in some ways: the shareholders are buying a temporary right to those earnings, but they are also getting the opportunity to build the thing, which in many cases is their main reason for wanting to do it. The aims of the government in these infrastructure projects are typically to bring in outside money and private-sector management.

We have learnt some lessons from our work on such projects all over the world, and they break down into four main categories.

The first is that like all privatizations it depends on **political will**. Someone has to have the wish to go ahead and do it -- as Margaret Thatcher and President Mitterand did with the Channel Tunnel, and as the Prime Minister of Malaysia did with the highway project. These countries have, therefore, gained a tremendous lead in this field.

Second, the terms have to be **very realistic**; investors and bankers are very worried about many aspects of these projects, including very often the risk that the country itself cannot repay the debt, the currency risk and a number of other risks.

Thirdly, the government must have a **smooth mechanism** within its bureaucracy for handling investors and bankers.

And, finally, one has to be **selective** and look at these things on a case-by-case basis: although we are great enthusiasts for them one has to face the fact that

some of these projects are a lot better than others, that many road projects will not be suitable for this kind of treatment.

Nevertheless there is scope for a lot more. We have proved that you can do the most enormous projects using these methods. Clearly it is going to be much easier in Western Europe and in South East Asia where you have got two of the critically important things: the ability to forecast traffic with some degree of certainty, and a local capital market to put in the equity and banking finance. In many parts of Asia, Africa, and Central and Eastern Europe, you cannot forecast with anything like the required degree of accuracy because these economies are in many cases dislocated or in a process of very rapid change; and often the local capital market is just inadequate or non-existent. So in those cases there will be a very big role to play for the European Bank, the World Bank, and international agencies in general.

This whole approach will provide lots of opportunities; there is lots of transport infrastructure to be built and I think there is tremendous scope. If you have a major transport infrastructure project to build, it is very worthwhile to look at the opportunities for bringing in the private sector. It is not always going to be right but very often it will be. It needs the will and the financial ingenuity, but I subscribe to the view that there are ways to make it happen, so let us get on with it.

21. PRIVATIZATION IN THE WATER INDUSTRY

John Elfed Jones

Chairman, Welsh Water

The language of the private sector can be difficult to understand if you have not learnt the meaning of the words; and part of the task that faces those of us who have been privatized is to explain to people the meaning of words that previously did not feature in their vocabulary. Words like profit, and investment, and market forces, are not easily understood by people who have grown up in a public sector culture where they were often taught that capitalism equates to greed.

At Welsh Water we are very proud of our achievements since privatization two years ago. We have been able to deliver significant benefits to our customers, we have been able to deliver significant benefits to our workforce, and we have been able to deliver significant benefits to our shareholders. And at the same time we have been able to look after the aquatic environment in a manner that previously we were not able to do. Quite simply this could not have been achieved if we had remained in the public sector. No matter which political party was in power, we could not have achieved it.

Let me explain in more detail what we have been able to do and the barriers that we have had to overcome in so doing. I will speak from my own experience but I have to stress that without a team of very imaginative management, and a committed and dedicated workforce, none of that which we have achieved within Welsh Water could have possibly been achieved.

Structure of the industry

The water industry, prior to 1974 in the UK, had been the responsibility of about 1,600 elected local authorities, together with a small number of private water companies. Public river authorities managed the rivers, and other water related functions were carried out by public boards and local authorities. In 1974 the industry was wholly reorganized with nine multipurpose regional authorities and one national authority (the one for Wales) being created, with a range of services -- including water supply, sewage collection, treatment and disposal, conservation, river management, pollution control, land drainage, recreation,

navigation and fisheries -- all under one roof. And, frankly, the concept was quite excellent: the total control of water from its source to the sea.

It was at that time that Welsh Water was set up, from an amalgam of various water boards and local authority departments, and the structure that was established in 1974 to all intents and purposes remained in place until 1989 when we were privatized.

I joined Welsh Water as Chairman in 1982. I had spent half my life in the public sector (in the electricity supply industry with the CEBG) and half my life in the private sector with RTZ and Kaiser. I had then been seconded as under-secretary to the Welsh Office. My brief from the Secretary of State when he appointed me was to run Welsh Water as a business in the full sense of that word. At that time the boards of all these regional water authorities were very large indeed, up to fifty in number. They were platforms for political debate more than anything else; but at the time of my appointment as Chairman, and after discussion with the Secretary of State, we actually changed in Wales to a small board of twelve.

Having both water and sewerage functions under the one roof does cause some problems, because conflicting issues emerge. You become both the gamekeeper and the poacher; you have a responsibility to ensure that the aquatic environment is not polluted and yet by your own actions you can become one of the greatest polluters. It does not sit too well, and it is interesting to note that in New South Wales right now, in Hunter Valley, the regulatory part of the Hunter Valley Water Board's responsibilities is being taken out and run by government.

Finance was particularly difficult during the 1970s and 1980s; constraints were placed on the authorities by successive governments in order to contain public expenditure. Successive governments went to pray regularly at the altar of PSBR and they still do it. The industry was being starved of capital investment; and even when there was a relaxation in political terms, various Treasury restrictions were introduced by way of reduced external financing limits. The fact was that the essential public sector programmes with long timescales were not determined by the needs of industry but by pressures on the politicians. This then was the backdrop to privatization.

Of the mechanics of privatization I do not intend to go into details. Suffice to say that it was not without its heartaches. The privatization of the water industry had seen more than its fair share of false starts. The first mention of privatization was made by the late Ian Gow in February, 1985; but it was not until 1987 when Nicholas Ridely was at the helm of the Department of the Environment that the privatization really got underway with a fundamentally changed proposal for the organizational structure of the industry, and with proper differentiation between the regulator and the industry.

Privatization and flotation of any industry is complex and it was particularly complex with the water industry. We had all manner of advisors, we had legal and financial advisors, we had technical advisors, and for the government it was a most difficult privatization because it involved ten quite separate companies. The workload was enormous; never underestimate the bureaucratic workload associated with privatization. There were 32 drafts of the prospectus for us in Welsh Water; each line on the prospectus had to be verified -- and this was a 600-page document -- at least three times (I had to prove that I was John Elfed Jones on four separate occasions!). To do all that required about 1,000 documents and about 25,000 pages for lawyers to report on.

Changes since privatization

We in Welsh Water now see our role as one of creating a series of partnership agreements. Our whole philosophy is based upon working in partnership. Partnership with our customers to deliver the services and quality of service that they want. Partnership with our workforce to improve working practices, conditions of work, and emoluments. Partnership with other utilities (we have signed a cooperative agreement with the Sydney Water Board, and have formed a joint venture company to build, own, operate and transfer some water treatment works for the Sydney Water Board). Partnership with our shareholders, in which we believe that we are using their money wisely so that they in turn enjoy long term returns.

We have entered into these partnerships only because there are sound business reasons for so doing. We are unashamedly motivated by maximizing profit: but it is what you do with the profit that is important, and we need to be able to explain to our customers, to our regulators, to our workforce, and to the community at large, why profit is good for them. Without it we are not able to undertake the massive capital investment programme that faces Welsh Water and the industry generally. We increased our profits by 32% last year to £128 million pre-tax, on a turnover which had itself increased 15% to £293 million.

What we have been able to do as a private sector company is to have a very tight control of our cost, and to manage our income to best effect. Without it I do not think that we could have embarked on the enormous capital programme that we have to undertake. We will be spending £1.9 billion over the next ten years in order to ensure that our promised standards of service are achieved and to ensure that the environment is being properly looked after.

The privatization of the water industry has improved the aquatic environment. It has become fashionable, almost, to knock the water industry and to suggest that in fact Britain is the dirty man of Europe. In Wales 90% of our rivers are in the top two categories of river quality, capable of supporting salmon, sea trout and trout. That compares with less than 40% in mainland Europe; so we are not the dirty man of Europe in that regard. And, indeed, the quality of our rivers is constantly improving.

You have to carry the workforce with you; without that you will not be able to succeed. It requires constant communication and constant understanding with the labour force. We have placed a great emphasis on explaining privatization to everyone throughout the company -- what it means for them as individuals. They share in the company: 4% of our stock is owned by the employees, and over 99% of our employees are shareholders in the company so it is as much their company as anybody else's, and they are a powerful shareholder group within the organization.

This partnership arrangement has led to a remarkable agreement where in fact no longer do we retain the blue collar/white collar ethos that prevailed in most industries in the UK. We have now a commonality of employee -- everybody is on the same conditions of employment, and the 'us and them' syndrome has disappeared.

Regulation

We run the most tightly regulated of all industries. We have the Director General of OFWAT, regulating our charges and regulating our standards of service: and it is right and proper that he so should do. His role is straightforward: he has only to consider one public and that is the customer; he has to address all concerns in the interest of the customer. Then there is the Chairman of the National Rivers Authority has only to consider the aquatic environment. He doesn't have to concern himself about charges to customers; he doesn't have to consider employees' interests; but he has to address the interest of the aquatic environment -- and it is right and proper also that such a task should be done by an independent organization outside the industry, to ensure that the potential polluter does not get away with it.

So the regulators are there to ensure that these newly privatized companies operate within the letter and the spirit of the privatization legislation. We cannot compete directly with other water companies; our patch is our patch and their patch is their patch. But there are certain criteria that allow us to compare our performance; and I predict that the good ones will flourish and the not so good ones are likely to be taken over in the fullness of time. But that will work to the benefit of customers, for the benefit of shareholders, most assuredly for the benefit of the environment, and undoubtedly for the benefit of the employees.

Privatization gives companies important freedoms; it has given us the freedom and the resources to make a start on a massive environmental and customer service improvement programme. It has also given us the freedom to make sure that all our people are dedicated to the pursuit of excellence in everything that they do. And it has enabled us to use the latent skills within our organization to develop commercially profitable businesses outside the core business.

We have made an encouraging start, but we do have a motto in Welsh Water, 'it isn't good if it can be better'. Our shareholders, our customers, our employees

and those who regulate the environment, insist that it should be better. But it has been good thus far.

22. THE PERFORMANCES OF THE ENVIRONMENT

THE PERFORMANCES OF THE ENVIRONMENT have been a subject of increasing concern in recent years. The environment is the natural world in which we live, and it is the source of many of the resources we need for our survival. The environment is also the source of many of the problems we face, such as pollution, climate change, and the depletion of natural resources. The environment is a complex system, and it is difficult to understand how it works. However, there are some basic principles that can help us to understand the environment and its problems.

General Performance of the Environment

Before we can discuss the performance of the environment, we must first understand what we mean by "performance." In this context, performance refers to the ability of the environment to provide the resources we need for our survival and to absorb the waste we produce. The environment's performance is determined by a number of factors, including the quality of the air, water, and soil, the amount of pollution, and the rate of resource depletion. The environment's performance is also affected by human activities, such as deforestation, agriculture, and industry. The environment's performance is a complex issue, and it is difficult to measure. However, there are some indicators that can help us to assess the environment's performance.

The first indicator of the environment's performance is the quality of the air. The air is the source of the oxygen we need to breathe, and it is also the source of many of the pollutants we breathe in. The quality of the air is determined by the amount of pollution in the air, and it is a key indicator of the environment's performance. The second indicator of the environment's performance is the quality of the water. The water is the source of the drinking water we need, and it is also the source of many of the pollutants we drink. The quality of the water is determined by the amount of pollution in the water, and it is a key indicator of the environment's performance.

The third indicator of the environment's performance is the quality of the soil. The soil is the source of the food we eat, and it is also the source of many of the pollutants we eat. The quality of the soil is determined by the amount of pollution in the soil, and it is a key indicator of the environment's performance. The fourth indicator of the environment's performance is the amount of pollution. Pollution is the release of harmful substances into the environment, and it is a major threat to the environment's performance. The amount of pollution is determined by the amount of waste we produce, and it is a key indicator of the environment's performance. The fifth indicator of the environment's performance is the rate of resource depletion. Resources are the natural materials we use to make products, and they are a finite resource. The rate of resource depletion is determined by the amount of resources we use, and it is a key indicator of the environment's performance.

The sixth indicator of the environment's performance is the amount of deforestation. Deforestation is the removal of trees from a forest, and it is a major threat to the environment's performance. The amount of deforestation is determined by the amount of land we clear, and it is a key indicator of the environment's performance. The seventh indicator of the environment's performance is the amount of agriculture. Agriculture is the process of growing crops, and it is a major threat to the environment's performance. The amount of agriculture is determined by the amount of land we use for farming, and it is a key indicator of the environment's performance. The eighth indicator of the environment's performance is the amount of industry. Industry is the process of manufacturing goods, and it is a major threat to the environment's performance. The amount of industry is determined by the amount of goods we produce, and it is a key indicator of the environment's performance.

The ninth indicator of the environment's performance is the amount of climate change. Climate change is the long-term change in the Earth's climate, and it is a major threat to the environment's performance. The amount of climate change is determined by the amount of greenhouse gases we emit, and it is a key indicator of the environment's performance. The tenth indicator of the environment's performance is the amount of biodiversity. Biodiversity is the variety of life in the world, and it is a key indicator of the environment's performance. The amount of biodiversity is determined by the number of species that exist, and it is a key indicator of the environment's performance.

So the stock market success of British Telecom and the subsequent widening of the programme had a major influence, not only on the structure of public and

22. THE PERFORMANCE OF PRIVATIZED INDUSTRIES

Richard Jeffrey

Head of Economics, Hoare Govett

Measuring performance

It is quite clear that the word 'performance' means very different things to very different people. If you just think of it in terms of a car: to the more aggressive person 'performance' refers to the 0-60 acceleration time, for the more staid it refers to the average fuel consumption, to the environmentalist it might refer to the level of exhaust emissions, to the scientist it might be the car's aerodynamics or its road holding qualities.

So performance is not a singular concept, and perhaps the best we have to go on is the stockmarket performance of companies. You might ask what is important about that. I think it is, in fact, of vital importance. The stock market should encapsulate all performance measures of industry. If a stock market is truly efficient and has good knowledge of the operating environment of the privatized companies, then the share price performance of those companies should reflect how they are performing within the economy.

The stock market intermediates between the users and the suppliers of investment capital, so for the privatization process to continue as a success, both in reducing the government's role in the economy and promoting wider share ownership, it is important that privatized companies are seen to co-exist happily with the private sector and in the stock market.

It can also be argued that it was the initial success of the privatization programme in stock market terms, that helped shape this aspect of the UK government's ideology. Would privatization have developed into a massive programme, had the first of the very large sales (British Telecom), proved a failure on the stock market? But in fact it was an enormous success and gave the government confidence to proceed for a much longer period with much wider aims.

So the stock market success of British Telecom and the subsequent widening of the programme had a major influence, not only on the structure of public and

private industry, but also on public sector finances. And it is not insignificant here that the privatization programme has allowed the UK government to repay about £25 billion of fixed interest of bond borrowing.

Just to give you some idea of the scale of the privatization programme; if we look at the stock market at the moment one of the principal indices is the FTSE 100, the *Financial Times* stock exchange index of the top 100 quoted companies. Of that index of 100 companies, 16 are privatized or half privatized, and account for about 20% of the total capitalization: so no-one can doubt their importance.

General measurement questions

Before looking at the performance of individual companies I want to make a few general comments. Firstly, privatized companies can be split into two relatively distinct groups. One group is the industrial and service companies. Many of these had earlier been rescued as part of the lame duck policies of previous administrations. In other words they were companies which would otherwise have failed, but were rescued by government. Others grew in state ownership, or were taken into state ownership for ideological or political reasons by previous administrations, so we would expect them to become in time little different from the rest of the industrial corporate sector.

The second group of companies which have been privatized are the natural monopolies, and we can include within this selection British Telecom, British Gas, and the Water and Electricity companies.

It is slightly less certain that the companies in the second group can survive happily as a part of the free-market economy. At the heart of the privatization philosophy must be the belief that competition can be introduced in most, if not all, of these industries; and of course that their products have an identifiable economic price. But most of these companies had (and still have) a monopolistic position in the market, still enshrined in law.

And there is another general complication that we have to take into account when trying to measure them through their stock market performance, and that is that the government has significantly under-priced many of the issues on flotation to ensure that they got off to a good start. That makes it difficult to measure completely the performance of these companies.

So one of the distortions we must try to eliminate when calculating this index is that of the initial under-sale. This we can do by bringing companies into the index a month after the privatization, so that the initial surge in the price arising from the under-sale effect has been lost.

Performance results

Doing this, we find that since mid-1986, privatized companies have performed more or less in line with the stock market as a whole; between 1984 and 1986 the index dipped sharply; but previous to that, there was in fact a period of relative stability.

Early phase. But of course an overall index can hide the messages of the individual companies within it. During the early 1980s the index of privatized companies' stockmarket performance was dominated by BP, which had been half-privatized in that the government only had about 50% shareholding at the time. For most of the period from the end of 1980 through to the end of 1982, BP was weak and that was part of the reason for some of the early downward movement in our index.

Things were helped by the addition of Cable and Wireless at the end of 1981; this was a stock which was fairly buoyant for the early part of its life. The privatization of British Telecom in late 1984 is reflected in a strong performance of the index at that time.

Second phase. The sharp decline of the index from late 1985 to the end of 1986 reflects a number of factors which conspired against privatized stocks during this period. Those influences included doubts as to the political environment. With the general election approaching in 1987 and the threat of renationalization, there was a significant under-performance by the Telecom stocks. The oil price collapse in 1986 also took its toll on BP, and there were other factors as well.

Recent phase. From mid-1989 through to 1990 the performance of the index reflected strong growth in British Telecom, British Gas, and British Airways.

Performance of the utilities

Again, this index does mask some of the underlying complexities, so it is worth looking at a partial breakdown of the index into utilities and non-utilities.

For most of the 1980s, the utilities group shows strong out-performance of the market. But up to late 1986 the index was dominated by the Telecom stocks and it is not really until 1989, by which time we have British Gas and the water stocks in the index, that it is really has any major significance. For most of 1990 the privatized utilities out-perform the market, though during 1991 that performance has been rather less clear.

I think there are perhaps three explanations for the performance of utilities: the first is straightforward, that they have out-performed the market on the basis of productivity-based earnings growth and have survived in the free market as very effective companies. The second explanation is that they are partly or wholly monopolistic trading conditions and therefore they are making monopolistic

profits. The third explanation is that over the last year or so utilities have been viewed as defensive during a downturn in the economic cycle and, therefore, they have out-performed the stockmarket as a whole.

Individual cases I would like to just quickly review the performance of some of the individual stocks in the index.

Looking at Cable and Wireless, from a peak which was reached in 1985 there was very heavy investment in one subsidiary, Mercury, which caused the earnings to deteriorate. But as Mercury's earnings expectations showed through it started to rally again up to a peak in 1989; since then it has been rather dull.

So far as British Telecom is concerned, election fears were showing through in 1986, and after that it was relatively dull. There was a period from late 1988 to 1989 where the market began to worry about the quality of service and the overall performance of British Telecom. From 1989 through to 1991, above average earnings growth when compared with other industrial companies began to show through and a stronger performance is evident.

Looking at British Gas, in 1988 there was a worry about a Monopolies and Mergers Commission Report, which depressed its stockmarket performance. From mid-1988 onwards through to late 1990 it has been achieving above average earnings growth, partly to do with the economic cycle. From its peak in 1990 there have been worries over a tariff review evident in the price.

Moving on to Thames Water: again, its out-performance of the market in 1990 was due to its defensive qualities emerging during the downturn in the economic cycle. It also got an inflation-based boost to its earnings. But there have also been political and regulatory concerns which have affected that stock.

For Southern Electricity, there is a fairly bumpy pattern: the Gulf War initially pushed it up, more recently in 1991 there have been political and regulatory concerns evident. National Power too has begun to suffer more recently from political worries.

The role of the utilities as defensive elements of the stock market is quite important because by introducing the utilities to the stock market the government has introduced a whole new sector. One of the benefits of the privatization programme is that utilities have actually begun to reduce the volatility in the overall stock market index, since utilities tend to out-perform during downturns in the economic cycle, and under-perform during upturns in the economic cycle: so they move opposite to the general industrial and commercial performance and because of that the general volatility of the stock market has been reduced.

Industrial and commercial companies

The industrial and commercial companies again have performed well over the 1980s but they have actually under-performed the stock market index as a whole.

Among these, the performance of BP is linked strongly into the oil price and peaks at the beginning 1979 and 1980 to reflect the Iranian revolution and the Iran/Iraq war. The oil price collapse which took place thereafter and came through very clearly in the 1986 performance figures. The government's marketing of one of its sales of British Petroleum can be seen in 1987 as a small out-performance, and the Iraq invasion of Kuwait is also evident in a small peak in 1990.

In British Aerospace there was a strong performance during the period in which overseas defence contracts came through in the mid-1980s; when the Civil Aerospace losses came through though in 1987 this reversed into under-performance; in 1989 performance was hit by strikes.

British Airways registers a rather dull performance and the Gulf crisis is evident in 1990 with severe under-performance.

Strong order books pushed Rolls-Royce up in 1988 and the first part of 1989, but as concerns grew over the outlook for civil engines then we found the stock has under-performed from mid- 1990.

British Airports has benefited very strongly from strong passenger growth in the latter part of the 1980s and early 1990, but the Gulf crisis took its toll.

British Steel has seen a fairly hectic pattern. Overall its relative price it has come down and recently that has reflected problems with steel prices due to the downturn in the economic cycle.

Conclusions

Some very broad conclusions from the performance of these companies are these.

Firstly, successful privatization of state utilities requires a stable political background, otherwise investors are likely to shy away. In the utilities many of the concerns which have hit share price performance over the last few years have been concerns related to the regulatory environment. Of course, the government has consistently been faced with the problem of trying to control their monopolistic position in the private sector.

If we look at companies in the industrial and service sector I think it is quite evident that they have under-performed. That under-performance has not reflected their inability to compete in the private sector, nor does it reflect any problem with the privatization process itself; on almost all occasions the under-

performance of those stocks reflect problems either with the individual sector in which they are operating, or, more generally, problems with the recent downturn in the economic cycle.

Overall, the government's privatization programme has been a success in the UK, but there are perhaps some provisos with the utilities in that it has proven extremely difficult for the government to regulate their monopolistic position. And perhaps their out-performance in stock market terms reflects the fact that they have actually, to an extent, exploited that monopolistic position.

On the other hand, so far as industrial companies are concerned the fact that they have existed happily in the private sector does vindicate the early policies of rescuing failing companies, and this ought to have implications for the future conduct of industrial policy.

23. PRIVATIZATION AND REGULATION

The Rt Hon Peter Lilley, MP
Secretary of State for Trade and Industry

In my previous post of Financial Secretary to the Treasury, I was responsible for taking forward the government's privatization programme. Now, as Secretary of State for Trade and Industry, my responsibilities include competition in the UK. I am delighted, therefore, to be contributing to this symposium organized by the Adam Smith Institute. Adam Smith was, himself, one of the major inspirations for what this government has achieved over the last twelve years in promoting competition and in creating greater freedom in the markets. The Institute has been a significant contributor to the thinking on privatization, and has also had an important role to play in development of the Citizens' Charter.

Change in the economy

All too often the extent of the past state involvement in the economy is forgotten. In 1979 the UK nationalized industries employed 1.7 million people, and dominated important sectors of the economy, particularly energy, communications, transport, steel, and shipbuilding.

Their actions directly affected every individual in the UK and almost every firm both as suppliers and customers. The performance of the state sector was therefore crucial to the performance of the economy as a whole.

But many nationalized industries were not performing well. They had combined borrowings of £2.5 billion in 1979. They had a poor record on profits, on investment, on productivity, and on industrial relations. The end result was a state sector which was stifled of initiative and freedom to develop commercial flair. Something had to be done.

Since 1979 we have transferred two-thirds of the nationalized industries and 900,000 employees to the private sector. We have privatized 46 major businesses; brought new standards of service quality and efficiency to these industries for the benefit of customers; and realized proceeds of £33.5 billion for the taxpayer. Virtually every company which we have privatized has increased its turnover, its profits, its investment and its productivity, as well as improving its industrial relations.

The process of privatization does not stop with the headline businesses, however. Privatization and the introduction of private sector disciplines are reaching out to every part of the economy. Already these ideas run through every level of government itself. Through privatization, through contracting out, through the creation of Next Steps agencies, and through the Citizen's Charter, government's commitment to delivering better service and better value for our customers -- the public -- continues with greater vigour than ever.

With encouragement, local government too has been active in privatizing and contracting out. They have also been instrumental in the implementation of that most tangible of privatizations -- the sale of the council houses to their tenants.

Objectives of privatization

In privatizing we have seven objectives:

- * to ensure these industries put the consumer first;
- * to subject them to the incentives and competitive disciplines of the marketplace;
- * to free them from political interference and bureaucratic control;
- * to free government from involvement in business management;
- * to resolve conflicts of interest and to ensure that where any regulation is necessary it is carried out by a regulator independent of government;
- * to give employees a direct stake in the success of their enterprise; and
- * to spread popular capitalism by enabling individuals to invest directly in these industries. There are now 11 million shareowners in the UK -- one in every four adults, and three times as many as in 1979.

Privatization of the utilities

We have been particularly criticized for privatizing the major utilities. It had long been accepted without question:

- * that the public sector utilities were natural monopolies;
- * that they could not therefore benefit from the disciplines of free enterprise; and
- * that in any case they would have to remain in public ownership to prevent abuse of their monopoly power.

But these assumptions do not hold water. There is manifestly a conflict of interest if ownership and regulation are in the same hands. The owner -- even if it be government -- will want to see a reasonable return from the industry, which may mean raising prices or postponing environmentally necessary expenditure. The notion that state *ownership* is necessary to protect the consumer or the environment is the reverse of the truth.

The only way to ensure single minded-regulation is to ensure that regulation is the sole function of an independent regulator, leaving ownership to the private sector. The Director General of Telecommunications was the first such regulator in the UK; we now also have regulators for gas, airports, water and electricity.

It is significant that where government has had the dual role of owner and regulator, the regulatory function has tended to play second fiddle. When the industries were in the public sector, no-one was explicitly charged with protecting the consumer. Nor were the duties of state industries towards the consumer and the environment spelled out in the way we have done in the electricity and water privatization Acts.

Opening up the market

Not all the activities undertaken by the utilities need to be monopolies. The privatization programme has shown the importance of competition in the market and of a structure which enables competition to develop. Competition is the catalyst which has brought about the culture change in these industries. Competition is at the heart of the privatization programme.

Of course, with such diverse industries, there can be no set form, no blueprint of what a privatized industry should look like. When we privatized the electricity industry we sought to achieve a competitive structure from the outset. Instead of one monolithic company we now have seven competing electricity generators and twelve distribution companies.

But competition may need to be introduced by stages. In the case of telecommunications, the government initially licensed only BT and Mercury. We now have two cellular, four telepoint and a number of other specialized operators. Three PCN operators will also be introducing services shortly. The government also made it clear, in its duopoly review, that it will consider any new application for a telecommunications licence. The market has now been opened up to the point where it is the most liberalized telecommunications market in the world.

In the gas market, the independent regulator -- backed by the Monopolies and Mergers Commission -- is also pushing forward the boundaries of competition. He has set a target for the competitors to British Gas to have a 30% share of the industrial market by 1993.

Regulation of remaining monopoly elements

Where monopoly elements remain, the regulator has a vital role to play. The first is to foster the transition to a competitive market. For example, the Director General for Electricity Supply has used his powers to permit large

industrial customers to buy more of their electricity direct from the new generating companies where this is pro-competitive.

In the water industry the regulator has the benefit of comparative competition between the water companies, which should -- over time -- ensure that the most efficient companies set the standard for the rest.

And *all* the regulators are working to ensure that access to the utility transmission networks -- be it a gas pipeline, the electricity transmission system, or the telecommunications network -- are on a fair and equal basis for all.

A second key feature of the regulator is to control prices where a monopoly element remains. One innovation in regulating these utilities has proved very valuable. Instead of fixing a limit to the return on capital that they can earn (which is the basis of regulation in the United States), we have said average prices cannot increase each year by more than inflation minus X per cent. The X is set on the basis of the productivity gains to be expected in that industry. The company still has an incentive (lacking under a fixed rate of return regime) to increase efficiency by even more than X per cent.

Profits of the utilities

There has recently been much comment on the profits of the privatized companies. Let me put the issue in context.

First, profits are better than losses. When British Steel was losing £5 million per day that fell as a burden on the taxpayer. Now, by contrast, the Exchequer receives in tax one-third of the profits earned by privatized companies. BT actually pays the Exchequer more in tax now than it ever paid in dividends when the state owned it entirely.

Second, utilities are not allowed to make monopoly profits by raising their prices. Their prices are tightly capped. The cap requires them to reduce real prices each year by an amount equal to their potential to raise productivity. They can only enhance profitability by increasing efficiency at an even more rapid rate than set by the regulator.

Third, if the utilities do succeed in boosting profits through exceeding efficiency targets, they are likely to have to share with consumers the benefit of that greater efficiency when the next price cap is set. So efficient and profitable operations now are good news for consumers, who will get even better price performance in future.

Thus, when BT was first privatized it was required to keep price changes 3% below the RPI each year. When the cap was revised it was tightened up to a 4.4% real price cut every year. And this year the OFTEL negotiated a 6.25%

annual real price cut until the end of the cap in 1993. OFGAS has also recently tightened the price cap on British Gas from RPI-2% to RPI-5%.

Utility prices have thus actually fallen since privatization. In the five years before privatization, domestic gas prices rose 11%. In the five years since, they have fallen by a similar amount. Telecommunications prices will have fallen over 30% in real terms since privatization by the time the current price cap ends in 1993.

Fourth, profits are essential to finance and reward investment. References to large profits without any mention of the size of the capital employed by the business and the size of the investment programme required are grossly misleading. For example, BT earns £2080 million after tax but invested £2758 million in 1990-1991. British Gas capital expenditure is also up by over 50% in 1991 to £1.2 billion; profits after tax were £918 million in the same year.

The water companies are sharply increasing their investment programmes after decades of neglect under nationalization. What is more, the water regulator has made it clear that increased profits should be reflected in increased investment. If not, he could force companies to reduce prices below the level permitted by the present cap.

Transparency

I attach great importance to transparency in decision-making by the regulators, and I know they do too. There is much more transparency now than when these industries were in public ownership. The regulators take pains to consult and explain their decisions. For example, OFTEL issued 35 consultative documents in 1990 alone. OFGAS is holding a series of meetings with customers to consult on the new tariff regime and improvements in standards of service.

We must watch that statutory requirements and considerations of commercial confidentiality do not unduly restrict the regulators' freedom to speak. The more transparent the basis for the regulators' decisions, the greater should be the confidence of the industry and the consumer in the decisions.

Some observers have proposed that regulators should hold public hearings before reaching decisions. Such openness may have theoretical attractions, but, as Americans will tell you, such a system can be slow and inflexible, and it can be all too easy to lose sight of the public interest.

Who regulates the regulators?

Of course, the question arises, who oversees the regulator?

It must be emphasized that the regulators are independent of government and industry. This is invaluable and helps ensure that regulation does not become a political football. It does not mean the regulators are not accountable. The public debate on the regulated utilities shows there is no shortage of keen and informed commentators. This is entirely appropriate for bodies which exist to protect the interests of the customer and it keeps the regulators on their toes.

The regulators are themselves very aware of the need to guard against regulatory capture. I pay tribute to their achievements in promoting competition and the interests of the consumer. The regulators are of course ultimately accountable to Parliament. They are required to submit an Annual Report and are subject to examination by the National Audit Office, which reports to Parliamentary Public Accounts Committee.

The Director of Fair Trading has responsibilities which overlap those of the regulators, providing an additional safeguard. And the regulators' decisions can, of course, be challenged in the courts by judicial review. If there were to be any suggestion of problems arising over the accountability of the regulatory regimes, the government will be the first to urge corrective action.

Service standards

The regulators for water and electricity were given statutory responsibilities to develop service standards from the outset. The regulators for telecoms and gas have been pursuing the same goals. In Telecoms, the number of public telephones in service has increased from 77,000 in 1980 to 100,000 now. The percentage of faults repaired within two working days has risen from 74% in 1987 to 98% in 1990. Waiting lists for new installations are now a thing of the past. In 1980, 262,000 customers were waiting for more than two months each. Today some 95% of orders are fitted on a date agreed with the customer. BT's domestic customers can claim £5 per day if a fault remains unrepaired for more than two working days, or for actual financial loss of up to £1,000.

New service standards for the electricity supply will come into force on 1 July 1991. Failure to comply with these standards will result in compensation payments to individual customers of between £10 to £50. In future, if the electricity company fails to keep its appointment you can be compensated. The electricity companies will also have to meet overall service standards and provide the Director General with figures of their performance. These figures will be published annually and, if necessary, taken into account in the next price review.

There are no doubts that there have been startling improvements in the level of service to customers, as a result of privatization and the vigilance of the regulators. However, there is no room for complacency. The improvements in service to the customer must continue and the regulators will have a key role in ensuring this occurs.

Then and now

We tend to forget just how dramatic are the changes brought about by privatization.

In 1978-1979 the nationalized industries borrowed the equivalent of £6 billion in today's money. Last year the Exchequer *received* about £2 billion from the privatized companies. Before privatization these industries were a drain on the Exchequer. Now they are making a positive contribution. Before privatization the nationalized sector averaged a zero return on investment. Now these industries are all making a healthy contribution to the economy. Before privatization, there was little incentive to improve efficiency. Now they face the carrot of profit and the stick of the regulator to increase efficiency. Before privatization there was no systematic protection of consumers' interests. Now there are independent regulators to safeguard them.

Before privatization, prices were set under the influence of a Treasury keen to reduce the PSBR. Now prices are set by the regulator's cap, reinforced by growing competitive pressures. Before privatization these industries were often starved of investment and had to compete with public spending on schools, hospitals and social security. Now they have massive investment programmes and only have to compete in the capital markets to demonstrate their programmes are commercially desirable. Before privatization, nationalized industries had some of the worst industrial relations in the country. Now a high proportion of the workforce have a direct stake in the profitability of their companies and recognize their well-being depends on satisfying the customer, not blackmailing the Treasury. Before privatization the politicians and bureaucrats ultimately controlled these industries. Now the consumer is king.