

ECONOMIC AID AND THE PRIVATE SECTOR

Rt Hon Christopher Patten MP

Development and the private sector go together, of course. It is no secret that I see the private sector as the prime factor in economic development, both in Britain and developing countries. The more I have travelled the more strongly I have found myself believing in market economics, private ownership and free trade. As Yugoslavia's dissident philosopher Milovan Djilas said the other day: "You cannot struggle against Capitalism to achieve something more efficient, because it is the most efficient... The root of the problem is socialist ownership".

To take an argument from the other side of the world from Djilas, the moralist and Peruvian Presidential Candidate Mario Vargas Llosa, in his foreword to Hernando de Soto's recent book, *The Other Path*, writes: "It is essential that the state remember that before it can redistribute the national wealth, the nation must produce wealth. And that in order to produce wealth, it is necessary that the state's actions not obstruct the actions of its citizens, who, after all, know better than anyone else what they want and what they have to do. The state must restore to its citizens the right to take on productive tasks, a task it has been usurping and obstructing. The state must limit itself to functioning in those necessary areas in which private industry cannot function. This does not mean that the state will wither away and die."

Adam Smith sought to show that markets were the best mechanism for allocating resources efficiently and hence for promoting healthy economic growth. But he also knew that businessmen were no paragons of altruism. Indeed, he did not expect them to be. In his well-known example, it was by virtue of the butcher's and baker's self-interest, not their altruism, that dinner appeared on our tables. But to ensure that this mechanism operated efficiently, it was necessary that markets should be competitive. Businessmen should be price-takers not price-makers.

The problems associated with that vision are well known. For a start, self-interest is a two-edged sword. Perhaps the other most familiar remark of Adam Smith's is the one about businessmen no sooner coming together than their discussion turns to some scheme for raising prices: in other words cartels and monopolies.

There are also problems independent of businessmen's motives: to do with the market imperfections, economies of scale, incomplete markets, natural monopolies, public goods, environmental effects. and so on.

These all have implications for the role of government which I shall be addressing later on. But I want to emphasize now that I believe that the role

of government is primarily an enabling or ring-holding one. This does not mean weak or passive government. On the contrary, it requires strong well-informed government. It is in stark contrast to the role played by government in various kinds of planned, even mixed, economies around the world in a vain attempt to dispense with the "invisible hand" of the market -- or at least to handcuff it -- by means of planning targets, administered price and controls of every kind.

PRIVATE ENTERPRISE AND DEVELOPMENT

The role of the market has been recognized by more and more countries, both in the Soviet bloc and in the developing world in recent years. They realize that without a thriving private sector their living standards will suffer and development will be impeded. The public sector can be improved -- made more responsive to market forces and subjected to financial disciplines -- but none of this can substitute for the dynamism of a competitive private sector.

Learning the lesson

This realization does not necessarily reflect any fundamental change in ideology. In many developing countries, immediately after independence, there was little in the way of private-sector development. It was therefore perceived as lacking the capacity for the scale and nature of development desired. What private sector activity there was -- such as export-oriented plantations -- was seen as benefiting the former colonial powers rather than their own people. In this situation it is understandable that the public sector should have been regarded as the spearhead of development and as a practical embodiment of newly-won independence.

For a time it all went swimmingly. Developing countries achieved a high rate of economic growth over most of the past quarter century. I am not just talking about the south-east Asian dynamos here. During 1965 to 1980 the countries of sub-Saharan Africa grew at just over five and a half percent per year on average. This is some two points faster than the performance of Western countries and a great deal better than the historical growth rates achieved by our smoke-stack Victorian forefathers after the industrial revolution.

But it did not last. Since the turn of the decade growth has slowed down dramatically in both Latin America and Sub-Saharan Africa.

External factors have had a hand in this: the turn-down in world trade and the increase in interest rates have made the world economic environment less hospitable. But this is not the main reason for the decline. The real problem concerns fundamental policies and the consequent inability and unwillingness of countries to adjust to changing conditions.

The ability to adjust depends on flexibility and responsiveness to incentives. You will not get these if you rely excessively on government direction and control and suppress private initiative and enterprise. You may be able to get by while conditions are favourable but it is the economies which are better attuned to the market which continue to grow when circumstances become tougher -- as countries like Korea and Hong Kong have shown in the 1980s. Their economic growth has slowed down only slightly, much less than the average for developing countries, during this decade.

The role of the public sector has come under increasing scrutiny as a result of this experience. It has been failing to deliver the goods -- and the services. And when it does manage to deliver, it does so at high cost. Inefficiency is the rule and scarce government resources go to bailing out loss-making public corporations at the expense of new investment or necessary maintenance. You know the picture; it is not so very different from much of our own post-war history in Britain.

The growing wave of reform

This hard experience has led to widespread recognition that the state has overstepped the boundaries of its proper role in many countries. An indicator of this is the number of countries undertaking structural adjustment with the assistance of the World Bank. In Africa alone, where the problems are most acute, 18 countries had initiated structural adjustment operations and another 14 had borrowed to support sectoral reforms by 1988. The reform programmes covered a wide spectrum of policy, including public finance, public enterprises, agriculture and the exchange rate. These programmes were also often launched in conjunction with IMF-assisted stabilization programmes. Many countries in Latin America and Asia are also moving in the same direction.

The main theme of these reforms is the reduction of state control and greater freedom for individuals and private enterprise. The aim is to promote behaviour which is motivated more by supply and demand and less by bureaucratic intervention. The benefits are felt at several levels. Competition promotes more effective use of resources; price movements in the market provide incentives to the right sort of producers; there is less scope for the essentially parasitic behaviour of the favoured few who gain control of scarce materials through bureaucratic allocation. There are often distributional improvements also: the higher prices for farm output which the reforms have brought benefit the largest single group of poor people in Africa.

The economic environment is therefore more conducive to the private sector. This is complemented by the state's withdrawal from many of the direct activities which have restricted the field of private enterprise. In the case of Africa there have been some significant declarations of interest:

Nigeria has issued a privatization decree that will affect more than 90 companies, including some of Africa's biggest parastatals with an estimated book value of \$3 billion.

In Cote d'Ivoire, the government has drawn up a list of 100 enterprises for sale to private sector.

In Ghana, more than 30 state-owned businesses are candidates for privatization.

Mozambique has privatized more than 20 industrial concerns.

In Guinea, dozens of trading parastatals have been closed down and a number of industrial plants are targetted for privatization.

Morocco is planning to sell off a quarter of the country's estimated 2,000 state-owned enterprises and is introducing liberal securities legislation allowing foreigners to own significant stakes in the stock of privatized companies.

We are still in the early stages of this trend. The idea has taken root but there is still a long way to go. In addition to the reasoning which pushed developing countries in the direction of public enterprise a generation ago, which I have already mentioned, vested interests have developed which make it difficult to reverse the process. In these circumstances, especially where competent managerial ability is scarce, it is extremely important that reforms are well designed, effectively implemented and sustained, rather than that governments try to do too much too soon.

THE ROLE OF GOVERNMENT

This brings me back to the role of government. Each country will have to decide for itself how far it goes in changing the balance between public and private sector. The first priority is to liberalize markets. That implies reductions in the scope of government activities. But how this is done, in what order, and how quickly, are all matters needing technical, economic and political judgement depending on the circumstances.

The promotion of private enterprise, and a business climate in which it can thrive, is not a simple matter of doing away with constraints. Individual initiative is an innate quality which can atrophy if its potential is stifled for long enough by controls, legal restrictions and red tape. A competitive and dynamic private sector will not spring up without help to fill the vacuum left behind by a retreating public sector. Markets will have to develop where none existed before; and markets cannot be competitive unless access is unrestricted. New institutions will have to be set up -- or existing ones reformed -- to cater to the demands of a more dynamic private sector. Flexible financial services will be needed.

Liberalization -- establishing an environment in which free markets can operate -- is one thing. But government also needs to ensure that they remain free. This is why I said that government has the role of holding the ring. There must be some rules; a regulatory framework within which the private sector operates. Without this the tendency for cartels and other anti-competitive behaviour to develop will prevent consumers from getting a fair crack of the whip.

The concept of free markets is closely related to broader freedoms. Rules are also needed here -- and the means of enforcing them -- in order to underpin social freedoms in this wider sense. But this kind of institution-building is demanding. A legal system is necessary to protect people in their social and economic activities. Statutes and organizations are needed for financial, educational, health, economic infrastructure and security activities. Freedom of speech and political freedom are close allies of economic liberty and well-being. Liberty is indivisible. It is a political tenet which the liberal democracies of the west have espoused for a century or more, although we have not always lived up to it in practice as much as we might have wished.

A similar question was put by Stalin 65 years ago when he asked "Can the final victory of socialism be achieved in one country?" and provided his own answer: "No, it cannot". Times change and now it appears that his political heirs are wondering whether either the question or the answer is relevant. "Free the spirit!", as the Pernod advertisement has it. To quote Vargas Llosa, "Economic freedom is the counterpart of political freedom, and only when the two are united -- two sides of a single coin -- can they really function."

The suitability of traditional institutions to the needs of changing societies need early consideration. New skills are required in both production and regulation. Korea is a good example of this. Its economic take-off followed far-reaching institutional changes including reform of land tenure, the installation of modern financial systems and education for all children. All this was in the context of a commitment to a market-based economy.

The Korean institutions are a blend of American and Asian experience. Other countries need to be similarly selective in adopting models to match their own needs. Traditional institutions may not meet all the needs, but foreign models may not perform to expectations in a different environment. Countries can borrow and modify, but institutions are always likely to be custom-built for specific circumstances.

The role of aid

The responsibilities of government are wide-ranging, therefore, but they do not include the provision of funds to the private sector. What then is the role of aid, essentially the gift of funds by one country to another?

There is a central paradox in the idea of aid for private-sector development. If healthy economic development is meant to be principally up to the private sector, it is not obvious that a government aid agency can help. Yet I believe that aid donors can help in a variety of ways.

Help with policy reform is one of those. Governments which are undertaking economic reform in a situation of crisis need respite on the balance of payment front, and aid can provide that. They also need help in designing suitable policies. In this we need to act in collaboration with other donors. The World Bank and the IMF tend to take the lead but we can help by supporting their line -- not uncritically, I should emphasize -- and by providing technical advisers to assist implementation in specific areas such as tax reform, companies' legislation and import liberalization.

Aid can also help to develop activities which a government decides to retain in the public sector but which underpin private activity. Education and health services are obvious examples. Economic infrastructure -- roads, power, transport -- is another example. These areas are in fact traditional ones for aid assistance. But the way we view them is changing. There is now much more emphasis on sustainability and attention to cost recovery. This is a logical counterpart to policy reforms at the macro level and the need to reduce the burden of subsidies on government budgets.

Aid for balance of payments support can also help the private sector directly. Our programme aid provides imports of intermediate goods, components and spare parts. These are crucial to the private sector in countries like Ghana, Tanzania and Malawi which are undergoing structural adjustment. Sometimes we can assist recipient governments in collaborative ventures with the private sector. But we must guard against discriminatory treatment and the creation of market distortions in such activities.

The main way we -- and other donors -- do this is to set up arrangements whereby aid is channelled to revenue-earning enterprises on commercial terms. No distinction is drawn between public and private enterprises in this respect. Accordingly, goods provided under programme aid are sold to commercial end-users at local prices. Capital aid for investment is on-lent through financial institutions on standard terms. The fact that our aid is

usually provided as a grant is not a material factor in these arrangements. The local government receives the payments in local currency and uses it to meet other budgetary cost: health, education, police and so on.

There are exceptions to this approach but they are carefully defined. Aid for non-revenue earning activities is one such exception. Aid for small-scale enterprise is another. The reason for allowing limited subsidies in this case is that small-scale enterprise is usually discriminated against in developing countries. We are prepared to try to level the playing field.

An important point to bear in mind in this connection is that the private sector encompasses an enormous range of activities. It is easy to think solely of large industrial enterprises and overlook small farmers, artisans, informal traders, and small-scale businesses. But in most developing countries these forms of private enterprise are much more important in terms of income and employment generation than the big firms.

These kind of activities have suffered as a result of government bias in favour of large-scale modern industry in the past. The small-scale sector has often been over-regulated and over-taxed. The regulatory burden alone is so heavy that most small businesses operate outside the law in many countries.

A glaring example of this came my way a year or so ago. It has appeared in the press since then but it is so striking as to be worth repeating. It relates to research by a lawyer into the time it takes to register a small business in different countries. In the US it takes three and a half hours: in Peru he estimated that it would take him 280 days working full-time.

Quite apart from doing away with these absurdities, small enterprises need help in other areas. They have difficulty getting credit because they lack collateral. Technical know-how and management skills are less plentiful in poor countries: they lack basic skills in accounting, marketing, stock management and other fields which seem elementary in Britain. They are always last in the queue for foreign exchange.

I believe that an expanded contribution to development from the small-scale sector will be one of the major gains of liberalization. We hope to help, but assistance of this kind needs a retail approach. Aid agencies are essentially wholesalers and we need intermediaries to provide retail facilities between us or developing country governments and the small businesses. We are developing links with a range of agencies for this, including non-governmental organizations. They are prominent already in relief and welfare work: we hope for expanded collaboration in income-generating activities.

Economic growth and social development

This mention of the activities of voluntary agencies reminds me that we should not regard economic growth and social development as alternatives. My primary focus here is the private sector in generating growth, but I expect this to be accompanied by social gains provided that it is managed properly. This is another point where strong government can be seen to be necessary.

I see close relationships between economic, social and political progress. The poorest countries are often the least democratic. Social development is unlikely without economic growth. But there is also a reverse flow: economic growth is more likely if social conditions are improving.

We can see this at several levels. Healthy, literate workers have higher productivity. Parents who expect their babies to survive have smaller families and less of the increment to output is swallowed up by extra mouths. Political stability is more likely when all members of the society are gaining from economic progress. So economic and social progress go hand in hand.

This is mutual self-interest at work rather than welfare principles but this issue gives me another opportunity to quote Adam Smith. A relatively unknown passage from the *Wealth of Nations* is the comment that: "All for ourselves, and nothing for other people, seems, in every age of the world, to have been the vile maxim of the masters of the world." Adam Smith was as strong on ethics as he was on economic realities.

PRIVATIZATION

I want to come now to the subject of privatization. How does it fit into economic reform process which I have outlined and how can the British aid programme help?

Privatization is a fairly well established trend in the developed countries, of course -- especially in the United Kingdom. It has attracted increasing attention in many developing countries and they are seeking to follow our lead. I have already given examples of the way it has caught on in Africa. I gather that it is now a routine matter for visiting officials to call in at the Treasury to collect the information pack on British privatization experience.

Broad benefits

It is not a panacea for all ills, but many benefits can be and are reaped. Management should improve from exposure to market disciplines; national budgets should benefit from the reduced burden of subsidies and interest charges. It can help to increase public participation in development. Because they are more efficient, privatized entities should also be in a better position to gain access to foreign expertise, technology, markets and capital. An important point in this is competition: it is the key to full realization of benefits. Privatization without it may be disappointing.

This leads me to the necessary point that privatization is a means to an end, not the end itself. Our objective is more rapid and sustainable development within the framework of a free society. It is the contribution which privatization can make to this which is compelling.

The British success

The success of the privatization programme in Britain has its roots in political will: determination and a clear mandate to roll back the frontiers of the public sector. But we also have a sophisticated capital market, a public which is accustomed to saving and investment, a good supply of managers and entrepreneurs and a large economy able to support competing suppliers. In addition we have an institutional framework of laws and regulatory organizations which prevent dominance by particular groups.

These characteristics of the British economy have allowed privatization via sales to the public, as in the cases of British Gas and British Telecom; or sales to private companies, as in the case of British Rail's channel ferries; or management buy-outs, as in the National Freight Corporation. But we are

also employing other approaches. They may not be pure privatization but they contain important elements of this. And they may be more appropriate to the circumstances of many developing countries.

To take the most basic approach -- deregulation permits competitors to enter markets previously dominated by state corporations. In the right circumstances this will increase efficiency in the parastatals without divestment. Splitting-up large public corporations can have similar effects, particularly in the context of deregulation. Their dominance is removed and comparative performance can be monitored as a spur to efficiency. The splitting up of AT & T in the US -- not exactly a developing country! -- is a spectacular example of this approach.

Contracting-out services is another option. Examples in the UK include laundries in the National Health Service and refuse collection by local authorities. The responsibilities, including investment needs, of the parastatal are thereby reduced and competition is introduced into the provision of the service. Contracting out management is another possibility, merging into joint venture operations between public and private sector.

Learning the lessons

The point of these hybrid arrangements is that they can secure the objective, greater efficiency, without completely transferring ownership of the enterprise. The reason why these options may be more feasible than outright privatization becomes apparent if we consider the constraints in many developing countries as compared with Britain and other industrialized countries.

These countries are both poorer than Britain and less endowed with enabling characteristics such as efficient capital markets and good managers. They are also tremendously diverse. The developing world includes comparatively affluent industrial powers such as Brazil and Mexico, large but poor countries such as India and Pakistan, impoverished Sub-Saharan states and tiny Pacific atolls. It is obvious that a standard privatization package cannot be applied in all countries.

The conditions of most Sub-Saharan African countries illustrate the more severe problems. The enabling environment is only now being created. Many are too small to support competitive enterprises in sectors requiring heavy capital investment and capital markets are rudimentary. Domestic savings are minimal and entrepreneurial and management expertise are in short supply.

In these poor countries, the prospects for privatization seem poor. But the arguments are not entirely one-way. Lack of managerial ability is one of the reasons for the public sector's failure. Managers are not available to run huge public corporations. It is much better to break them up into more manageable entities. Their dominance of the markets, and the financial drain caused by their non-viability, have undermined savings and stifled capital market development.

Foreign capital flows

And we should think not only of domestic finance when considering the means of privatization. Private foreign investment is also available. It should not be rejected for crude nationalistic reasons. Most foreign private

investment takes place between developed countries and we regard it as healthy. Japanese investors bring both capital and know-how to Britain, we do the same in the US, the US invests in Canada and here, and so on.

Developing countries should not regard private foreign investment as exploitative. It brings managerial and technical skills as well as much needed capital. It is not altruistic, of course, but there are mutual advantages.

Britain is a major source of such private flows to developing countries. We have provided over six billion pounds in long-term direct investment to developing countries over the past four years. This is as much as all the other countries of the European community in total.

Private foreign investment and aid are complementary in many respects and both have a role in privatization. Aid goes largely to the poorest countries and contributes importantly to the enabling environment and infrastructure. Most private foreign investment goes to the more affluent developing countries for revenue-earning investments. Together net private flows and aid account for over 1 per cent of our GNP in most years, despite the decline in net bank lending in recent years.

Aid has rebounded from the artificially low level of 1987: in 1988 it accounted for 0.32 per cent of GNP. This year our aid programme will grow by 12 per cent in cash terms and 7 per cent in real terms.

FOREIGN INVESTMENT AND AID IN PRIVATIZATION

How can these flows be harnessed to assist privatization? One example is provided by the Commonwealth Development Corporation, which is the ODA's flagship for private sector development. It receives soft loans from the ODA but invests on commercial principles, recycling the net returns to promote further development. Its total investments and commitments in developing countries are now about £1,100 million.

The CDC has become much more heavily involved in the private sector in recent years. Less than 30 per cent of its portfolio was in the private sector in 1980 but this figure had risen to 54 per cent for its new commitments in 1988. It invests on a long term basis, has built up very substantial expertise and can manage projects as well as providing investment funds. It can work with both local and foreign partners -- as well as governments. It is very well placed to operate in developing country environments and is demonstrating its capacity in privatization activities.

Acting as a private investor, the CDC is taking ownership and managerial responsibility for divested parastatals in a number of countries. In Malawi it now holds majority stakes in the Kawalazi Estate Company and the Sable Farming Company and also manages them. Both were previously owned by the Government and the CDC took part in the whole privatization process. In Tanzania the East Usambara Tea Company was previously a public enterprise but CDC is now managing it and is taking a majority stake.

The Trinidad and Tobago Development Finance Company is another interesting but more complicated case. The Government's holding is being reduced to 42 per cent; private investors are taking 30 per cent; and CDC and its German, World Bank, equivalents are taking 27 per cent.

Of course the CDC is a public sector corporation. But its participation with other private sector investors is facilitating the transfer of enterprises from the government to the private sector in developing countries, particularly where capital markets are not well developed and existing management needs strengthening. It is also CDC's policy to seek to sell off its equity investments to local interests in due course and use the funds for new activities.

The CDC is a unique combination of private sector principles and public sector funding in Britain, but the regular aid programme is also contributing to privatization. I have already referred to the contribution we can make to the enabling environment; structural adjustment programmes provide different types of examples. In Malawi we have linked our programme aid to the macro-economic conditions negotiated between the Government and the World Bank. These conditions have included divestiture arrangements, and our 1987 programme aid grant was specifically linked to liberalization of the marketing of agricultural products. This had become centralized in the parastatal, ADMARC.

Our programme aid in support of structural adjustment everywhere supports the introduction of market principles and directly provides inputs for the private sector. We have pledged a total of £92.5 million programme aid to Ghana since 1983 when the Economic Recovery Programme began. Early tranches were directed towards specific sectors: forestry, power, education. Since 1988 we have been disbursing new programme aid assistance through the foreign exchange auction, with no detailed appraisal of end-users. Around 85 per cent of our programme aid now goes to private sector users. I need hardly add that our support for structural adjustment, our assistance to the private sector and our encouragement of privatization is not neo-colonialism. None of these policies will work unless there is local political will and popular support behind them: so we are not interested in trying to bribe developing country governments to implement policies against their will or better judgement. That would be in no one's interest and it would almost certainly guarantee that the aid was wasted. Each aid recipient country has to be responsible for and committed to its own programmes.

As you may know we think we can help with the design of privatization. The CDC made an important design contribution in the Malawi case which I have just mentioned. We have provided several grants from the regular aid programme for technical assistance to countries considering how and what to privatize. A £200,000 grant to Malaysia met the costs of a British Merchant Bank in drawing up a privatization master plan. £150,000 has been provided for Thailand to fund consultants drafting a White Paper on privatization. Part of a sector aid package to Kenya was earmarked for identification of peripheral activities of the Agricultural Development Corporation which could be privatized or liquidated.

Other donors are offering similar kinds of assistance. The US has been particularly active and its assistance for the privatization of the National Commercial Bank in Jamaica is a model of its kind.

In all this I see a clear link running through an appropriate climate for private investment, the attraction of foreign investors and the success of privatization. Our support for the Multilateral Investment Guarantee Agency (MIGA), and the thirty bilateral Investment Promotion and Protection Agreements we have negotiated with developing countries, are therefore relevant. They protect foreign investors against non-commercial risk and

therefore remove one of the barriers to investment and private sector development.

Of course the decision to invest abroad has to be with the British company. We can help to create appropriate conditions and remove obstacles. The public sector services and infrastructure we support underpin foreign as well as local private enterprise. But individual investors must then take decisions in the light of their judgement of market prospects. We cannot provide direct subsidies, as I have already pointed out.

European aid

There may also be a role in this for European aid. It is worth remembering that Britain's share of European Community aid programmes accounts for about a fifth of our own aid programme. European Community aid can play an important part in encouraging the private sector in developing countries. European Community aid to Africa, the Caribbean and Pacific is provided under the Lome Convention which is at present being renegotiated. At the opening of the renegotiation last October the ACP countries referred to trade as the centre piece of Lome, and to the need for development of private sector activity as well as the attraction of foreign investors. Negotiations are now taking place on the provisions to be incorporated in the new Convention including those on processing and manufacturing, assistance to the ACP private sector and measures to encourage investment in the ACP countries.

The Community should be able to provide valuable support in these areas both through the provision of risk capital and through the provision of European Investment Bank loans. My aim is to promote imaginative use of this money and to ensure that it is channelled to those who can best take advantage of it. In addition, the EC will be able to play its part through the provision of technical co-operation to help the ACP to put the right economic policies in place and to give advice to ACP businessmen. Links between EC investors and ACP businesses will be sponsored by the joint ACP/EC Centre for Industrial Development.

Assistance will also be offered to non-ACP countries through the new EC Investment Partners Scheme -- often referred to as the Cheysson Facility. It will offer support for pre-project studies, help to bring together joint venture partners and provide some capital as well as training and management.

BOOT Projects

Apart from attracting foreign companies to invest in and manage newly privatized parastatals, some developing countries are pioneering a new instrument for introducing foreign firms into sectors hitherto dominated by the public sector -- so called BOOT projects. BOOT stands for Build, Own, Operate and Transfer. There can be variants of this, and one or more of the last three letters can be left out of the formula. But usually the foreign investors finances, operates and profits from a new project over an agreed fixed period and then transfers ownership to the host government.

To attract investors, these projects will clearly have to be reliable revenue earners. Infrastructure projects have been high favourites to date: public utilities, toll roads and bridges. But the concept is highly flexible. In theory, the financier need not recoup all of his investment plus return during the operating period, but could receive the balance at the transfer stage. It all depends on his cash flow needs and the local government's financial

projections. There are two points to note in this ingenious mechanism; it allows a country's investment plans to go forward when otherwise they might falter due to current financial stringencies, and it introduces private enterprise in areas which have often previously been the preserve of the public sector.

As in all sector activities, risks are involved. It will be a matter for negotiation between the foreign investor and his local counterpart -- which may or may not be the government -- how the risks are shared. Risk-sharing rather than risk-shifting is the key. Many of the advantages will be lost if either party -- host country or investor -- is wholly relieved of risk.

FUTURE PRIVATIZATION

The experience we have gained suggests several models for public and private sector collaboration in privatization. A comprehensive model might incorporate:

- * Programme aid to help support the economy as a structural adjustment programme liberalizes it.
- * Arrangements for privatization or similar measures within that programme.
- * Technical co-operation using consultants or academics to draw up an overall strategy for privatization.
- * Technical assistance to reform the framework of laws and institutions.
- * Guidance from City firms to help in the privatization of specific parastatals.
- * Investment by British companies in the privatized organizations.
- * Government-to-government aid for related infrastructured developments.

The brevity of the sketch should not disguise its complexity and timescale. It could spread over many years.

A second model is provided by CDC activities in recent years. CDC or foreign private firms can enter joint ventures with developing country governments, with the foreign partner managing the enterprise and part-owning it with the government and others. There is a role for aid in this with or without CDC: a role for aid in helping to establish the enabling environment and preparing the ground for divestiture.

BOOT projects provide a different model. This can be seen as the entry into markets dominated by the public sector as part of deregulation.

Getting it right

Both technical cooperation and capital aid can contribute in these models but I should repeat the point I made earlier about market distortions. It is perverse to introduce new distortions, new subsidies, as we try to liberalize and improve the way markets work. End-users should pay full market costs of goods and services provided under aid. I explained how we try to arrange

that under programme aid. BOOT projects present different problems but I envisage that any capital aid injected would be by way of on-lending through the local government, so that the enterprise receives the aid on commercial bank terms, or by financing a government equity stake. Obviously this would have to be limited to a minority holding.

In all these areas we are really at the beginning of the road. Intentions have been declared, intellectual arguments won, but most of the implementation lies ahead. For instance, Cote d'Ivoire is trying to sell off one hundred or so of its public enterprises, but only twelve have been sold so far.

That does not argue for rushing ahead with privatization. Privatization is in my view the right course and an essential course. But it needs careful presentation.

The first fundamental ingredient is political will. There will be many setbacks and obstacles and it is vital that governments should have the commitment to overcome them. It is then necessary to prepare the ground, determine which enterprises to privatize, install regulatory machinery, choose the particular type of privatization to adopt and attract finance. Overseas finance should not be ignored in this.

It is also necessary for governments to consider how to run the enterprises left in public ownership. Not all enterprises can be privatized and those left behind must be made more efficient, more sensitive to consumers' needs. This is easier once a good number of the parastatals have been privatized. They provide examples of better management. The government can concentrate its resources on a narrower range of activities. Even the enterprises left in public ownership gain from the privatization process.

CONCLUSION

For my final word, I want to revert to my earlier thought that privatization has many forms. The form which is right a particular country and enterprise will depend on local factors -- the size of market, the management capacity, the sources of capital and so on. The important thing is to set off on this path.

THE ROLE OF THE COMMONWEALTH DEVELOPMENT CORPORATION

John Eccles

The Commonwealth Development Corporation is a public body which empathizes with attempts to move assets out of the public sector into the private sector or to improve operations by joining public-sector assets with private-sector assets or, indeed, CDC assets.

We are Britain's bilateral development agency, the commercial arm of Britain's aid programme. We operate mainly in the Commonwealth, but not exclusively so -- we have 25% of our operations outside the Commonwealth. Inside and outside the Commonwealth, we operate in about four dozen countries, nearly half of them in Africa with the remainder in Asia, the Pacific, the Caribbean, and Latin America.

At the present time we have 275 projects, which we take on case by case. We are not aiming for macroeconomic structural adjustment, though we like to go into enterprises that will assist in the development of the economy. We try to avoid politics: we are much more comfortable when the political decisions have been made. We do not regard it as part of our job to preach the politics of private enterprise.

We do more than just providing the money. We do invest in equity and have quite a number of projects where, for the time, we take the majority equity stake. We provide loan money as well. We also manage, which makes us an exception amongst official development finance institutions. We market the technical expertise we have within the Corporation.

Fifty percent of our projects are in agriculture, with the remainder scattered across the sectors of tourism, industry, development banks and utilities.

We are investors in the private sector, and always have been in our forty-year history: currently putting about 60% of all of our new money into the private sector. So again, we straddle the public and the private sector.

New capital strategies

We are interested in the creation of capital markets. We have formed venture-capital funds. We are becoming involved in unitized funds as we go into the 1990s and we are very interested in creating situations in which public issues of shares can be made; and with that in mind, we are very interested in supporting the divestment of shareholdings held by governments or government agencies.

NEW CAPITAL FOR ECONOMIC DEVELOPMENT

Roger Leeds

The International Finance Corporation is founded on the premise that most of the development institutions to date have focussed most of their energies and resources on providing developing countries with assistance at the level of macro-economic adjustment rather than on the downstream activity of implementing privatization transactions.

We believed that there was a niche here that the International Finance Corporation might help to fill, given our background in promoting the private sector in developing countries. And so we created within the IFC a nucleus of technical expertise called the Corporate Finance Services Group which is specializing exclusively in providing developing country governments with the assistance in design and implementation of privatization transactions.

The point of departure for our work is after the decision makers in a particular government have made the decision that they are going to privatize a particular enterprise or group of enterprises. We are involved in the how do you do it and in implementing these kinds of transactions.

The special problems of developing countries

We already have a number of lessons which it might be useful to convey to you which reflect our operating philosophy.

The first is that implementing the process of privatization transactions in developing countries is different from what has been happening in the United Kingdom and elsewhere in the developed world. We therefore have to be very careful about transferring the experience of the developed countries to the developing countries.

One difference, for example, is the availability and accuracy of data in developing countries which makes the job much more difficult than anything you can imagine in the developed world.

Accounting standards are very different.

The political decision-making process is very different, much more complex, and much slower in most developing countries. The capability of the civil service in most developing countries to monitor, supervise and implement privatization programmes is far different from anything you would encounter in the United Kingdom.

The breadth and depth of capital markets in developing countries is far different and this affects the implementation process.

And finally, most of the state owned enterprises being privatized in developing countries do require a substantial measure of operational and financial restructuring in the process of privatization and that is a very time-consuming process.

For all these reasons, it is much more difficult, time-consuming and complex to implement privatization transactions in developing countries, and I am very wary of trying to transfer the experiences that we see in the United Kingdom and elsewhere to these countries. And the expertise that is required to implement privatization transactions in developing countries is quite different.

An interdisciplinary exercise

The second lesson that we have learned is that privatization is very much part of an interdisciplinary exercise. It is not simply a financial task to be carried out by bankers (I am permitted to say that because my training is as a banker!).

Let me give you an example. We have been awarded a mandate to implement the privatization of Philippine Airlines. Our team for that includes, in addition to our financial experts: two lawyers that specialize in regulation and legal aspects of privatization; two engineers who are specialists in the appraisal of airlines; a capital market specialist to measure the institutional capacity in the domestic financial market; a team of local accountants and local attorneys; a public-relations specialist; and last, but certainly not least, an economist.

Local expertise

A third lesson we have learnt in part of our operating philosophy is that we must integrate local with foreign expertise. We have come to feel very strongly that one of our roles as a development institution is to assist in upgrading the local capability in the implementation of privatization transactions.

But there is a second, and equally important reason: there are many things that we think that the local expertise can do better than us. It would be very short-sighted to try and bring in a group of foreign experts to implement a privatization exercise without utilizing very valuable local expertise in the accounting field, in the legal field and so forth. So we go out of our way to integrate foreign expertise with local expertise and I think that is very important.

Complexity

Fourth, privatization is very complex and time-consuming and this is particularly true in developing countries. I think that suggests that all of us in the developing community who were involved in assisting other countries to implement privatization transactions should lower our sights, set less ambitious targets, be more modest in our expectations, and adhere to what some people have referred to as the case by case approach. To expect to do too many privatization transactions at the same time, for example is simply unrealistic.

WHY PRIVATIZE UTILITIES?

Utility Basics

PART IV -- PRIVATIZING UTILITIES

Why privatize utilities? I would like to start with the prior question: "What is a utility?"

It seems to me that a "utility" provides an essential service through an infrastructure network, and the ownership of that network (because it is usually a capital intensive physical network) suggests an element of natural monopoly. Further like an elephant, there are more recognized descriptors than defined: utilities are things like electricity, gas, telecommunications and water.

Utilities are a natural monopoly. They are a natural monopoly because they are a network of infrastructure. They are a natural monopoly because they are a capital intensive physical network. They are a natural monopoly because they are a service that is essential to the well-being of the community.

In contrast, private utilities are a natural monopoly. They are a natural monopoly because they are a network of infrastructure. They are a natural monopoly because they are a capital intensive physical network. They are a natural monopoly because they are a service that is essential to the well-being of the community.

Among these are the natural monopoly of the utility industry. The utility industry is a natural monopoly because it is a network of infrastructure. It is a natural monopoly because it is a capital intensive physical network. It is a natural monopoly because it is a service that is essential to the well-being of the community.

THE ARGUMENT FOR PRIVATIZING UTILITIES

The argument for privatizing utilities is a complex one, but it can be summarized in two main points.

The first is the quality of service. The quality of service is a key factor in the decision to privatize. The second is the cost of service. The cost of service is another key factor in the decision to privatize. The third is the efficiency of service. The efficiency of service is a third key factor in the decision to privatize.

WHY PRIVATIZE UTILITIES?

Lynda Rouse

THE PROBLEM OF UTILITIES

Why privatize utilities? I would like to start with the prior question: "What is a utility?"

It seems to me that a "utility" provides an essential service through an infrastructure network, and the ownership of that network (because it is usually a capital intensive physical network), suggests an element of natural monopoly. Rather like an elephant, these things are more easily recognized than defined: utilities are things like electricity, gas, telecommunications and railways.

In some countries, as a matter of history, they have been investor-owned. The United States is the archetypical example of that, all major utilities, including railways, are or have been investor owned throughout most of the US. Interestingly, water is an exception as I understand it, in the US water is municipally owned for the most part.

By contrast, France, which even at the height of their privatization programme in the mid-1980s, had an explicit policy exclusion on the privatization of monopolies, but their water utilities are to some extent shareholder-owned and are very successful and aggressive commercial companies. But water apart, the French had explicit policy objections to privatizing monopolistic utility companies.

Among those who believe in privatization such worries persist: it is widely believed that while a sound intellectual case can be made that privatization in general is a good thing and brings with it undoubted economic benefits, the privatization of these kinds of companies intrinsically has more disbenefits than the reverse. I hope to present to you coherent argument, against that proposition.

THE ARGUMENT ABOUT MONOPOLIES

The arguments against privatizing monopolies take two forms.

The first set of objections which I will deal with are associated with the quality of service provided. The worry is that if something is an essential commodity or service, the provision of it is essentially a public service and the nasty world of commerce has no part to play in it. I am going to call those the *public service* or *quality of service* objections to privatizing utilities.

The second set revolve around the presence of natural monopoly in these utilities, and the argument goes that commercial companies cannot be trusted with monopoly, and if they are given one they will use it to put prices to such a level that the goods and services will be outside the reach of normal consumers.

Quality arguments

The public service arguments are:

- * there must be universal access to the commodity in question and therefore the laws of supply and demand have no part to play;
- * such supply must be secure, while normal free markets cannot ensure the provision of secure supply;
- * if you are shareholder owned, the temptation to take short cuts (with safety, engineering standards, the environment, the quality of service and the long-term integrity of this very valuable infrastructure) in the interests of profits is just overwhelming.

Those are the arguments which say, for these quality reasons such businesses should remain in the benign hands of the state.

On the contrary side of the argument, we have many examples here in the UK, and I am sure elsewhere, of state-owned businesses where these shortcuts are taken, where these ideals are not delivered in the public sector. And the reason for that I think is intrinsic, that if the government not only regulates these businesses but also owns them, it suffers an inevitable conflict of interest. Must it come up with the cash to meet the standards or should it sanction the price rises that are required in order to meet those standards? In most years the balance of forces on a government tilts towards the short-term political pressures against the long-term interest of the business, and politicians go in the direction of the short term.

Contrast with that what happens if the utility is privately owned? It is now possible to enshrine explicitly in a licence all of the obligations and responsibilities which go with this privilege of having a franchise with the limited monopoly power it confers. Having set your standards, you can then enforce them more efficiently because the government is now regulator but not the owner, and therefore the roles of gamekeeper and of poacher are separate.

Price considerations

It is true that the enforcement of standards will have an effect on price. That is on the whole a good thing; it is absolutely right as far as possible that prices should reflect proper costs so we do not squander resources -- say in using pure water on the garden, particularly in a heatwave.

It is perfectly reasonable as an instrument of policy, of course, to choose to require the utility, or allow it, to cross-subsidize within its customer base. It might be that connecting remote rural locations to the telephone network, for example, would completely justify cross-subsidy of all consumers to the benefit of those remote consumers. But in such cases, because it is an explicit permit that is required, the figures are there so the regulator can require the costs of the exercise to be identified. So we can check that there are no

hidden subsidies as well; and of course if you know what something costs your chances of minimizing what it costs are rather greater than if you subsume this cross-subsidized activity into the generality of a commercial operation.

Finally, it is perfectly reasonable for the government to go the whole way and actually subsidize the delivery of some essential services itself. The same arguments apply if it is not the owner of the business, but employs a separately owned business to perform its policy objectives: it must know what the costs are, because if you know what the costs are you can control them. I would contend that that differentiation between the provision of subsidy and the provision of service leads to greater objectivity and efficiency in the delivery of both.

Monopoly arguments

It is rather harder to argue with the problem of controlling the extraction of monopoly rent.

What do I mean by monopoly rent? A monopoly is extracting rent when its prices are higher than they should otherwise be. If we all knew what they should be, regulating them would be very easy indeed. But typically, the phenomenon occurs because the utility has higher costs than it really should have or needs to have. Perhaps because it employs more capital it can argue that it needs a higher return. But how much return is right? And how much capital?

Alternatively, the utility can be making excessive profits, so it can have very tightly controlled costs, and a very tightly controlled capital base, but just be earning a return that really far exceeds anything legitimately required in terms of its cost of capital.

The problem of utilities, whether or not they are publicly owned, is how to stop monopoly rent being extracted in these ways, to the detriment of consumers.

So there are two possible manifestations of monopoly rent -- internal leakage through a high cost or capital base, and externally in terms of excessive prices to customers.

If you are in the private sector and you have a share price, there are very strong pressures on you not to maintain excessive costs if you can avoid it. More typical of a private sector monopoly, therefore, is the attempt to extract monopoly rent for the benefit of shareholders, but that is much more easily spotted and therefore much more easily stopped.

For these reasons it is rather easier to avoid monopoly rent extraction in the private sector than in the public sector. Nevertheless, I do not want to say it is easy; it is not. It is an intrinsic problem with any monopoly and my advice to you is to do two things to deal with it: first of all minimize its scope, and then secondly, control it as effectively as you can.

Dealing with monopolies

Minimizing its scope is no easy matter with a monopoly, because one of its characteristics of monopoly is that it grows. It is the only buyer in town for whatever is feeding into the network -- electric power, gas or water -- but that

natural monopoly is the only buyer around, and also the only buyer of components for what is often a very sophisticated and unique type of network. It can use that power in two ways: it can either exercise uncommercial and unfair control over its suppliers, or it can take them over; so monopoly spreads outwards through the economy unless something is done to stop it. The same forces are at work on the delivery side, where anybody seeking to use the monopoly network to deliver a product or a service finds that the owner of the network can price him out and can cross-subsidize into any competitive areas to make sure that the monopoly always beats the competition.

These monopolies are usually by definition monopoly employers, people with particular kinds of skills; this is the source of another major difficulty -- that those employers often find themselves facing up to monopoly unions and the cost-escalation consequences of that for pay rates in the industry can be demonstrated quite easily.

The last worry is that a monopoly accumulates a monopoly of knowledge; if you try to compete, you find that the only people who really know the technicalities of what is being proposed are employed by the industry, because that is the only employer in town.

I think you can see that such problems are intrinsic to natural monopolies such as the utilities.

A basis for control

It is very difficult to avoid the propensity for monopolies to grow outwards and dominate far more of the economy than they need to. But controlling that propensity is where the problem starts and it starts there independently of ownership, because any kind of monopoly will behave in that way. The antidote to that is some radical restructuring prohibitions of the monopolist entering into certain areas of business, all the evidence that one can get together suggests that governments have more chance of enforcing this kind of control if they are not at the same time the owner of the business and susceptible to pressure from the monopoly unions and other such factors.

How do you circumscribe the business? Restrict it to its core network through restructuring, and split that core network into regional components if it is possible; that gives you some basis of comparison of performance. Any regional monopoly will still find all sorts of arguments why his costs have to be higher than the chap next door, but nonetheless, a regulator has more chance in standing up to a them if he can compare the performance of similar sorts of business. So that is a strong case for regionalization.

If you want competition to grow around a core network you have to open up access to it on some basis, so a basis is needed for pricing the use of this core network. That is easier said than done; the allocation of costs within these or any businesses are open to manipulation, and finding out the true cost and the right return on a network at the heart of a sophisticated business is not an easy problem. It might be that the regulator has to guess a number and enforce it.

Finally, it is absolutely essential to make the businesses account separately for their separate activities to be sure that they are not subsidizing from the monopoly core, charging high prices where they get away with it, and using that revenue peripheral to keep the competition out of markets. An

unintended benefit of privatization is that if you force people to focus on all the the elements in their business and what they cost and what they deliver, then almost by definition they run these businesses more efficiently.

Setting the limits

However successful one is in circumscribing monopoly we still have the problem of coping with the monopoly rent. How is the regulator to second-guess the management and know if the costs are as they should be or if they are out of control? How is he to know if the assets are now being "gold plated"? He might recognize gold plating if he sees it, but there are degrees in this. How does he know just how capital intensive this business really needs to be?

So that is what the regulator is trying to do, quite a difficult thing for him to have to do with a relatively small staff. I would contend that in the private sector it is possible to put the business into a situation in which it faces other incentives and other pressures, which will reinforce the activities of the regulator, and give him a greater chance of succeeding. In the private sector, each business will have a share price to defend and if the thing is structured correctly, the management of the business know they are susceptible to takeover.

For example, the British Gas Corporation recently was forced into a number of anti-monopoly measures by the MMC. The analyst in my firm who follows that sector was writing on the impact this would have for the bottom line and for the share price, and a very interesting remark at the end of his report was: "However, more important for the share price is how the management copes with these difficulties and these pressures". And so to have a management on trial, the share price in the market place, and the firm being capable of being taken over if somebody else in the same regulatory constraint with the same assets can produce higher shareholder value -- those pressures reinforce the regulator and make the avoidance of monopoly rent far easier than it could be in the public sector.

In public-sector monopolies, by contrast, the government often makes matters worse. It will not sell its shares (everybody knows that). It is not interested in share performance, so it is an inefficient shareholder and very bad at putting on pressure if the management performs badly. Sometimes the government itself adds to cost: it extracts monopoly rent (back door taxation), and if it is short of cash it can just force the prices up in the industry. It can give in to union pressures as a matter of politics, it can require uneconomic investment in deprived areas, or perhaps protect the utility suppliers -- the coal industry in this country extracts a monopoly rent through the electricity industry. And sometimes governments will protect sectional consumer interests, heavy industry for example, at the expense of other consumers. So all the time the government is owner, the ability to add to the monopoly rent and join in the game at the expense of the consumer.

In private-sector monopolies, the government is gamekeeper but not poacher, so it is quite clear whose side the government is on -- the consumer side. Responsibilities of the regulator are explicit and therefore his task is easier. The management's responsibilities to shareholders are clear and they are circumscribed by precise conditions in licence. The management faces the added pressure to protect its share price, so it cannot allow a monopoly rent to leak through into higher costs or higher assets than necessary, and the possibility of takeover concentrates minds.

Other benefits of privatization

There are financial benefits too. By definition, because it is an essential service that is being supplied, almost everybody who wants it has it and has as much as they need and therefore there is little scope for growth. Usually they are quite mature businesses and the scope for cost reduction through step technology change is quite limited -- (telecommunications is an exception). Prices are regulated, so the scope for capital growth in earnings in these businesses is quite small. However, the regulator shares with the management a responsibility to keep on supplying this essential service and to allow shareholders a reasonable rate of return. So for the shareholder these are safe, mature income stocks, which deepen the capital structure and reduce the volatility of capital markets.

Another financial characteristic of these bodies is that their networks are capital-intensive. They often require quite lumpy investment programmes, while governments habitually fail to invest in the infrastructure because they face periodically short-term pressures either on prices or on cash flow. The privatized utility must make a clear distinction between investment which will earn a return and investment which is actually going to maintain its infrastructure. We have witnessed a change in the accounting policies of the Water industry just this year as they approach privatization, where they have started accounting for repairs on their sewers and on their water pipes as revenue rather than as capital expenditure. So again, this is a process of exposing people to proper management of the fundamentals of the business. They cannot ignore cash flow and dividends because they have shareholders to satisfy. On the other hand they cannot ignore quality standards in the long term because they have the regulator to satisfy.

It is my belief that the play of opposing forces will lead to far greater efficiency of capital employed in these businesses than we have witnessed to date.

Four points

First, the privatization of the water industry is a very important step in the process of privatization in the UK. It is a step which will lead to a more efficient and better managed water supply.

Second, the privatization of the water industry will lead to a more efficient and better managed water supply. It is a step which will lead to a more efficient and better managed water supply.

Third, the privatization of the water industry will lead to a more efficient and better managed water supply. It is a step which will lead to a more efficient and better managed water supply.

Fourth, the privatization of the water industry will lead to a more efficient and better managed water supply. It is a step which will lead to a more efficient and better managed water supply.

Finally, the privatization of the water industry will lead to a more efficient and better managed water supply. It is a step which will lead to a more efficient and better managed water supply.

PUBLIC AND PRIVATE APPROACHES IN THE ELECTRICITY INDUSTRY

Oliver Letwin

International Privatization Unit, N M Rothschilds & Sons

Electricity privatization is at the leading edge of practice today, and poses, in many ways, the archetypal problems of privatizing utilities.

Privatizing an electricity industry is probably the biggest challenge of all the challenges which privatization has posed, for not just policymakers, but also those charged with implementation. It involves all the difficulties of restructuring and regulation.

The surprising thing is that, despite these difficulties, electricity privatization is mushrooming. In one form or another it is underway in the UK, in New Zealand, in Singapore, in Canada, in Scandinavia, in Australia, in Pakistan, in the Caribbean, and in at least four countries in South America; and in quite large stretches of the rest of the world it is being considered. Three years ago there was not a single example of major electricity privatization even on the agenda seriously -- that is to say, being worked out in practical terms -- anywhere. A remarkable transformation.

Four models

However, one should not think of this as something which is homogeneous. At least four models are being adopted and each one has its own potential, its own dangers, and its own kinds of reward.

The first is not privatization at all but something very much akin to it; that is to say, restructuring without privatization. The second is to go the whole hog, restructuring with a total privatization of the industry. The third is privatization without restructuring, sale of the utility without change. And the fourth is a form of privatization which does not involve actual sale of the core utility.

Let me deal with some case histories of each of those and try to illustrate the rather remarkable lessons which emerge from these four models.

Restructuring without privatization

Restructuring without privatization is a model of activity which is going on at present in Holland and in parts of Scandinavia, and which has gone on in electricity industries for about fifty years. In almost every country you can mention people have been organizing and re-organizing electricity industries in the hope that some new form of organization of the same elements, in the same ownership, will somehow improve matters.

Thus, electrical utilities have been collected out of small municipal systems into regional systems, integrated from regionality into super-regions or whole countries, disintegrated from countries into regions, from regions to municipalities, from municipalities to sole generating sets. You can find examples of industries which have never known a stable period; which have been either aggregating or disaggregating so fast that they are unaware in which state they have been at any time.

The UK industry is actually quite a good example of that past historical performance: collected, aggregated, federalized, re-integrated, re-federalized. No discernible change, I think, occurred in the operating efficiency of the UK electricity industry as a result of those changes. Many changes of course occurred from year to year in technical efficiency characteristics, but none of them that you could directly attribute to the form or shape of the organizational structure.

Why not? Why is it that the prospectus for the changes in structure without any change of ownership is so gloomy? Because broadly speaking what determines cost and efficiency in the electricity industry remains the same to a remarkable degree, regardless of the organization. If there is no change of ownership, if there remains no competition, if there is no new form of regulation and there are merely new bodies controlling the same entity in a more or less disaggregated form, then the same set of people go on running the industry in much the same way as previously.

That group -- the engineers -- have been running aggregated and disaggregated, integrated and federalized electricity industries for years and years, and doing it in roughly the following way.

They find out at the beginning of each year how much money is available for shiny new electricity machinery. I am quite amazed and impressed by the effervescent ability of technocrats to create new technological innovations, almost all more expensive than the last. Some of them have been spectacular advances, but the full economic benefits were not put under much scrutiny in advance -- they were merely large and shiny. Large shiny nuclear plants are on the whole less economically efficient than anything else one can dream of. Nevertheless, engineers go for them, in fact they have gone for everything, because you start at the beginning of the year with the amount of money that is available, and then you list your engineering projects in order of their spectacular shininess and glory.

Someone in the accounting department may indeed have quite different investment criteria. But that is not much good to anyone in the industry because the money has to be spent, and it is spent. And it is spent on the machinery. In country after country I have listened to board meetings deciding how much more money they were going to spend on another piece of machinery for which they have no economic analysis.

So my view is that restructuring without privatization, not a new phenomenon, will continue for many years to come, and will probably do as little to improve matters in the future as it has done in the past.

Restructuring and privatization

The next model is to restructure everything completely and sell off the resulting structures. There are two examples of that in the world at the moment. In one case it is a decided policy and in the other under serious

consideration -- the UK and New Zealand. One, a radical Conservative/Thatcherite government, the other a radical Socialist government, an interesting contrast. Both see in restructuring and privatization an opportunity for injecting into the engineers' rule a phenomena wholly unknown in public sector electricity utilities -- a serious responsiveness to capital employment efficiency.

There is no merit in a state-owned electricity industry being efficient in the employment of capital -- you merely get less to spend next year. In a market-place, with its financial pressure, there is every merit. The privatization of the whole industry to create serious financial disciplines and prompt the efficient use of capital, together with a restructuring to introduce serious competition in supply, introduces the power of customer choice. Then it is not left to the regulator to fight a lone battle against monopoly rent extraction.

It turns out that it is far from difficult to imagine ways of creating a competitive electricity industry. The practical difficulties of creating a competitive industry are of course immense; what is surprising is not that but that conceptually it is a reasonably simple matter.

Electricity is actually a commodity, despite its normal description as a utility. It is a commodity which can be traded, actively and effectively, and in real time. It is a commodity for which there is huge and indeed growing demand almost everywhere in the world. It is a homogeneous product, by and large. It can be supplied competitively: you can build many different kinds of generator in many different places and still supply electricity. And it is a commodity which has a peculiarly perfect method of economic pricing attached to it. In short, it fulfills almost all the economists' criteria for a competitive industry.

But how on earth do you make the electricity distribution network competitive? The answer of course is that you do not. You do not try to make wires competitive because they are a classical natural monopoly. It is pointless to search for competition there because you will not get it. There are parallels in other sectors which should convince us of this: for example, there is no competition either in the existence of and franchise for roads. But there is plenty of competition amongst taxis and buses, and likewise it is perfectly possible to have serious competition in electricity generation even if the transmission network stays intact.

That is precisely the model which is being followed in the UK and in New Zealand, and what we are beginning to see is the emergence of the proposition that, apart from regulating fair play amongst competitors, the only role remaining for the regulator is to set fair common carriage terms for the network.

In the end, the regulator is reduced to the role of policeman of the one element of the system that remains in the hands of a natural monopolist (or natural monopolists). But perhaps even that monopoly can be broken down: regional disaggregation has again become a feature, particularly of the UK scene, the network monopoly being divided up between different geographical areas.

So full privatization to create serious financial pressure, for serious use of capital on an economic basis not an engineering basis, allied to a restructuring which breaks the industry up regionally and functionally, and creates competition amongst generators and suppliers so that end customers

get the benefits, is a prospect which is not merely theoretical but is coming about in at least two countries.

Privatization without restructuring

The third option I have in mind is privatization without any restructuring. The government of Singapore has recently announced that it intends in due course to privatize the electricity and gas undertakings of the public utilities board in that country. There is no sign that competition will be part of the scheme in Singapore -- a small country, highly integrated, where it is difficult to see how one would divide up the system. It is far more likely, to judge by the announcement, that the entire electricity system will be privatized as a whole.

So that is the model where you privatize but do not restructure. I think the result must be fairly predictable: a highly efficient use of capital resources, and an extreme need for regulatory vigilance. In the case of an electricity utility with virtually fixed demand, with vast potential for the extraction of monopoly rent, the need for the regulator to inspect that and control it will be intense.

And another problem is that a unitary electricity utility will characteristically be very large in relation to a stock market: particularly in relation to a relatively less developed stock market than those that exist in the US, the UK and Japan.

On the other hand, that offers, for a developing country particularly, an opportunity which a competitive electricity industry does not offer, namely the opportunity to provide a safe income stock of a peculiarly solid kind, and hence to use the privatization of the electricity utility as a vehicle for creating a quite different scale of capital market. In most cases there is no other stock that will ever arise that would be so safe, and so suitable for unsophisticated small investors, as an electricity utility privatized whole. Broadly, demand is inelastic, supply is infinite, and there will be income from now until doomsday.

And the interesting question is whether the benefits of using electricity privatization to change the nature of the capital market outweigh, or are outweighed by, the competition benefits of splitting up the industry.

The fourth approach

But there is a fourth model, and the one which is actually most likely to spread, and spread like wildfire. It has already spread more than any of the others, and in fact I am unable to give you a complete account of because there are undoubtedly many cases I simply have not come across. This approach is that of contracting out the function of generation.

Contracting out electricity generation is midway between the local-government model of contracting out and that of franchising of private sector projects for major infrastructure projects such as the Channel Tunnel or the Sidney Harbour tunnel.

In the case of electricity generation, you are not quite taking a franchise and giving someone the right to extract a toll, nor are you quite taking a tiny service and allowing some existent provider to provide it instead of the government. What you are doing is making open to competitive tender not

just the construction of generation but the investment choice itself, and the financing of it.

In Pakistan, in the Dominican Republic, in Canada, in Australia, in large parts of South America, in many countries in Europe, these kinds of projects are going forward or under discussion.

What they offer is the prospect of taking just one part, but the most capital-intensive part of electricity systems, and subjecting that part to true private-sector discipline. They turn the utility into a proxy friend for the customer, and make people choose seriously between different possible investments in generation. And that has some surprising and remarkable effects on the way in which the utility itself is organized and understands itself.

Engineers do not like grading investment projects. They will give you a technical analysis, but are not so interested in economic evaluations. So when the process of generation, which typically absorbs a half to two-thirds of the total capital investment of electricity industry each year, is transferred out of the utility and into the hands of the private sector, a remarkable transformation begins. The engineers move down the building and the economists start moving up. You start having an investment appraisal, not on the basis of what shiny new machinery can we build, but rather on the basis of how to use limited funds to build the largest amount of generation and give the highest security standards that the utility can provide.

It is very far from perfect, it does not deliver customer efficiency in itself, but this strategy does change allocative decisions between one spending of the available capital and another -- and perhaps in the course of doing so it prepares the utility for a different view of the rest of its life.

MAKING THE CHOICE

Those, then, are the choices. One, restructure and do not privatize: almost certainly you will end up with a lot of effort and no result. Second, go the whole hog, restructure, turn it into a competitive industry and privatize it: then you will almost certainly produce the highest degree of competitive efficiency, and will not have a large utility dominating the stockmarket. Third, sell the whole in one block: you will have a tremendous effect on the capital market, maybe a transforming effect, but you will pose a problem for the regulator trying to keep the thing under control. Fourth, take generation and contract it out: you may achieve not only cheaper generation, but a transformation of attitude inside the utility. Or you may not.

It is quite unclear at the moment, with the speed of change we have, whether there will actually be a nationalized electricity utility in the world twenty years from now; there could very well not be. It may be that generation is universally contracted out by that time, except in those places where the whole industry has been sold in one form or another. Nor is it by any means clear whether these utilities will on the whole remain single monopolies, or whether they will have been split up and true competition will have been introduced through the private sector.

What is clear is that there will be a growing gulf between the relative growth and efficiency shown by the competitive privatized electricity utilities, as against those few remaining as state monopolies (if there are any). I think it will provide the starkest single example of the difference between

privatization and continued state control: the starkest because electricity industries are very large, they are very visible, their performance is very easily measurable and the mistakes being made at present are on an enormous scale.

PRIVATE IS A YEAR'S IMPROVEMENT FOR THE EDITOR

Editorial Board

Editorial Board

Editorial Board

Editorial Board

Editorial Board

The privatization of British Telecom (BT) is the largest of the privatization programs in the UK.

The very first state enterprise to be privatized was British Telecom in 1981 and the first public utility to be privatized was British Gas in 1986. The privatization of British Telecom was a landmark event in its own right as the sale of 51% of British Telecom raised £1.5 billion, the largest sum for a single company at that time. This success opened the way for other public utilities to be privatized and led to a wave of privatization in the UK.

The privatization of British Telecom was a landmark event in its own right as the sale of 51% of British Telecom raised £1.5 billion, the largest sum for a single company at that time. This success opened the way for other public utilities to be privatized and led to a wave of privatization in the UK.

THE PRIVATIZATION OF BRITISH TELECOM

Privatization has been a key part of the Conservative government's policy to reduce the size of the public sector and to improve the efficiency of public services. The privatization of British Telecom was a landmark event in this process.

Before 1981 British Telecom was a part of the state-owned telecommunications infrastructure. It was a monopoly, while Cable & Wireless operated in the market for international telecommunications. The privatization of British Telecom was a landmark event in this process.

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Following the privatization of British Telecom, the government provided the statutory powers for the privatization of other public utilities.

In the period since the privatization of British Telecom, the company has increased turnover by about 50% and has a forecasted turnover of £1.5 billion. Cable & Wireless has also increased its turnover.

PRIVATIZING A TELECOMMUNICATIONS SECTOR

John Collings

Coopers & Lybrand

The telecommunications sector has played a key role in the development of the privatization process in the UK.

The very first state enterprise to be privatized was Cable & Wireless in 1981 and the first public utility to be privatized was British Telecom in 1984. The privatization of British Telecom was particularly significant because of its size: the sale of 51% of British Telecom raised £3.9 billion and was three times oversubscribed. This demonstrated the ability of the capital markets to absorb large privatization share offers.

The privatization of British Telecom also provided a test bed for the regulation of newly privatized utilities to ensure that they did not abuse their market dominance. Thus British Telecom provided a model for the subsequent privatizations of the gas, airports, electricity and water industries.

THE TRANSFORMATION OF THE SECTOR

Privatization has enabled both British Telecom and Cable & Wireless to be transformed into companies capable of playing leading roles in a global telecommunications industry.

Prior to 1981 British Telecom was part of the Post Office, providing telecommunications services in the UK under a statutory monopoly, while Cable & Wireless earned most of its profits from providing external communications services for twenty-six territories, and both internal and external services for a further eleven territories -- in both cases mainly under franchise agreements with the governments concerned.

The British Telecommunications Act of 1981 provided the statutory framework for transforming both these companies through the separation of British Telecom from the postal business, the privatization of Cable & Wireless, and the liberalization of the UK telecommunications market.

Subsequently, the Telecommunications Act 1984 provided the statutory powers for the privatization and regulation of British Telecom.

In the period since 1981 British Telecom has increased turnover by about 2.5 times with a four-fold increase in profits. Cable & Wireless has shown a

five-fold increase in turnover and a six-fold increase in profits in the same period.

International advances

The financial performance of each company continues to depend heavily on its core business activities, though both have been diversifying their businesses. For example, BT has made a number of investments in North America, covering equipment manufacture, electronic mail, and cellular radio -- the latter most notably with its \$1.6 billion acquisition of a 22% stake in Macaw, the largest US cellular radio operator.

British Telecom has also entered a number of joint ventures in such areas as mobile communications, information services, research and development, and overseas network operations.

Cable & Wireless now competes in the UK market as a network operator, through Mercury, and as an equipment supplier through its acquisition of Telephone Rentals.

In Japan, Cable & Wireless has a major stake in IDC, which has been licensed to provide international telecommunication services in competition with the established carrier KDD. Cable & Wireless is also leading consortia to provide private fibre-optic cables across the Atlantic and Pacific Oceans, which it will link to its US network to provide a global digital highway.

THE NEW DYNAMISM

What the British Telecom and Cable & Wireless experience demonstrates is how much dynamism there is now in the telecommunications sector, and the resulting opportunities for business development and expansion for those companies that are ready to take the opportunity.

Three key forces underline this dynamism:

- * rapidly changing technology;
- * pressures for greater liberalization in the marketplace; and
- * the increasing sophistication of user needs.

However, the traditional posts and telecommunications administration is ill-equipped to take advantage of the opportunities that these forces for change are creating. Having evolved to provide a limited range of basic products and services using a stable technology in a monopoly environment, the traditional PTT tends to be domestically focused, supply-driven and to have a strong public-service culture.

In order to ensure that their national economies benefit from the exploitation of modern telecommunications, various countries are now embarking on policy programmes that include restructuring, commercialization and regulation of the telecommunications industry to create a telephone operating company (or "telco") that can be innovative, market-orientated and dedicated to performance improvement.

The changes needed

From an environment in which policy-making, regulation and commercial operations were undertaken by a single arm of government, there are moves towards separating these three functions and splitting telecommunications from posts, thereby giving the telco a separate identity; and the establishment of independent regulation meets one of the most important pre-conditions for the introduction of competition where that is deemed appropriate. In terms of ownership, the restructuring process can go on to privatization but often stops short at the stage of incorporation under stateownership -- in other words it will be corporatized but not in our sense fully privatized.

In re-shaping the telecommunications sector, policymakers have to resolve some significant conflicts. Innovation and competition will increasingly result in product and service differentiation by the telco, while competition and an increasingly commercial focus will put pressure on traditional cross-subsidies. Such changes call into question the social obligations that telcos have traditionally met, including the requirement to provide service universally at uniform prices, and in some cases at unremunerative rates.

Global issues

These are not localized changes, but ones that are happening in every continent.

From our own perspective the focus of attention in the first part of the 1980s was on the UK, Japan and the US, where we were involved both as auditors and consultants (including economists) in the privatizations of British Telecom and NTT and the break-up of the Bell system. More recently the process has spread so that in the past year alone we at Coopers & Lybrand have been involved in telecom-sector privatization issues in such diverse countries as Singapore, South Korea, Portugal and Hungary. In carrying out our work on re-structuring we find a number of recurring issues.

Valuation: There are two factors which are likely to result in the net book value of assets shown in the accounts being unrepresentative of the value of those assets to the business.

Firstly, due to technological and market change, assets may reach the end of their economic lives before they are become physically unuseable.

Secondly, due to technological change, the replacements for existing assets may be cheaper, whilst at the same time offering greater functionality and lower operating costs.

Capital needs: The scale of telco capital expenditure requirements is another problem area. In mature networks, capital expenditure is required to modernize the network so as to improve service quality and to be able to offer a wider range of services. In less mature networks the infrastructure may be more modern but there is a need to increase penetration rates, often in relatively unprofitable locations such as in rural areas and in the residential market.

The need to fund this capital expenditure may give an incentive to privatize; as seems to have been the case in the UK. However, the cash-flow implications of such major capital expenditure programmes may lead to

doubts about the feasibility of privatization, particularly if the telco has at the same time to meet public service obligations and also, perhaps, to continue to fund losses in posts.

Regulation: Regulation is another difficult area; potential investors will be aware that regulation is a key determinant of shareholder value and they will therefore seek clarity, stability and predictability in the regulatory regime. Consumers will need to be reassured that the privatized telco will not exploit its market dominance through over-charging or providing poor service quality. I think it is a lesson of the experience of BT in the last five years, that where you are putting strong pressure on prices you also need to be able to regulate service quality as well, to ensure that market dominance is not exploited through lowering service standards.

Competitors will look for reassurance that they will not face unfair competition, particularly the cross-subsidization of competitive businesses from monopoly businesses; or from a refusal by the telco to interconnect its system with those of the competitors. Employees will be concerned at the impact of regulation on job security and work practices, whilst government will be concerned at a possible loss of control over a sector that is of critical importance to economic and social development. It is clearly no easy task to put in place a regulatory framework which satisfies these many requirements, whilst ensuring that regulation is applied with a sufficiently light rein that the advantages of privatization can be obtained.

BRINGING THE FUTURE CLOSER

In the telecommunications sector there are a number of forces at work which privatization will help along. For this reason we expect to see further privatizations in the telecommunications sector, even in countries which are not committed to a broad strategy of privatization.

CASE STUDY: THE PRIVATIZATION OF BRITISH TELECOM

Peter Benson

Director, Coopers & Lybrand

British Telecom was not the first, but very much the leader, among the major privatizations of utilities across the world. It was in its day a huge privatization, raising £3.9 billion.

It had every conceivable problem that I have ever since met in any other privatization I have dealt with; it is a classic case study. The glorious thing about the privatization of British Telecom, however, was that it was a huge success. There were considerable doubts as to whether it would work -- but it did.

THE FUNDAMENTAL ISSUES

Privatization is a continuous process. You have to do a lot of work before privatization, next there is the privatization itself, and then there is a lot of follow-through thereafter. Let me go through some of the important issues that we faced in this process with respect to BT.

Public-sector ethos

British Telecom had long been part of the British Civil Service; it had been a government department from its birth in the early years of this century, all the way until 1969, when it was turned into a public corporation (that is effectively, a nationalized industry). That makes seventy years as a government operation.

As such, it was run by civil servants. I have a high admiration for civil servants: but they cannot run businesses -- they are not trained for that purpose.

For its part, BT had no profit motive -- government would always bail it out. It was a complete monopoly -- nobody else could run a telephone service. It had no long-term planning -- because no government, in my experience, plans more than two or three years ahead. It had very patchy investment, and in the years running up to privatization it was actually making losses.

That business had to be turned into one which would be commercial and of obvious attraction to investors.

The business started, of course, with a terrible public image. If you had asked the average man in the street in the United Kingdom what he knew of

British Telecom before it was privatized, he would have told you that it would provide him with a telephone of any colour -- so long as it was black -- and connected to a barely adequate service. Other than that, he knew nothing of it. Somehow that company had to be turned into something that would be saleable not only in this country but across the world.

Thus the corporate culture had to be changed. Of course you have to change that ethos in a vast number of ways and it is a continuing process. It starts with the little things: before privatization, for example, I was a mere "subscriber"; it was my privilege to subscribe to BT's service; now I am happy to tell you that they call me a "customer" -- and they actually treat me as one -- a small change, but vitally significant.

Capital needs

The difficulty about changing an ethos, of course, is that you have to find some quick way of manifesting to the investing public that you are actually doing so. The only way that you can do that in a very short space of time is through the accounts of the concern, because that is one positive way in which you can demonstrate in figure terms that a business that was a government monopoly may be attractive to potential shareholders.

So the first thing BT had to do was to get a grip on its accounts and reflect the change it was seeking to make in accounting terms. What that meant was looking at every single accounting policy of that business. It was a long and tedious process but it meant going right through BT's accounting policies, considering how they accounted as a government industry, and asking how they should now account to be attractive and commercial to potential investors.

Let me give you one positive example. The old rule about fixed assets in British Telecom was very straightforward; British Telecom up to privatization was run largely by engineers, and the engineers' principle was that you built a bit of equipment and then you used it until it fell apart. If you built a telephone switch that was designed to last for forty years, there was no question of taking it out of service before those forty years were up -- regardless of the technology or the level of service required. It lasted forty years, it stayed there, and it was written-off over that period.

But with privatization in the air, BT had to settle down and face the fact that they had no fixed asset base that would actually serve their customers; and to resolve to establish a fixed asset base that could cope with customer demand and changing technology. About the time of privatization in the early 1980s, telecommunications technology was beginning to change extremely fast and so they had to study their asset base in enormous detail.

The effect was quite dramatic. Of an asset base of £8 billion in 1983 they wrote-off £2 billion (or one-quarter of it), in the last six months before privatization. And that is the scale of the changes you sometimes have to make. That was not an easy exercise, but it was necessary.

Legislation

Almost certainly if you are going to privatize anything as big as BT, you will have to legislate; and in BT's case we had to legislate a lot. There were in fact two British Telecommunications Acts, one in 1981 which took it out of the Post Office and one in 1984 actually to privatize it.

The problem about legislating is of course that a legislator does not always quite understand commercial considerations. And we had to work terribly hard with BT and its lawyers, to ensure that the Acts of Parliament would in fact enable BT to operate properly in a commercial world.

When we came to look at the 1984 Act we discovered upon close reading that the legislators had not recognized that it would be necessary for BT to pay dividends to its investors after privatization. In fact it would have been illegal under the Act as originally drafted for it so to do. There had to be a lot of scampering around to set that right.

Regulation

The concept of regulation is of course very simple. BT was a monopoly: some modest competition was introduced on privatization, but basically it retained its monopoly of the telephone system. If government controls a monopoly, in theory it looks after the interests of the consumers; the risk is that if private industry gets hold of a monopoly (and BT was going to become private), it might abuse that monopoly. So you have to have some form of licence or regulation that will enable government to ensure that the monopolistic privilege will not be carried too far.

The 1984 Act set up OFTEL -- the Office of Telecommunications. This is a quasi-government body that has no other duty in life but to apply, in relatively light-handed terms, regulations to ensure that BT does not abuse its monopolistic position. Now, of course, it is a very delicate balance that has to be struck and the BT licence had to be drafted with enormous care to ensure that the regulatory constraints would not unreasonably impact upon its business.

Some of you will be familiar with the arrangements. The key one was an arrangement that BT can only lift certain of its main telephone prices according to a set formula -- that is the RPI - X% formula (the retail price index minus a small percentage). Until this last year that percentage was 3%, and after the four- year period it was lifted in 1989 to 4.5%. So BT can only lift certain of its prices by the retail price index at a particular time less 4.5%.

Something nasty

Just about every commercial business has something nasty in its woodshed, some system that is not working, some lack of control, some disaster or some problem. If you are a long-standing public limited company and you have compliant auditors you can probably smooth out these difficulties over a period; you can agree to get them right, avoid too much publicity and so on. That you absolutely cannot do if you come to be privatized -- you must come to the market with clean hands.

We had a problem with BT (we were BT's auditors) and the problem was this. Since 1969, when we were appointed, we had qualified in a major way our audit report on the BT accounts in every year for the first thirteen years -- that took us to 1983. We varied the qualification as time went by, sometimes it was fixed assets, sometimes it was stock, sometimes it was income and sometimes it was debtors or a combination of all of those; but we always managed to find something serious. It was not surprising: BT had been controlled by government and government does not account in quite the same way as the private sector does.

It was put to us by the lead merchant bank of the day that either the qualifications were removed or privatization would not go ahead. And when it was put to us in that very calm way, we looked hard for solutions and we were able, with a bit of help from BT, to lift the qualification. But it took a lot of work to achieve that, four years of dedicated effort to correct some very weak historical systems so that we could tell the investing public that BT was clean and properly organized.

Foreign ownership

BT decided that not only would it sell its shares in London and in Europe, but also Washington, Toronto and Tokyo. That was a bold step for BT to take, the more so because it decided that it would launch its shares at the same price across the world.

The difficulty about that of course is that you are selling shares in different jurisdictions, which is not an easy thing to do; you do not have to have one prospectus, you have to have a US prospectus, you have to have a Swiss/European prospectus, you have to have a UK prospectus, and (worst of all) you have to have a Japanese prospectus.

Although the laws are different, provided you go over and explain what it is you wish to do early enough it is amazing how the problems go away. We went with BT to Washington to see the SEC, we went to Toronto to see the Ontario Securities Commission, we went to Tokyo to see the Ministry of Finance: we went in very good time, we explained the differences between BT's arrangements in the UK and how they would appear in those foreign jurisdictions, we highlighted some of the problems we had, and we were met with quite astonishing cooperation. And those problems melted away. But, nevertheless it was a major exercise. We were covering half the world.

The prospectus

The prospectus is the selling document, the document that goes to potential shareholders.

We issued, for the first time ever in this country, not only a long prospectus as we had to under the law, but also a mini- prospectus for the man in the street who would not understand all the rest of the jargon. The main prospectus was extremely hard work; it took one year solid to get it right. There were five lead firms of merchant banks involved, four firms of publicity consultants and personal relations people, four lead firms of stockbrokers and dozens of other little ones, two firms of actuaries, and no less than twelve firms of lawyers in addition to one modest firm of accountants (ourselves). You see the problem. We had one year's dedicated hard work to get that prospectus in a proper publishable form.

There was the question of the profit forecast. When you issue a prospectus in the United Kingdom you also have to issue a profit forecast as part of that document: in other words you have to tell the investors what sort of profits you are going to make in the future. BT had some difficulties here because they had never produced a profit forecast; in fact they had never thought in terms of profit before -- it hadn't been too important to them. They were quite good at budgeting but the idea of actually producing forecast profits to publishable standards was very alien and difficult for them.

David Hume, the Scottish philosopher, taught that the whole of our life is lived on the assumption that tomorrow will resemble today. That is fine for most of us but of course it was all wrong for BT, because they were changing their business and their ethos, and they were changing against a background of huge technological development; so what it had done in the past was pretty much irrelevant to what BT was going to do in the future. And it was a very hard exercise to forecast what profit that business was likely to make once it was in the private sector.

BT had to face the fact that once it was privatized it would actually have to produce quarterly accounts -- and very swiftly. They had never produced quarterly accounts, certainly not in a hurry! A lot of work had to be done in advance to be certain that BT would have a system that could produce quarterly accounts of publishable standard immediately it was privatized. And we had to do the same with the annual accounts. The annual accounts used to come out in a very dilatory way because government wasn't too fussed about them in the past; that timetable had to be speeded up enormously. And the presentation of those accounts had to be improved. We had to go from rather uninformative government-type accounts to sophisticated commercial-type accounts. Many of you will know what that costs in time and effort.

Keeping the show on the road

Finally, there was the awful problem of keeping the show on the road. BT did not have any management who had ever carried out a privatization. Why should it have? It had never done it before. And such management hardly existed in this country because nobody had done it in quite the way that BT set out to do it.

So the problem was to keep the BT business going while simultaneously trying to manage the prospectus, the launch, and the privatization. The latter they found that tremendously exiting: they flew all across the world on roadshows; but at the same time management did have to go on and actually run the business, and run the business in a highly changing and volatile situation, at the same time coping with this change of ethos. It was very difficult.

Again, it is a continuing process; BT to a degree are still struggling with that problem, there is still something of a civil-service ethic in the business. Of course there is; it has been like that for seventy years. I believe it will take at least another decade before management is fully settled down to running a commercial business in the full sense of the word. They have achieved miracles so far but they have further to go still.

To privatize BT effectively took four long years of dedicated effort and we needed every month of those four years; but spending the time was tremendously worthwhile because it was a huge success.

PART V -- OTHER PRIVATIZATION TECHNIQUES

PART V -- OTHER PRIVATIZATION TECHNIQUES

THE MECHANICS OF THE BUY-OUT

Laurie Brennan

It is a common confusion in this country, certainly after the high profile privatizations of the past, that privatization means is an offer of sale to the public. It does not always mean that. It has often meant a buy-out by the managers, a trade sale or any of the other corporate arrangements to transfer the control of a company.

The enormous advantage of a public offer is the pricing. You have members of the public taking the asset at a known price. It helps spread wealth and allows individuals to invest in state assets.

But a privatization by public offer needs a market; you need the right business and you need the right time and environment for it to work. It is certainly by no means true that in every country there is either a stock market or even a suitable stock market. And even in Britain the government has found that certain businesses it wanted to privatize have just not been suitable.

The buy-out strategy

This is where employee buyouts can fill a gap. I just take three examples to illustrate the point.

Some years ago the National Freight Corporation was sold to its managers, its employees and the institutions. It was recognized that that business needed a time of consolidation before it came to the market and, indeed, in 1989 it did come to the market and has enjoyed enormous financial success. It fostered probably the first lorry driver who has emigrated for tax reasons.

Unipart is another business which was owned by the Austin Rover Group. Austin Rover Group, thinning itself down and eventually going in a trade sale to British Aerospace, sold off various peripheral businesses which were simply being strangled by the overall group philosophy (which was geared to the making of cars and was really not best designed for the making of parts for those cars). So Austin Rover, to its own benefit and to the benefit of its parts operation, allowed Unipart to go in a sale to its managers, to its employees and again to institutional backers. Unipart is now two and a half years down the track and is still on course for an eventual flotation.

At a different level we have the buses. At national level the National Bus Corporation which has sold off its activities. At the local authority level, local-authority bus operations are being sold on the grounds that they can be more efficiently run in private sector. It is the nature of a bus enterprise,

which so often centres around one-man operation; that is attractive to have a large and significant part of its ownership in the hands of its workforce. And you will find that most, if not all, of the sales of local authority bus operations are largely to their workforce. (Yorkshire Rider, which was sold recently was sold 51% to its managers and 49% to its employees, has gone extremely well and is forming something of a model for current sales.)

So you need the market. You need the right business at the right stage in its cycle. We must allow it the time to complete some of its cycles of long term investment before it can do well in a stockmarket floatation.

THE BUY-OUT

Now the buy-out is an alternative. It is an alternative which, as I have illustrated, is used by the British government in certain cases.

In the balance that any business must make between debt. But this leverage makes the buy-out a potent weapon. It is so potent because in the equity stake, where the whole long term value lies, the entry price is very low. That helps you bring in employees, who in their nature are not capital investors, who have families and commitments as we all do. They are not like institutions, able to take a fifty-year view and have a constantly positive cash flow.

If you are faced with getting employees involved, if that is one of your objectives, you must have a low entry price. It is curious to me that institutions have provided enormous incentives to get managers into equity but they are only now beginning to realize that they must make this prospect available to all employees.

The debt market

An essential ingredient for a buy-out to succeed is that there must be an appetite for debt. There must be people must be willing to lend debt on suitable terms and if the market does not produce those providers then a buy-out simply will not work.

In the UK we have developed an appetite for debt, largely because the banks, under enormous competitive pressure in a deregulated market, have begun to move to higher-risk debts. They do not necessarily want to take direct equity risk but they are willing to move up the scale of risk to mezzanine finance to get better returns in a more competitive market.

We have also found pension funds are more anxious to come down directly into company investment, and we now have pension funds who have their own venture capitalist arms who will provide finance directly into a buy-out.

What a buy-out is

Let me deal, however, with one point. I no longer refer to buy-outs as management buy-outs. It has become almost the habit of people nowadays to regard them as management buy-outs. They are not. Employees of all levels can be included in buy-outs and should be. And where the vendor is a political entity, a local authority or a government, it is very often the employee bid that is favoured because that helps the political objective of spreading wealth.

It simply is not credible to come up onto a rostrum and face the employees and say: "Wonderful news chaps -- we not only manage you now we own you." Very often the workforce may not be in a mood to trust the managers, or have suffered at their hands in the past. But then the real crunch comes when the manager has the gall to go on and say: "The really good news is that I will become very very rich while some of you keep your jobs; and those of you who do are going to have to work a lot harder to make me rich." It is at that point that I find the insensitivity of some managers quite beyond belief.

The excuses

The unfortunate thing in the UK has been that for some years the institutional investors have not helped because they have allowed managers to believe that it is not possible to involve employees. You would be amazed at the number of reasons that can be advanced, all of which were quite valid until recently.

One argument is that you cannot talk to employees. It is unlawful: if you talk to employees you are offering them an equity stake. In most jurisdictions that is an offence: because New Co plc has not been formed and you are apparently making an offer of equity to people who are its employees. Therefore you are making a public offer, you need a prospectus and if there is none you are open to prosecution.

There is the confidentiality point. How can you talk to thousands of workers and hope that the terms of your bid will not leak to the competition should the bid be contested? How can you complete a buy-out quickly if you are trying to control and manage thousands of investors?

It cannot work anyway, we are told, because the equity is of so low a value in the whole deal that if you had to spread it out among the whole workforce they would each have to contribute only five quid. It is not credible to ask them to undertake enormous structural change for that kind of input. They do not believe that something worth five pounds can end up worth five thousand pounds or fifty thousand pounds.

The solutions

Those problems in fact were solved and were solved by a technique called ESOP -- employee stock ownership plans as the Americans will have it, or employee share ownership plans as we will have it. All it means is debt schemes for employees.

In most countries, a company cannot give its equity to its employees without such a scheme because it is a criminal offence and employees will face tax charges. So these ESOP schemes are designed to get equity into employees' hands.

But employees, like anyone else, have to sell. They have to dispose of shares occasionally because they do not go on forever like institutions. They die, they get old, they have daughters who marry. They have financial crises. They have to sell. So you want a private market for these shares between the owner- employees.

An employee benefit trust is a mechanism for achieving this. Sometimes you do not actually need a trust, you just need a holder of shares, some neutral party that can make the desired transfers: but let us call it an employee

benefit trust. The company can make loans or supply shares, or make gifts to the trust. With that cash the trust can then go to shareholders and buy shares. And that is the essence of what I will call the ESOP.

It is the answer to most of the problems in involving employees in buy-outs. You see straight away its virtues of confidentiality and speed. Before you have even formed New Co plc, the managers who are the original shareholders in New Co can sit down with the institutions and potential lenders as trustees of the trust rather than as New Co Managers. You do not need to talk to two or three thousand employees, as long as you can work on trust your workforce when you are able to talk to them.

What kind of assets?

We found an enormous appetite amongst employees for preference shares because they understand them and, since employees have some savings in a building society, they are used to investments that give you your money back when you want it and give you a rate of interest in the meantime. It is only since the privatizations that they have begun to get happy with equity investments with no guaranteed rate of return and no guarantee that you can sell them. Fixed interest, fixed coupon assets are very often preferred by the employees.

In typical buy-out where the management team will have pure equity. The institutions will have the preference stock which is a redeemable but no equity-growth stock, and will have some equity. You can position employees favourably between the two: if institutions buy three preference shares for every ordinary share (it is the ordinary share that will give the high exit yield) but you allow only employees to buy two prefs for every ord, then they must do better than the institutions on exit.

Once you have established that in their minds you need say little else. The managers can go forward on that Monday morning and say: "Look, we've worked hard. We are going to get very rich, and you can get rich too proportionately. And I am not going to sell this to you, I don't have to. And those hard men from the City have been over my books for nine months, they are investing, even though they will not do as well as you. Now make your own mind up."

When we did this in Unipart we had a queue. We were twice oversubscribed. Blue-collar workers in Unipart put forward two million pounds. We could only allow them to take up just over half of that.

Wider application

I have been talking about the way in which some British companies have been offered to buy-outs rather than being privatized by public share issues. Let me look now at the international ramifications of that.

If you are in a jurisdiction where there is no stock market market, or if you are in a jurisdiction where capitalist policies are not necessarily going to be accepted very quickly, then think about the buy-out concept. Is that not a way of delivering the means of production to the workers -- company by company instead of over the whole state? It was therefore no surprise to me that at an international conference in Washington in 1989 there were people from Poland, China and the Soviet Union who were speaking in favour of that kind of structure from an entirely different kind of political perspective. One of the

amazing thing to me is that the involvement of the workforce has the support of the right and the left. And it is not surprising if you think it through.

The people from Poland were talking about the problem of sovereign debt and the problems of western banks lending that debt into Poland, and everyone was mindful of the experiences in Latin America where banks have had to reschedule debt repayments. And this took us on to the further issues surrounding debt-equity swaps.

One of the unpalatable aspect of swaps to a bank, is that they are switching from an asset called a debt, into something called equity, which is even less certain and so carries no value in their balance sheets -- in their liquidity ratios they will often have to strike out the equity. So instead of surrendering sovereign debt for an equity stake in a privatized business, why not swap sovereign debt into debt in sort of structure? So, that the bank, instead of lending to the government lends to a trust or an arrangement where the equity growth will pass, through the share schemes, to employees.

The banks will still have debt finance and perhaps a little equity and will be repaid. But instead of giving sovereign debt to the state, the banks are providing debt to a specific company. There are enormous incentives for those managers and employees to produce, so the banker can see the source of his repayment. It is still a debt and still counted as an asset and he may still be able to write it up.

From the political side I would guess that many countries would think equity spread amongst their workforce far more acceptable than equity spread among foreign holders. And it is a way of spreading ownership even where there is no stockmarket.

The benefits

So, wherever one is and whatever political perspective you hold, I would commend to you both the higher role for the workforce in the privatization process -- and therefore a higher profile for debt, because debt is the only way that the workforce can get into equity at a low price. You can, through this mechanism, actually spread wealth.

It is getting tougher, in the competitive world we live in to build a successful business from scratch. But you can give people an edge. If you institutionalize certain techniques which are equitable but get people in on low equity prices, you may begin to spread wealth across your nation.

The British government, more than any other, has shaped share schemes over the past decade. It has concentrated on producing individual share owners responsible for their own assets. During the privatization process, it has turned individual employees into wealth owners. It has used that to begin the assault on corporatist unions and to turn them into responsive mechanisms so that individuals have a stronger role in them. It has used the privatization programme to increase the public's share ownership to an enormous extent.

So I do not think it is going too far to say that this government has seen the spread of share ownership amongst both the public and employees as one of the central planks of its very successful privatization programme.

CONTRACTING OUT LOCAL SERVICES

Robert Poole

Reason Foundation is a public policy think tank somewhat analogous to the Adam Smith Institute and we have been studying privatization in the United States since 1976, especially local government contracting-out of services. We have been publishing a newsletter now called *Privatization Watch* since 1976 and watching this development grow and expand across the country.

The United States, you must realize, is quite different from Britain in the relationship of local government to the national government. In Britain, Parliament is able to impose requirements for competitive tendering on local governments and to make all sorts of other changes; whereas in the United States local government has much greater autonomy and so we see a much greater variety of practices in our city and county governments all across the United States. Some people call it essentially a laboratory experience whereby we can study different policies and procedures taking place between different cities and even within the same state.

And so we have had a very rich field to research over the last fifteen years.

Wide use of contractors

There have been three large surveys of local government contracting in the United States -- in 1972, 1982 and the most recent one last year in 1988 -- and they have shown a major growth of contracting out of municipal services over that time period. There are altogether seventy-one types of services categorized in these surveys, everything from ambulances to zoning. There is some amount of contracting out in every single one of those categories, even in some aspects of police services. In five of those seventy-one services, private-sector contracting is very well represented.

In the towing away of illegally parked vehicles, eighty percent of the cities and counties contract with private firms for that service. For providing legal services to local government, fifty-five percent of them use the private sector on a contract basis. For operating street lights, 46%. For the disposal of hazardous material forty-four percent and for operating homeless shelters, 43% use the private sector.

Other services that are quite extensively contracted out include commercial and residential refuse collection, street repair, tree trimming and various other forms of gardening services.

The stages of privatization

We have generally observed that the move to contract out local services takes place in three distinct stages. And this is true historically across the country and it also tends to be the pattern within a particular city.

What is generally the first stage is what we call housekeeping services whereby the city decides to start purchasing from contractors things such as the janitorial services, the cleaning services within the city buildings and things like cutting the grass in the city parks and maintaining the city vehicle fleet. These are relatively small services, and there are many local small businesses already in business providing such services, so it is very easy to find suppliers.

Alongside these are professional services like legal services, engineering services, and architectural services, where you have highly specialized expertise. Especially in smaller cities and towns, where you very often do not have enough work to justify a full department of these qualified people, it is often more cost effective to buy those services as they need them from local professional firms.

Stage two of the contracting out process tends to be larger scale services that are delivered directly to the public, directly to the citizens. That is such things as refuse collection, street sweeping, operating emergency ambulances, operating park and recreational facilities, golf courses, tennis courts and things of that sort, and (in some cases) fire protection.

Now these services, because they are delivered to every citizen, are more politically sensitive. People notice if things are different from the way they have always been and they are likely to complain about them, so it is a larger decision for governments to think about contracting those services. But that is now going on extensively and the amount of it has been growing for the last decade in the United States.

Stage three, the most recent and the most ambitious form of contracting is the provision of infrastructure, and that means such things as waste water treatment plants, garbage disposal -- incinerators and landfills -- public hospitals, local jails, and bridges and highways.

Build Operate Transfer (BOT) schemes are now becoming an important factor in providing new infrastructure in the United States and there are many advantages. Typically, this is done on long-term contract or long-term franchise of twenty or thirty years at which point the facility, the project is transferred back to government control.

The benefits of competition

There are some obvious potentially important advantages in obtaining services competitively and from private contractors.

The theory says that if you substitute competitive conditions for the previous monopoly conditions you will have more responsive, better services that are more attuned to the needs that people actually have and that you will have lower costs because there are strong incentives for efficient performance.

That is certainly a plausible theory; and one of my friends in the private sector who operates fire departments says that there is nothing like the threat

of losing your business, of having contracts dry up, to concentrate the mind on the task of really trying to figure out how to mix people and equipment and systems in the most cost-effective way to get the job done.

Theory and evidence

So it is to be expected, at least on theoretical grounds you would have more cost-effective services by moving to private contracting. What does the evidence actually show?

I mentioned that we have a kind of large-scale laboratory in the United States for observing lots of different ways of providing services. People have taken advantage of that over the last decade to do a number of studies, looking at an equal number of cities and counties that produce services in-house or, on the other hand, contract with the private sector to provide them. The conclusion has been virtually overwhelming. Almost all of these studies show that for the same level or quality of service, you can obtain it at substantially lower cost through competitive contracting with the private sector.

The service that has been most widely studied, and we know of at least eight studies now, is refuse collection. And the largest US study was done at Columbia University some ten years and showed that when all costs are taken into account (including some costs that governments frequently do not include when they tell you what they think the cost of providing services is, such as retirement benefit costs and a proportion of the city overheads and so forth) it is as much as sixty or seventy percent more expensive on average, for local government to pick up the refuse than for private contractors to do so. And a similar result of 40% to 60% higher costs have been seen in other studies in the United States and in Canada.

In southern California where the Reason Foundation is located we have a great deal of contracting with the private sector and another consulting firm from New York was hired by the US government about five years ago to do a study comparing public sector and private sector services in southern California. For each of eight different services they looked at ten cities that provided the service in-house and ten cities that did it with contractors. They looked at comparable levels of service and then figured out what were the actual costs per unit of service. They found that garbage collection was forty percent more costly when it was done by the cities with their own workforces. Maintaining and trimming trees along the street was 37% more costly when done by local government. Street cleaning was 43% more costly when done by the local government itself. Grass cutting was also 43% more expensive done in-house. Traffic signal maintenance was 56% more expensive. Building maintenance was 73% more expensive and asphalt paving was 96% more expensive.

Fire services

Let me just illustrate one further example. I mentioned fire protection a minute ago and this is one service that people do not imagine the private sector can produce for some reason -- I suppose because it concerns life and property. But in fact there is a well established trend in about eight or ten US states to have private companies in the fire protection business, competing for competitive contracts to provide local fire protection services.

One of these in Arizona has been studied very extensively. There was a comparison made between the privately contracted services in Scottsdale Arizona and the in-house fire protection services in three nearby cities of approximately the same size and the same type of land use and the same type. It turned out that on all the usual measures of performance -- such as the annual loss from fires, the fire insurance rates that home owners had to pay and the average response time of getting to the fire -- was very comparable between the private firm and the public sector. But when you looked at the cost, it was about fifty percent less costly to have the service provided by the private company.

When the researchers looked in more detail at how it was that the private firm was able to deliver the same level of performance but at half the cost they found that the private firm had developed a smarter way of providing fire protection. Not only had they made many innovations in the equipment that they used -- design innovations, and using equipment that no other fire departments had thought of using -- they also figured out that fire protection is unnecessarily labour-intensive in terms of full-time manpower.

Most fire departments in the United States use only full-time people; although most of the time they are sitting around and waiting for a fire to happen. It is very unproductive and the private company figured that they would be able to get essentially the same results by paying a smaller core group of full-time people to do the waiting at fire stations and a large group of reservists who had other jobs. There was an agreement with their employers that whenever a fire call came they could leave their job and respond to the fire.

It turned out that over a period of years that system proves to be just as effective at getting trained manpower to fires as it is having all full time people. But the incentive to get the most for your money simply does not exist in the vast majority of local government fire departments in the United States and it has been pioneered by private companies.

Future frontiers

In some service areas there will be a new burst of activity in private-sector provision in the United States.

The first of these areas is prisons. This has been controversial in the United States and where it has been proposed in other countries has been controversial too.

In the majority of US states, the prison conditions are not very good. In fact, various groups representing concern about conditions in jails have gone to court and have obtained court rulings that conditions are not acceptable and must be improved under penalty of law. And yet many of these bad conditions still continue. So this has helped to create a market for about a dozen private companies that will either operate an existing prison on a contract basis. They are paid so much per inmate per day or will build, own and operate entirely prisons; their services are offered to local authorities or to state governments or even to the national government for hire.

These types of private prisons or jails exist in five or six states in the United States so far. They have been in existence for around five years and so far we have seen very few problems. They generally produce about ten to fifteen percent cost savings -- not as much as in some of the other areas, though there is potential for greater cost savings as firms design and build

Another very large area in the United States is privately financed and built roads and bridges. We have a severe need for new investment in highways and bridges in the United States and there is a beginning of new interest by the private sector.

The third area is airports. It seems to be a small but very promising worldwide trend to have large financial institutions joining forces with engineering and construction firms to build and operate airports as potentially for profit ventures. The growth of air travel is enormous and there seems to be a serious shortage of airport capacity. More and more people in the private sector are realizing that this creates business opportunities and there is a significant trend beginning to both take over and modernize existing airports and to design and build new airports as business ventures from scratch.

So, to sum up, contracting out of services, using the private sector rather than in-house workforces, offers a tremendous opportunity to city governments. This is true potentially any place in the world. Both the theory and the evidence shows that you can get better services for a given amount of money, or spend less money to obtain the same services, if you harness the forces of competitive private enterprise.

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WANDSWORTH'S EXPERIENCE OF CONTRACTING

Sir Paul Beresford

Contracting out is not new. Most British local authorities have used the private sector to a greater or lesser degree, in providing some of their services. The most obvious example, certainly in this country, has been major building contracts.

However, it has been doggedly resisted in the main service areas, the main blue collar areas of local authority services: rubbish collection, street cleaning, and the maintenance of transport fleets. These have remained in-house and there has been little attempt to seek assistance from the private sector in providing better services.

The reason that is generally given is that you can control better through direct contract; but the real reasons are usually political. There is resistance, particularly in the rural areas of this country, to any change -- a belief, almost a paternalistic belief that the way we have done things for years must be the best. The reality is, as we can now see, quite different.

There was a recent efficiency study done by a London local authority which summarized that reality. When their direct labour dustmen were compared with those of neighbouring authorities, it was found that they collected less than one ton of refuse each per day. In comparison our own private sector dustmen achieved over four times that per day.

THE WANDSWORTH EXPERIENCE

Competitive tendering is a technique that has caught the eye of the Conservative government because of the experience inside our own little area of London. The idea developed when it became obvious to us that the traditional methods of achieving change through management and negotiation were failing.

The problem

My borough is the largest of the thirteen inner London boroughs. It has an area of thirteen square miles, a population of two hundred and sixty thousand residents and about one hundred and ten thousand dwellings. When we took over control in 1978 from the Labour Party it was a typical British inner city area with typical British inner city problems, with many needs indices worse than Liverpool. Compared to the other twelve inner London authorities it had a middle rank on unemployment and nearly the highest level of local taxation.

Today -- and a contribution has come from competitive tendering -- it has the lowest unemployment and it has far and away the lowest local taxation.

Back in 1978 the services were deplorable. The street cleaning was haphazard and in some areas non-existent. The unions would not allow free movement of workers to areas of service need. Negotiations were stalled at every opportunity. The refuse collection was notorious. Everything but everything was done on a "task and finish" system. By that I mean they started at six in the morning and, if not watched carefully, were out by eleven. Residents received a poor quality service at seemingly escalating costs.

When we swept into power in 1978, we aimed to produce high quality services at a price that our local taxation base could afford. So we used the traditional method; more years of long hard negotiations. After years of talking we produced a small percentage saving on bin collection. To my amazement this was heralded by the management, and the unions, as a triumph. It was -- for the unions.

A new approach

However, a senior officer in the administration department and I set out to compare our very large mechanical workshop with a commercial one of the same size producing about the same work output. We discovered that they produced about the same amount of work with one third of the staff, and much lower costs. So we decided to propose competitive tendering with contracting out.

There was a period of disbelief by management and senior politicians but we did take our first tentative step. It was a new area so we used outside consultants to draw up tender documents. We were feeling our way and the private sector were nervous in their response. But it really concentrated the minds of the workforce. We had real negotiations, in contrast to negotiations between unions and management we had negotiations between men and managers. The direct labour department won the contract with £2.25 million savings; a 29% cost reduction.

The council, deadlocked in other negotiations, decided that we liked our first taste of this so we went further down the road.

Seven years later we have tested, directly or indirectly, nearly forty different services. Of those forty, approximately two-thirds went out to competitive tender. Of those, two-thirds have been contracted out, one third remaining in-house.

We have now come to the point where many of those services have come to the end of their first contract period and are being put out to re-tender. The competition is fiercer but the private contractors, are better.

For example, our street sweeping service used to be disastrous. On contracting it out to a private firm, we realized that the level of service that we thought was correct on paper turned out to be quite insufficient. We were able to compensate. We did not need any union negotiations, we did not have any bonus claims. We approached the firm and extended the size of its contract. At the end of that contract we went out a second time and we increased the service level by thirty percent. And the winning bid -- in spite of the inflation over the previous five years, in spite of the increase of the contract during that five years, in spite of the thirty percent increase in that

contract when it went out the second time -- cost less than the in-house service did some five years before.

We had achieved a remarkable improvement in the quality of our service; we had achieved a remarkable improvement in our understanding of the service; and made some large cost savings at the same time.

Source of savings

In the services that went out to competitive tendering but remained in-house, the main source of the savings was efficiency. There were other savings from the better use of plant and vehicles in some of the services.

There was also an average 42% reduction in manpower. This is particularly striking in the refuse collection service where their in-house department started with 256 people, made a small saving and dropped to 216, realized the crunch, the tender, was coming and dropped to 201, then dropped to 133. Today the contractor has barely more than over a hundred, even with a bigger service.

This indicates the kind of savings available, whether a service be in-house or contracted out. The street lighting service is not contracted out but has used a private sector approach. It is a very much bigger service than it was in 1965. But just compare the work force -- twenty-five down to six today. And from twenty-five vehicles down to five.

Redundancy costs

A major factor in deciding whether to switch to a contractor is of course the redundancy cost and we set that against the contractor.

Where it is appropriate, the cost of these redundancy payments is spread over the settling-in period of the new contract in the form of a good behaviour bond. The necessity for this bond was obvious in the early days when the refuse service was under tender. The moment we put the refuse service out, the men went on strike. We retaliated by hiring a number of temporary private contractors. An incredible rash of violence ensued: heads and limbs were broken, men appeared in court, and one contractor lost five or six vehicles in a radio-ignited firebomb attack on his depot.

So, on the successful winning of a tender by a private contractor, we brought in an enhanced redundancy scheme in the form of a time paid good behaviour bond, the money being paid over a period of time only if there were no disruptions. We had a very peaceful hand-over period. Many of our workers collected their cheques and went and worked for the new contractor, just as they would have in the private sector and, interestingly, when we have retendered, the new contractor has taken over the contract with the workforce similarly collecting their cheques and going and working for the new contractor.

Generally we have required the new contractor to interview the existing workforce for positions as this provides for a continuity of knowledge. But there is no compulsion for the new firm to take the old hands.

THE TENDERING PROCESS

Our first two contracted-out services were street cleaning, followed by refuse collection. The quite spectacular improvement in service, combined with the contractors' ability to ensure the quality of service of our choice, and the stupendous bonus of the financial savings, decided the council to embark on a general policy of putting all appropriate services out to competitive tender. It is now a requirement for all service directors to test the competitiveness of their services against the private sector where this is appropriate.

Inevitably, of course, we found resistance. Many service officers saw this as an insult to their own workforce and management skills; and we had councillors who should have known better being paternalistic about the services. But the officers nowadays prefer the management control that the new system gives them. They prefer the flexibility. And they certainly do not miss the constant negotiations about changes and arguments over bonuses.

Initial savings

In the early days, because of the investment of staff time needed to draw up contracts, we started with a feasibility study on each service before we went any further. Management would draw up a brief outline of our requirements and discuss it with the private sector.

The talks were exploratory. Potential contractors were able to indicate whether or not they would be interested and we also took the opportunity to discuss the best way to issue tenders. We got an indication from the contractors of a cost figure, which we could use as a guide on whether to proceed further. (The initial quote did serve to indicate the size of the savings that were potentially there. Nevertheless, in most cases when it actually came to the real day of competitive tendering, totally different and generally very much lower figures were submitted.)

This exploratory process is not necessary today. There is now a wide library of feasibility studies from councils all over the country and the contract documents can be utilized by other local authorities.

The specification

The key, of course, to a successful tendering exercise are the contract documents and the specifications. Preparation of these can take some considerable time. However, the local management will have some very relevant knowledge and should be identified with and held accountable for every stage of the tendering process -- helping to ensure that at the end of the day they remain responsible for the delivery of the future service.

Our experience was that the managers proved well able to produce the specification either by themselves or with help from temporary consultants, particularly within the area of work measurement and field observation.

The specification always contains details necessary for providing the service on occasions with maps, plans and so forth. We have details of the frequency of regular tasks, and of special tasks that may arise from time to time -- clearing up the leaves in the Autumn, for example. The specification can also include details of the methods to be used -- for the refuse collection, whether it is collected from sack or from bins. Quality standards may also be included. To take another example, in the grass cutting service we set a

maximum and a minimum height for the grass. The contractor may cut the grass as often as he likes or as infrequently as he likes so long as he is between those two heights.

Monitoring the results

Interestingly, contractors actually prefer these tight detail exemplified by these contracts because it enables them to assess exactly their costs and hence their prices. From our point of view it makes it very easy to maintain tight control.

That control is done by the council on a detailed inspection and default system. The success of the execution of a contract is assessed by a team of council inspectors daily, either by a complete survey or a random sample. Furthermore the public are encouraged to complain if they feel any need and these complaints are investigated by the council inspectors. This type of contract compliance is applied to both direct-labour and contracted-out services.

The difference of course with the contracted-out services is that failure to comply brings a diminution in payment, in certain cases a deduction in the form of damages and, of course consistent failure can mean the loss of the contract to that private firm. This has happened twice and has resulted in our hiring new temporary contractors while we went out to tender again.

In our case, for every single competitively tendered service -- whether the service has been contracted out or not -- the new service has been demonstrably better than the old.

Quality assurance

Each contract provides for a financial reduction if tasks have been inadequately performed. Clear specifications make it possible to of approach. It also demonstrates that it is possible to give different areas of the service different levels of importance. For instance, a key reception room at the headquarters of the council would be graded as more important than the broom cupboard. And it is possible to alter the priority of a service when circumstances change.

Our experience has shown that the damages for poor performance need not be, and indeed should not be, punitive. From our experience even small amounts are adequate to ensure that it is in the contractor's interest quickly to put shortcomings to rights.

In addition to financial deductions and damages the contract should contain a system of penalty points with the prospect at the end of the day of termination if required.

Duration of contract

We set the contract levels for five years and in one case it has been extended to seven. The reason for this is that the period of a contract should be long enough to justify the contractor's initial investment in, for example, plant and equipment, management effort, staff recruitment and training, and familiarization. The argument against the long contract is that it might lock the council into a contract with a poor contractor. But this is spurious because if the clauses for default and termination have been drawn up

properly, then the poor contractor can be readily removed and re-tendering started.

We found that on the second round of tendering considerable savings have been attained. But just as important, at the second stage you can wipe the slate clean, draw your specifications up anew if they need it, and take a completely different approach to the service.

CONCLUSION

In short, the lesson from our years of experience, is that competitive tendering, whether contracted out or in house, gives an understanding of the service unequalled previously. It gives a quality unequalled previously. It gives value for money.

In this country, the government has recently required local authorities to put a number of services out to competitive tender. The first short round of this has occurred. There has, predictably, been much resistance and a good deal of evasion.

But I anticipate that, over the next few years, authorities will find themselves delighted with the service and with the savings they are now getting. And the first short round has already saved, I understand, something of the order of £26 million. There is more to come because this initial £26 million is a mere ten percent.

In time, local authorities will recognize the benefits, in terms of their understanding of their service, and the control and value for money that competitive tendering brings. They will overcome the prejudices so that competitive tendering becomes a normal, standard, everyday, non-political fact of life.