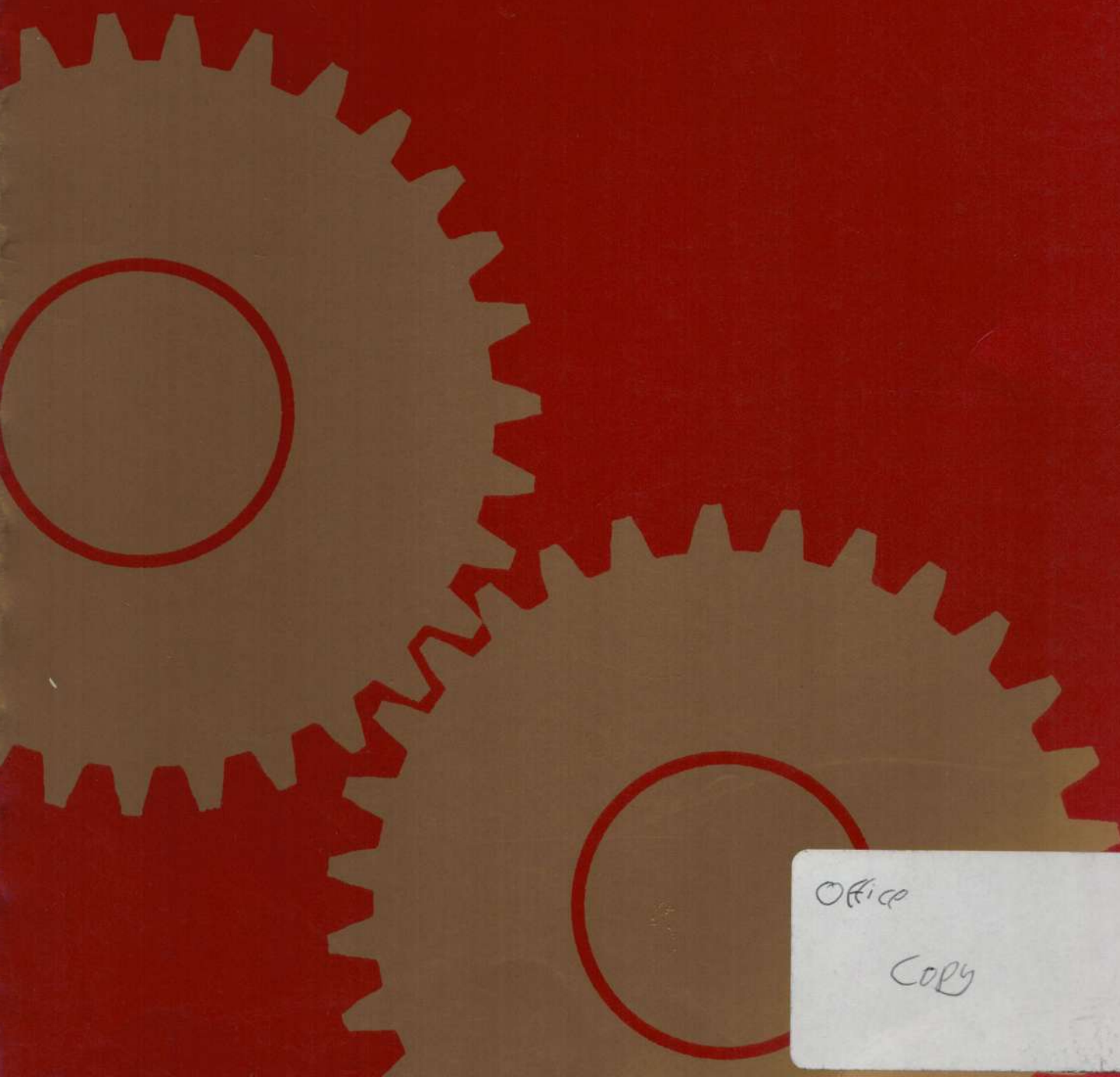


# PRIVATIZATION IN PRACTICE



Edited by Eamonn Butler



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PRIVATIZATION IN PRACTICE

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Director, Asia & Australasia

**PRIVATIZATION IN PRACTICE**

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## **PRIVATIZATION IN PRACTICE**

Edited by

**Dr Eamonn Butler**  
Director, Adam Smith Institute

From an international conference  
sponsored by the

**Adam Smith Institute**

#### A note on sources

The views expressed in this publication are those of the author and do not necessarily reflect those of the Council of the European Union. They have been prepared for the Council of the European Union and are presented as

'In every great monarchy of Europe the sale of the crown lands would produce a very large sum of money, which, if applied to the payment of the public debts, would deliver from mortgage a much greater revenue than any which those lands have ever afforded to the crown. ... When the crown lands had become private property, they would, in the course of a few years, become well-improved and well-cultivated ... the revenue which the crown derives from the duties of customs and excise, would necessarily increase with the revenue and consumption of the people.'

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Adam Smith, *The Wealth of Nations*,  
Part 2, chapter 2

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## THE FRONTIERS OF PRIVATIZATION

**Rt Hon Nigel Lawson MP**  
Chancellor of the Exchequer

I congratulate the Adam Smith Institute on organizing this symposium with so many people from so many different countries. It is a sign that privatization has swept the world in a way that few could ever have envisaged possible. I hope you will forgive me a little quiet pride that it was this country which pioneered the concept. Indeed, the very word 'privatization' has passed into a number of languages, including Japanese. In fact, no fewer than three of the papers come from former Treasury officials who have subsequently privatized themselves!

I myself have been involved in the privatization programme one way and another from the beginning first when as Financial Secretary to the Treasury between 1979 and 1981, I was given the responsibility under Geoffrey Howe, the then Chancellor, for getting the programme off the ground; then for a short time as Secretary of State for Energy, when my first task was the privatization of the huge government stake in North Sea Oil, at that time the largest privatization ever undertaken; and now since 1983 as Chancellor of the Exchequer responsible for the coordination of the biggest privatization programme which the world has ever known.

### The context of privatization

Privatization, although a programme without precedent and an outstanding success in its own right, has to be seen in context. The seven major industrialized countries of the Western world, have now had fourteen economic summits, two complete cycles of meetings in each of the seven summit countries; and one can see so clearly how, throughout the world, economic thinking has changed dramatically between the first of those two cycles and the second.

During the first cycle coordinated fiscal expansion was seen as the key to faster economic growth, but as we all now know the policies of the 1970s led instead to accelerating inflation with growth disappointingly low.

During the second cycle of summits the consensus has shifted. It shifted towards using macroeconomic policies to control inflation and stimulating growth by freeing up markets and pursuing other structural reforms designed to improve the supply performance of our economies. The result of this has been that during this second cycle the summit countries have seen the longest period of economic growth in post-war history.

That is the revolution of the 1980s. It is a revolution which has spread far



beyond the seven countries which meet at the annual summits, and encompasses governments of very different political persuasions, in very different circumstances all round the world. A belief in government action as the way to economic success has been replaced by a belief in the markets. Relying on markets means reducing tax rates and restructuring the tax system to reduce distortions and biases. It means getting rid of unnecessary rules and regulations, and it means subjecting as much of the economy as possible, including the public sector, to competitive and market forces. And it is in this context that privatization has its natural and rightful place.

### **Privatization and performance**

Privatization is an integral part of a free market approach to the economy but the case for it does not rest on theory; certainly in Britain it rests on the practical evidence of the performance of the nationalized industries before 1979 and on the performance of the privatized companies since 1979.

By 1979 the state sector in Britain had become more extensive than ever before. The nationalized industries accounted for one-tenth of national output, more than one-seventh of total fixed investment, and some 1.5 million employees. But so far from living up to the original ideals of efficiency and commitment to the public good they were in fact a heavy burden on the rest of the economy. Their losses and borrowing amounted to nearly #3 billion per year; their record on investment and productivity, and on industrial relations, was very poor indeed. Their service to the public was the butt of endless jokes. This was in no way the fault of those who worked in these industries; it was inherent in the system itself.

Clearly, this was a situation which could not be allowed to continue. Not only was the financial cost substantial but since the nationalized industries dominated the key sectors of transport, energy, communications and steel, to name but a few, their inefficiency was an intolerable drag on the economy as a whole. The problems of state ownership were not new. Adam Smith himself advocated the sale of crown lands in *The Wealth of Nations*. I quote: 'When the crown lands have become private property they would, in the course of a few years, become well improved and well cultivated'.

Indeed, it wasn't hard to see why the nationalized industries have failed to live up to the high ideals set by their founders. Managers cannot manage properly if all their decisions are second-guessed by politicians and civil servants. Investment can clearly be better planned and appraised if the finance depends upon the commercial judgement of the capital markets. A crucial stimulus is taken away if managers and the workforce know that in the end their financial position is underwritten by the state and survival in no way depends upon responding and satisfying the needs of the market.

### **Getting things ready**

For those state-owned industries not immediately ready for privatization the first step, therefore, was to replicate the disciplines of the marketplace as closely as possible. This involved setting the nationalized industries in a firm framework, agreeing a corporate plan, setting clear financial targets, (often accompanied by objectives for cost reduction), and monitoring of performance. But within that framework, management was given as much freedom as practicable.

The nationalized industries responded well and in many cases their



performance was transformed in particular by the prospect of privatization. British Steel, for example, operating in a particularly difficult sector of the world economy which made a net loss of nearly £1.8 billion in 1979/1980, is now back in profit and set to be the next major candidate for privatization. But reforming industries within the state sector can only achieve a certain amount -- never enough; the target has always been privatization.

### **Starting out**

The early privatizations were ordinary commercial businesses; British Aerospace, Amersham International (the radiochemicals business), National Freight and Britoil (the former British National Oil Corporation), most of which were already in competition with private companies. These broke new ground in a number of ways, not least in stimulating a wider shareownership in general and employee shareownership in particular. This has been a crucial secondary objective of the privatization programme right from the very start.

Privatization, as Geoffrey Howe explained in his 1979 budget speech, is: 'An essential part of our long-term programme for permitting the widest possible participation by the people in the ownership of British industry. This objective -- wider public ownership in the true meaning of the term -- has implications not merely for the scale of our programme but also for the methods of the sales we should adopt'.

The next radical step forward came in November 1984 with the sale of British Telecom. Taking a vast near-monopoly utility out of state hands was a completely new departure. The case for privatizing the utilities is essentially the same as for other nationalized industries: it enables managements to manage. Finance is raised from the capital markets rather than from the taxpayer, and the company gets the vital spur, both of knowing that its success depends on satisfying its customers and of seeing its performance reflected in its share price. But the special circumstances of the utilities required radical new developments in the method of privatization, both in preparing the industry and in making a success of the sale. Thus, to reinforce commercial disciplines and to prevent the exploitation of monopoly, British Telecom was placed under a regulatory regime which was specially devised as part of the preparation for privatization. We licensed Mercury -- a brand new telecommunications company -- to compete nationally with BT wherever practicable. Mercury is now beginning to reap the benefits of its investment in the business market in the UK. It has recently moved into new markets, both domestic and international, and is now providing public call boxes in direct competition with BT.

### **Perfecting the techniques**

The other new feature of the Telecom sale was its sheer size: at nearly £4 billion it was at that time by far the largest UK share sale ever -- indeed the largest anywhere in the world. Without a healthy economy and a sophisticated financial system, a privatization of this size would probably have been impossible. Secondly, many so-called experts were highly skeptical at the time. In the event, as you will recall, it was not only achieved with ease but also gave us the opportunity for a quantum jump in the extension of share ownership in this country. This was achieved by a wholly new approach to selling shares, including television and press advertising, special mini-prospectuses aimed at potential new investors rather than city institutions, the chance to pay in instalments over a considerable period of



time, and special encouragement to small investors not merely to buy the shares but also to hold them, through such devices as free bonus shares after a qualifying period of years.

Many argued at the time that these techniques would prove an expensive flop and that ordinary people were simply not interested in buying shares. In fact the UK public offer for British Telecom was nearly nine times oversubscribed with shares allocated to more than two million investors, most of them first time share buyers.

These techniques were improved and used again two years later for the even larger sale of British Gas. This time nearly five million people bought shares and that is in itself a measure of dramatic change in public attitudes. People who at the outset may well, and indeed were, suspicious of the privatization programme are now eagerly participating in it; and they have held on to their shares. After the initial flurry of selling which always occurs when an issue goes to a healthy premium, share registers have been remarkably stable and British Gas still has nearly three million shareholders; what is more, over half of them report that they check the share price every week. These sales broke new ground and since then other large-scale flotations of British Airways, Rolls Royce, and BAA (the former British Airports Authority), have each attracted more than one million investors.

### **Other approaches**

At the same time there have been a number of other privatizations using, where necessary, different approaches, but equally important for the aim of getting businesses into the private sector. Companies within British Shipbuilders have been sold individually to interested buyers. The Royal Ordnance factories were sold in a trade sale to British Aerospace, the National Bus Company was privatized by selling seventy regional operating companies separately, essentially via management buyouts with the expressed aim of promoting competition. This was a complicated route to follow and certainly not an easy option for the government. Nevertheless, it was completed eight months ahead of the statutory deadline.

There is no single right way to privatize a nationalized industry. The point is to look carefully at each industry and decide on the best method in that particular case to promote competition wherever it is possible to do so, to promote wider share ownership wherever it is possible to do so, and always to seek to stimulate a better service for the customer.

### **Some examples**

Seventeen major businesses have now been returned to the private sector and just as the case against the nationalized industries was based not on dogma but on their manifest inadequate performance in practice, so an important test of privatization is how the privatized companies have actually done since they moved into the private sector. And the overwhelming majority have seen higher output, higher investment, better industrial relations and morale, and higher profits.

Let me take three particularly notable examples: Cable and Wireless has experienced steady growth in sales, profits, investment and employment. Jaguar, the car company, which performed dismally in the 1970s, has seen production at an all time high, investment up substantially, and two thousand new jobs. The National Freight Corporation which was privatized through a



combined management and employee buyout in 1982, has expanded its business, opened major new distribution centres, and has now embarked on acquisitions on the other side of the Atlantic, and its shares are now trading at over forty times their original price.

### **Spreading the benefits**

Success of this sort benefits the workforce, the shareholders who typically include the great majority of the employees, who we always sought to offer shares on favourable terms, and, of course, the economy as a whole. Not least, it is good news for the customer because a private-sector company is not going to succeed for long, indeed it may not even survive for long, if it does not satisfy its customers. For example, it was pressure from the consumers, backed by the regulator, which obliged British Telecom to repair its callboxes more quickly so that now over 90% are in working order compared to only 75% last October. It is most unlikely that the improvement would have occurred so remarkably quickly if BT had remained nationalized and with no competitor, and of course the emerging competition from Mercury will help to keep standards high.

The privatization programme has also succeeded in the secondary objective to which I referred earlier, that is to say of radically widening share ownership in this country. Helped by special arrangements of one kind and another, millions of people have bought shares for the first time in a privatization and this has contributed to a three-fold increase in the number of shareholders since 1979, which now extends to one in five of the adult population of this country. One particular objective has been to encourage employees to acquire shares in the companies they work for -- a valuable way of enhancing their commitment to the firm. Special incentives have therefore been given for employees to acquire shares in every privatization where a majority shareholding has been sold through a stockmarket flotation. As a result 90% of those employees who were eligible have become shareholders in their companies.

Privatization has thus transformed a substantial sector of the British economy and brought about the largest extension of share ownership that we have ever seen in Britain. These achievements give the lie to the old accusation that the only reason for privatization was to raise money for the Exchequer. Indeed, with the UK budget deficit now almost entirely eliminated without even one penny piece from privatization sales, this charge could scarcely be more ludicrous.

### **Changing attitudes**

It is now well over seven years since the first British company was privatized as the first step in a long term programme, and as privatization and the extension of share ownership have gone ahead public attitudes have changed quite remarkably. In the early days privatization was regarded with considerable skepticism and doubt; it was often derided as a short term gimmick. Today it is an established part of the political and economic landscape, not only in Britain but around the world. At first it was greeted with hostility, now it is a manifest success. And whereas in the early days people tended to think that each privatization might be the last, now they look ahead to the next one and beyond that.

The plain fact is that the government has continually pushed back the frontiers of what was thought capable of being returned to the private sector



and as the programme continues -- and we have a heavy programme ahead of us -- the frontiers will be pushed back further still.

### **Future programme**

Let me be quite clear: the privatization programme is certainly going on. The stock market collapse of October 1987 was a dramatic event at the time but there is no reason whatever to think that it has undermined the capacity of the London market to support worthwhile new issues. Indeed, although the crash did mean that the BP share sale failed to bring wider share ownership as we had hoped, it did serve to demonstrate the ability of underwriters and sub-underwriters in London to meet their commitments in full at a particularly testing time.

All things considered, the events of that October have in no sense slowed the momentum of the privatization programme. Preparations are, therefore, well underway for four major new privatizations; British Steel and Girobank in the next year or so, and the Electricity industry and the Water industry later this Parliament.

Electricity privatization will be a truly massive undertaking both in its scale and its complexity. An industry which was once thought a natural and inevitable state monopoly is not merely being sold to the public but being sold in a way which has been specifically designed to promote competition. In England and Wales alone (a separate sale will take place in Scotland), the present Central Electricity Generating Board will be divided into three companies: one will own 30% of all the generating capacity, all of it non-nuclear; the second will own the remainder, both the remainder of the fossil fuel and all the nuclear; the national grid will be formed into a third company and transferred into the ownership of the twelve electricity area boards which will themselves be privatized as twelve separate distribution companies. The new distribution companies will be able to obtain their supply, not just from the two competing generating companies in England and Wales but also from any other source if they so wish. In particular, they will be able to buy power from private generators, both existing ones and new ones, who will be given fair-access terms to enter the market. The generating function accounts for some three-quarters of the distribution companies' costs, so they will have a strong incentive to contract with the most efficient source of generation they can find. Real competition in generation will thus develop steadily over time.

Privatizing the ten Water Authorities in England and Wales will also provide a powerful stimulus to greater efficiency, with the companies for the first time competing for finance from the capital markets. Investors large and small will be able to compare the performance of the different authorities which will, of course, be reflected in their share price.

Both Electricity and Water will be subjected to a demanding regulatory regime covering both the prices they charge and their standard of service to the customer; and both, needless to say, will be designed as wider shareownership issues.

### **Smaller sales**

Alongside these two very large privatizations the programme of other smaller sales goes on. Plans have already been announced for the sale of further sections of British Shipbuilders. British Aerospace has made an offer for the Rover Group, the former British Leyland; and Girobank is to be sold to a trade



buyer. Once again, the approach necessarily varies with the circumstances of the industry concerned but the objective remains the same: to return the industries to private hands with all the benefits that that has been shown to bring.

We have already now privatized very nearly 40% of the state commercial sector that we inherited in 1979. By the time the present programme which I have outlined to you is complete, some 60% will be back in private hands. And we do not intend to stop there.

### **Continuing potential**

Consider for a moment the main nationalized industries that will then remain. Private capital can be introduced into the coal industry by liberalizing present licensing arrangements for private mines. Depending on its progress towards viability, British Coal itself will be a candidate for future privatization at some later date. Privatization of British Rail also remains a distinct possibility for the future, and a variety of suggestions are emerging already.

Whatever is decided in individual cases, and we are looking now over a programme stretching over a very considerable period of time, one thing is absolutely clear: the burden of proof on privatization has changed completely. Not so long ago the question was: 'Why privatize a state-owned industry?'. Now, thanks to the manifest success of privatization, the question is: 'Why should any industry remain in the state-owned sector?' This question isn't being asked simply by the present government, it is also coming from the management of the industries themselves who can see very clearly the advantages enjoyed by the industries that have been privatized. It is coming too from investors, large and small, who can see the potential of businesses that are currently held back by the constraints of being in the public sector. And, increasingly, it will come from customers looking for a more responsive service. In other words, what we have done is to push back the frontiers of what is thought capable of being privatized so far, that no nationalized industry is completely out of consideration. And that truly is a radical development, although the idea that it is simply not the government's job to run industries is scarcely a new one: some of us have thought that all along. As I put it some years ago now: 'The business of government is not the government of business'.

We have come a long way in the nine years since 1979 and in the process we have created the real prospect that in due course the nationalized industry sector as we now know it will, to all intents and purposes, disappear altogether. The industries themselves, of course, will in no way disappear, indeed they will go from strength to strength in a more dynamic and more competitive environment giving better service to their customers. That is the point of privatization, that is the reason why we embarked on it, and that is the reason why I believe it will continue both here and around the world.

*Nigel Lawson: Minister of Finance of the United Kingdom*

### **QUESTIONS AND DISCUSSION**

**Question:** What accounted for the success of privatization?

**Nigel Lawson:** I think that there were three things. First that it was an idea whose time had come. That sometimes happens in politics and it certainly happened in this case. Second, we are fortunate in this country in having a highly developed financial sector, and that was obviously very helpful to us in



having such a large programme of privatization to carry through successfully. Thirdly, we simply learnt as we went along. Here was something with no precedent and we had to start right from the beginning, Ministers and officials alike, but we learnt as we went on and the lessons we learnt in one privatization we applied to the next. We now have acquired a considerable fund of knowledge, and in the process I think that the private sector has learnt a great deal about the new issue business which it perhaps did not know before.

**Question:** What has happened to the proceeds?

**Nigel Lawson:** Basically, what the proceeds enabled us to do was to get the public sector borrowing requirement down very much more quickly than would otherwise have been possible, and that was extremely useful because we inherited a public sector borrowing requirement which was far too large. We have now got to the point where we have a substantial budget surplus, and as I indicated, even if we were not getting a penny piece from privatization the deficit now would be very small indeed. But on the way it did enable us to get the budget deficit down very much faster than would otherwise have been the case and that was extremely useful.

**Question:** I am sure many of the privatized industries were at one time serving certain public functions without any inherent profit potential, such as bringing a bus service to a very small hamlet. What happened to those functions after these companies were privatized?

**Nigel Lawson:** First, remember that many of these non-profit activities were probably activities that should not have been undertaken at all. Where there may be for social reasons a desire to maintain a non-profit making service, then it does not necessarily follow that has to be provided by a company in the public sector. An explicit subsidy can be given to a private enterprise to perform the particular service in question, if you want to maintain it. do.

There are cases where we do decide to keep some activities in the public sector. In the Water industry for example, although we are privatizing the Water companies, we are only privatizing the actual provision of water and sewerage, those two very big businesses. The other things which the water companies do at the present time, the control of pollution and various other non-commercial functions of that kind, are being preserved in a very slimmed-down regulatory body called the National Rivers Authority, which will remain in the government. But that will be a very small organization and the huge bulk of the water business, the provision and supply of water and the supply of sewerage facilities, where the big investment is and where the big employment is, those will be in the private sector.

**Question:** Could you talk about the government strategy of contracting out of public services and its impact on the economy?

**Nigel Lawson:** That is a first cousin of privatization as commonly understood, which we are encouraging in central government, in the local authorities (where we are bringing forward legislation) and indeed in the National Health Service. We are encouraging contracting out by central government, local government, and the Health Service in various activities where they can get better value for money from the private sector.

As a result great savings been made by central government and the National Health Service. The experience is rather more patchily so among the local



authorities because, depending on the political complexion of the local authority, some of them resist contracting-out. Those that do contract out have achieved great savings for themselves and much better value for money.

In very many cases when local authorities have done something, for example refuse collection, they have allowed the existing local government workforce engaged in the activity to tender for the contract. Time and time again we find that the existing workforce has tendered for the contract at a far lower cost than they had been doing it hitherto. So the saving has occurred without any change in the actual people who are carrying out the work but it is done more efficiently and at a lower cost.

Encouraged by that, we are introducing legislation to oblige local authorities to go for competitive tendering across a wide range of services.

**Paul H Elicker** (Centre for Privatization, USA): On the issue of redundancy, how much of a political concern was it before you embarked on the programme? What political constraints did it place on you and how did you deal with it?

**Nigel Lawson:** I do not think that I can give a general answer to how that has been dealt with. There have been redundancies but they have not been particularly associated with privatization. The process of getting the nationalized industries into a more efficient state while they were still state owned certainly involved a considerable number of redundancies at that time. These were managed in the way that any business has to manage them. Although when they are state-owned there is a certain amount of political flak, that is something which you have to face. If you explain to people in a democracy why things have to be done then they are prepared to accept a great deal more than people often give them credit for.

The Steel Industry, for example, which is the next major privatization candidate and which is doing extremely well now, was massively overmanned when we first took office. All the slimming down, and all the redundancies have occurred during the time that it has been owned by the state, as part of the process of making the industry more efficient. We put in new management, as we did in a large number of the nationalized industries. Those new managers, who usually came from the private sector, were determined to run these organizations on a commercial basis and were in no way hostile to the idea of privatization.

**Malcolm Bale** (The World Bank): You implied that the raising of revenue for the government was less than a totally worthy goal. From where I sit in the World Bank it seems like it could be a very positive benefit for some countries. Could you explain why it is that you felt that was a less important goal than some of the others?

**Nigel Lawson:** Because it is essentially a temporary achievement, very important but lasting only for as long as the privatization programme is going on, as long as there are state-owned companies to be sold. Then it comes to an end.

It can certainly go on for a very long time -- we have a privatization programme at around £5 billion per year which will go on for several more years at £5 billion per year. But eventually that will come to an end, whereas the benefits to the economy of having these industries in the market sector and the benefits which come from having a wider spread of share ownership,



those are benefits which are lasting and go on indefinitely. That is why I put those two things ahead of the benefits that you get from raising capital.

Opinion may vary from country to country and in the World Bank you deal with a wide range of very different countries, but in the UK the government's credit is very good. If it had been purely a matter of raising finance we would have no difficulty whatever in raising the finance by selling gilt-edged securities.

**Geoff Gaynor** (Heritage Foundation): You indicated that the major motivation was not raising revenue but what is if you could not make it, a general impact on revenue for the government, not simply what it has taken in?

**Nigel Lawson:** I cannot give you a number, certainly in revenue terms you get the benefits of the taxation on the company's profits. If they were earning profits before you privatized them and some were and some were not, they differ, but if so far as they are earning profits before then those profits were flowing to the government as 100% shareholder so you have lost the whole of the profits and are only then getting the taxation on the profits in the future. Although there may be over a considerable period of time a gain in revenue terms, because over a period of time profits would have expanded very considerably so the taxation you get outweighs any loss of revenue, the immediate impact may well be some loss of revenue. That is certainly the case, for example in the Gas industry, when we privatized it because that was a very profitable industry at the time we privatized it.

**Musibau O Sanni** (IMB Securities, Nigeria): I recall in 1979 the Exchange Control Act was abolished in this country. What in fact, if any, has this on the success of your privatization programme?

**Nigel Lawson:** I think that the abolition of Exchange Control in 1979 which we did within six months of taking office, has brought great benefits to this country. I do not think that it has had an enormous bearing on the privatization programme as such, that is certainly not where the main benefit has come, but there are various connections certainly. It may seem paradoxical but the abolition of exchange control, although what it permits is British investment overseas which previously was not permitted, it also makes people overseas have far more interest in investing in Britain because of the complete freedom of capital movements. That has certainly been helpful in the context of privatization because in all the major big privatizations we have encouraged a degree of overseas participation. That has undoubtedly helped in the success of these very large sales.



## THE MECHANICS OF PRIVATIZATION

**Gerry Grimstone**  
Director, Schroders

Privatization, the transfer of state assets to the private sector, has become a global phenomenon. A recent survey showed that over fifty countries worldwide have either carried out privatizations or are actively planning them.

### The spread of privatization

The British Government, the originator of privatization in its modern form, has raised over £25,000 million for the UK Treasury by selling state assets; and has transferred more than 600,000 workers from the state sector to the private sector. Countries as diverse as Malawi, Malaysia and Mexico have become enthusiasts for the privatization concept. Even the People's Republic of China is considering how privatization can be used to affect social change and to develop the capital markets.

Why has privatization in Britain and elsewhere proved so successful? Why is it now studied so closely by so many countries worldwide? It is because successful privatizations are not primarily financial transactions. A properly conducted privatization programme will not only raise finance but can become an engine for social and macroeconomic change. For example, privatization has more than trebled the proportion of people in Britain who own shares. It has transformed the Jamaican stock market; and the mechanics of privatization have now become so well developed that, provided they are pursued with skill and energy, any country can benefit.

### THE KEY STEPS

#### Setting the objectives

I believe that a key first step in developing a privatization programme is the setting of objectives. The starting point for this is often the realization that state owned assets are not operated as efficiently as privately owned assets. It may be possible to achieve allocative efficiency within a state sector but productive efficiency is nearly always lacking. Whatever control systems are adopted, continuous efficiency in the state sector is an elusive concept. Bureaucratic control is never a satisfactory substitute for market forces.

The original rationale of the British privatization programme was primarily economic. Nationalization in Britain had not been a success. Despite the high hopes of its originators, criticisms were continually voiced about the low return on the capital employed in the state industries, their record on prices,



productivity, and manpower costs, and about the low level of customer satisfaction that they provided.

It can be argued that these shortcomings resulted from deficiencies of control techniques rather than being an endemic feature of state ownership. Whatever the truth of this, British political and administrative systems seem powerless to bring about the necessary changes within the public sector; and privatization was heralded by the incoming Conservative government in 1979 as being the only way to bring lasting improvements in economic performance.

### **Non-economic objectives**

Having noted that the primary objective of the British programme in its early days was economic efficiency, the political and popular success of the programme was helped by the realization that a privatization programme can fulfil other objectives than purely that of increasing efficiency. Indeed, as we discovered in this country as the programme proceeded, efficiency does not even have to be the main criterion.

As presently organized the British privatization programme, in common with other programmes elsewhere, has the following key objectives:

- \* to increase efficiency -- either through competition, deregulation, or other means;
- \* to raise finance which can be used to fund other expenditure priorities, to reduce borrowing, to reduce taxation, or any combination of these;
- \* to encourage employees to own shares in the companies in which they work;
- \* to boost the level of share ownership in the general economy, to strengthen the capital markets;
- \* to gain domestic and international prestige.

It was the recognition early on of the multiplicity of these possible objectives, and the fact that so much can be achieved, that were the secrets of privatization success. The balance of objectives will vary from country to country and may change with time; but the broader the path that is followed the more a privatization programme will be immune to criticism, and the easier it will be to develop the momentum that is so critical to success.

Although the economic and political arguments in favour of privatization may now seem clear cut, it was very easy for opponents in the early stages of the programme to argue that the programme was misjudged financially. Was the government selling the family silver to fund current expenditure? Should we not keep profitable industries in state ownership? Those are questions often asked by countries which see the political and macroeconomic arguments in favour of privatization, but are worried that, sale proceeds apart, the subsequent loss of a privatized industry's profits may harm rather than help a country's finances.

It may well not be clear intuitively that selling profitable industries will be of financial benefit, apart from the immediate proceeds from selling equity are ignored. However, consider the full range of future benefits. The combination



of increased tax payments by privatized companies (as their efficiency and profitability increases once they are freed from government constraints), the interest savings on the government debt that can be repaid, the dividends which may be received from any minority shareholdings that the government has retained, and the funding of future investment requirements in the private sector rather than by the state, can often produce a continuing cash benefit to the Exchequer, even when the initial sale proceeds are disregarded. Thus, it is often possible to justify privatization on financial grounds alone.

### **Planning the programme**

Having determined the desired objectives for a privatization programme, the next step is often the development of a masterplan -- a task, for example, which we at Schroders have just been appointed to do in collaboration with a local partner for the Government of Malaysia. A privatization masterplan will normally incorporate the following key steps:

- \* it will review and determine the overall objectives for the programme;
- \* it will review all potential privatization candidates -- and I stress the word 'all';
- \* it will identify possible implementation constraints for the programme and how best to remove these;
- \* it will decide preferred methods of sale;
- \* it will draw up a rolling action plan;
- \* it will commercialize, or start the process of commercializing, selected privatization candidates;
- \* it will bring about any necessary legal and constitutional changes; and
- \* it will bring the programme into its implementation phase.

Once drawn up, the masterplan will need to be approved at the highest level within the government if momentum and credibility are to be maintained, and I believe that one of the ingredients in the success of the British privatization programme, certainly in its early days, was the close personal attention which the Prime Minister paid to the programme.

### **Suitable candidates**

In selecting preferred privatization candidates a number of factors need to be considered. First and foremost, are the candidates suitable for sale? It may seem obvious to stress that but it is occasionally forgotten by those attempting to administer a privatization programme that, unlike nationalization, privatization has to be a two-way process. Governments may want to sell a company but somebody else must also want to buy it if the transaction is to be brought to a successful conclusion. Wishful thinking is rarely enough when it comes to implementing a privatization programme.

A suitable candidate will have a business that is capable of being sustained under private ownership. The easiest, and also the fastest, candidates to privatize are those which are already operating profitably in a competitive environment. Loss makers can be privatized, but if continuing subsidies are



going to be necessary for social or other purposes, subsidy mechanisms must be found which nevertheless explicitly ensure that there is an appropriate transfer of risk to the new owners.

In the privatization of the National Bus Company, the government was able to demonstrate that loss making rural bus services in England and Wales could be privatized by splitting the National Bus Company into a large number of privatized successor companies, requiring local authorities who wish to subsidize specific bus routes to advertise the fact and to seek competitive bids for the subsidy. The operator which bids for the lowest subsidy consistent with the specified standard of service gets the franchise. This approach has led both to a dramatic reduction in subsidy levels whilst preserving, and indeed sometimes enhancing, standards of service.

It will always be true that the hardest candidates to privatize are the natural monopolies because the public interest will require that an effective regulatory regime is put in place before privatization. This both takes time and raises issues of principle which a new privatization programme that had not yet acquired the confidence of ministers, investors, and the general public, might not be able to survive. Always start with the easiest companies first.

Of course, the easiest candidates to privatize will be the profitable competitive companies, and the objective must always be to try to move companies into that competitive and profitable sector.

### **Countering the obstacles**

But privatization is never easy. Traps lurk around every corner, constraints on action always exist, and they must be identified and countered if privatization is to proceed. I believe that these constraints can be grouped into three broad categories:

**Financial matters:** these may include, obviously, the performance of the company, market capacity and market conditions at the time the privatization is carried out.

**Attitudinal constraints:** the bureaucratic resistance from moving bodies from the state sector to the private sector. No government official likes seeing his empire dismantled from underneath him. Many workers in the state sector have no idea what it is like to work in the private sector, unless they are educated and well informed will fear the change.

**Political constraints:** how to secure the public interest? How to deal with feelings of nationalism which often arise in privatization? How to allocate any windfall gains which arises during a sale process?

There is no doubt that the experienced team gains confidence from the fact that some familiar constraints appear on each and every privatization, and previous solutions can often be used time and time again. Each and every privatization presents different challenges and opportunities, and constant fine tuning is needed, as well as the occasional radical innovation. Markets never stay still, and resting on precedent is never enough.

### **Methods of sale**

Once it has been determined that there are suitable candidates and that the identifiable constraints can be minimized or eliminated, it is time to consider



possible methods of sale. Desirable methods of sale will be determined both by the programme's objectives and by practicalities.

Politically it is often very desirable to spread the ownership of privatized shares widely and to distribute any financial windfall that arises accordingly. Because of this, public offerings of shares with a bias towards small domestic investors are normally the preferred choice if they can be achieved. Failing this -- and it has to be recognized that a public offer is always a severe test for a company and for a capital market -- management or employee buyouts are often welcomed provided that the funds are available and the company's cash flow and asset backing can support the necessary leverage.

The most difficult sales to bring to a popular conclusion are sales to corporate purchasers, trade sales, particularly if overseas buyers are involved. The politics of privatization are such that domestic investors normally have to be given preference, although minority sales overseas can be an important factor in bringing an otherwise domestic sale to a successful conclusion.

**Hierarchy of choice:** Interestingly, in determining sale methods, I believe that a hierarchy of political desirability can be set up. The most desirable are the public offerings, the least desirable are the overseas international trade sales.

As it happens this hierarchy also coincides with the level of capital market sophistication that is necessary to bring the sales to a conclusion. The difficulty this causes, particularly for an LDC, is that those sales which are most desirable politically, the public offerings, may be the hardest to achieve because of the state of the capital market in the country concerned. I have sometimes known of situations where LDCs have been pushed into privatizations by the terms of structural loans before the capital market development in their country has reached the point where such a step is desirable. In those circumstances the only sales which may be able to be achieved are sales to corporate and to trade purchasers. This may, or may not, be desirable in the context of that country.

## THE ACTION PLAN

Once intended candidates and methods of sale have been identified and constraints identified, it is possible to draw up an action plan and this is often done on a three year rolling basis. This long time horizon is generally necessary because, although the sale itself may take only six months to prepare and conduct, the preparations, such as commercializing the company, introducing the necessary legal and constitutional changes, and devising a regulatory regime if necessary, can often take up to two or three years to complete. It also, of course, makes sense to space sales out both to avoid overburdening market capacity and to prevent one sale from distracting investor attention from the next. Even with a programme that has as much momentum as the British programme, achieving more than four sales per year is a very difficult target.

I also have no doubt that tight central control and coordination is necessary if a series of sales is to be completed successfully. Many obstacles and problems need to be overcome if sales are to be achieved -- a high degree of political and administrative commitment is necessary if the programme is to proceed.



## **Coordinating the sale**

Once one moves forward towards a sale those conducting it will at some point need to advise the vendor on likely proceeds. If it is to be a private institutional sale, in due course a competitive auction will be needed to set a price. Obviously, a competitive auction will mean the demonstratively fair market price is obtained and this may aid public accountability. But it is not always as clear cut as might be expected; bidders, as well as naming a price, will often hedge it around with various conditions which may or may not be easy to value.

Often, if the management of the company concerned are participating in the bidding process, other prospective bidders might be concerned that the management have an unfair advantage and thus may not want to bid. In some cases management teams taking part in a competitive auction may be given a defined price preference, and this may cause a non-management bidder to wonder whether the time and expense of making a bid are really worthwhile.

Pricing a privatization by public share issue is never easy, especially if there are no market analogues already in existence. Conventional pricing techniques in the London market normally involve establishing likely future earnings, and applying a multiple to those earnings based on a review of analogues. Traditionally, in London there is an understanding that a well judged flotation will go to an immediate aftermarket premium of around 10%-15%. When no analogues are available a certain amount of imaginative thinking will be needed; but provided a reasonably secure stream of dividends can be identified a yield-based valuation can usually be drawn up.

It may often be rational for a government conducting a series of sales to seek to maximize price advantage over a period of time rather than in any individual sale. It is very important if one is planning a privatization programme, to get a bandwagon rolling, and it is unlikely to be in the interest of a vendor to price each privatization issue to the last penny.

## **Equity considerations**

What makes a successful privatization is not easy to define. On the one hand an aftermarket premium is a good thing provided it is not too large. Millions of shareholders are desirable provided their applications are not so scaled down in terms of shares distributed per person so as to make the resulting investment meaningless. Overseas sales are welcomed, but provided they make the domestic offering successful, but not if it appears the domestic interests are being prejudiced.

In practice the demand for privatized equity can be categorized as follows:

- \* demand from employees;
- \* demand from the domestic retail market, the small shareholder;
- \* demand from the domestic institutional market; and
- \* demand from the international institutional market.

At the end of the day, despite all the attention which one should pay to wider share ownership, unless the domestic financial institutions -- the pension



funds, the insurance companies -- are keen to participate, the sale is unlikely to be successful. Yet, if the institutional participation is too great, the political benefits of spreading ownership widely amongst employees and the general public will be lost.

The ideal is an offer structure which segments the sale into defined portions and attempts to generate an element of unsatisfied demand in each portion, but particularly amongst the domestic institutions. This is because the domestic institutions will always be the most likely buyers in the aftermarket if left short of shares. The general public may like shares but what they really want are shares which go to a premium.

Prior market research might provide a useful indication, but is rarely accurate enough to be relied upon. Even using sophisticated market research techniques, demand is very hard to predict in advance. An offer structure is needed which is flexible enough in its allocation across segments to cope with changes in the demand which actually manifests itself. We have developed, for example, a technique called flexible clawback which involve allocating shares provisionally to institutions at the beginning of the offer, thus creating a perceived retail shortage. We promote demand in the retail sector through advertising and other techniques, and then claw back the institutional shares which had been provisionally placed with institutions. The amount of clawback will depend on the demand that materializes in the retail sector.

#### **Market effects**

Because of the fact that privatizations are an order of magnitude greater than previously contemplated transactions, and because of the unique characteristics of privatization, there are profound capital-market effects from a sales.

Two main positive impacts can be distinguished. First of all privatization can lead to a widening of the national capital market by introducing new investors, both domestic and international. Secondly, privatization can lead to a deepening of the capital market by introducing mature companies with a strong market position. Both these effects, which are interrelated, are clearly advantageous. A successful privatization programme will often lead to personal savings being switched into the stockmarket from other forms of investment.

#### **Inducing investors**

How can new investors be tempted into privatization? Existing distribution channels are normally not adequate for that task. Distributors, stockbrokers, and financial intermediaries are normally happiest selling shares to their existing clients rather than to new clients. If shares are to be sold widely, new distribution channels often need to be created. The vendor has to go over the heads of the normal intermediaries, both by motivating a more lively sales force than traditional stockbrokers, and by selling directly to prospective shareholders.

No vendor is more suited than a government to take on this challenge. A typical sale will be advertised widely in both the press and the television. Generous commissions will be paid to financial intermediaries. Small shareholders, at the vendor's expense, might be given the added attraction of a loyalty bonus if they hold their shares for more than a defined period, or perhaps given discounts off the company's products -- particularly in the case



of a widely used utility.

The effect of these inducements, in encouraging new investors to enter the stockmarket for the first time, can be profound. For example, more than one million people bought shares in British Telecom who had never before bought a share in their life.

Privatization can deepen as well as widen a country's capital market. This arises because it is often a country's dominant businesses that were previously nationalized and brought into state ownership, or have always been owned by the state. They were in the state sector originally for what must have seemed very good reasons, because of their position in the economy, their strategic importance, or their size and market dominance. It is those characteristics which in privatization enable such companies to give depth to a stockmarket, and thus to provide ballast to what may otherwise have been an unduly speculative environment.

### **Creating the capacity**

The juxtaposition of the two affects that I have described, the widening and the deepening of a capital market, means that privatization, contrary to the original expectation of economists and others, can create its own market capacity, and this is a very important phenomenon. There are a number of reasons for this.

First of all, the equity that is sold is of good quality and represents a new investment opportunity. Purchasers gain comfort from the fact that the vendor is a government, and they have learnt by experience that governments are risk averse when it comes to privatization. When I was partly responsible for the British programme, international banks would telephone us in the Treasury and ask to be put down for as large an allocation of shares as possible in whatever we were privatizing next, and at whatever price it was sold. Clearly not rational behaviour in investment terms, but it shows the kind of bandwagon which a privatization can attract.

Secondly, one has to remember that a government which is raising finance by selling equity will borrow less for a given public sector financial deficit than it would do otherwise. A government's total demand on the capital market may, therefore, be unchanged by a privatization programme. The government itself creates market capacity by selling less debt in those circumstances. Also, of course, the equity of utilities that hold a dominant market share, either through operating a natural monopoly or otherwise, can closely resemble debt in its financial characteristics and thus may be accommodated in that portion of an investor's portfolio previously reserved for fixed-income securities.

Thirdly, even a single privatization can create a company that is a material component of a national stockmarket index. Those investors who attempt to match their portfolios to the main constituents of a country's capital market, must buy privatized equity if they are to maintain their relative market position. Indeed, going beyond that, some privatized equity -- for example, that arising from electricity or telecommunication utility -- gives good exposure to the totality of economic development in a particular country and this may be valued by an investor.

Fourthly, governments who are selling equity become interested in the operations of the equity market and, implicitly or explicitly, take steps to



strengthen the equity market. Traditionally, of course, governments only operated in the debt market and left the equity market to its practitioners. This is now no longer the case in countries which are pursuing successful privatization policies, and is also true, of course, that the same political philosophy which produces privatization is also likely to encourage market liberalization and deregulation.

### **Marketing**

In order to achieve the capital market benefits I have referred to, a sophisticated marketing programme must be created to maximize interest from all classes of investors. Such a marketing programme will normally be extremely cost-effective. Not only can the campaign stimulate sales and enhance the commercial image of the company that is being sold but it can provide an opportunity to project a country's general economic development and financial status.

### **CONCLUSION**

Many countries worldwide would like to have a privatization programme; few countries can assemble sufficient determination, expertise, and credibility to achieve one. Privatizations are unlike all other financial transactions, because of size, political sensitivities, investor interest, and the complexity of privatization's objectives.

A privatization programme is most likely to be successful if the critical participants in the programme are identified early on, and dealt with in the most appropriate fashion. These key groups normally include the following: the general public who we represent as taxpayers, customers, and voters; the management and the employees of the firms being privatized; prospective investors; commentators; and opponents of privatization who will always be present no matter how well conducted the programme is.

At the end of the day, fair pricing which balances the need of the taxpayer and the investor, voucher offers for customers, free shares for employees -- not least because giving a small number of free shares for the workers is a very effective way of negating national trade union opposition to the sales -- retaining the privatized company's existing corporate and management structure; widespread distribution of shares; full and frank disclosure of information; and careful attention to detail, are all ingredients in the successful privatization.

### **Political and economic aspects**

What lessons do I draw from all of this? First, privatizations are not merely financial transactions, and opportunities will be lost if they are treated as such -- the British programme, in its early days, suffered from this. Secondly, the case for the programme must be argued effectively and enthusiastically. Thirdly, involving employees and the general public, to the greatest possible extent, not only helps provide market capacity it can also help create genuine popular successes. In political terms, few policies can claim the benefit of privatization and be so attractively presented in terms of privatization's ability to increase industrial efficiency, to raise money, to boost ownership amongst employees and the wider general public, and to carry domestic as well as international prestige. Provided the relative interest groups are clearly identified at an early stage and are kept as happy as possible, everybody



Privatization is changing the political and economic landscapes of many countries. Techniques have now been developed to such an extent that provided the political will is there and finance is available, privatization is a credible option worldwide. But the mechanics of privatization are, of course, only the beginning of the process. For privatization to become a sustainable long-term phenomenon, the companies which are created must be successful and must add to and not subtract from national wealth. Only time will reveal the extent to which that is achieved.



## DETAILS FOR A SUCCESSFUL SHARE ISSUE

**David Clementi**

Managing Director, Kleinwort Benson Securities

I would like to make some general remarks about some of the principal techniques which have been developed in the UK privatization programme, covering the points which are likely to be of most interest to those studying privatization. The four areas I propose to cover are regulation and competition (a banker's perspective on what has happened); how the privatized companies' relationship with the government after privatization is defined; special, or golden, shares; and building of demand for shares, covering in particular the role of overseas markets.

### Regulation and competition

Bryan Carsberg has spoken in detail about regulation in the telecoms market, but perhaps I could describe the structure more generally. The UK government has privatized a number of monopolies or quasi monopolies such as Telecom, Gas, British Airports, and is now preparing for the privatization of the Electricity and the Water industries. The government has adopted two complementary approaches to constrain the potential for abuse. The first is the introduction of a regulatory system; the second is to introduce competition.

The regulatory regime has usually had two main features. First is a license which is issued to the privatized corporation. The licence includes a number of terms and conditions designed to prevent cross-subsidization within the corporation, or to require the provision of specified services. The licence is administered by a regulatory body, which in the case of Telecom is OFTEL.

Second is a form of price control -- the RPI-X% formula described by Professor Carsberg. This approach to regulation contrasts with the type of regulation typically seen in the United States, where regulation has set a ceiling on rate of return on capital rather than on price increases. We have felt the UK approach had a number of advantages: it avoids the inherent complications in a return on capital scheme where the definitions of profit and of the capital base involve a number of arbitrary judgments; from the government's point of view it controls tariffs, which is generally considered to be more politically sensitive than profits; and from the investor's point of view, it ensures that efficiency gains flow to investors and that there is not the diminished incentive to increase profit which characterizes rate of return schemes.

The RPI-X% formula was modified in the British Gas and British Airports privatizations to reflect the significance to these undertakings of costs in a



particular sector rather than movements in the RPI generally. The formula applied was a variation of RPI-X% which allowed changes in a specific sector to be reflected in the price ceiling.

The second approach to contain the potential for abuse of a monopoly position is the introduction of competition into the sector, and I believe the government, and certainly Bryan Carsberg, have always regarded regulation as a poor surrogate for competition as a means for encouraging efficient markets. Increasingly, the government is trying to maximize the potential for subjecting privatized companies to competitive pressures. For example, the government has indicated that it will allow private sector consortia to compete with the Central Electricity Generating Board as part of the privatization of the Electricity industry.

### **The relationship with government**

A clear and binding definition of the relationship between the government and the privatized corporation is critical if investors are to be able to predict with reasonable certainty how the corporation is likely to perform in the aftermarket. In particular, potential investors will always look for some reassurance that the government is not able to use any residual shareholding as an instrument of social policy; or to exercise any other influence which may detract from the corporation's ability to maximize profits and its efficiency.

The UK government has always given a binding undertaking to distance itself from the commercial operations of a privatized company, and this undertaking is generally set out in the offer document, normally in the following way:

'HM Government does not intend to use its rights as an ordinary shareholder to intervene in the commercial decisions of the corporation. It does not expect to vote its shareholdings on resolutions moved at general meetings, although it retains the power to do so'.

### **The golden share**

A related aspect to the relationship between the government and the privatized corporation is how to establish relationships which are acceptable to potential investors but which will prevent the corporation from acting against the public interest. For example, the government has been keen in a number of privatizations to ensure that the privatized corporation cannot be owned, or effectively controlled, by non-UK interests.

The mechanism which has been developed to prevent such an unwelcome move is the golden share. This share operates in a number of different ways, but the most common is for the government to require the corporation to include in its articles of association a provision that no person can own more than 15% of the corporation's share capital.

The corporation also issues the government a special share with special voting rights which are triggered only if an amendment to the articles is proposed. These voting rights, once triggered, will allow the government to out-vote all other shareholders. The principal benefit of this mechanism, from the investor's perspective, is that the voting rights attached to the special share can only be triggered in well-defined circumstances, and only in response to those circumstances. It is essentially a passive instrument which



cannot be used by the government to interfere in the day-to-day operations of the corporation.

### **Demand and overseas offers**

A feature of most of the UK privatizations is their size in relation to other conventional equity issues. Privatizations will often exceed by several times the size of familiar private-sector equity offers. A key issue which faces governments and advisors is how to develop sufficient demand to ensure that the offer on such a scale is taken up at an acceptable price.

The approach in the UK has been to try to achieve the widest appeal not simply in the institutional market, but also among the general public, and in overseas markets. The experience in the UK has been that powerful, competitive dynamics can develop between these separate markets. A sense of scarcity develops which, depending on the structure of the offer, can build and create the capacity to absorb the issue successfully.

The equity market crash of October 1987, and its consequences for the BP share sale, raised questions about the continuing viability of this strategy, and whether there would be sufficient demand for equity in each of the markets to generate the competitive forces necessary. I am generally positive about the prospects.

The institutional market appears to be redeveloping its appetite for equity, and is likely to be attracted to equity offers which demonstrate the type of high quality earnings which generally characterize privatized companies.

The retail market has been a major source of demand for privatization issues in the UK. The policy of broadening and deepening share ownership may have been knocked by the BP share offer, and the increase in inflows to building societies seems to reflect something of a flight to safety. But the building societies themselves may, ironically, play an important role in re-establishing the retail sector's confidence in equities: a number of leading British building societies are currently contemplating conversion to PLC status, and if such conversion is done in a way which permits members to become shareholders in substantial numbers, this could help to re-build the confidence of the retail sector in equities and bring a new vitality to the government's wider share ownership policies.

The overseas market seems less certain following the BP sale. The difficulties with the overseas tranches, particularly from North America, appear to arise largely because the lead managers there did not reduce the risk they were carrying by using larger underwriting groups. The difficulties did not seem to arise through any particular weakness among overseas investors.

The effective integration of an overseas, and particularly a US, tranche into UK-style offers for sale has always been a delicate task. The complexity arises because of the different timetables underlying the sale arrangements. US practice does not involve a ten day offer period which is the feature of large offers for sale here and is necessary, partly to satisfy stock exchange requirements, and also to allow the retail sector time to apply; the UK does not yet have the comprehensive retail distribution network of the United States. In the US, trading starts immediately following the pricing and underwriting, and the underwriters are not exposed to the risk of substantial market movements over that ten-day period which can effect issues in the UK.



One of the issues raised by the BP share sale and the equity market crash in October 1987, is the extent to which US banks will be prepared to underwrite UK privatizations, and particularly whether they will still underwrite on a UK basis. Much will depend on the state of the markets at the time, and US perceptions of the likely success of the sale. It seems possible that there could be less enthusiasm than in previous privatizations among some of the banks to underwrite on UK terms, particularly with the current type of *force majeure* arrangements which effectively leave the decision whether to proceed or not entirely with the UK government. In these circumstances, and if there is doubt about US commitment, the government may need to rely more heavily on other international markets, particularly continental Europe where offer structures are more similar to the UK practices.



## FLOTATION MARKETING

**Anthony Carlisle**

Managing Director, Dewe Rogerson

Flotation marketing has come a long way since the days of Telecom, and in this session I would like to look at four things:

1. What is the role of flotation marketing?
2. How does it work?
3. What has been achieved to date in the UK in terms of privatization marketing?
4. What may be some of the challenges for the future?

### THE ROLE OF FLOTATION MARKETING

The fundamental objective of marketing is to create a perception of scarcity. No one buys a financial asset today if they think it is going to be worth less tomorrow, and flotation marketing, therefore, must lead potential investors and commentators to believe that a share offer will be oversubscribed: and to believe this in advance of the share offer happening so that they buy, or they recommend buying, in the offer and create over-subscription and a healthy aftermarket.

That is the unalterable definition of success. No matter the nature or the size of a flotation, no matter whether it is institutionally or broadly focused, in whatever market conditions, the role of marketing and communication is to contribute to achieving that objective -- the perception of scarcity, and to do so in the most cost-effective fashion.

In undertaking that, one always has to remember that all share offers are distinct because each company is distinct, because market conditions and environment vary, because the size of offers can change markedly, and because each offer may have more objectives than success alone. In the past, some of those objectives have included widening and deepening share ownership, achieving a specific shareholder profile that may suit the company, or positioning the company to achieve commercial advantage out of the flotation.



## MAKING IT WORK

A wide share offer campaign is often the biggest communications exercise a company will ever be involved in, and it is important to get it right. Broadly, of course, the pattern of flotation marketing will alter widely between different countries simply because the regulatory regimes will have a fundamental impact on what is possible and what is not. All that said, and while there will be all these variations, the principles of marketing and the underlying investor psychology are fundamentally the same in all developed market places.

### Potential audiences

I defined the objective of marketing, and there are three potential audiences that one can turn to: the institutions of a particular country, the retail public of that country, and overseas capital markets.

The extent to which those markets can be tapped and approached clearly is going to be a function of the size of the offer and the other objectives that may be set, such as retail share marketing. It was not a political imperative in the case of British Telecom that led to wide retail marketing, it was a marketing imperative. In the run-up to Telecom it was perfectly plain that the City institutions were so sceptical about the ability of such a large offer to be successful that they were unwilling to subscribe it in full. Therefore, the question became whether we could generate from the public, the only other potential market place, a sufficient demand to create the perception of scarcity.

But whatever balance of investment audiences may be decided upon, the marketing task is then to stimulate investment interests from each sector, to generate competition, and to build tensions between those markets.

The investment interest that will be generated is always going to be three-fold. First comes the perception of the company and the industry in which it operates. It must be seen as a very attractive business in which to invest. Secondly, not just the company but the offer terms must look attractive. And thirdly, it must be made plain that a lot of other people recognize that, because both the company and the terms are attractive, a lot of people are going to come into the offer. By establishing those perceptions one can increase both the number of investors and the price at which the shares can be sold.

### Credibility

The fundamental starting point is the strength of credibility of the image of the company that is to be offered. That is the determinant of how much flotation marketing can be undertaken, how much can be seen to be appropriate, and what it can achieve. Whether we are talking about an institutional or a retail offer, flotation marketing is a function of corporate image. It is not equity investment in itself that attracts the general public, it is the notion of buying into a specific investment, a specific company with which they feel familiar, for which they have a high regard, and which they think constitutes a good deal.

That is why flotation marketing can typically be divided into two phases: first of all a corporate campaign to broaden and develop the image of the company whose shares are to be offered, and subsequently a flotation campaign.



### **An example**

This is what British Steel, for example, has done in advance of its share offer. Its TV advertising runs: 'Over the past few years, British Steel has had to get into shape to compete in one of the world's toughest markets. It has not always been easy but the results have been dramatic. We have made ourselves leaner, and tougher, and more flexible. Output is up, UK sales are up, exports are up, profits are up, our prospects are a good deal more attractive. British Steel: In shape for things to come'.

That campaign has run on TV, in the press and in posters, since last year. It is part of a corporate marketing effort by British Steel which has substantial commercial objectives lying behind it. But undoubtedly there is going to be a benefit, one hopes, to the flotation that follows later this year.

If one is running campaigns of any sort, one has to be very clear about the investor psychology that is going to be tapped at the end of the day. It is worth running through the stages that an individual has to go through before he may think that something is worth applying for.

The essential frame of mind which has to be created is for people to think it is a good deal and they are not alone in thinking that: to see that everyone else shares the view and to see this reflected wherever you look. That is the stage that has to be reached for a flotation to be successful, and all of that depends on the credibility of the company. By the time that a share offer campaign starts, the company image, the regard the people have for that company, their perception that it is a company with strength of management and finance, with prospects and vision, all need to be clearly established.

### **Inviting interest**

That done, the first task of a flotation campaign is to issue a broad invitation to whichever your audience is, that they can now take part, that this offer is aimed at them. It is the interaction of that invitation, with the image of the company, which will in the first instance generate interest. If there has been a succession of successful share offers, in the past, this is also the step that signals the arrival of another one, and that people have nothing to lose by signing up and keeping an eye on it.

That interest, when aroused, leads people to want information. so for that reason there must be a share information office: a physical focus for the campaign, a means of handling enquiries of all sorts (sometimes well into many millions of enquiries), and a way of running a dialogue with the people who may become the eventual shareholders.

### **Interest into action**

I doubt if information has ever been enough to persuade anyone; once people know about something they want to turn to those for whom they have regard and ask what they should do. Therefore, the next stage is to convince people by gaining the endorsement of the professional advisors and the opinion leaders to which people turn. That is why media endorsement is so critical.

Share offer marketing has two sides -- all the paid-for communications which you can control with quite considerable precision to create awareness and interest and make a news story; then the media endorsement and analysts' endorsement which flow from that, which secures the type of press cuttings



that you need, and the type of broker reports that you need to make any of these offers a success.

If one has got people convinced that it is a good idea, then one also has to have them ready to take action, because the application window of a share offer is never going to be open very long. Again, the lead will come from the informed audiences of analysts, media, and others. Those people will form a view and retail it to the broader investor audiences, and in the process their judgement will be magnified and if it is favourable, the feeling of a good offer which should not be missed will gain ground.

### **Range of marketing tools**

All of that can be formalized in some considerable depth by research models which trace the course that individuals and others will follow, from becoming aware to making investments, and the reasons why they will do so and, indeed, why some will drop out and not invest. The communication programmes that are necessary to act upon that understanding of investor psychology will include: the research to give understanding and to keep people on track to show what is happening, the share information office, information materials to answer enquiries and to help presentations, direct mailing (which is likely to be the largest single source of response), intermediary marketing, roadshows, employee communications (which are absolutely vital), media relations, institutional marketing, advertising, and public exhibitions.

There is no sense of prioritization in that order of that list, they are just the range of typical programmes.

The total marketing effect comes from the impact of all of those programmes working together in one integrated strategy. That is one of the reasons why it is often very helpful to have a single agency running all of those programmes.

### **THE STRATEGY IN ACTION**

Let us turn to one of the campaigns that shows the development of investor psychology in the advertizing -- the TSB campaign. The two TV launch commercials which issued the invitation ran as follows:

'How would it be to own a bank? Now is your chance, this September TSB shares will be offered for sale to the public. If you would like to know how many shares you can buy, how much they will cost, and how to apply for them, phone 0272-300-300, or come into any TSB branch. We will send you more information and reserve you a prospectus. The TSB -- now it is your turn to say "Yes".'

This last sentence, of course, was reminiscent of the TSB's general advertising catchphrase of 'TSB -- the bank that likes to say "Yes".'

'If you have ever wanted to own a bank we bring you good news. This September TSB shares will be offered for sale to the public. How many can you buy? How much will they cost? How and when can you apply? Call 0272-300-300, or call in at any TSB branch. We will put you in the picture and reserve you a prospectus. The TSB -- now it is your turn to say "Yes".'

Now coming towards the middle of the campaign, the tone becomes crisper:



'It won't be long now. Next month TBS shares will be offered for sale to the public. So if you would like to own a bank here is your chance. Everyone can apply, you don't have to bank with the TSB. How much can you invest? Can you pay by instalments? Phone 0272-300-300, and we will give you more information and reserve a prospectus for you, or call in at any TSB branch. The TSB -- now it is your turn to say "Yes".'

On to the pathfinder prospectus:

'It isn't every day you get a chance to buy a bank. From September 15th prospectuses for the TSB share offer will be available to everyone. The offer is then open for only ten days from September 15th until 10 am on September 24th. You have still got time to phone 0272-300-300 to get more information and reserve a prospectus, or call in at any TSB branch. The TSB -- don't leave it too late to say "Yes".'

Now the TV advertisement during the offer period:

'The TSB share offer lasts only another few days, it closes at 10 am on September 24th. For a prospectus and application form call at a TSB branch or any other bank. The TSB share offer -- its on now.

That was a nine week campaign, which produced 3.3 million enquiries and five million applications for the shares. It ran in coordination with all the other programmes that I mentioned.

## THE ACHIEVEMENTS

So much for marketing. What has actually been achieved?

Most obviously, the number of shareholders in this country has grown rapidly; a quadrupling of shareholders from about two million in 1983 to over nine million last year, and settling back now around between eight and half million post the crash last October.

Secondly, the profile of those shareholders has altered dramatically. The types of people who have bought into the TSB and the government privatizations are different from the traditional shareholder, and consequently we are now looking at a profile, in this country, of private shareholders very close to the profile of the national population. Only 29% of shareholders came from the A and B socio-economic groups at the end of last year, compared to 56% in 1983; some 37% of shareholders were in classes, C2 and D, compared to 17% only in 1983. Shareholders are now distributed evenly throughout the country getting rid of the traditional bias that used to exist towards the South. In terms of age, over half are under forty-five years of age now, compared to 33% in 1983.

The depth of shareholding, however, does not match that dramatic swing in the profile. Over half of the number of people who own shares do so in only one company, and the number who own in two companies or more is about 25% of shareholders. One of the great tasks of the future, therefore, is to deepen as well as to widen share ownership. That said, it is quite plain that the public acceptance of share ownership as a means of investment has risen enormously. Forty-six per cent of the adult population, that is almost 19 million people, say they have often thought about investing some money in



stocks and shares. That is about twice as many as in 1984.

Privatizations have also had the effect of increasing interest in the wider stockmarket. For example, about half of the TSB's shareholder base of about 2 million people feel that they will at some time buy shares in other companies.

Shareholder loyalty is important. In the immediate aftermarket you would expect, and indeed you see, quite a substantial sell-out amongst the short-term holders, but the residual holders are extremely loyal. Telecom still has 1.7 million shareholders out of 2.4 million to start with; TSB has 2 million remaining out of 3 million allocated holdings. And, of these 2 million remaining TSB shareholders, for example, say that they will never sell.

If you look at the reasons for owning shares, or not owning them, one of the fundamental points about privatization marketing is it has broken the barriers. What was for the few, for the rich, for the privileged and well-connected, is now accessible for the majority.

## THE FUTURE

We have to re-establish this programme after the October 1987 crash. That crash reminded people that equity investment is a risk, and it also reminded marketeers that no amount of marketing can overcome fundamental changes in the actual environment.

What people have got wrong is some belief that the crash has altered attitudes towards share ownership -- it has not. People's attitudes towards share ownership have stayed very much the same; the problem is that the interest has become armchair rather than active. It has created a need to convince people once again that it is worth investing in a share offer in order to bring people back from the touchlines onto the playing field. We are going to need a very clear endorsement from the media, and the media are going to be very wary of committing their reputations and their status, not to mention their readers' money, to anything that they are not convinced of. Firmly re-establishing the programme requires further visible offers in which investors do well, to bring back the memories that a (government) share offer is a place where ordinary people can make money. The importance of British Steel may be not just the bringing to the market of a great British company, but also providing the pathfinder for the second half of the privatization programme.

### New offer structures

Within the remaining programme, the water and electricity privatizations are forcing everyone to develop new structures. Not only are these extraordinarily large offers, but they involve for the first time the floating of ten separate companies in the case of water, and twelve distribution companies for electricity -- the latter to be followed up by the floatations of two very large generation companies. Creating individual identities for those companies, floating them simultaneously, enabling investors to buy specific investments rather than some sort of composite share, and retaining the simplicity that is absolutely essential to mass marketing offers, is a task which forces us into new thinking. It is also going to require very firm control and co-ordination in the marketing. It could also open something that is politically very attractive -- regional marketing. Of course, you cannot conceivably market one of those companies I have talked about only at a regional level. But the Water and the Electricity Boards do have to create an identity for each other; they are going



to be interested in forging relationships with their customers; and there is a good opportunity on regional level to promote that.

### **Who gets the giveaway?**

If you take the general point that maybe 10-15% of the value of a company in any successful share offer has to be given away if the bandwagon effect is to be secured (and the whole privatization programme made more successful in consequence), who at the end of the day should get this give away? So far, one may argue that the giveaway has gone to city institutions, perhaps to the stags, perhaps in the case of some companies to shareholders of firms that they then acquire. There is a lot of thinking that has to go on about whether or not we can develop the structure of offers to encourage the type of shareholder profile the companies really want, to encourage long-term holders, and to stop treating the retail market as if they were all one animal -- they are not.

### **Widening and deepening share ownership**

I agree with what David Clementi said when he looked forward to the possibility of building societies widening share ownership in this country; they have the ability to take it a good deal further. The scale of the Water and Electricity privatizations also have the ability to widen it. I do not, however, believe the government privatizations will necessarily mean that wide share ownership and privatization march hand-in-hand to the same degree that they have before; no-one could keep that pace up. But there is the opportunity to widen and, particularly in the structure of those two offers, also to deepen share ownership.

### **Cheaper dealing**

It is a perversity of the UK marketing programmes that we have moved from Telecom, and indeed TSB, where it was possible for subscribers to buy and sell shares for around £5, to one where £20-£25 is now the more common starting point for share dealing. It is a classic example of the traditional way of responding to a marketplace being out of tune with where that market has got to. I believe it is possible through the computer-based systems, and that is essential, for us to get back to cheaper dealing in this country; but I have high hopes that organizations like Sharelink, and perhaps also people like Barclayshare, will deliver us back to those days within the foreseeable future.

### **Corporate campaign**

British Airways before the early 1980s was bankrupt, largely due to the wrong sort of economics, but also due to a sort of a service which even internally at the bottom of the price was not the best, and management needed to change. Having improved all that, we had an opportunity to improve the public's image of the company even before we got to the starting gate itself.

In the 1980s, in co-operation with the government and the government's efforts, we played the corporate image campaign. It was the largest corporate advertising and marketing campaign of any of the big companies in this country. But that has changed and I believe more stringent in recent years, but we embarked on a major corporate marketing campaign in 1988, with a major press and television advertising campaign.



## TAKING BRITISH AIRWAYS TO MARKET

**David Burnside**

Director of Public Affairs, British Airways

The Government's intention was to privatize British Airways much earlier than it did. We were sitting waiting and ready in the mid-1980s to take the company to the investing public, but the first feasibility slot we had was February 1985, which was going to come just after the British Telecom flotation. It was in the Telecom sale that the Government and the Stock Exchange first realized the scale of what they were moving into. They did not really know what a big marketing campaign was, or what it was like to try and sell shares to the general public rather than the traditional investment institutions that existed in this country and overseas.

In late 1984 and early 1985 we were working with the Telecom advisors in a very bullish market, ready to go two or three months after Telecom. Then, because of problems affecting the international airline business -- the Laker problem, bilateral route negotiations between the United States and the UK, a fall-off in traffic after Libya and nuclear explosions in Eastern Europe -- we faced nearly two years of postponement. When the airline was brought to market last year, we seemed to have been preparing the company for a long time.

### THE MARKETING EXERCISE

I will concentrate on the PR and marketing exercise of the two or three months before the issue itself.

#### Corporate campaign

British Airways before the early 1980s was bankrupt, badly run, with the wrong sort of schedules, not rationalized, a standard of customer service internationally at the bottom of the opinion polls, finances in a mess, and management needing some changes. Having improved all that, we had an uphill task to improve the public's appreciation of the company even before we got to the starting gate itself.

In late 1986-87, in co-operation with the government and the government's advisors, we planned the corporate market campaign. It was the largest corporate advertising and marketing campaign of any of the big flotations in this country. Guidelines have changed and become more stringent in recent years, but we embarked on a useful corporate marketing campaign at the end of 1986, with up-market press and television advertising campaigns.



British Airways still had a pretty mixed reputation in the marketplace, so in corporate advertising we had to remind people, especially in the United Kingdom where the bulk of the issue was taking place, the size of the company. It included a television corporate advertisement, before the issue campaign started proper, which ran as follows:

'More international travellers choose to fly with British Airways than with any other airline: that is why it is saluted as the world's favourite airline. In fact it has been turned into one of the world's most profitable international airlines.

'Even here in Britain one does detect a certain sense of pride in the fact that British Airways is now bringing in a gross revenue of over £300,000 every hour. That is the kind of success you have to take your hat off to. No wonder the world's favourite airline is Britain's highest flying company'.

### **List building**

Following the corporate advertising campaign, in co-operation with the government, we moved on to the list-building advertising, the government immediately following our corporate campaign to build up big lists of potential investors. An example of a TV advertisement of this nature runs:

'People of the United Kingdom, your attention please. Very soon the opportunity to buy shares in a major British company comes to you; the company is British Airways. To be sure you receive a prospectus and application form ring: 01-200-1000 day or night, or send off the coupon in your newspaper. The British Airways share opportunity: 01-200-1000'.

Another example of this type of advertising ran:

'This is a countdown, a countdown to takeoff, because very soon you will have the opportunity to buy shares in a major British company -- British Airways. To be sure you receive a prospectus and application form ring: 01-200-1000 day or night, or send off the coupon in your newspaper. The British Airways share opportunity: 01-200-1000'.

With hindsight now I think I probably would have limited that list-building advertising at the later stages but we were breaking new ground.

### **Pathfinder prospectus**

As we moved from that period, and published the pathfinder prospectus, we constantly had to look for advertising press publicity to extol and promote the glamour of a big international airline business. We sought to get a lot of publicity around the pathfinder prospectus launch, which has become a very normal way of launching a prospectus. We involved the Secretary of State for Transport, our Chairman Lord King, and some of our own staff. Indeed, the television coverage we received from the pathfinder prospectus right through to impact day *itself* got national and international coverage!

We hired one of our own BAC 1-11s to take roadshows round the United Kingdom, and we also went to Japan, Europe and the United States. The use of roadshows in the United Kingdom came out of the early privatizations, and privatization has taught big companies like British Airways just how important it is to go out round the regions to customers, to your clients, and use roadshows.



## Impact day

To announce the opening of the application period, we again used the right sort of background for television advertising. I believe other companies use rather boring methods to advertise their offer price. By contrast, we went to the Savoy Hotel, we had a firework display on the Thames, we had the biggest ever laser display in London. And we got National and Coast to Coast television in the United States -- the United States was the second most important market that we were promoting outside the UK retail and institutional markets. It was a high-tech extravaganza costing somewhere in the region of £250,000, with a giant globe marked with BA routes bobbing on the Thames, Concorde flying in, its captain speaking live by radio link to a boat fitted with enormous speakers.

With the right sort of company and the right sort of product, we were able to get widespread coverage on national television. You need the right sort of photo opportunities to get that scale of coverage for the flotation itself; but you also need good corporate marketing coverage for the company.

## THE LESSONS OF PRIVATIZATION

The importance of your employee relations campaign on privatization should never be forgotten. In the early days of our privatization we gave too much weight to the opposition of trade union leaders who were politically opposed to privatization. When we did our market research among our own workforce they wanted us to answer questions about their standard of employment, their pension, all the day-to-day issues in working for British Airways; once they were offered free matching discounted shares it became a very attractive offer for them.

Do not underestimate the importance of bringing your workforce with you and your internal communications programme. British Airways, as a worldwide marketing company, has massive internal communications programmes of newspapers and videos, and such communications must be with very detailed staff research because otherwise it is easy for you to be misrepresented among your own workforce.

The corporate campaigns must be worked out in co-operation with the government's advisors, if you can get chairmanship of the joint committees between the government's advisors, brokers, bankers, PR and advertising men, that will help to have a co-ordinated and parallel campaign throughout. Many of the privatization programmes have spent far too much time in argument between advisors, and I think we have learnt from that in recent years.

Privatization has brought great benefits to British Airways. The company now is at the end of a roadshow programme in which we are outlining to the financial community, our travel agents and civic leaders, just where British Airways is today. We could not have bought British Caledonian, or acquired a software company in the United States, we could not have taken receipt of aircraft within the time and the price we wanted to acquire them, if we were still in the state sector.



## QUESTIONS AND DISCUSSION

**Riad Imam (USAID, Egypt):** Normally national airlines are known for losing money. In what situation is British Airways? You said the company were losing money before. Have you started to make profit yet, or do you expect to make it soon?

**David Burnside:** In the early 1980s we were technically bankrupt but still solvent because our debts were guaranteed by Her Majesty's Government. We became the world's most profitable international airline in the mid-1980s, and we have made profits and have been at the top of the international airlines, for the last two or three years. Our recent profits established us as the most profitable international airline in the world. We have been profitably trading independent of government now for four or five years.

**Question:** A good deal of British Airways debt was written off by government. May it not be a pre-requisite for privatizing an airline to write off a lot of its accrued debt?

**David Burnside:** There has been a lot of incorrect publicity and comment about the debts of British Airways. In 1980-1981 we had debts of £1.2 billion, apart from the write-off on Concorde, all the debts have been repaid through profitable trading of British Airways. There has been no direct subsidy from Her Majesty's Government since the present management, Lord King, Sir Colin Marshall, and Gordon Dunlop, took over in the early 1980s. We inherited (and government guaranteed) a high debt; but through profitable trading and rationalization, de-manning, and increased productivity, we reduced that debt and increased our earnings. We have not been a subsidized airline.

**Eamonn Butler:** Can you talk about the de-manning? British Airways was a conglomerate put together from two old airlines, and you did have a lot of duplication and over-manning.

**David Burnside:** In the early 1980s we did, partly because of the very slow merger between BEA and BOAC, the two old companies from which British Airways was formed. In the early 1980s we cut the workforce from 60,000 to 40,000 over two years to give us a basis for producing a profitable international airline. But by far the greatest part of the reductions were completely voluntary. We had generous redundancy terms, and used natural turnover to make the adjustments.

**Question:** Airline deregulation is an idea whose time has come, but if you deregulate an industry the profit potential of that industry decreases -- and thereby the prospects for successful privatization. How do you reconcile privatization and deregulation in the airline industry?

**David Burnside:** Certainly we would like to see faster liberalization and deregulation in the EEC, but then the EEC and the United States have got to break down the barriers between the two continents because despite the US reputation for its great liberal regime internally, it is in fact very protectionist internally. We are not allowed, as an international carrier, to buy a controlling interest in a US airline, and we think that is wrong. So we would like the EEC and the US to negotiate a deal between those two great trade areas. Let the Americans buy British airlines and then let the British buy American airlines; we feel that we are in a strong position.



**Question:** During the build-up to your privatization you used a lot of advisors in relation to marketing, advertising, and PR. Have you any advice to offer people on how to put together this group, and more importantly, how to manage them?

**David Burnside:** First, you need to set up a superstructure within your own company. For the people who are involved with the financial marketing/PR side of the company, privatization should be at least 80% of their job; that is what we did in British Airways. Then, on behalf of the company, use outside advisors with plenty of experience in privatization. Also try to take chairmanship of as many committees as you can, because then you can co-ordinate the PR and marketing campaigns.

## THE OPPORTUNITIES FROM PRIVATIZATION

Let me begin by highlighting the key aspects of what I believe is a significant opportunity in privatization.

Firstly, the company must escape from the grip of government interference and control, which is the lot of any nationalized industry. This opens up great opportunities and new horizons. Secondly, it must be allowed to respond to the market, to take responsibility for its performance and recognize its customers' needs. Thirdly, it must be placed in the competitive position where it will be able to survive and prosper. The key to success lies in the customer rather than in the government. The appropriate decision as to whether the company should be sold is fundamental to the success of the sale. Thirdly, it must be able to operate in a competitive environment in terms of technology, service levels and speed. It is necessary to maximize its ability to serve these customer needs.

Fourthly, it must be able to operate in a competitive environment. Disciplines and incentives are needed to ensure that the company strives for maximum efficiency, to the benefit of the customer and the public. And to provide real value for money. Finally, the company must be able to operate in a competitive market. It will have to be able to compete with other companies, rather than with a nationalized industry. In British Telecom's case, the sale of the company has led to the establishment of a large number of new companies, such that the growth of competition in the UK's core market is expected to be significant. A regulatory system is therefore needed.

Let me cast your mind back to 1981 when British Telecom's privatization was the Government's first major step. Privatization was clearly a matter for the Government, and for Parliament, and British Telecom, rightly, did not take a public stance on the issue. But it would be dangerous to say that the Government was not led by many within the business at the prospect of being freed from government control and the constraints of government activities. These have become extraordinarily fulfilling because as a result of such exciting technical opportunities they were beginning to see the potential of meeting customers' rapidly developing expectations.

## The boost of competition

Along with privatization came the wide-ranging expansion of the industry.



## THE PRIVATIZATION OF BRITISH TELECOM

**Dr Robin Bomer**

Director of Government Relations, British Telecom

### THE OPPORTUNITIES FROM PRIVATIZATION

Let me highlight the three key thrusts of what I believe a company may reasonably expect after privatization.

Firstly, the company must escape from the web of government interference and control, which is the lot of any nationalized industry; this opens up great opportunities and new horizons. Secondly, it must be allowed, indeed encouraged, to think commercially, free of political strings, and recognize its customers' needs instead of being placed in the uncomfortable position where politicians dictate what its customers should have. (This 180-degree turn towards the customer rather than looking always the opposite direction to its sponsoring department of government is fundamental to the benefits that can be gained). Thirdly, it must be allowed the commercial flexibility in terms of investment, service levels and so on, that are necessary to maximize its ability to satisfy those customer needs.

Such freedoms, of course, cannot be unencumbered. Disciplines and incentives are needed to ensure that the company strives for maximum efficiency, for the maximum quality and variety of services, and to provide real value for money. Ideally, the normal disciplines of a competitive marketplace will provide what is necessary but, in fact, rather few of the major nationalized industries have ever operated in anything approaching a fully competitive environment. In British Telecom's case the scale of investment needed to establish a large national network is such that the growth of competitors' share in this our core market is bound to be relatively slow; a regulatory system is therefore needed.

Let me cast your mind back to 1982 when British Telecom first learnt the Government's intention to privatize it. Privatization was clearly a matter for the Government, and for Parliament; and British Telecom, rightly, did not take a public stance on the issue. But it would be disingenuous of me to conceal the excitement that was felt by many within the business at the prospect of being freed from government control and the consequent constraints on our activities. These had become extraordinarily frustrating because at a time of such exciting technical opportunities they were beginning severely to constrain us in meeting customers' rapidly developing expectations.

### The boost of competition

Along with privatization came the wide-ranging expansion of the embryonic



competition which had been introduced between 1981 and 1984; indeed, that was one of the driving forces behind the process. Virtually all of our activities now face competition, the actual level of competition is already high in some sectors, and set to expand rapidly over the next few years in most others.

Not only is fair competition good for our customers and for our actual or prospective competitors, it is also extremely good for us. It provides a major stimulus to management and staff alike, it clarifies the demands of the marketplace, and it should, ultimately, allow the replacement of a formal regulatory system by the natural regulation of the marketplace. There are a host of other benefits I could mention but the company's position on this has been made very clear time and again: we welcome fair competition in all our activities.

There is an interesting relationship between competition and privatization. In principle, of course, there is no reason why they should not both be introduced independently, and indeed in some industries being considered for privatization it is clear that the scope for competition is strictly limited. But it is harder to conceive of an effective and fair competitive marketplace without privatization. A nationalized industry has a significant advantage, particularly in that the government can be relied upon to bankroll it. Equally, the nationalized industry is constrained in ways which make it almost impossible for it to compete in a sensible commercial manner: its purse strings are controlled by government, and its ability to diversify is strictly limited.

In our particular case there was another difficulty because we retained a substantial regulatory role between 1981 and 1984. Inevitably we were subject to endless, though ill-founded, allegations that we were deliberately abusing our position as regulator in order to favour our own competitive activities. In such a situation the true facts become almost unimportant; suspicion of foul play is enough to prevent the perception of a fair and open marketplace which is essential if competition is to thrive.

## THE PROCESS OF PRIVATIZATION

Returning to the privatization itself, the build-up and hard work began well in advance. A great deal of sweat and toil went into the preparation of a prospectus, which was complicated by the fact that British Telecom was a company without a previous track record in the private sector. A substantial proportion of top management time for a good many months was dedicated to the essential public-relations work, and to the debate with Government on the proposed regime, on the mechanics of privatization, on the capital structure for the company, and so on.

### A damaging inheritance

All that made it an exhilarating period for those involved leading up to the privatization and the excitement of the flotation itself and its resounding success.

In hindsight, however it has become apparent that we were at the same time floating two jagged icebergs into the path of the ship we were about to launch. The first was a major diversion of top management time just when the maximum possible attention needed to be paid to the business and the changes that it faced. Secondly, all the publicity that surrounded the flotation



led to unduly raised expectations about what the company could deliver in the short term.

The reality was that nothing had changed the day after flotation compared to the night before. We had the same directors and management, the same staff, the same outdated and under-invested network and, perhaps above all, the same nationalized industry culture. You just cannot transform that situation overnight, or even in the course of the odd year or two, notwithstanding an investment programme that we now have running at some £2.4 billion per year. The company was faced with legitimately high customer expectations but no means of giving satisfaction to those expectations immediately. That factor has been with us ever since privatization, notwithstanding the company's many real achievements.

British Telecom was also left with other damaging inheritances. Like PTTs around the world which had been used from time immemorial as an instrument of government policy, it had a tariff structure which owed more to successive governments' views of social welfare than to any commercial or economic strategy. There were massive imbalances between prices and costs, and the cost structure was in any case little understood because, as a nationalized industry, that understanding had never been regarded as necessary. BT has had to build up from scratch the systems needed to provide this, and those were still some way from the necessary level of sophistication.

In addition, the purchasing policies of the government had been severely constrained and it had never been allowed to impose any competitive disciplines on its suppliers who had increasingly depended on it as a captive market.

### **Living with change**

All those things were bound to take time to put right. The basis on which privatization was carried out, and in particular the regulatory regime, had to be designed to provide the flexibility for such distortions to be eliminated in as painless a way as possible. But it was natural that our suppliers should find a new approach uncomfortable until they, like British Telecom, had acclimatized to the new environment. It was also natural that those customers whose telephone bills had been subsidized over the years should not easily accept or understand the rebalancing that meant some customers did not fully benefit from the substantial overall reductions in British Telecom prices which have occurred over the last four years.

The process has not been easy for the management and staff of BT either. They have been subjected to more change in the last four years than in the previous seventy. A secure, if dull, working environment was threatened by the introduction of competition, and uncertainty rather than excitement tended to prevail among many of the staff. Because of that the board worked extremely hard at internal communications during the run-up to privatization to try to ensure that its message got across. That is a much harder task than it may sound, and in the event the board's belief that competition would be beneficial to the business, and that privatization will best enable British Telecom to cope with competition, did not get across as convincingly as we would have wished.

That their determined efforts were not wholly successful was mainly due to the fact that privatization had become a major political issue: an issue of the



type which is resistant to normal management and staff communications. The conjunction of privatization, new competition, and fierce political infighting does not seem to happen to the same extent in most privatizations, and the communications problem may often be for that reason a somewhat easier nut to crack.

### **The regulatory structure**

Amongst the changes that BT has faced has been that of learning to live with a novel regulatory system. A key role of any regulator must be to ensure fair play between all participants in a liberalized market; and in some senses to act as a surrogate, mimicking the effects of competition where it does not yet exist naturally. It is very important to remember that regulation is only a surrogate and that its greatest success may well be measured in the degree to which the development of normal market forces over a period reduces or even eliminates the role of the regulator.

This message has been missed in some other countries where regulation has developed into a vast self-perpetuating industry. It is also crucial that regulation remains flexible and avoids laying down, or hanging on to constraints which are not really necessary. There is a great risk of heavy-handedness inhibiting innovation and even limiting the scope for competition. Overall, I believe that the regulatory regime in this country has so far been a remarkable success, especially considering the novel approach that was taken; but it certainly has been difficult at times for British Telecom, and (no doubt) for OFTEL as well.

### **THE EFFECTS OF PRIVATIZATION**

Let me finish by taking a quick look at what has happened to the various constituents of privatization. In pride of place must come the customer. For the first time ever the customer has been given an unprecedented safety net in terms of prices, through the RPI-3% requirement in our licence. On top of that we have been able to freeze prices for basic services until at least the end of March 1989, a virtual price freeze for two and one-half years. The customer has also benefited enormously from open competition in the choice of equipment, in the provision of value added and data services, from choice in the cellular radio and mobile telephone fields, and increasingly, from the choice between BT and Mercury. None of that could have been contemplated while British Telecom was part of the public sector.

### **Assuring service quality**

Inevitably there were those who maintained that the quality of service arguments of 1987 were the result of having a private sector company with its eye on the bottom line rather than on customer service, and that privatization was about private profit instead of public service. The fact is that that could not be further from the truth; we have always recognized that commercial success depends ultimately on giving the customer what he wants first time, every time.

I cannot now delve into the series of factors which led to the difficulties last year, but certainly the pressure for profits wasn't amongst them. What is more, we have, for the first time, published quality of service targets which we are committed to achieving during the current financial year. We have recently backed up that commitment by announcing that we will accept



limited liability or penalties for various service failures. So far as I know that is a unique deal for the customer unmatched by any other telephone operator in the world. Just compare it with our public sector status when we had statutory exemption from any form of liability!

### **The government**

What about the government? What about the allegations of selling the family silver? Far from that, the government now finds that it has sold just over 50% of its stake in BT and yet the 49% it still owns is worth about as much as 100% was before privatization. It no longer has to act as a banker and, even better, it now receives a handsome income from the company. Last year, for example, it received £1.5 billion in the form of corporation tax, loan stock interest, and dividends -- quite apart from VAT -- and that is a great deal more than it used to receive when BT was a nationalized industry. The government, and through it the general public, has not done badly.

### **Staff and shareholders**

Another important constituency is the staff of the company. There have been no redundancies to speak of -- there have been some staff reductions but they have been accomplished by natural wastage and voluntary early retirement. Some 96% of the staff of the company became shareholders at privatization, and over 40% are today contributing voluntarily to savings schemes to enable them to buy further shares in the company. In 1986 nearly all staff received shares as part of the profit sharing scheme, and another £38 million has just been set aside for that scheme this year. So there have been benefits for staff as well, linked into the success of the company.

Shareholders generally have not done too badly either, they have seen good capital growth in their shares -- notwithstanding the 1987 crash -- and they have seen earnings grow steadily each year.

### **The company and its suppliers**

The suppliers may not have been initially enthusiastic about the cold draught which blew round their shoulders, but I doubt if many would now deny that this was at least a part of the stimulus for the changes they have since brought about; and the new competitiveness which they seem happily to be finding in the world as well as the UK marketplace.

Finally, what about the company itself? The objectives I mentioned at the start have been broadly achieved. The company is no longer shackled by government, nor faced with untoward pressure from that quarter. It has turned its face towards the customer, and it is subject to proper market pressures and disciplines from shareholders and customers and, increasingly, from competitors. It has to behave in a way that is in the best interests of the business rather than in a way that might satisfy political considerations -- which is as it should be. It is free to develop its business, free to join the world leaders in telecommunications, and free to expand into the growing and challenging world of information services and telecommunications internationally. Above all, it has to stand on its own feet.

In brief, privatization presents companies like British Telecom with the opportunity to be part of the world scene, with the incentive to succeed, and with the knowledge in our case that if the challenges of modern communications needs are met then there are real benefits for all.



## THE ROLE OF THE REGULATOR

**Professor Bryan Carsberg**  
Director General, Office of Telecommunications

I want to cover three sections of interest in our activities. First, the statutory framework and the way it works. Secondly, to focus on the promotion of competition which is a key element of the way we approach things. Thirdly, to look at regulation where competition is not yet strong enough to do the job.

### THE INSTITUTIONAL FRAMEWORK

Regulation of the telecommunications industry is a system of checks and balances in which the Secretary of State, OFTEL, the British Courts, and the Monopolies and Mergers Commission, each potentially have a role.

OFTEL is a government department but it is a non-ministerial government department, established in that way to create a force for regulation that was independent of ministers and, therefore, independent of short term political pressures. In order to operate telecommunications services you have to have a license, and the Secretary of State issues those licences with advice from me. My main jobs are to enforce the licences, which contain detailed rules, and I do that with support from the courts if necessary -- if I have to take enforcement action the real sanctions are provided by the courts. I also have to make determinations under the licences, some of the rules are left open-ended and I have to determine a matter to give them actual applicability. For example, undue discrimination by British Telecom is ruled out and it is for me to decide what is undue in that context, and if somebody feels aggrieved at my decision, or at my lack of a decision, then they can take me to court and ask for judicial review.

My other main job with respect to the licences is to amend them if necessary. Only I can initiate the procedures for licence amendment, and only I can complete them. But if the proposed amendment is disputed by the licensee then I have to make a reference to the Monopolies and Mergers Commission, and can only proceed if I have their broad agreement -- so the MMC provides the check on me in that particular case.

Two other elements of the statutory framework are worth mentioning. One is that I have a duty to investigate any representation that is made to me about telecommunications, provided that it is not frivolous. And I have the power to require the production of information; I could not do my job without that power and it is given to me both by statute and by the licences.



## **Objectives of regulation**

In carrying out these functions I have regard to certain objectives for the regulatory regime and they are set out in general terms by the Act of Parliament that set OFTEL up. I am told that I must do all I can to secure the provision of services to meet reasonable demands. I have to make sure that if there is a service, and it is an economic service, that it is provided. Then I have to promote the interests of customers as regards price, quality and variety of service; and, most importantly, I have to promote competition (obviously, though not explicitly, because that is the best way of promoting the interests of customers). I have to promote efficiency and I have to promote research and development. I have to promote certain things that are consistent with helping the UK international trading position.

## **PROMOTING COMPETITION**

When it comes to the application of these concepts to particular decisions, I like to have a clear basis for decision and that basis is encapsulated in the single sentence which says that my objective is to assist the interests of customers as far as possible by promoting competition whenever that is possible, and by resorting to an efficient kind of regulation where competition is not yet effective.

So promoting competition is my first weapon as regulator, and my best weapon as regulator, although in other cases I have to resort to regulation of other kinds. I liked Robin Bomer's thought that regulation should mimic competition. It is a phrase I use frequently and I think the best way of deciding what is an effective method of regulation is to mimic competition, to ask just what would happen in a competitive market, and to try to make it happen in a regulated situation.

## **Benefits and barriers in competition**

I take refuge in the thought that one should promote competition as far as possible, and I regard competition as the regulator's best and first weapon. I think of it in that way because competition helps you to find out what is possible. As a regulator you can never really judge with great confidence how efficiently services can be provided; competition finds that out because competition can give somebody else the opportunity to prosper by doing better. Most importantly, competition is a way of promoting innovation in the market, and that is particularly important in telecommunications because technological change is happening with great rapidity at present and we need to give it every incentive to develop new services for the customer.

But, of course, there are limitations to how much competition is possible in an industry like telecommunications, and particularly with the basic telecommunications service. The problem is well known; it is that there are very large fixed costs in establishing a telephone network, and large economies of scale. This means that it is always cheaper, other things being equal, to meet extra demand by expanding an existing network rather than establishing a new one. That sets a limit to how much competition is possible and, indeed, it is the characteristic which economists say gives rise to a natural monopoly: if you create competition, then you would expect a monopoly to emerge eventually. But there is something on the other side of the equation that justifies competition in this situation and it is that other things are not equal as between the competitive situation and the



non-competitive; efficiency and innovation are likely to be greater in the competitive situation.

Introducing competition in an industry like telecommunications gives you some gains in terms of the efficiency with which things are done, and some losses in terms of reduced economies of scale. Weighing those two things is fundamentally the basis for deciding how much competition is worth having.

In basic services we have proceeded cautiously by establishing a duopoly, one competitor to British Telecom -- Mercury, now a wholly owned subsidiary of Cable and Wireless -- and we are waiting to see how that goes for a few years before considering further extensions to it.

### **Making competition work**

There are a number of things about the framework which makes us confident that competition can be sustained in spite of the difficulties that I have already mentioned. One way of achieving that is by the obligations that are given to the two competitors. British Telecom has the obligation to provide universal service over the whole country and (with minor exceptions) at a fixed maximum price. Mercury, on the other hand, has been given minimum coverage obligations but beyond that, choice as to whether it provides service in a particular region or not. The effect of that is that Mercury can choose much more than British Telecom where it operates, it can choose to operate in the areas that appear more profitable and that advantage can offset its initial disadvantage from the lack of the same level of economies of scale. In addition to that, social obligations are important in telecommunications, and BT has the lion's share of those at the present time: things like maintaining unprofitable public callboxes in rural areas. And finally, there are the terms and conditions on which the two duopolists work together -- the so-called terms of interconnection.

All of these things that I have described can be juggled in order to create a situation in which competition is possible; they can be set in a way which equalizes the burdens that each carry. You may say that that is a bit artificial because what it means is that you are in some ways artificially tipping the playing field in the direction of the new entrant while recognizing that there is an inherent advantage to the established operator. A bit artificial it may be but it seems to me that that does not matter, it is worth doing and the benefits of it can be very great indeed. It is a way of getting competition, and the benefit of competition strongly outweighs the disadvantages it may have.

### **Fair trading rules**

On the subject of competition I would mention one other point relating to fair trading rules where you have a situation in which there is a residual element of monopoly power. In the case of British Telecom at the moment there remains a very substantial element of monopoly power but competition nevertheless exists to some extent on basic services and much more widely on the provision of other non-basic services and in the supply of apparatus. However, it is important to have fair trading rules to make sure that any monopoly power is not used in a way that makes competition impossible -- in a way that gives the monopoly operator an unmatchable advantage in other areas of activity.

Those fair trading rules are contained in the licensing regime as well as in the general competition law of the UK, and it is important that they should be in



the licensing regime as well because that is a swifter and surer way of enforcing them. We have, for example, a rule against cross subsidization which is a fair trading rule. We have rules against undue preference: BT must not prefer its own competitive businesses over its competitors' businesses for example.

If I were to give one word of advice to a new regulator about the administration of fair trading rules it would be this: you have to have a pro-active policy towards enforcement of fair trading rules. You begin with a situation in which the incumbent, British Telecom in our case, has such a strong advantage from its established market position, that competition will only really happen if the regulator goes out of his way to make clear that he intends it to happen and uses all the powers at his command to make it happen.

It is not so much that the regulated company is trying to get away with shady practices -- indeed it is not that at all. The problem is that the potential competitors approach the market with doubts about whether it really is going to be possible to stand up against the established operator in this kind of situation. Only if the regulator emphasizes his determination to enforce fair trading rules actively will people have confidence in the fairness of the market, confidence enough to come to it and participate in it fully.

What I mean by 'active enforcement' is that the regulator should not sit in his office waiting for the complaints to come in, but should go out looking, should explain the rules, and should make it quite clear that he intends to enforce the rules actively if he finds any breaches of them. With that in mind, for example, we conducted a survey from OFTEL of people's experience with buying apparatus from British Telecom and from British Telecom's competitors to make sure that we could not find any cases of unfair trading.

The effect of that policy has been a healthy one. BT has almost without exception complied with the rules and I think it is now true to say that BT's competitors have substantial confidence in the fairness of competition.

## REGULATION

I turn now to regulation. When OFTEL was first established there was much talk of 'regulation with a light rein'. It always seemed to me that that was an unfortunate description and, indeed, a misleading description. I would readily subscribe to the view that regulation should not be carried to the point of excessive detail, to the point where any possible benefits from regulation would be outweighed by the costs. But it seems to me that any notion that there are great areas of activity where there is no need of regulatory power is mistaken. The regulator must be free to go anywhere where there can be an abuse of monopoly power otherwise customers cannot have the assurance that their interests are being protected.

That scope is available to the regulator under the British regime because of the requirement that I mentioned earlier, that I have the duty to investigate any representations that are made to me. If somebody makes a serious representation I have to investigate it and that means that it is the complainants to me that set the regulatory agenda to a large extent.



## Price and quality examples

To illustrate regulatory activity, and to show in particular how I see regulation as mimicking the effects of competition, I want to look at two interrelated matters -- price control and quality of service.

With price control the rule is that British Telecom is limited to increasing prices in an area of main activity by RPI-3% -- three percentage points below the rate of inflation. The advantages of that approach are that it is simple to administer, it gives good assurance to customers, and most importantly of all it gives an incentive for efficiency. If the regulatee, once the rule has been fixed, can operate at a lower level of cost than had been assumed in setting the rule, it makes extra profit and it is allowed to keep it. It has the incentive therefore to become more efficient.

That contrasts with the situation in what is often known as rate of return regulation under which cost increases can, generally speaking, easily be passed on to customers so that there is relatively very little incentive to avoid cost increases. That is what you would expect to happen in a competitive market; you have to be efficient in performance to survive. And so you should be in a regulated market.

Initially the RPI-X% rule was set with limited coverage; it did not cover all of BT's services where there was a monopoly position. It might be better next time to extend the coverage so that it does cover all main elements of monopoly position. I take that view because I believe in the efficiency qualities of the regime, and it seems to me that those properties of promoting efficiency should be brought to all of BT's services and not just to some of them.

The need to provide for a re-balancing of prices, some going up more than others, or some going up while others go down because prices are out of line with costs at the date of privatization, is something I agree with. It was provided by the price control rule because it was an average requirement and not a requirement that applied to each price. On that subject I would simply observe for the rest that re-balancing creates more regulatory tensions than almost anything else because those who depend heavily on services, the prices of which are re-balanced upwards, shout loudly about it when the time comes, and those who are benefiting from reductions tend to keep rather quiet.

On quality of service, the problems of 1987 that Robin mentioned were not mainly the result of BT's trying to improve profit at the expense of quality of service. They were caused mainly by BT's strike of engineering staff at the beginning of the year which had much longer lasting and widespread effects than we had expected; and by the existence of a good deal of out of date technology in the network.

Those experiences did prompt us to ask whether the incentives in the regulatory regime for improving quality of service were as strong as they needed to be. We thought they were not because in the regulatory regime as it then stood there were virtually no incentives of that kind. There was no requirement to meet particular quality of service standards, there were no requirements for accountability, and there were no financial penalties.

I took two main actions to improve that situation and the first of them preceded the problems of 1987. The first was that I thought BT should accept



public accountability for its quality of service by publishing statistics, setting itself targets, and being monitored on its performance against the targets. It agreed to do that in late 1986, although unfortunately it did not actually start doing it until October of 1987. Nevertheless the structure is in place now and its second report showed a better performance on quality of service than was shown by any previous set of statistics that I had seen.

I also considered whether in addition to accountability more financial incentives were needed and I thought that they were. We found particularly that there were two areas of poor performance -- fault repair and the time taken to provide new service.

I therefore asked BT to accept contractual liability for not repairing faults as quickly as it should -- two days was the limit we set on it -- and also I asked BT to give a firm contractual date for providing a new exchange line and to accept liability if it did not do that within two days of the contractual date. BT agreed to do that, the agreement being that there would be a minimum liability of £5 per day when the scheme comes into effect -- BT would pay customers £5 per day compensation in the absence of a claim for a higher sum, up to a limit of £1,000 for residential customers and £5,000 for business customers -- and this will begin in April 1989. The new rule gives customers better assurance than they have had previously in the UK and in any other country of the world.

#### THE PRIVATIZATION INCENTIVE

What is the role of privatization in all this? I see privatization as the thing that makes the regime work with its incentive properties as well as it should. I do think that much of what we have done would be an improvement over ministerial regulation for a state owned industry, but it all works much better if you have privatization because the effect of privatization is to give people the incentives to earn more profit, on which the regulatory structures depend.

Many of the benefits of the regime are not easily captured in statistics, they are more qualitative things that you see by talking to people in the industry. I find, in OFTEL, that I am seeing people who come to tell me about new ideas for new products and new services, things that did not happen in the past. If they are competitors to BT was no use trying because you were not allowed to do it anyway, and if you were BT, there was not the same need to bother because you were not going to run the risk that somebody else would run off with the marketplace if you did not do it.

In another two or three years that kind of effect will have shown benefits in telecommunications which go far beyond those that are visible today, to the point where I do not believe that it will be possible to argue seriously against the proposition that privatization and the introduction of competition has improved things beyond all recognition for the customer.



## PRIVATIZATION TECHNIQUES IN FRANCE AND THE UK

John Williams  
Kleinwort Benson

I would like to talk about some of the contrasts between the UK and French privatization programmes. What I will be saying will be based very largely on our work with the French government on their first privatization, that of Saint-Gobain in November, 1986. I doubt the French will now re-introduce the ambitious privatization programme that they started in 1986 and carried on into 1987. But I thought it would be useful to describe some of the contrasts that we noticed, as an illustration of how another government tackled the issues raised by privatization.

### THE CONTRASTS

#### Timing and preparation

Firstly, in the timing and preparation of privatizations, the UK government first concentrated on privatizing companies that were reasonably capitalized, usually having some experience in the private sector, proven management in place, and no requirements for regulatory regimes. Cable and Wireless, British Aerospace, and Jaguar were among the first British privatizations.

The French government adopted the same type of approach -- it went for the easy targets, which enables privatization to be done very quickly. The UK government has now moved on to tackling much more difficult candidates. BT, British Gas, British Airports, and the Electricity industry all raise fundamentally different and more difficult questions. It follows that the time taken to prepare these industries and corporations for privatization is a lot longer. There is a very big difference: Saint-Gobain required only a matter of months before it could be privatized, whereas we now talk about years before an industry is ready for privatization.

#### Parliament and legislation

My second set of contrasts concerns the role of Parliament and legislation. In the UK, the Acts of Parliament which allow the government to privatize corporations tend only to establish a broad framework, and the government will normally argue very strongly for the maximum discretion on valuation, structure, timing, and any special concessions for employees and to the retail sector. There is little parliamentary accountability on the mechanics of privatization in the UK until after the event.

That contrasts very strongly with the French experience. The French



government was faced with a number of legislative constraints: for example in France there is a privatization commission, a statutory body, independent of government, which sets a minimum valuation for the company being privatized -- there is no such constraint on the government in the UK. Also, under French law, there are provisions which require the government to meet retail applications to a certain level, and there are limits on the amount of any offer which may be sold overseas. The UK government has much greater freedom.

### **Role of the government**

Third in the UK, the government and its advisers dominate a privatization exercise. The company will be closely involved in the privatization, and may meet some of the costs of the privatization as well, but typically, the government will chair and run the key committees that are concerned with structure, timing and pricing. By contrast, in France the balance of responsibilities is more equally shared with the company being privatized. Saint-Gobain, in fact, led the marketing, was responsible for documentation, and also had a major involvement in the running of the overseas tranches of that privatization. (That contrast may be more apparent than real, of course, given the different role of the French civil service and its role in industry).

### **The similarities**

The similarities in many ways are just as striking and interesting as the contrasts. Perhaps the most fundamental similarities are in the objectives of privatization: to maximize proceeds from a privatization, and also to spread share ownership. This similarity in objectives has led to a number of consequential similarities on the marketing side. In the UK the government makes extensive and sophisticated use of a variety of advertising media -- roadshows, television, local and national press, and radio -- to alert the retail sector to the investment opportunity to the privatization. The French followed very similar procedures, and also used multi-media campaigns to build interest and consciousness of the privatization.

A second similarity is retail incentives, where both governments make special arrangements for employees and for the retail sector, often in the form of loyalty bonus arrangements which give free shares to individuals who retain their shares for a specified period. In addition, the UK government offers, typically, the opportunity to employees to acquire shares on a preferential basis, free shares, and shares at a discount. The French government also adopted those techniques, and to meet the same objectives.

Thirdly, on the methods of sale, a number of similarities emerge. The French government, like the UK government, tended to rely on fixed price offers and on extended offer periods to give the public the opportunity to participate. The French government also introduced clawback arrangements, an established feature of UK privatizations, which allow the government to claw back shares from institutional and overseas investors shares to meet retail demand.

Fourthly, both the UK and French governments were very concerned to limit flowback -- that is, shares coming back from overseas in the immediate aftermarket. Flowback opens the government to the political criticism that shares were denied to the domestic market, and particularly to the retail sector, and were sent overseas to satisfy speculative demand. Both governments considered formal mechanisms for preventing flowback, but in



both cases they decided that such mechanisms detracted from the marketability of the shares, and so undermined the whole basis of the offer. Both governments also concluded that the most effective way of inhibiting flowback was to ensure that overseas tranches are led by institutions who are prepared to generate and sustain a local liquid market in the shares.

The final similarity is golden shares. The French too used a form of golden share, or special share, to make sure that the activities of the privatized company could not conflict with the national interest.

To focus sharply on some of the key problems of privatization in a developing country, I now turn to the question of how to get a good start when the privatization programme is in one developing country. I have pointed out that the

#### ANALYSIS OF A STRATEGY

Last year the government of that nation passed a privatization law authorizing the sale of about thirty companies. The President stated that the aim of the programme was to spread ownership amongst the population, to invigorate the private sector, and to improve efficiency.

First, good. Good because their government was the first which authorized the privatization of several companies. They did not have to get a new law for every company. But it was not so good because the law was not very good. Good because the aim of the programme was to spread ownership amongst the population, and this could be achieved by getting popular approval. And good because there was support for the privatization programme in the very top of the government.

Secondly, they listed the companies for sale. It was a list of thirty companies, not a list of thirty profitable and reasonably successful. This was good in that they did not attempt to sell the largest or the most successful companies, and they did not get the privatization programme off to a disastrous start. It was good because it did not spend four years compiling a list of companies to work out what they were going to do. But it was not so good because they did not even bother to put out a survey of the views of the public. They were going to sell what was there, and so some of the most valuable companies for privatization were not on the list. It was not also because they did not even ask other interested parties what they thought of the privatization programme. They did not ask because in many cases they decided to sell on a private basis. They did not ask because they did not have a list of companies. (I have said that the state holds only 2% of a company, and it is better to have a list of companies.)

Thirdly, they decided to launch a campaign to get the public to understand the privatization programme. This was good because the campaign was very effective. It was good because it was a campaign to get the public to understand the privatization programme, and it was good because it was a campaign to get the public to understand the privatization programme.

Fourthly, they have a good list of companies for sale. This was good because



## PRIVATIZATION IN DEVELOPING COUNTRIES - 1

**Peter Young**

Director, Moncrieff Strategy

To focus sharply on some of the real problems of privatization, in a developing country, it may help to review what is good and what is bad about the privatization process in one developing country I have just returned from.

### ANALYSIS OF A STRATEGY

Last year the government of that nation passed a privatization law authorizing the sale of about thirty companies. The President stated that the aim of the programme was to spread ownership amongst the population, to invigorate the private sector, and to improve efficiency.

This is good. Good because there was one law passed which authorized the privatization of several companies -- they did not have to get a new law for every company as we have had to do, unfortunately, in the UK. Good because the aims of the programme were popular, to spread ownership amongst the local population -- and this could be reckoned to get popular political support. And good because there was support for the privatization programme from the very top of the government.

Secondly, they chose ten companies for sale first, and most of these companies were already profitable and reasonably successful. This was good in that they did not attempt to sell first the largest or the most loss making companies, and thereby get the privatization process off to a disappointing start. It was good because it did not spend four years commissioning studies to work out what they were going to do. But it was bad because they did not even bother commissioning a survey of the whole public sector except to see what else there was to sell, and so some much better candidates for privatization were overlooked. It was bad also because they did not consider other methods of privatization such as deregulation and contracting out; and bad because in many cases they decided to sell only partial holdings in those companies (because even if the state holds only 5% in a company it still interferes to a fairly large extent).

Thirdly, they decided to launch a television and radio advertising campaign to explain privatization to the population at large. This is good, and such advertising can be very effective. However, they did not bother to run any employee relations campaigns or to educate the workforce or the management, and that is bad.

Fourthly, they have neglected to reform the investment climate in that country.



Taxes on capital income are still very high and you would have to consider carefully why one would wish to invest in anything. Regulations are incredibly oppressive, it is virtually impossible to fire anyone, and there is widespread suspicion of anyone who possesses large amounts of money (n that the are reckoned to have made it illicitly or to have stolen it from someone: there is a law allowing action against people who have large amounts of money, while anyone who has a bank account of over \$20,000 has to report it to the central bank. Therefore it is not surprising that this country's citizens choose to keep their money in Switzerland and not at home. The point of the privatization campaign is to bring that money back and to invest it into productive areas of the economy.

Fifthly, they have established a special privatization unit with a specific responsibility for privatization, and of course that is good. However, that privatization unit has not sought any advice from private sector specialists either within the country or outside the country, such as merchant banks and accounting firms. No audits have been done of any of the companies to be privatized. The civil servants do not have any experience of privatization, nor any advisers to help them carry out the details.

The first privatization that they wished to carry out was through a public offering. There is no capital market in the country, they have written to a local bank asking for help to set one up but didn't get a reply to the letter -- and they wished to privatize in two month' time.

#### A case in point

Take an example of a company which they attempted to privatize about a year ago, a chain of food stores. They asked for bids, and amazingly enough, they received four serious bids for this company -- a company which loses a lot of money -- one foreign and three local. One of the bids was from the employees of the company.

However, in their request for offers they did insist on retention of all the employees in the future, which few serious bidders could commit themselves to, and were asking for bids on the basis of a ludicrously high valuation of the company -- they thought the enterprise was worth \$1 billion, whereas clearly it was worth a quarter or a fifth of that.

They decided to negotiate only with the company which had offered the highest amount of money, which was the foreign firm; although when it was clear that this bidder could not be persuaded to pay \$1 billion, they decided not to sell the company at all, and to let it out on a management contract. They refused the employees' bid, which was nevertheless the second highest, and refused to negotiate with any of the other bidders. Therefore, they turned down an opportunity for involving employees in privatization, for spreading ownership locally, for actually getting some money in, and for turning around a company that was, in fact, losing \$300 million per year.

#### CONCLUSION

Nevertheless, in most of the other aspects of their privatization campaign they have got many of the essentials right, even though they do not have the specialists' advice to assist them. They have decided to sell to the local population, backed by an educational campaign, they want to spread ownership, they want to improve efficiency. But they have not quite got it







## PRIVATIZATION IN DEVELOPING COUNTRIES - 2

Alfred Latham-Koenig  
Ernst & Whinney

My task is to give you an overview of privatization in LDCs, its modes, problems, and opportunities. I will outline the main reasons for privatization in LDCs, the different modes of privatization practice in LDCs, some practical examples in Asian, South America, and Africa, the constraints and pitfalls of privatization in LDCs, and ways in which governments of LDCs can overcome the obstacles to privatization.

### The reason for privatization

Interest in privatization is spreading rapidly among developing countries. Countries as different and as far apart as Chile and Turkey have sold off state-owned firms to the private sector. Admittedly there has been more interest in rhetoric than action; according to a recent report prepared for the World Bank the number and scale of actual divestitures in LDCs seems extraordinarily small in the light of the considerable discussion that the idea has generated.

On the other hand other forms of privatization, such as management contracts and leasing, have been used in many LDCs to relieve governments of the burden of non-viable state enterprises and to improve the efficiency within the state enterprise sector. Other LDCs have tried introducing more competition and deregulation in public monopolies to promote greater efficiency.

What are the reasons for privatization? I suggest that the main reason is the dismal performance of the state enterprises which, between the mid-1950s and the mid-1970s, proliferated in key sectors of LDCs. Apart from agriculture, the state remains important in most sectors, and dominant in transport, communications, and all the utilities. And it has grown: in Mexico in the 1960s there were about 150 state-owned enterprises, but by 1982 that number had jumped up to about 1000. In Brazil the number of parastatals increased from 150 in the 1960s to 700 at the beginning of the 1980s. However, over the years and especially since the oil crises, disenchantment with the performance of the state sector gradually set in. Many of them failed to fulfil most of their basic functions, accumulating instead large labour forces, swollen budgets, and enormous debts.

As pressure on government revenues grew, resources for financing these parastatals became scarcer, and they became regarded as a serious drain on limited public funds. The lack of clear managerial objectives, their non-economic pricing policies, and excessive political interference attracted



growing criticism.

At the same time as these criticisms were being voiced, the advent of Thatcherism in the United Kingdom and Reaganism in the USA, with their emphasis on private enterprise, was affecting the policy of both bilateral and multilateral donor agencies towards aid to the LDCs. These agencies began to urge LDC governments to allow the private sector to have a greater role in their economies. Indeed, in early 1986 the World Bank set up a section to deal explicitly with measures for improving the efficiency of public enterprises by restructuring and privatization. And the US Agency for International Development established a privatization fund to provide technical assistance to LDCs wishing to divest some of their state-owned enterprises.

Since bilateral donors now link their interventions to LDC acceptance of World Bank and IMF policies for economic reform, measures to rationalize public expenditure and increase the scope of the private sector have become almost standard features for the economic packages that LDC governments are under pressure to implement.

Although LDC governments accept that some form of privatization of their loss-making state enterprises has become necessary, there is a conspicuous lack of the ideological enthusiasm that can be found in Britain. Pragmatism and expediency, not politics, are the main motives for privatization; LDC governments simply want to use their resources more effectively.

### **The modes of privatization**

Let us look at the modes of privatization. First, divestiture of state-owned enterprises by initiating a share flotation on the stock market. This has been comparatively rare because the existence of a well-functioning capital market, and a substantial body of investors, are the exception in developing countries. In sub-Saharan Africa, for instance, only the stock exchange in Abidjan and to a lesser extent those in Harare and Nairobi, are of a sufficient size; while Asian stockmarkets outside Hong Kong and Singapore are mostly rudimentary.

A recent report from the Asian Development Bank on capital markets in six Asian economies found that equity markets were an insignificant source of capital. As a result, Western-style privatizations have occurred in only a few countries, mainly Malaysia, Singapore, and Korea, and to some extent in Brazil and Jamaica. A more common occurrence has been the selling back to the former owners of those enterprises which had been taken over by the state. This happened typically in Chile and Bangladesh. In Chile many of the enterprises taken over by the state in the 1970s were denationalized in 1974-1975. But since 1975 there have been three further waves of privatization which reduced the number of public enterprises from 507 in 1973, to less than 35 in 1987. In fact you could say that privatization of public enterprises has been a permanent policy in Chile during the last decade. As for Bangladesh, denationalized many enterprises in the jute, textile, and banking sectors.

It is interesting that another recent study by the World Bank found only some 100 examples of total, or partial, sales of state-owned enterprises in 15 countries: 13 in Africa, about 165 in Latin America (including those in Chile), and 250 in Asia (including those in Bangladesh).

There is another method of privatization which the British Chancellor of the



Exchequer called 'the first cousin of privatization' -- that is, contracting out. By relieving the government of a burden of non-viable state enterprises, or of some of their activities, measures such as private management contracts and leasing can act as major forces for improving efficiency within the state enterprise sector. This has been tried in Thailand (for instance) with its privatization of port facilities. Contracting out does not involve a clean break with state control, but can be seen as a privatization of management. However, many governments in LDCs have found such arrangements difficult to structure and to maintain successfully.

The other mode of privatization is deregulation. The abolition of statutory barriers preventing private operators from competing with state enterprises is also one way of improving the efficiency of these enterprises and preparing them for eventual privatization. Such market loosening is often associated with other measures of economic liberalization, and examples can be seen in the reform of agricultural marketing boards in many developing countries.

The key issue underlying these various modes of privatization is the degree to which each option meets the test of improving competition.

### **Privatization in practice**

In practice, Asia is probably making the most progress, although other places are already well on the way. Pakistan has already returned to private ownership some 2000 flour, rice, and cotton mills, and it has striven to make public enterprises more efficient through deregulation and restructuring, with a view to eventually privatizing them. Malaysia has created a government committee on privatization and diverse activities including telecommunications, container terminals, aircraft maintenance, and civil aviation, are in various stages of being privatized. Singapore is interesting because it was committed to state capitalism but now it is retreating from this and the top-ranking public-sector divestment committee has recently recommended a massive privatization programme to take place over the next ten years. In South Korea the government privatized all commercial banks and sold large industrial combines to the private sector.

In Latin America, Mexico has embarked upon a very wide-ranging programme of privatization, and it is expected that by the time the present government leaves office in December 1988, only 463 parastatals will be left out of the 1000 it inherited in 1982.

In Africa, most privatization has taken the form of management contracts or leasing. Thus the Ivory Coast has contracted out its water supply network, and Kenya has done the same for road construction and maintenance. But there are two countries in Africa, Nigeria and Togo, which have very ambitious privatization programmes. Togo wants to dispose of all of its public sector enterprises, and Nigeria's president plans to sell the government's stake in hundreds of companies.

### **The pitfalls**

Now I come to the most important part of my comments, which is the constraints and pitfalls of privatization.

Next to the weakness of capital markets (which is the major obstacle to privatization) the fear of foreign interests, or certain ethnic groups gaining a monopoly power, is probably the greatest deterrent to privatization. In



Indonesia, for instance, where trading and merchant operations are largely controlled by the local Chinese community, any privatization proposal that might result in their further domination of any sector is unlikely to get official approval.

Resistance from vested interests which tend to lose from privatization can also be a major constraint. The management and workforce of public operations are naturally keen to maintain their job security, and the civil/military bureaucracy, which through these corporations exercises considerable financial and administrative power and influence, naturally seeks to perpetuate government control.

Another common constraint is the fact that governments in LDCs rarely want to sell profitable enterprises, while the money losers they *do* want to sell, with little asset value and high liabilities are unattractive to buyers on terms which most governments are prepared to accept.

A further constraint is the shortage of able managers to run a privatized enterprise.

Another of the pitfalls of privatization is the risk of increasing the concentration of power and ownership in countries where the range of potential buyers of privatized companies is small. There is also the risk that governments, eager to present sell-offs as attractive propositions may preserve certain monopoly privileges for the privatized enterprises, such as protected markets. In such cases the fact that the enterprise does not operate in a fully commercial environment defeats an important reason for divestiture.

### **Overcoming the problems**

There are various ways in which LDC governments can overcome some of the obstacles which I have mentioned. First of all, governments must clarify their policy and make their objectives explicit. Second comes setting up a central administrative unit to manage the privatization programme. Third, it is important to design a comprehensive privatization strategy classifying state enterprises into different groups, according to their prospects for privatization. Fourth, is changing the policy environment, the institutional arrangements, and the targets of the enterprises that are candidates for privatization, as if they were operating in a more commercial environment (the use of performance contracts as in Senegal and Gambia may be advisable). The fifth method is setting in motion direct action to achieve the turn round in performance in such obvious areas as marketing, financial management, quality control and so on. Sixth, when these measures show up in performance and profitability, make active plans for divesting -- valuation of the assets, preparation of a company prospectus, investor search, and so on.

The real merit of this procedure is that when divestiture eventually occurs, it is the culmination of a well planned series of necessary reforms, and it has a better chance of producing positive results. LDC governments will usually require outside experts to advise on the preparation of state enterprises for privatization, identifying potential buyers, and structuring deals.

### **Conclusion**

In practice there may be only limited scope for privatization in many developing countries. Transfers from state ownership are likely to be gradual



and confined to a few developing countries well on the way to industrial development, such as Mexico and Turkey, or countries with high levels of domestic savings and with developing capital markets, like South Korea, Taiwan, or Malaysia. But most LDC governments tend to concentrate on restructuring public enterprise and making them more efficient and they see privatization as a second stage to be embarked upon when capital markets are more developed.

Oliver Leaman  
Rothschild

My company has a good deal of experience around the world taking on privatization, not only major privatizations in the UK - I am presently involved in the electricity privatization here which is a £25 billion job - but also in China, Jamaica, Spain, Malaysia, and Singapore to name five out of the fifty fifteen countries. What I really want to tell you is that it is not as easy as it may sound.

The first LDC that I ever ran to this with in terms of privatization was an LDC then known as the UK. We were much less developed then, we needed to be, in fact we were spending a hell of a lot to becoming a properly impoverished nation.

We started, not with a burning protest, not with the well known fact that privatization was not, but even with political will (in fact almost every cabinet minister, with the possible exception of Mr. or Leverage and Sir Geoffrey Howe was at that time arguing about, or opposed the privatization in the UK). Since then I have been lucky enough to deal with privatizations in a number of LDCs and in every instance, not only countries like Singapore. My main observation is that it is an extraordinarily tricky process, one that goes right when you do not expect it to and one that goes wrong when you do not expect it to.

The problems of private sales

What might be thought of as the most difficult kind of privatization is actually probably the easiest namely ways to achieve it the circumstances are right, and that is a public sale.

By concept, it is like a large buy-out, a bought with obstacles. Most people think it is a low risk activity, it is a public sale or enterprise. It is, it is possible perhaps to buy it, it is not too much, but it is not. You have a lot of objections in most LDCs to any of the potential purchasers, most purchasers come from outside and there is a good deal of suspicion about anyone coming from outside and there is a good deal of fear of rich men coming in and being over the system. On the other hand, it is often difficult to persuade anyone from the inside who is rich and powerful to take over the industry in an LDC (even that many of them are not rich and powerful but are powerful and do anything other than run it round by getting rid of all the staff, closing down half the services, and turning the thing into a quite different kind of industry at considerable capital cost).



## PRIVATIZATION IN DEVELOPING COUNTRIES - 3

Oliver Letwin  
Rothschilds

My company has a good deal of experience around the world advising on privatization, not only major privatizations in the UK -- I am presently involved in the electricity privatization here which is a £25 billion item -- but also in Chile, Jamaica, Spain, Malaysia and Singapore to name five out of perhaps fifteen countries. What I mainly want to tell you is that it is not as easy as it may sound.

The first LDC that I ever had to deal with in terms of privatization was an LDC then known as the UK. We were much less developed than we needed to be, in fact we were speedily in 1979 on course to becoming a properly impoverished nation.

We started, not with a booming market, not with the world knowing that privatization worked, not even with political will (in fact almost every cabinet minister, with the possible exception of Nigel Lawson and Sir Geoffrey Howe was at that time anemic about, or opposed to, privatization in the UK). Since then I have been lucky enough to deal with privatizations in a number of LDCs and in newly industrializing countries like Singapore. My main observation is that it is an extraordinarily tricky process, one that goes right when you do not expect it to and one that goes wrong when you do not expect it to.

### The problems of private sales

What might be thought of as the most difficult kind of privatization is actually probably the easiest in many ways to achieve if the circumstances are right, and that is a public offer.

By contrast, a sale to a single buyer is fraught with obstacles. Most people think it is a low risk activity to take a public sector enterprise, identify a suitable person to buy it and sell it to them, but it is not. You face colossal objections in most LDCs to any of the potential purchasers: most purchasers come from outside and there is a good deal of xenophobia almost anywhere. Also, most outside purchasers are rich and powerful and there is a good deal of fear of rich and powerful persons coming in and taking over state assets. On the other hand, it is often difficult in practice to persuade anyone from the outside who is rich and powerful to take on an industry in an LDC (given that many of them are not profit-makers but loss-makers) and do anything other than turn it round by getting rid of half the staff, closing down half the services, and turning the thing into a quite different kind of industry at considerable social cost.



When it comes to the mechanics, it turns out to be very difficult to do a private institutional placing in an LDC. You might think you could identify with ease the institutions that would purchase, then set a price or organize a tender, and end with the institutes buying the shares. But too often what actually happens is that institutional investors gang up. In a small community, they work together and push the price down, so you must either sell at a knockdown price or you give up.

Equally, you might think it easy to sell to a group of employees and managers, a form of privatization successfully engineered in many cases in the UK: you do not need a public offering, you do not need a large capital market, and therefore it should be easier. A few, about 15%, succeed but the rest, about 85%, fail and go bust. That is because a leveraged management buyout is a highly risky enterprise and you cannot persuade the management and employees of most dead duck enterprises to take them over, borrow up to the eyeballs, and run them as highly successful items on the day after privatization.

### THE PUBLIC OFFER MECHANISM

So you are then left with public offers, which have always been thought to be a difficult kind of privatization; but despite the fact that this technique needs sensitivity and imagination, I do not think it is remotely impossible in an LDC. A public offer does not depend on a highly sophisticated capital market structure, and perhaps not even on having a capital market at all.

### Bull and bear markets

Let me dwell on the question of public offers in a period of bear markets and in places where one is faced with highly undeveloped capital markets. In a bull market, you can take a company, advertise its corporate image in the way which we have developed in the UK over a sufficient time, price it cheaply, use all the techniques which have been carefully developed (here, in France, in Japan, and in the United States) for mass marketing. You then discover that there are very large numbers of people who are not stupid, who will spot something going for 80% or 70% of its worth. If a company is properly advertised and properly discounted people will buy it even in an unsophisticated capital market.

But now we are in a bear market and yet the UK government is entering on what must now amount to a £45 billion programme for the sale of the water and electricity industry in the short term, and coal, steel, and rail, in the long term. The same basic logic applies in bull and bear markets! The difference is price: in a sophisticated market like the UK, you have to price lower to account for market risk in a bear market. In an LDC which has no capital market, or where investors are scared of equity, it is necessary to adopt different measures to deal with bear markets. One route which has worked well is to sell bonds priced at normal bond yields, but which give the investor the potential to convert them at an attractive price into shares at a later date. An option to convert a bond which is at normal bond prices into a share at a later date of your choice is an attractive free gift.

It is possible by means like this to provide investors with security against the downside risk, to bring them in on a large scale, and to start a process of popular capitalism even if an LDC during a bear market. The choice of mechanism in an LDC depends on spotting what the real difficulties are, and



then carrying out a privatization in a way that will actually appeal to ordinary individuals and their perception of their own self interest. It is in the end a marketing exercise, it depends on understanding your market, and adapting the product to that market.

### The question of political will

These techniques are not, however, a sufficient condition for success. LDC privatizations, like those everywhere, also need political will. In most of the countries where I have been an observer, but where relatively little has yet happened, the reason is that there is hardly anyone who is willing to take the risk. If anybody in an LDC supposes that it will actually be possible to maintain a sustained privatization programme without risk and without failure, then the best thing is to try something else. There will be risks and there will be failures, and most politicians will be keeping out of sight until there is a success. The reason why some places which have succeeded in privatizing is because there is someone in a strong position who is willing to take the risks.

Is your country actually in the hands of people who will take the risks? If it is not you are wasting a lot of time and effort. If it is, then the next thing you need to do is throw overboard all the common preconceptions about what is easy and what is difficult, and find someone who really knows what they are talking about and who has been through it and got it wrong as well as right, and who will be able to point out the things that do work and the things that do not work.

My guess is that roughly 50% will come off and 50% will not come off. At the end of that process when you look back, as we do now in the UK, at years of the process, you will find people forgetting the bits which did not work -- success has its own momentum. But at the beginning it did not look that way here and it will not look that way to you, and you cannot expect it to.

### A sound record

There have been about 100 privatization programmes in the UK, of which about 80% have succeeded. In the United Kingdom, privatization programmes which have succeeded have raised about £130 billion to the public purse.

A good many of these are large scale, and of the railway, but even large management and enterprise buyouts of parts of nationalized systems (e.g. the financial services industry) will be able to do the same thing and raise substantial sums of money for the government.

It has been a 10-year process, and there is a lot of work to be done, but I think there has been a very significant part of the work done. What has been done is that in 1982, for example, the government decided to privatize, and it has achieved that. It has a lot of work to do, but it has a lot of work to do. It has a lot of work to do, but it has a lot of work to do. It has a lot of work to do, but it has a lot of work to do.



## THE MANAGEMENT BUY-OUT

**Jeremy Seddon**

Director, Barclays de Zoete Wedd

I ought to start by explaining what we actually mean by a management or an employee buyout. Very simply it is a business where the management, or in some few cases, the employee body as a whole, have a significant stake (it need not be a controlling stake) in the enterprise.

### Changing attitudes

Privatization is an economic mould-breaker and buyouts have had only a small part to play in that. But they have in turn broken some moulds themselves.

Take the effect of buy-out opportunities on union attitudes. In the National Freight buyout, the company had 22,000 employees, in centres stretching all over the UK, so there was a very considerable problem in educating the workforce about what we were asking them to do. It was early in the privatization programme. They were doubtful about privatization, without being asked to write a cheque to buy shares and take part in it as well. It was quite some problem. So a great many seminars were organized around the country at which people explained the background of this.

### A sound record

There have been about forty examples of employee buyouts, or management buyouts, in the United Kingdom privatization programme which have contributed in round terms about £500 million to the total proceeds.

A good many of those, and a large amount of the money, has come from management and employee buyouts of parts of National Bus. (I was irked by National Bus because we were advising the company and were prevented from taking equity in any of the resulting companies, which have all been successful!)

It has been a small part in financial terms of the privatization programme, but I think it has been a very significant part politically. When National Freight was privatized in 1982, its success demonstrated to everybody what can be achieved. Indeed, the record of businesses that have been privatized by buyouts in the United Kingdom has been very good overall -- in some cases outstanding -- there have been no failures here.



## THE THEORETICAL BASE

Some of you may not understand fully how buyouts operate, so let me explain how a buyout is actually financed because it has a lot to do with the way that they will operate in future.

### The financial base

The management, or even the employee group as a whole, will probably be able to afford only a relatively small part of the total finance that will be required to buy the business from the government. Because of this, if you are going to give them a large share in the equity, the risk capital base for the business, is going to be quite small. How, therefore, do you fill the gap between the small amount of risk capital available from that group and the sum of money that you must raise to buy the business?

The first answer is that first of all you go to your friendly neighbourhood banker and you borrow as much as you possibly can, but even that, very often, is not enough. So you then go to specialist financial institutions who will provide the remainder in the form of what they call mezzanine finance (the bit in the middle), which is a mixture of loans, preference shares, with an element of equity often added to compensate for the additional risk.

The result is the highly leveraged structure -- an awful lot of debt supporting a relatively small amount of equity. Hence the risk; and there is indeed considerable risk in these businesses.

### The corporate plan

With this in mind, my own organization saw an investment opportunity in National Freight -- which the more that we looked at it, seemed a very satisfactory investment opportunity. We did not look at it as a privatization, but as any other equity investment opportunity; and we subjected the plans of the National Freight management to exactly the sort of intense scrutiny that we would give to anybody else who came in off the street asking to borrow a lot of money from us.

I believe that the only way that you can offset the exceptional financial risk that is involved in a buyout is by having an exceptionally good corporate plan to cope with future risks which may arise and which would hurt the business.

### Pricing policy

There is another element which will impact on the level of risk that is involved in a buyout and that is, of course, setting a price on the enterprise. The more you depress the price the less the leverage, and it certainly the case in this country that we believe that if you are to encourage an employee buyout then the risks must be less even than for a management buyout. There is a reason for that. If you are asking the managers to subscribe the risk capital you are talking to a group of people who, hopefully, understand what the risks are about, understand how the enterprise runs, and understand what they are doing when they are making an investment. Of course, you are probably offering them an exceptional opportunity as well, and one which should be shared more widely, perhaps with all the people who contribute to the enterprise in the form of the workforce as a whole. But if you ask this wider group to invest, you are asking a group of people to take a risk who might not understand its implications -- and not just a risk with their money but a risk



with their jobs. You must make sure that the risk is acceptable, and that will almost certainly involve setting a price for the enterprise that will be less than an outsider bidder might be prepared to pay. However, and National Freight demonstrates this, there are political and commercial advantages from choosing an employee buyout.

The other side of the high risk in buyouts is the very high potential reward, because if a buyout is successful and the debts are repaid, the value of the equity can rise very rapidly. So, for example, for every pound that was invested by an employee of National Freight, that is now worth £56; and another employee buyout in which we have been involved -- a small business sold by the British Steel Corporation some years ago -- every pound invested is worth £20.

### **The problems of success**

There are actually other problems that derive from the very success of this growth in the value of equity. For example, if you are a shareholder in one of these enterprises and you wish to sell your shares, for instance on retirement, or if you get the sack, or choose to leave the company, or even you wish to diversify your wealth, (the average investment in National Freight was £700 so the present holding is a worthwhile sum of money). Further, how do you raise the money to give a share holding to new employees coming in? The answer is that there is a limit to how much you can do. It is impossible to conceive growing the business at such a rate that the number of new employees coming in can afford to buy these valuable shares. So National Freight, Vosper Thorneycroft, and Victaulic, the three largest employee buyouts that have been running for some time, have had to solve this problem by introducing outside institutional shareholders. In the case of National Freight and Vosper Thorneycroft, this has been done through private placements to outside institutions. In the case of Victaulic, by a very successful flotation.

This course of action leads to dilution of the employee shareholding. Success, in other words, contains the seeds of destruction of the original ambitions, both of the seller and of the original investors. It is possible to see devices being used, for example differential voting rights for the outside institutions and for the employees, that will slow down this process. But this is not a perfect solution. There is a conundrum here that we do not have a solution to.

Perhaps buyouts may come to be only bridging transactions between state ownership and another set of owners. That is no bad thing if that period of ownership does something remarkable, as indeed it has in the case of National Freight. When it was bought out it was losing money; since then it has grown and expanded rapidly, and is now a profitable diversified business. Even the government has had something back -- the tax revenues that it has had, have far exceeded the original purchase price for the business.

### **Applying the model**

If there is merit in an employee buyout or a management buyout, it is more likely that it will be found in service industries rather than in heavy industry. In an industry where the majority of the workforce has an interface with a customer, working a little bit harder makes a visible difference. If you are halfway down a steel strip mill, working a little bit harder doesn't actually get you very far and, indeed, could well end up in too much steel ending up in the stockyard. If you are driving a lorry or are a stewardess on an aeroplane, by



being a bit more courteous and efficient you actually do something more for the enterprise collectively. I believe that it is possible that service industries are those which will benefit most from this style of transaction.

Some capital assets may be seen as key national or local government infrastructure investments such as rail and road transport. Nevertheless it would be sad to insulate these sort of businesses from the benefits of privatization, and specifically from the improvements in performance that these (as service industries) might achieve from high employee participation. New options, being explored on a small scale in some LDCs already, such as leasing infrastructure assets to the employee groups that run them, would have a number of positive effects. For example, they would reduce the price, helping the workforce to finance participation in enterprises where growth is hard to foresee. One plausible option is for the owner of an infrastructure asset, the state or the local government, to receive a rent for the assets to provide it with an adequate return, while the employees invest in an operating company so that their rewards are linked to the revenues that can be earned from operating these assets. These might include both direct revenue from customers, and (if it is an enterprise where it is felt that the state should still subsidize it) a subsidy to the operating company to provide the service. There is a wide range of variants that you can see as being possible.

### Conclusion

It must be said that this is not a model free of problems. What happens when the assets come up to be replaced or renewed? What happens if the operating company runs into trouble?

I comfort myself with this thought -- which is that if there were no problems there would not be jobs for people like me. There are both problems and opportunities in conventional buyouts and for this possible new model, but I hope that this very brief survey will at least help to promote novel thinking about them.



## TECHNIQUES FOR PRIVATIZING UTILITIES

**Eric Anstee**

Director of Privatization, Ernst & Whinney

I shall consider several important questions. What utilities are candidates for privatization? What are the special features of selling utility rather than any other concern? What government objectives and benefits are sought in the context of selling a utility?

Then I would also like to spend a short time on looking at the plans for electricity and make some observations as to how far the plans have gone so far.

### The utility candidates in the UK

Let us look firstly at the utility candidates for privatization; the UK has already achieved British Telecom, British Gas, and the main airports. All of these are regarded as utilities and all have some form of regulated market.

Also in progress is the privatization of the Electricity and Water Authorities. The Electricity industry in the UK consists of the twelve distribution companies selling power to domestic and industrial users, and what will be two generating companies once they have been broken up from the existing CEGB. The national transmission system will be placed in a separate company under the control of the distribution side of the industry. There will be two Scottish companies which are joint distribution and generating companies privatized separately in Scotland.

What are the possible future candidates? The first two on my list are railways and coal, recently confirmed by the Chancellor at this conference. The Prime Minister has said that she has no intention at this stage of privatizing the Royal Mail but I think what we will see is a creeping privatization, and parcels and the counter service are obvious targets. We have had a discussion today on the prospects of private capital being introduced into road building and I think we will see a lot more of that; we have already seen the introduction of private capital to a second crossing on the Dartford Tunnel. Some privatization is taking place on the fringes of the health sector, and there has already been some speculation that health laboratories will be pushed into the private sector. Lastly, there are new measures to reform school financing, which must be considered as one of the first stages towards possible privatization of education.



## **SPECIAL FEATURES**

What do the words 'public utility' in this context mean? They mean something useful for the public. I do not propose to discuss the political or economic arguments which exist or whether a utility is something for government to own, finance, and operate. As an advisor in the field of privatization I would like to look at some of the special features I believe arise when governments are considering the privatization of a utility.

### **Full analysis**

One of the requirements that has not received sufficient attention is that you must get a full analysis of the business. In particular in the case of a utility, your examination will look hard for competition and will look at the extent that regulation will be necessary. How much will reorganization of the industry be necessary? How much will the business strategy of that entity need to be changed to react to whatever the proposals of the government are?

How will the shares in the privatized utility be perceived? Utility stocks tend to be thought of as an income stock. Whether they are regarded as for income or growth may depend on an examination and the size of the regulated and non-regulated markets.

### **Tariff reform**

The major thing in privatizing a utility is the re-evaluation of the existing tariffs. Are they adequate to provide commercial returns? Should the tariff continue to be on the same basis? With electricity we have area tariffs according to the geographical area of the distribution companies, but within those areas there is only one domestic tariff. Should there be tariff differentials? Will the process of privatization drive up or drive down general tariff levels?

The reorganization of the utility will require an analysis of the management. We have already seen, particularly in the utilities in the UK, that capital structure changes mean major changes to management and accounting systems which affect the financial function. Similarly there are new skills which will be required elsewhere which will affect general management.

### **The types of regulation**

There are two types of regulation that are generally regarded as appropriate -- price regulation and rate of return regulation.

Looking first at price regulation, there is the problem that you have to find a starting point. Are the tariffs at the right levels? Are they at a reasonable level from which to privatize a utility? Will they provide the right commercial rates of return? The RPI-X% formula requires you to judge the efficiency and cost levels within the organization to assess whether the X factor is at the right level. For electricity, there is also the fuel cost element and the question whether or not there should be full pass-through of those fuel costs or not.

Is price regulation really just an extension of the rate of return on capital basis? At first, it might be. You have to start somewhere and that somewhere could be judging the appropriate rate of return. But if we continue with rate of return regulation, which I believe will be the long term basis of regulation in this country, we must face up to future problems, such as the efficiency in capital spending. One of the ways for the regulator to judge the rate of return



here is to carry out efficiency reviews on the capital spending. How do you protect customer care and service? There can be separate regulatory regimes to cover these issues.

### **The objectives of privatization**

The chief benefits of privatization for a utility must be freedom from government constraints, and I would highlight particularly the investment constraint, decision-making on projects, and expansion into complementary businesses. For example, the British Airports Authority has already announced an expansion into hotels and property -- something that would not be envisaged while it was state controlled.

Another objective is a thorough review of the business, management practices, operations, finances, and markets. Can competition be introduced? In the case of British Telecom, the government licensed Mercury. Improved customer service, is becoming increasingly of concern in the UK.

On a macroeconomic level, widening and deepening share ownership, raising money for central government, and widening the tax base are important issues.

## **ELECTRICITY PRIVATIZATION**

I would like to conclude with a closer look at electricity privatization in the UK to date. What were the major conclusions the government reached in the review of the electricity industry? It was producer dominated inasmuch as the Central Electricity Generating Board was the sole source of supply of electricity; and there was major government influence being exercised over the industry, tariffs set to pass on all costs, no competition, and a single purchaser of new technology.

### **The objectives**

What are the priorities that have been set for the electricity privatization so far? Government wants a customer driven industry, they want competition introduced into generation; the distribution companies will compete, and customers will have the right in the industry so there will be service standards.

What do we look for in a successful privatization? Reduced prices to consumer, productivity gains, improved service standards, higher investment, higher profits, greater diversity, particularly global involvement (and there I would mention British Gas and the success that they have of taking their business overseas), and improved technology.

Cecil Parkinson recently summed it up concisely in the following comments on his plans for electricity:

'Electricity privatization will have the following benefits. To customers -- there will be a downward pressure on prices, there will be rights over the monopoly supplier regarding performance, and there will be rights to be a shareholder. Large customers will have a choice of the supplier by access to the transmission system. The labour force -- there will be a range of employers competing for his services, there will be greater shareholder possibilities for him, he will participate in management, perhaps on the Board, and better



To summarize my presentation I have considered the candidates, the special features of looking at a utility to looking at the government objectives in carrying out the privatization of the utility, and the progress so far on electricity.



## **PRIVATIZING ELECTRICITY**

**Dr Odgers Olsen**  
Ernst & Whinney

### **Selling the utilities**

To sell the utilities, the government must offer a product that is attractive now and in the future. This is a particularly difficult problem because the electric supply industry is a complex industry, and through restructuring it will be even more complex.

### **Fair competition**

The generation company is going to be split into two pieces. The former generation company, the CEGB, used to own and control the transmission grid, but now the transmission grid will be owned by a new company called the National Grid Company (NGC), which in turn will be owned by the twelve distribution boards. Each distribution company's ownership share of NGC is not yet determined, but of course the government must make sure that these very diverse entities are treated in such a way that they all are attractive to the investor. This is difficult for two reasons. The first being that they are interrelated so any decision concerning the generators will affect the distributors. Second, what is good for one is not necessarily good for the others.

We must look to the future of these interrelationships. We cannot set up a structure and a set of costs for generation that tie all utilities to a regime affecting the current rates because new future generation will come from new private sector entities that enter into the generating market with costs lower than those currently being experienced. These existing generation companies must be able to price their product competitively relative to new entrants into the industry.

### **Better information**

In order to make the product attractive, the government must provide adequate information on the economic and regulatory environment so that those who invest will have assurances that this environment will promote commercial viability. This is particularly true since the Monopolies and Merger Commission issued their Report on British Gas. A key item is that in pricing the existing generating units there must be some element that reflects their relative value in the market. That could mean that the existing CEGB assets must reflect something akin to replacement cost after taking into account availability, dispatchability, the efficiency with which the unit can be run, and the security and pricing of the fuel source that is used by a particular



generating unit to provide electricity to the distribution boards and ultimately to the customers.

In order for investors to make wise decisions in distribution companies they must have some assurance that the distributors can make wise decisions with regard to the sources of power that they purchase. This requires the distributors have access to information about generating units. Information concerning the availability dispatchability, efficiency and fuel sources for existing CEGB units, does not seem to be available in any detail to those people who will ultimately have to contract for power. But how can a distributor that is required to contract for generating capacity make decisions as to capacity cost and energy cost he is willing to pay if he has no idea as to what those costs and running efficiencies might be? The distributors who are the buying representative of the customers who have paid and will continue to pay the bills, need access to that type of information.

### **Balance of interests**

In order to sell the electric utilities is it necessary to achieve through legislation and licence the necessary balance between customers, the generators and the distributors.

The tools that the government has available to achieve this necessary balance are the opportunities it can offer the new privatized sector, the competition which it encourages, and the judicious application of regulation. It is going to be a very difficult balance to achieve because of the complex new interrelationships, and because of the knock-on effects: if for example a generation company has severe troubles, the distribution companies that buy power from it would also have trouble and vice versa. Because the electricity supply industry cannot be allowed to fail, it is imperative that this balance be established.

### **Generation issues**

Let us turn to the generation companies. Two generation companies will be successors to the CEGB. In order for these companies to be successful it is clear that their assets and their services must be reasonably priced, consistent with the market. In addition to the cost of the electricity produced, distributors must consider the reliability of the units, and the availability of back-up power for various units.

For the generation companies to be attractive in the marketplace, it is clear that they must be ready and able to step into the second round of competition. It now appears that the generation plant will be allocated in the first instance to the distributors. Hopefully that allocation will reasonably reflect the load shape of each distributor. Once that initial allocation is made the generators must be ready for the second round wherein they will have to compete with the other entities that are able to enter the generating market.

Over time, because of the effect of depreciation, the annual capacity cost of a private generation company will decline. But this is quite a different way to look at capacity cost than what has happened in the past. The method that is reflected in most private company accounts is historical accounting, while the electricity utility so far has used current cost accounting, which generally implies an increase each year in the level of capacity cost. The private sector does not have any particular compelling reason to look at current cost accounting, and if they look at historical accounting they can set a pattern of



charges which decline over time. The successors to the CEGB may well have to compete with that kind of time pattern of cost if they are to be competitive in the market.

### **Making competition work**

The government policy, one of encouraging competition, is a good policy. Here are some of the requirements that are necessary to make sure that that competition does emerge.

Sites must be made available to a number of private companies to locate generating plants. Environmental considerations may delay the emergence of competition if sites are not already approved. The need to meet future growth, and replacement requirements indicate there will be a home for new generation. Fuel for new competitive generation must be available and economically priced. Contracts with distributors will be hard to come by if distributors and their customers are asked to bear all the risk on fuel price variations.

The privatization of the distribution companies creates a fairly significant dilemma for the government. First, the customers have to be protected from monopolies; secondly, the regulation and rules and licences should encourage competition in generation; and finally distributors must be given the opportunity to be viable and grow.

When privatization occurs, one of the hoped-for benefits is that there will be considerable savings in the cost of electricity. The structure and the regulations governing the transactions between the generators and the distribution boards are fundamental to that. If the savings occur and new generators pass savings directly through to large customers, it is then likely that the the benefits will be more or less localized and enjoyed by only one type of customer. If on the other hand the savings that arise from privatization are passed through the distributors first and then reflected in their tariffs, it is likely that that savings will be spread over a much larger base of customers. The distribution of savings associated with efficiency gains through competition will be basically settled by the structure, regulations, and license conditions that are adopted. These same conditions will also affect the success that competition in generation is able to achieve.

This is a policy question, it is not at all clear how the government might move on this, but the distribution of the benefits of privatization is closely related to the way in which regulation and contract procedures between generators and distributors is handled.



## THE EUROTUNNEL EXAMPLE

**Richard Lloyd**

Director of Morgan Grenfell International

### WHAT EUROTUNNEL IS

In 1985 about 48,000,000 people crossed the Channel, and sixty million tonnes of freight. This traffic is expected to double by the year 2003. Eurotunnel is a fixed link across the Channel, being built entirely with private money.

The Eurotunnel system is based on twin rail tunnels and a service tunnel. There will be a choice of through trains or shuttles for both passengers and freight. Passenger through trains will offer all the comfort and convenience of regular direct travel to and from major cities either side of the Channel. With the proposed highspeed network the trains will travel at speeds of up to 185 miles an hour in France. Paris and London will be about three hours apart direct from city centre to city centre, with no need to change trains. Through freight services are expected to cut some current container journey times by up to one third, vastly increasing the volume of freight carried by rail.

Freight and passenger through trains will be run by the national railway companies, paying Eurotunnel for use of its system. The shuttles -- separate services for passenger vehicles and freight -- will be operated by Eurotunnel between its Folkestone and Calais terminals, and also designed to handle over 2,000 vehicles per hour in each direction. There will be no need to book, since there will be space for up to 200 cars per shuttle, at peak times running every twelve minutes or so. Platform to platform, the journey will take about thirty-three minutes at speeds of up to 100 miles per hour -- much quicker overall journey times than either hovercraft or ferry, day and night throughout the year virtually regardless of the weather. The shuttles will run on a loop, and through trains will be networked in with them by sophisticated control systems.

Under the sea, the tunnels will run some 40 metres below the Channel bed, bored mainly through chalk, extensively investigated, and considered ideal for tunnelling.

Ten major contracting names in the UK and France are jointly responsible for building the system. If they complete the tunnels below budget they will share in the savings but they will suffer significant financial penalties if time and cost schedules are not met. Laser-directed drilling machines will bore the main tunnels at a planned average rate of half a kilometer per month. Working from both sides of the Channel they are scheduled to rendezvous beneath the sea in 1991.



## Political concessions

The political decision has been taken, the Channel Tunnel Act has been passed by Parliament, the Treaty has been ratified, the concession is in force committing the government to a privately run system giving Eurotunnel the go-ahead. Loan finance of £5000 million and equity of around £1,000 million, has been arranged; including a public share issue. Not a penny of public money is going into Eurotunnel. Eurotunnel has the same commercial freedom as any other company, setting its own prices without special government price controls.

Eurotunnel effectively has the right of first refusal to build a second link up to 2010.

The government will not facilitate another fixed link built by a competitor to operate before 2020 -- 27 years after Eurotunnel is scheduled to open -- and then only if it is also totally privately financed. Eurotunnel's concession has a term of 55 years expiring in 2042.

## FUNDING THE PROJECT

Last year at the first Adam Smith Institute Conference on privatization, John Redwood summed up his approach to privatization. He said: 'If you want to do it you can; it is good for your wealth, and it is good for your economic health'. He then spelt out a few rules, including this one: 'If you get long faced bankers or brokers worrying you about market capacity I have one simple recommendation -- sack them and find someone who will deliver the goods'.

Finding private finance for infrastructure projects needs that very same positive approach, though you may have to be just a little more patient with your advisers because it is a little more difficult to put private money and private management into the big projects that for many generations have been financed and operated by governments.

In addition to Eurotunnel, we have been involved with a variety of infrastructure and privatization projects. One that is in progress at the moment is financing a 800 kilometre toll road to be privately operated in Malaysia. But the Channel tunnel is far and away the biggest of them all, and unlike far too many such projects this one is actually going ahead -- the money has been raised and Eurotunnel is now burrowing its way from both countries towards the centre of the Channel.

At the end of the concession period, the tunnel will be handed back to the British and French governments. But much more important, the project is going to be constructed, operated, and maintained by the private sector, bearing the full commercial risk; and the financing is entirely private.

## Finding the finance

We were fortunate enough to be one of the two original advisors, together with Flemings, and we were later joined by Warburgs and a team from France.

The financing was in several phases. The first was called the Pre-mandate Phase and lasted nearly a year, ending in January 1986. During that time



## **The key factors**

So what were the key factors in making a success of this very large financing?

Many of them, as I said at the beginning, come down to nerve and commitment.

As recently as 1984, major banks and leading financial journals were saying that the project could only be financed with a government guarantee. For nearly two hundred years people had been sceptical about this project. There have been dozens of studies and many false starts.

To make matters even more difficult, the month before the all-important equity offer (on which the loans also depended), the crash of Black Monday hit the world's stockmarkets. After the strong bull market that had sustained all the successful British and French privatizations, the markets plunged dramatically -- by 35 per cent in London in a month. But the financing did go ahead as planned.

The first key factor, vital to success, was political commitment -- both Mrs Thatcher and President Mitterand enthusiastically backed the project. Clearly, political will has to be the starting point of any privatization.

Second, despite Black Monday, equity investors were ready -- after suitable persuasion -- to take long-term risk. And the highly successful British privatization programme had shown that financing on this scale was possible. Before the revolution in investors' attitudes, brought about by the privatization of Telecom and the rest, such a large issue for a new venture would have been highly suspect.

The third factor was the nature of the project and the management team running it. Here again nerve and commitment were vital -- not least that of Eurotunnel's co-Chairman, Alastair Morton. But the project itself is a very good one -- and allied to this is a very strong team of contractors, with excellent records and reputations. In a project like this, the banks and investors will insist on only the strongest, most successful and technically competent contractors.

Finally there was a credible and thorough financing plan. This was vital for two reasons. It helped to win the concession against some extremely strong opponents and it helped to get the commitment necessary from the lenders and investors. The plan had to be immensely detailed: it had to take into account the complicated -- and sometimes conflicting -- needs of different stock exchanges, different tax regimes and legal systems, and out of all this provide adequate security for the lenders. But it worked.

## **Other projects**

Of course not all build-operate-transfer or other infrastructure projects will have all the advantages of Eurotunnel. In particular, there is the element of the financing risk where Eurotunnel had a major advantage. In Eurotunnel's case the cash flow is in hard currency -- like the currency of debt service. This is a valuable benefit, which is generally not available to infrastructure projects in developing countries.

Pakistan is one example. At the moment, we have the job of coordinating the finance for two privately financed power stations there. There is also the toll



road in Malaysia which I mentioned earlier. Both these projects will earn local currency and both will have to repay foreign loans. Some government support or guarantee therefore is essential.

However, the necessity of some government support does not mean there is no scope for the private operator; these kinds of projects can bring with them some of the other major benefits of privatization. The benefits include additional private sector finance, or private management, or both. Private management, rewarded partly by its success in operating the completed project, is likely to be more efficient than management by a government department. There may well be cases when the more efficient management is more than sufficient to justify the private operator's involvement, even in the absence of cheaper or additional money.

In the case of Pakistan, private sector financing (including local and foreign equity) is unlocking a World Bank loan that is only available for privately financed projects. The principal investors will construct the power stations and their reward will be dependent on good management and good maintenance. Once the power stations have been paid for, the investors will hand them over to the government.

A further example of private management is a large power station in China, half-owned by outside investors. It was built in 22 months, nearly a year ahead of schedule.

Clearly, as governments reduce their roles to those of governing, they are finding more and more ways to hand over to the private sector the financing and management of many different kinds of enterprise. The financing of Eurotunnel shows that the money can be raised in very large quantities for an infrastructure project. I am fully confident that Eurotunnel's management will successfully compete for, and win, the necessary traffic to make the operation -- as well as the financing -- a great success. We are hoping for -- and expecting -- success in other countries and with other types of projects.



## PRIVATE FINANCE OF INFRASTRUCTURE - THE ISSUES

**George Muir**

Director of Morgan Grenfell International

I would like to focus on what the strengths of the private sector are and what it can bring to infrastructure projects. Why, and in what circumstances it can assist in the provision of these projects.

Quite clearly, roads, bridges, tunnels, and power stations, can be built by governments; indeed they very often are. So why should you involve the private sector at all?

I see two principal contributions the private sector can make.

First is management and motivation. I do not want to suggest that public sector management is inherently less skilled or less dedicated than management in the private sector, but it is different; the combination of management expertise and the profit motive makes the difference.

Then there is money. Money can be important in different ways. Sometimes what is important to governments is the risk capital which the private sector can bring to bare but sometimes governments simply have a limited access to funds of any kind and a private sector project can increase the pool of funds available. In other cases the government may want to find a way for the beneficiaries of an expensive project to pay for it directly.

There will remain some projects which cannot be structured so as to introduce risk capital and where the distinctive combination of management and profit motive is not so relevant. These projects are best carried out in the public sector, often through a conventional design and build construction contract.

On the other hand there is a proposal by a British company, APCL, to build, own, and operate a power station in Northern Ireland, it would involve significant capital as well as management expertise and motivation. But APCL has not had to take a commercial view of the market for the electric power. This is a risk being taken by the Northern Ireland electric utility. If the project goes ahead the utility will contract to buy all the power delivered by the APCL power station. In this respect the project is different from Eurotunnel, which had to take market risk in deciding whether enough people would want to use its tunnel. Eurotunnel clearly involved a substantial element of risk capital, considerable management expertise, and intense motivation.

The challenge for those responsible for infrastructure projects is to devise a concession agreement or management contract which will properly harness



private sector money and skills.

Close to the heart of an infrastructure project will lie a large bank loan, but at the very heart of the project there will be a concession agreement; that agreement will not be easy to negotiate. Firstly, concession agreements often have to look many years ahead, because of the long duration and high capital costs of infrastructure projects, and this creates its own problems. Secondly, governments often want to pass more risks to the private sector sponsors than the sponsors can properly handle. Foreign exchange risk and interest-rate risks are particularly difficult for private sector sponsors to handle. Thirdly, there are often conflicts between the sponsors of the project, who are often contractors, and the lending banks, and indeed equity investors.

If it is possible to pass market risk on to the sponsors then the concession agreement will tend to flow in a fairly straightforward and natural way. If it turns out that it is not possible to pass market risk on, then there are many more difficulties, many more choices that have to be made, and greater clarification needed about people's objectives. In those circumstances I would strongly recommend both governments and sponsors to set clear and realistic objectives for what they are expecting from the private sector.

### **Practical difficulties**

The first problem in creating a project is how to make it an identifiable unit with its own cost and management. The second problem is how to devise a sensible method of charging, how to create an adequate revenue stream. River crossings lend themselves to privatization: they are identifiable and you can create a revenue stream by charging tolls. On the other hand, privately financed roads, particularly in a crowded country like Britain, are more difficult; although in large, less densely populated countries toll roads can make a lot more sense.

Ports and hospitals are identifiable and require management which is responsive to customer needs, but in many cases it can be difficult to create an adequate and sensible revenue stream.

Power stations can be built in the private sector, they are identifiable and you can create a revenue stream, and to this extent they are a particularly sensible type of project to pass over to private sector sponsors, and this we see in a number of countries around the world.

However, you cannot easily pass market risk to sponsors of a single power station. The greatest benefits tend to arise when the entire system is formed into a company and its shares sold to the public sector. In this way, responsibility can be passed on to private sector investors. The same is true of telephone networks, and airlines. While governments may wish to establish the overall strategy, it is the market, not government, which should decide in detail what sort of telephone network, what sort of airline, and what sort of electricity industry a country should have.