THE MECHANICS OF PRIVATIZATION

Edited by Eamonn Butler
THE MECHANICS OF PRIVATIZATION
Acknowledgements

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A note on context

The views expressed in this publication are those of the author and do not necessarily reflect those of the publisher or copyright owner. They have been prepared in their original form and are presented as 'Public services are never better performed than when their reward comes only in consequence of their being performed, and is proportioned to the diligence employed in performing them.' Adapted from a speech prepared for the London Conference on Privatisation in 1987. Some circumstances may have changed, stock prices have altered, but the principle remains.

Adam Smith, The Wealth of Nations, p.678

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A note on content

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With the exception of Chapter 7, these papers were prepared for the London Conference on Privatization in 1987. Some circumstances may have changed, stock prices have altered, and additional services have been privatized.

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Foreword

Nowhere does there exist a greater concentration of expertise on privatization than in the United Kingdom. The privatization programme in the UK started before those of other countries, and has included government companies and services that are larger and more diverse than anywhere else.

Indeed, British merchant banks, marketing agencies, policy analysts, and other institutions now have so much knowledge about how to make privatization work that their advice is one of the UK's most thriving export industries! The whole world, it seems -- whatever the prevailing political colour -- wants to know how to reap the benefits of privatization.

It was to assemble the best of this expertise that in July 1987 the Adam Smith Institute sponsored the first London Conference on Privatization, from which most of the papers in the report derive. Over 100 finance ministers, businesspeople, and other delegates from all over the world came to learn for themselves something of the mechanics of privatization.

In the intervening period, the sudden decline and continued nervousness in the international stock exchanges has made some people wonder whether the public's enthusiasm for privatization issues can persist. However, the signs remain good: the shares of privatized companies in the UK are still outperforming the market as their management is nourished by the new disciplines of private ownership; and there remain plenty of techniques that can make the transfer of public services to the private sector without the need for stock market floatations. For example, the paper by Dr Madsen Pirie, written specially for this report in February 1988, explains the 'unsung story' of management buyouts.

It is clear that privatization, using all of the twenty or more different approaches that are available, will continue to sweep the world. If done well, it produces better management, greater efficiency, better service for the customer, a spread of ownership from governments to the people -- and large measure of political popularity into the bargain. This report provides policymakers in all countries with a manual to help them understand the mechanics of this important process.

Dr Eamonn Butler
Director, Adam Smith Institute
THE BENEFITS OF PRIVATIZATION: AN OVERVIEW

Rt Hon Norman Lamont MP
Financial Secretary to the Treasury

It is a very great pleasure to come to an international conference on privatization. Many is the time I have made speeches about how privatization is now sweeping the world from Canada to Spain, from Sri Lanka to Bangladesh; but never did I think I'd speak at a meeting where I think all those countries, or certainly three-quarters of them, are represented.

I should like today to address my remarks principally towards the theme of privatization as a means of widening the ownership of capital.

THE OPPORTUNITY FOR IMPROVEMENT

However, I would like to take as the agreed starting point what I think must be common ground, that all over the world state control of nationalized industries simply hasn't worked out as the proponents had originally hoped. That I think is a very common experience and it is one that is held by developing countries as much as by advanced industrialized countries. The former have learnt that the great hopes held out for state control have not always been achieved and have brought tremendous problems -- budgetary problems and ever-increasing state support. The dead hand of bureaucracy and a complacent insulation from the realities of the marketplace has crushed enterprise and efficiency and led these industries to become a growing burden on the taxpayer.

It is in the face of this insidious decline that we have operated a new policy: a policy to transfer businesses to private sector ownership or, where this is inappropriate, to demand that they become successful businesses within the public sector. But making something a successful business within the public sector is merely a first step towards returning it to the private sector, and certainly as far as the trading public sector in this country is concerned, I can see no reason why, ultimately, everything that is in the trading sector shouldn't be returned to the private sector.

The driving force behind privatization policy is twofold. First, to ensure that the industries themselves are run more efficiently to the benefit of consumers; and second (and this is the point I want to concentrate on) to give individuals a direct stake in the industrial future of their country.

Some achievements

But before I come on to the more theoretical case for transferring capital
ownership of the state industries from the public to the private sector, I should just like to refer to some of the achievements of our privatization programme in this country so far. One thing we notice is that there is a great deal of publicity at the time that companies are privatized and their record and history in the public sector are closely scrutinized, but after they have moved from the public to the private sector, often they fade away. Perhaps this is because good news is no news; perhaps it is because at this stage in the privatization programme we've come to take it for granted that privatized again do better in the private sector.

I'd like just to mention two examples of successful privatized companies. The National Freight Corporation was privatized in 1982. Their profits last year was seven times those achieved in 1982. A rising proportion of the workforce, now no less than two-thirds, own shares. A number of employees now have a capital stake worth probably several hundred thousand pounds. Those who work in the company, with small, large, and medium-size stakes, all have seen very substantial capital appreciation, such has been the performance of the company. The valuation of the shares has gone up a remarkable forty-six times.

Car manufacturing is an industry with a troubled past in this country and one of the companies that has been privatized is of course Jaguar. Although its profits were roughly stable last year compared with 1985, they were still one-third higher than in 1984, the year that privatization took place. Output last year was at record levels and investment was up some 64%. One of the great prizes of Jaguar's turnaround has been an increase in jobs; they have taken on another 2,000 people since privatization. The Chairman recently reported his confidence about the future and how the company was now intending to invest, compared with turnover, much larger percentage sums of money that it believed were going to make it much more competitive in the world marketplace.

In all, since 1979, we have privatized fifteen major businesses which include British Airways, British Telecom, and British Gas. About 650,000 jobs have gone to the private sector and the state-owned sector of industry has been reduced by more that a third since 1979.

Tendering programme

I'd like also to draw attention to another important development which has gone in tandem with the privatization programme and which has particular relevance to the non-trading sector, that is competitive tendering.

In the National Health Service, where competitive tendering has focused on domestic, catering, and laundry services, savings of about £93,000,000 per year have been generated from a budget of about one billion. Some of these savings have come from in-house organizations becoming more efficient and cost-effective. All these savings are kept by health authorities and can be used to provide better services for patients.

We are going to require local authorities in this country to put six services out to competitive tender -- refuse collection, catering, street cleaning, building, cleaning vehicle maintenance, and ground maintenance. There will be powers to require local authorities to put more services out to tender in later years.

The aim of the legislation is to ensure that the taxpayer receives value for
money by allowing private firms to compete for business with in-house organizations. Local authorities will be required to evaluate bids fairly, and if they don't, the Secretary of State has the powers to prevent the services merely being kept in-house. Obviously there would be no point in requiring local authorities out to tender if they could ignore the competitive bids or insert irrelevant clauses into contracts to further political aims. We have designed the legislation very precisely to prevent these manouvurengs, which can sometimes reach quite ingenious lengths.

POPULAR CAPITALISM

So this is our programme of privatization, liberalization, and competition; but as I said, what I particularly wanted to emphasize is the expansion of capital ownership -- popular capitalism.

Privatization does, in my opinion, make sense in terms of industrial logic returning the companies to the competitive sector, often where they came from originally. But it is not possible to understand the momentum behind privatization or the political attraction that it has in this country, without seeing it in the context of the government's commitment to extending individual ownership. Privatization is only a part, albeit a critical one, of our campaign to create popular capitalism.

Power to the individual

If I had to chose one single belief that has motivated our approach across the whole range of policy, economic and social, it's the belief that we should give back to people the power to make decisions about their own lives. Ordinary people want that responsibility; they want to work to achieve things for themselves rather than to rely upon the state. One of the things that strike politicians most remarkably on the doorstep today, is how this philosophy really is finding an echo among the public of this country and particularly, among sections of the public who in the past might have been expected to support socialist parties. When I go down to some of the poorer council estates of my constituency, there I find a great new enthusiasm for the Conservative Party, a large part of which relates to privatization. People who might be lorry drivers or people working on the road have bought shares in privatized companies and are very enthusiastic about what has been achieved.

Wider home ownership: This policy, of course, was building on something we'd already done with housing, because we gave council-house tenants the opportunity to buy their own homes some years ago. That is a process that has revolutionized home ownership in this country. Over one million council houses have been sold. Over one million people now take pride in their homes and know that their fate as regards maintenance, their responsibility for looking after their houses, is in their hands.

Wider share ownership: Similarly, share ownership, along with the growth in pension ownership through personal pensions, is something that is now happening more and more, all part of the move towards the wider dispersal of wealth and property in this country. We intend now to make share ownership the major part of this advance in the future. Just as home owners take pride and interest in what they own, so a new crop of shareowners will take pride and interest in British industry. Watching the performance of companies gives ordinary investors an insight into how companies work, into the process of
wealth creation, and into the need for efficient and profitable companies if our economic policies are going to succeed and the country prosper. Extending share ownership both gives people a stake in the success of British industry and contributes to that success by helping ordinary investors to understand their own role in the process of wealth creation. Popular capitalism can therefore be a potent force in breaking down artificial barriers between owners and employees, barriers that have dogged this country and industrial relations for many years.

**Employee shareholders:** The encouragement of employee share ownership is another particular area where we have concentrated a lot of effort. We have taken measures towards this in seven out of the last eight budgets. We have substantially improved the terms of the employee share schemes that we inherited and we have introduced two further schemes. There has been a very considerable response from industry and I am sure that will continue. There are now some 1,300 all-employee schemes (that is, of course, where 100% of the labour force in the company are involved in the share scheme) now in place. When we came to power in 1979 there were only a handful. On top of that, a million and a half employees now have direct interest in the success of their company as a result of these schemes and those numbers are growing.

**The results:** Taken together, these measures have changed the face of share ownership in this country.

**The individual as owner**

I would like to turn now from employee share schemes to individual share ownership as a whole. In 1979 individual share ownership stood at three million and seemed to be set for an irreversible decline. By the beginning of 1987 eight and a half million people owned shares -- a threefold increase since 1979. One in five of the adult population now has a direct stake in British industry. If I had to chose a statistic that I think summed up the Thatcher years it is that. The number of people owning shares in British industry is not much less now than the number of people who belong to trade unions.

Over three and a half million first time shareholders have been attracted by privatization and over a million by employee share schemes. Indeed, the level of share ownership in the UK is fast approaching that in the US, where 25% of the total population own shares, or unit trusts.

Are we reaching the limits of individual share ownership in this country? I don’t think so. Our aim must be that owning shares should be as common as owning a house or having a bank account or a building society account; and by that standard we have a long way to go. We will continue to use the privatization programme as a means to achieving it. But we don’t need just to increase the number of shareholders, we also have to ensure that those people who have become shareholders as a result of the privatization programme now become regular investors in the shares of British companies.

We have introduced a number of schemes to try to bring that about. A year ago the Chancellor introduced a scheme called our Personal Equity Plan. This provides a uniquely simple and attractive way for investors to buy shares in a range of the most successful companies. The Scheme allows investors to build up accumulations of shares on a tax-free basis year by year up to £2,400 a year; and provided they hold those for a minimum period then at the end of
that period their holding is free of all Income Tax and all Capital Gains Tax.

Since the Scheme into effect in January this year, we have had an encouraging response. Personal Equity Plans have been taken out at the rate of a thousand a day in the first five months. I think that this is only the beginning. More and more investors will take out Personal Equity Plans as the message spreads and the message is that investing in shares is for everyone, not just the privileged few.

INDUSTRIAL EFFICIENCY

Perhaps I could turn now to the opportunity for increased efficiency in the companies which have been privatized. We are convinced that companies will prosper in the private sector away from the interference of government. Improved performance comes from freedom from political and bureaucratic interference and the ability to respond flexibly to the needs of customers in the marketplace.

This increased efficiency can come about through competition or in other ways. Privatized companies also have access to capital markets which they don’t have when they are in the state sector, which means that funding is available for worthwhile projects; there is the discipline of competition offered by other companies and the test of the marketplace; there are more incentives for both management and employees when they themselves profit by means of increased dividends and share values.

Monopoly or competition?

Perhaps I could say a word about state monopolies because some who favour privatization in general may have reservations about privatizing large companies as monopolies. The privatized utilities, such as British Telecom and British Gas, are exposed to limited, but by no means non-existent, competition. Where competition can exist it is extremely important that one should work hard to create the opportunity for competition to occur.

The extension of privatization to industries which were previously state-run monopolies has been accompanied by the introduction of tough and transparent regulatory arrangements which are designed to give full protection to consumers while allowing and enforcing private-sector standards of efficiency in management. This is in addition to the liberalizing measures which have been introduced. Telecom and Gas operate under licences which contain both explicit and detailed provisions to protect the interests of the consumers. These provisions are enforced by regulatory bodies, respectively OFTEL, the Office of Telecommunications and OFGAS, the Office of Gas Supply, which may back up the provisions with orders that are enforceable in the courts.

The Director Generals of these regulatory agencies are independent of government and where possible, each has a duty to promote or ensure competition. Before we privatized British Telecom, we did a considerable amount to open up the whole telecommunications industry to competition, both at the user end but also at the transmission end as well. There the second major operator, Mercury, has been licensed and can interconnect to BT’s network and provide a rival service. In Gas, similar arrangements are available for BGC’s grid and storage facilities.
In addition, certain important non-commercial duties are prescribed. BT, for example, is obliged to provide certain public services including rural call boxes. In those areas where the utility businesses are subject only to limited competition, the main regulatory mechanism which we have applied is a price control formula. This offers direct protection and benefit for all customers: price increases of the main services are restricted.

These arrangements, a combination of liberalization and regulation, provide a framework for protecting the interests of the customers of these utilities. I think it is fair to say that our approach in the regulation of utilities has attracted a lot of interest from other countries and is seen as an alternative to the present systems of utility control operating in many other parts of the world. This is because licences, coupled with price control, confer assured and observable benefits to the customer where competition is limited, while also encouraging efficiency.

THE FUTURE

I'd like just to say a word about our intentions for the future. From April, 1988, the Government is free to sell its remaining holding in BT, though we haven't made a decision yet to do that. We've made it clear that our Intention is to privatize two major utilities within the next few years. Those are electricity and water, and I don't think anybody should underestimate the magnitude and the complexity, both in terms of legislation and operationally, of turning both those industries into private-sector utilities.

Perhaps I could just deal first with water. It is our intention to return both the water and sewerage functions to the private sector while retaining the responsibilities for environmental and regulatory matters in the public sector through a new National Rivers Authority. It will be responsible for many of the environmental questions on reservoirs and rivers, including things like fishing rights. But we believe that privatization of the Water Authorities will benefit customers, employees, and the nation as a whole. And again the authorities will be freed from government controls over their financing which has been a sore point with the water industry.

We have also made clear our intention to privatize the Electricity industry which again is a massive industry and a massive opportunity for wider share ownership. Again the questions here, about the structure of the industry, and what the scope is for competition, are both extremely sensitive issues and ones that demand an enormous amount of work.

Learning the lessons

Even a brief consideration of our planned privatization shows there are no blueprints. Every single one is different. If I were asked to give advice to a country embarking on its own privatization programme, I would say just two things. The first is to look very closely at the state of the company or industry to be privatized. A frequent effect of state control is that the businesses take rather longer to get ready for privatization than one hopes or imagines. Bringing new management and restructuring the finances of these businesses is often essential before any form of sale can be completed.

My second piece of advice is that it is very necessary to get the best financial advice available. We are fortunate to have a very considerable body of experience in the City of London in handling privatizations and, perhaps what
is more Important, in handling successful privatizations.

QUESTIONS AND DISCUSSION

George Newfelt (Coopers & Lybrand, Canada): What incentives, if any, are you providing to the state employees affected by the activities being contracted out in the Health Service?

Norman Lamont MP: There are no incentives comparable to the share incentives that we can give to people when a company is floated on the Stock Exchange, and obviously the two situations are very different. This is one of the problems, of course: the privatization of the services is often very strongly opposed by those who sense that there is a threat to their jobs -- which indeed there is, if those jobs are not being done efficiently. Our consideration is to get the best value for money and to get better service, because there is no doubt that there are enormous inefficiencies in some of these services. What we do ensure, however, is that the in-house workforce are always given the chance to tender for the services themselves. It is very important that they should have that opportunity to carry on providing the service, subject to competition.

Wendell Cox (United States): Could you comment on the experience of deregulation of public transport of services outside London, with particular emphasis on the impact of the consumers of those public transport services?

Norman Lamont MP: It is very early days, and we only have a very limited experience of it but I think the experience has been favourable. Certainly, the public reaction has been much better than the critics had expected. What is remarkable about the privatization and deregulation has been the number of management buy-outs that we had. We decided not to privatize the National Bus company as one entity. (Whenever one privatizes a state monopoly the management always tell one you've got to privatize it as one company: it can't be split up, no-one will buy it, the unions won't wear it, it has all sorts of diseconomies if you split it up, and so on.) I think that is an argument that is highly suspect, and with National Bus, we decided that we would split it up. Many of its constituent parts were attractive for management buy-outs, and we have succeeded in selling tens of these individual bus companies. This has been, I think, a very considerable achievement.

Deregulation has also worked well. Again, it is early days but my impression is that bus services now are more tailored to the needs of the consumer. There are fewer large but empty buses going around, and more smaller buses, some of them providing services where before there were no bus services at all. In that sense you have got services that are more tailored to the needs of the consumer.

In London, buses are not deregulated but we have taken a first step whereby some services within London Transport have been put out to tender, though not deregulated in the sense that there are still the old routes and one operator per route. The degree of direct competition is very limited: it's on the old regulatory basis. But even there, putting it out to tender has brought about, in my opinion, improvements in services even within London.

Luis Llobia (Spain): What do you anticipate the reaction of the new shareholders will be when the prices of their shares go down, as sometime they must eventually do?
Norman Lamont MP: All we can do is to emphasize to investors exactly what is emphasized with any mutual fund or any unit trust, the uncertainty of future market conditions and the volatility of share prices. But I think that all the utilities that we have on the launching pad are ones that have a very good future in this country.

Dr Madsen Pirie: Perhaps I could add (not being subject to the same restraints as the Minister) that the privatization issues since 1979 have overwhelmingly outperformed the market.

Question: One of the main arguments against privatization in the developing world is that it leads to substantial increase in prices. In the case of the National Freight Corporation, for instance, where the profitability has increased by sevenfold, was that due to higher prices being charged by the company?

And on a second point, does your policy differentiate between the nationals and foreigners as regards share ownership and maximum holdings?

Norman Lamont MP: On prices, I see no reason why there should be price increases when a company is transferred from the public to the private sector unless these state organizations have been pricing in an uneconomic way. If you wish to maintain uneconomic pricing as an objective of policy, obviously you can't do it in the private sector unless you do it directly by subsidy, but I am not sure that that is a wise policy to follow. Indeed, some would argue that it is due to the realities of the marketplace and real pricing that the proper use of resources is promoted when companies are transferred into the private sector.

It isn't generally the experience that companies that are put to the private sector then put up their prices. That has not been the experience of BT in this country; in some respects, the pressure of competition from Mercury and others has forced it to shave its prices. In gas, we have seen a big reduction in gas prices, partly due to energy market conditions but partly due to privatization. I don't regard pricing as an argument against privatization but that does depend on the policy objective you have.

Your second question was about ownership and restrictions on ownership. Obviously, in companies that have a defence role or a potential defence role, we do take measures to ensure that the control of the company is going to remain within this country. Our warship yards have been privatized. for example, and we have, of course, sold them to British companies and have restrictions on further sales. The Government would be involved in any decision if the existing owners wanted to transfer the assets to another country.

Sometimes we have restricted ownership by means of the Government retaining a Golden Share in the company which gives it a say in any change in the Articles of Association. It is the Articles of Association of the company that can give one some degree of control in those areas. By and large, we don't wish to have such control except where there is a direct defence interest.

Dr Shabrawi (Egypt): There are two critical concepts that you mentioned in the beginning of your speech. The word 'privatization' or the concept of privatization may be appealing or acceptable within a democratic society but in the Third World the word 'privatization' may be associated with denationalization and people may put a bad interpretation on the word.
The second issue, which is very critical, is the successful management and transformation from state ownership to popular ownership. There is a very critical shortage of management in the Third World; what do you recommend in order to get over this problem, especially if we have vested interest groups that have been capitalizing on public ownership?

Norman Lamont MP: I agree it's a rather an ugly word for a good thing but I have been on the search for another word and haven't had much luck.

The second point you made was about management. Yes, management is absolutely crucial to privatization and you asked what a developing country which might have limitations on management could do.

There were times when we felt that we had limitations on good management in this country, certainly in the public sector. I think the important thing is that businesses should be run by businessmen and not by retired politicians, generals, or civil servants. Also I would say that management is an international skill. I don't think that one should be bashful or reluctant to employ the best talents anywhere available in the world. We caused a certain amount of controversy by appointing a South African to run our motor industry, an American (originally from Scotland) to run our steel industry, and a Canadian to run our shipbuilding industry. However, I think the results showed that it was worth it.

Those people not only made a marvellous job of running the companies, but they also imparted much in the way of skills to other people and they did a tremendous job in developing a career structure. One of the important things that we said to them was that your job is not only to turn this industry around, it is also to find your successors and to have a management team in place. I don't think one should be worried even about paying very large salaries to people in order to get that one man in the world who can turn an industry around and put a good team in place when he leaves. It's a price well worth paying.

Question: In the macro-economic background, how would you rate the control of inflation, vis-a-vis privatization? Would you consider the improvement in efficiency more important than the reduction in public sector borrowing requirement that it brings?

Norman Lamont MP: I think that the significance of privatization in macro-economic terms is two-fold. One is the increased efficiency and that is often underestimated. The size of the public sector in most countries may represent typically 30% or 40% of GDP, so a small improvement in the efficiency of such a large part of the economy is very significant in overall terms.

The second significance in macro-economic terms is the reduction in subsidy in public spending, and therefore in taxes. The effects of that on personal incentives and job-creation are clear enough.
ORGANIZING A PRIVATIZATION PROGRAMME

Gerry Grimstone
Director, Schroders and former Assistant Secretary, HM Treasury

When the Conservative Government, led by Margaret Thatcher, came to power in 1979, the state-owned industrial sector in Britain accounted for just over 10% of the country's gross domestic product. Nationalized industries employed around one and three-quarter million people and they dominated the transport, energy, communications, steel, and shipbuilding sectors of the British economy.

Eight years later, nearly half of the previously state owned industrial sector has been privatized. More that twenty thousand million pounds has been raised for the Exchequer. Over six hundred thousand workers have been moved to the private sector and the proportion of people in Britain who own shares has more than trebled.

So what is the background to privatization in Britain and its relevance to other countries? What objectives have been followed? How was the programme organized and implemented and what has been its impact on capital markets?

Whether or not the British approach carries any pointers for your own country is for yourselves to decide. What cannot be denied, however, is that privatization has proved a vastly more popular success in Britain and elsewhere that its originators expected. To date, it has had a startling effect on the performance of the companies which have been privatized, on the capital market, and on the overall economy.

THE HISTORICAL BACKGROUND

In order to understand the development of the British privatization programme and how it is organized, it is important to appreciate the historical background.

The hope of nationalization

The nationalized sector in Britain was largely created forty years ago. If the Cabinet Papers of that period are examined, it will be seen that the industries' founders had very high hopes for their progeny. It was believed that bringing industries into state ownership would imbue management and employees with a sense of the public good. It was thought that productivity and efficiency would increase and that wage demand and price increases would be moderated.

Because of this belief within the United Kingdom, the industries were given a
surprisingly light legal framework in which to operate. It was generally thought sufficient to provide for a body of good men and true to run the industries, to place some overall controls on borrowing and investment and to require the industries to break even, taking one year with another. If the theories had worked, it is clear that nationalization would have been a startling success in Britain.

**Practical results**

However, in practice, the performance of British nationalized industries, like others elsewhere in the world, was generally disappointing. Criticisms were continually voiced about their low return on capital employed; their record on prices, productivity, and manpower costs; and about the low level of customer satisfaction that they provided.

The reasons for these shortcomings are complex. In may cases it can be seen that the fault lay not with the management and the workers of the industry but with the system. The industries were continually open to political and bureaucratic interference. Social and commercial objectives became confused to the detriment of both. The industries finances were underwritten by the Government and it became clear that success was not necessary for the industries to survive.

As it became apparent during the 1950s and 1960s that the industries could not be left to their own devices, a generally non-political bipartisan approach to control developed. The light legal framework was supplemented stage by stage by an increasingly stringent administrative control framework. By 1978/79 there was a whole panoply of investment approvals, financial targets, performance aims, financing limits and so on. The effect of this framework was to create a set of external stimuli that tried to provide pressures, similar to that normally provided by market mechanisms.

**The re-think**

When Mrs Thatcher’s Government came to power in 1979 their starting point was that no bureaucratically operated market could ever be as effective as the real market when it came to stimulating efficiency. They took the view that the only long-term way to improve the efficiency of the industries was to subject them to the rigours of the marketplace, and this implied privatization, deregulation, reduction of monopoly, and increased competition. The driving force for the programme in its early days was thus basically economic and directed at improving efficiency. I think you have to understand that to realize how the programme has developed subsequently.

There has certainly been some change in objectives since 1979, particularly the greater emphasis on promoting popular capitalism and ownership, but the original rationale for the programme was one of improving efficiency has been maintained.

By July, 1981, having been in power then for two years, the UK Government’s position on privatization, like a number of countries elsewhere in the world today, was that it was desirable but very difficult. This is shown rather clearly in a pamphlet written Geoffrey Howe, the then Chancellor of the Exchequer. Its main conclusions read: ‘The need for privatization, competition and financial discipline is even greater in nationalized industries than we imagined’ and ‘Progress in the direction of privatization is often more difficult than it may appear to some of its armchair advocates’. I will be coming to later some of
the lessons that we have learnt in Britain in terms of how to overcome some of these difficulties of organization.

OBJECTIVES AND RESULTS

Improving efficiency might have been a key objective, but it very soon became clear that a properly organized programme could fulfill other objectives than just those of increasing efficiency. And as it is at presently organized, the British programme (in common with a number of programmes elsewhere in the world) has the following aims:

1. To increase efficiency through competition, deregulation, or other means.
2. To raise finance which can be used to fund other expenditure priorities, to reduce borrowing, to reduce taxation or some combination of these.
3. To encourage employees to own shares in the company in which they work.
4. To boost the level of share ownership in the general economy.
5. To strengthen the capital market.
6. To gain domestic and international prestige.

The power of privatization and the extent to which it has been taken up now around the world derives largely from the fact that objectives of this sort can be intertwined into one programme.

The results

Judged by its objectives, the programme in Britain has clearly been successful. Sixteen major sales have been completed and millions of new investors have been introduced to the stock market through the programme.

Worker participation

And there has been a high level of employee participation. Typically, somewhere over 90% of the workforce of the companies which are privatized take up the bonus and other share offers that are given at the point of privatization. That has had a powerful beneficial effect as far as the Government has been concerned, in that the participation by the workforce largely negated the opposition from trade union leaders that was sometimes found nationally. One in five of the adult population of the UK is now a shareholder compared to one in ten in France and one in 20 in Japan.

Performance: The performance of the companies has improved drastically. The profits of British Aerospace have trebled since privatization, Cable and Wireless profits are up sevenfold, Amersham’s profits have doubled, Jaguar’s are up a third and the National Freight Consortium’s have increased sevenfold. The combination of freedom from statutory and bureaucratic constraints, strong balance sheets, progressive elimination of internal inefficiencies and, fortunately, generally favourable economic conditions, has done wonders for the companies concerned.

Tax revenue: It wasn’t at all clear in the early days that privatizing profitable
industries would benefit the Exchequer beyond the proceeds from selling the equity. However, some modelling work that was carried out indicated that the combination of increased tax payments by the companies as their profitability increased, the interest savings made by the Government on the debt foregone as a result of selling equity, the dividends from residual shareholdings, and the funding of future investment programmes in the private sector rather than by the state, produced continuing cash benefits to the Exchequer. I think that is an important point because I find that we are often asked, 'Why should a Government sell a profitable company?' Now, at least in the UK it is possible to demonstrate the long-term financial advantages to the Exchequer of moving such companies to the private sector.

THE PROCESS OF PRIVATIZATION

I would like to turn now to how the privatization programme in Britain was organized.

Administrative centre

Within this country nationalized industry policy has always been the responsibility of the Treasury. Policy statements are presented to Parliament by Treasury Ministers and the general coordinating mechanism is run and serviced by Treasury officials.

The reasons for this are not hard to fathom. Whilst it was appropriate to have sponsoring Departments responsible for individual industries, somebody had to hold the ring. None of the individual Departments were prepared to see other individual departments have responsibility, so the focus of power shifted easily and readily to the centre.

Controlling both policy and purse-strings put the Treasury in an extremely powerful position. Because privatization policy was seen as an adjunct of state industry policy in its early days, it was natural for the Treasury to take on responsibility for privatization policy and the overall coordination of the programme. At least that was how it seemed to Treasury ministers and officials. In practice, this approach produced clear benefit. The close connection between the Treasury and 10 Downing Street could be used to good advantage.

The Treasury's desire for revenue, although not unduly emphasized in public, would sustain the programme's momentum and the Treasury's innate abilities could be deployed to advance a policy that was central to the Government's thinking. It was also clearly beneficial -- and this is an important point -- to create a small caucus of officials at the centre who would be involved in each and every privatization. This eased technology transfer between departments and helped to overcome the inertia that tends to seize Government departments when privatization threatens to break up much-loved bureaucratic fiefdoms.

Given the market viewed the sales as a programme, the Government had to do likewise. One of the first points of advice we have always given governments around the world is that there has to be a high level of political and administrative commitment for a privatization programme to succeed. It is very easy to have the desire to privatize, but to put it into effect means that the right mechanisms must be set up within Government.
Three requirements

Achieving successful privatizations is a long and complex process. Three separate lines of action can be identified.

The first of these are legal and constitutional changes: changing the legal constitution of the company, setting up a regulatory regime if a natural monopoly is involved, passing the necessary statutory and legal authorities.

The second step is reorientating the company’s business systems and management towards the private sector.

The last step, once a commercial entity has been produced, is selling the company.

In our experience, these steps may take anywhere between two and three years to complete. The most critical step in some ways and the longest step is the commercialization. Many obstacles need to be overcome. Commercialization can only be done from within the company, it cannot be imposed from outside. You need good quality top management.

Easy sales first

It is also very important to establish the credibility of a privatization programme early on if momentum is to be sustained and investor interest generated. This points absolutely clearly to doing the easiest sales first.

Now what is an easy sale? An easy sale involves selling a company which has been trading on the fringes of the public sector and which already has the necessary private-sector orientation. To take industries out of the heart of the public sector and to reorient them is a lengthy process. It must never be forgotten, and at times ministers have to be reminded of this in countries around the world, that privatization, unlike nationalization, is a two-way process. Governments may want to sell companies but somebody else has to want to buy them. This is the essential difference between privatization and nationalization.

Choosing the method

Methods of sale in the British privatization programme have been determined by the programme’s overall objectives and by practicalities. Because of the desire to spread ownership widely, public offerings of shares have been a preferred choice where this can be achieved. Failing this (and a public offering represents a very severe test for any company), employee and management buyouts have been welcomed, provided that the funds are available and the company’s cash flow can support the necessary leverage. The most difficult sales to bring to a popular conclusions are sales to corporate purchasers, particularly, if overseas buyers are involved.

The politics of privatization, and this is the same worldwide, 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.

Market effects: In terms of the capital market effects of privatization, two main positive impacts can be distinguished. First of all, it is quite clear that privatization can lead to a widening of capital markets by bringing in new
investors, both domestically and internationally. It can also lead to a deepening of the capital market in the country by introducing mature companies which have a strong market position. Both these facts which are interrelated are clearly advantageous to the vendor.

THE TELECOM EXAMPLE

The sale of British Telecom in 1984 was the first privatization anywhere in the world specifically designed to have widespread popular appeal. Prior to British Telecom there were many people within Britain, including some at the highest levels of Government, who doubted that the British general public could be taught to buy shares through privatization. The proportion of shares owned by the general public in Britain was decreasing and attracting even fifty thousand people into a privatization offering was reckoned to be good going.

A new approach

Yet the British Telecom sale attracted around two and a quarter million applications and around half of those people had never before bought a share in their life. The sale was five times larger than any sale that had been previously attempted.

Such success stemmed from a new approach to share issues: British Telecom was the first to be marketed on a wide scale to the general public.

It was clear to all of us who were involved in the sale that traditional methods of selling shares were not capable of creating a new breed of share owners. Stockbrokers were happiest selling shares to their existing clients and therefore if shares were to be sold widely, new distribution channels needed to be created. The vendor would have to go over the heads of the traditional intermediaries, both by motivating a more lively sales force than was found in traditional stockbroking firms and by selling direct to prospective shareholders. No vendor was more suited than the Government to take on this challenge.

Popularity: Why was British Telecom so popular? Well, first of all it combined features of both a utility and a high-technology business which made it ideally suited to inexperienced shareholders. Everybody was very conscious that there were no advantages to the Government in putting inexperienced buyers into a company whose performance might have been depressing afterwards. Small shareholders were, at the Government’s expense, given the added attraction of a one-for-ten loyalty bonus if they held their shares for more than three years. Alternatively, they were given discounts off their telephone bills. The sale was advertised widely, in both the press and on television, and generous commissions were paid to the financial intermediaries. A new selling force was effectively developed.

The sale captured the public’s imagination, proved (with the benefit of hindsight) to be significantly underpriced, and was both a popular and political success. It marked the emergence of popular capitalism in the UK and showed that the largest privatizations, if properly handled, could be successfully absorbed by the capital market.

Prior to British Telecom, to raise five hundred million pounds in a single transaction in London was thought remarkable. The British Telecom sale raised nearly four thousand million pounds, paid by installments over a
three-year period.

PRIVATIZATION AND THE CAPITAL MARKETS

How can privatization deepen as well as widen a country’s capital market? It is often a country’s dominant businesses that were previously nationalized and brought into state ownership because of their position in the economy, their strategic importance, or their size and market dominance. And it is these very characteristics which on privatization enables such companies to give depth to a stock market and to provide ballast for what otherwise may be an unduly speculative environment. That is why a number of countries worldwide at the moment are using privatization as an instrument of strengthening and developing their capital markets.

Privatization creates capacity

The experience of Britain and other countries elsewhere shows again, contrary to the original expectations of economists and some market commentators, that privatization can create its own market capacity. There are four reasons for this.

Firstly, the equity that is being sold is normally of good quality and represents an attractive investment opportunity. Purchasers gain comfort from the fact that the vendor is a government and they have learnt by experience that governments are very risk-averse when it comes to handling privatizations. From my own personal experience I can remember a number of times when we have had overseas banks approach us to buy shares in privatized companies. They have said: ‘We don’t mind what the next privatization is that the British Government will be doing, but if we can have 10% of it, at whatever price it is being offered, we would like to have it’.

Now, clearly, if you can develop that kind of stockmarket following worldwide, it eases the process of sales. Success is valued very highly by governments on privatization, and this is no wonder given privatization’s invariably high profile.

Second, in terms of creating market capacity, a government that is raising finance by selling equities will need to borrow less money to finance a given public sector financial deficit than it would do otherwise. A government’s total demand on the capital market may thus be unchanged by a programme of sales. (It is also true that the characteristics of some of the companies that are privatized, particularly utilities operating a natural monopoly, can closely resemble debt in their financial characteristics and thus they may easily be accommodated into that portion of an investor’s portfolio previously reserved for sovereign debt.)

Thirdly, and this point is often overlooked, even a single privatization, because of its size, may be a material component of a country’s stock market 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 position. Some privatized equity, for example, a national electricity or telecommunications utility, also gives very good exposure to the totality of economic development in a particular country. This is often valued by an investor.

It should also be remembered that governments which are selling equity
become interested in the operations of the equity market and implicitly or explicitly take steps to strengthen the market. Traditionally, governments worldwide only operate in a debt market, whereas the equity market tended to be left to market practitioners. This is now no longer the case and it is also true that the same political philosophy which produces privatization is also likely to encourage market liberalization and deregulation. Privatization and the growth of London as an international financial centre have gone hand in hand.

Secondary benefits

Now in order to capture the capital market benefits, a sophisticated marketing programme must be created to maximize interest from all classes of investors. Such a programme, in terms of its effect on proceeds, will normally be extremely cost-effective. However, not only can such a campaign benefit the proceeds and the commercial image of the company that is being privatized, it can also provide an opportunity to project a country's general development and financial status. The roadshows used to promote privatization can also be used to promote the country and its economy.

Many countries would like to have a privatization programme. Very few countries can assemble sufficient determination, expertise, and credibility to achieve one.

Protecting the national interest

To move on to a rather different subject, the significance of some of the companies which have been sold in the UK and elsewhere is such that privatization would not have been possible if steps had not been taken to protect the national interest. It cannot be ignored that state-owned companies may often have a dominant position in the economy of the country. If steps are not taken to secure the national interest on a case by case basis, privatization will not be possible.

In this country, the Government has wanted to ensure that some companies' continued independence is guaranteed, implying that they cannot be taken over by other companies. We have wanted to require, at times, that the Chief Executive would remain British for some of our companies. We have wanted to restrict foreign ownership in some companies where defence or security interests have been at stake. In the case of natural monopolies, which have been privatized, it has, of course, also been important to ensure that customers' interests are fully protected.

Now it has proved possible, at least in this country, to build in safeguards to protect these important requirements in ways that are fully compatible with United Kingdom and European Community Law. No special legal framework had to be created in order to do this. Where necessary, specific restrictions have been written in to a privatized company's Articles of Association, the company's statutes. And in order to ensure that these restrictions cannot be varied after privatization, the Government has retained a special share, called a Golden Share, which has been created to protect those Articles regarded as essential. It is a technique which has since been copied by many countries worldwide.

I don't intend today to discuss regulatory arrangements in any detail other than to note that much of the conceptual benefit attributed to state ownership of natural monopolies result from an assumption that the State will somehow
act properly in relation to those monopolies. In fact, anybody who has observed closely the political bargaining associated with the annual expenditure round in countries worldwide, and the outside influences that determine whether or not state industry should invest, would realize the important role of political expediency in regulating monopolies in the state sector and the advantages to be gained from moving to a clear and transparent regulatory framework based on sound economic principles.

LEARNING THE LESSON

Now I said earlier I would review some of the lessons to be learnt from the British privatization programme and some of the mistakes that were made in the early days. Although the programme is a popular success, mistakes were made and lessons were learnt by experience.

New techniques

In the early days of the programme, the sales were treated very much as one-off individual market transactions and no real attempt was made to coordinate the programme nor to capture the public's imagination. Market professionals, in particular, consistently underestimated the power of privatization to attract retail interest and persisted in offering too few shares too cheaply to the British public. Although there had been developments in offer techniques, there was sometimes reluctance in the City of London to introduce innovations, even where these would clearly benefit the vendor.

Because demand for privatization can be an order of magnitude greater than is commonly found in private sector sales, and is sometimes very hard to predict in advance, offer structures are needed which can cope with unexpected demand that materializes in the offer period. The Cable and Wireless sale, in December 1985, which Schroders conducted for the British Government, pioneered a new technique, flexible clawback. When the issue was oversubscribed, shares were brought back from institutional investors and made available to the public. This was a new technique designed to spread ownership in the face of high levels of demand. Subsequent sales have followed suit.

Privatizations differ from all other public offerings, particularly in terms of political sensitivity, size, investor interest, and the complexity of objectives. The luxury of treating them as purely financial transactions is simply not available.

Public relations

If a privatization programme is to be pursued, it is important that the case for doing it is deployed publicly and often. Whether or not increasing efficiency, spreading ownership, or raising finance are the objectives, the intellectual and economic justification for the programme must be coherently presented. If the emphasis of the programme is seen to be primarily political, or is seen to be primarily financial, problems will result. Not enough attention was paid to this in the early days of the British programme.

Identifying the interest groups

It is also most important that the critical participants in the programme are identified early on and dealt with in the most satisfactory fashion. These key
groups normally include the following:

1. The general public, who have a role as taxpayers, customers and voters.
2. The employees of the firms being privatized.
3. The management of the firms being privatized.
4. Prospective investors.
5. Commentators and opponents of privatization.

Pricing

Fair pricing balances the needs of the taxpayer and the investor. Voucher offers for customers offering discounts on bills and free shares for employees help overcome public or trade union doubts. Retaining the privatized company's original corporate structure is of clear benefit to the management concerned. Widespread distribution of shares, full disclosure of information and careful attention to detail, are all necessary if a successful sale is to be achieved.

THE SCALE OF SUCCESS

Now I think it is true to say that the British privatization programme has gone further and faster in the last three years than even its most ardent supporters expected. To raise five thousand million pounds a year from privatization is now seen as unremarkable. The British Gas sale attracted five million applicants and was the world's largest ever equity transaction. In the first half of 1987, three major sales, British Airways, Rolls-Royce and BAA are all following in quick succession.

The Conservative manifesto for the 1987 election pledges that Water Authorities and Electricity Industry will be privatized and says that more state-owned industries will be sold in ways that involve share ownership, both for the employees and the public at large. Your guess is as good as mine what these candidates might be, but clearly British Steel, parts of the Post Office, London Regional Transport and some other companies are all likely candidates.

In political terms, few policies can claim the benefits of privatization. Few can be so attractively presented in terms of privatization's ability to increase industrial efficiency, raise money, boost ownership amongst employees and the wider public, and generate domestic as well as international prestige. Provided the relevant interest groups are clearly identified at an early stage and are kept happy, everybody seems to win. Indeed, if the programme in the UK is pursued to its logical conclusion, UK nationalized Industry will soon cease to exist. Within a period of around fifty years, the wheel that Herbert Morrison started turning in 1933, with his book on the socialization of transport, will have come full circle. Herbert Morrison's views on this, unfortunately, will never be known.
QUESTIONS AND DISCUSSION

Fouad K Hussein (Egypt Investment Finance Corp): When you privatize companies, how do you put the price tag on the share? Secondly, what can we do to assure the public in case there might be a change of political wind in the future: that this privatization will not be reversed?

Gerry Grimstone: First of all, I should stress that the objectives for a country’s privatization programme must be tailored with reference to local circumstances. The programme will be a complete failure if countries mindlessly copy other country’s objectives. Each country has its own priorities and will have its own objectives. What is important however, is that those objectives are worked out in advance and a country knows what kind of privatization programme it wishes to have before it starts. One has to match the objectives to the aspirations of the vendor.

That affects pricing: you have to strike a fair price. It must be a price that, when commentators are looking at it afterwards, shows clearly that neither side, the taxpayer, the investor, the vendor, has been taken undue advantage of. Now it happens that there are valuation techniques, formula techniques, which can be applied to give a starting point for the valuation of the company. Any investment banker could talk eloquently on those. What is important, is to develop a market feel and a feel for what privatized equity will trade at in the aftermarket.

However, it has to be recognized that privatizations produce a very odd class of equity that is sometimes hard to evaluate. Because investors know that governments want these sales to be a success, privatization has developed a following worldwide which transcends some of the actual absolute characteristics of the equity. Pricing can be very difficult. Traditional valuation techniques often don’t work. All one can do is to use one’s best judgement to fix a price. It is also very true to say that if you are government, looking at a series of sales, it is more advantageous to you to create an aura of success, which runs on from sale to sale, than it is to get the last cent or the last penny out of an individual sale.

I think that this is a lesson which we learnt in the UK. Until the Britoil sale, in November 1982, that tradition was to price the shares to the last penny. It was then realized the proceeds could be maximized over the longer term not by pricing individual sales to the last penny, but getting some enthusiasm going for privatization. That maximizes proceeds over the long term.

If these sales can be made a popular success, if you can involve many, many millions of people in the process, the chances that they will be reversed by subsequent administrations are clearly diminished. And it is also important at the end of the day to isolate, as far as one can, the companies from future government influence, perhaps by declaring in the prospectus (where it becomes part of the contractual terms between the incoming investor and the Government) that the Government will not interfere. It is the case on some of the British privatizations that investors could sue if a future government chose to interfere in the companies. Other techniques, such as passing the right sort of legal framework, or developing the right company articles, can be used to isolate a company from government influence. If privatization can be made a popular success, it will persist; if it is seen as a conspiracy or as a way of selling shares to backers of governments or to favoured financial institutions, it will not last.
Jim Lafferty (US Office of Personnel Management): Sir Colin Marshall, talking about the British Airways' experience, described how a severance package was negotiated with the trade unions, and in that instance, he said, he had to deal with seventeen different trade unions. Are there any reliable generalities to be gleaned from the British experience with privatization in dealing with trade unions? What effect have they had, thus far, in the outcome of some of these privatization efforts?

Gerry Grimstone: The first thing I think that we have found was that the workers were scared of the process because they did not understand it. These were workers who were in the public sector, they were used to the public sector. There had to be a very strong educational effort. The management had to go out to the workforce to explain what privatization was and how it would benefit the companies and employees concerned. There has been a programme of videos, news letters, and corporate roadshows in order to do this. Fear and ignorance were two of the biggest problems that had to be overcome. Perhaps, because of a perceived political stance towards privatization in the UK, I think it would be difficult for any trade union leader to come out formally in favour of privatization. But if you can develop offer techniques which involve the workers of the companies to a very large extent in the process, if you can see a take-up of over 90% among eligible employees of shares (and this has been done in the UK by giving small numbers of free shares, so-called bonus offers, where for every one share an employee buys he is given another share free, and by giving employees some preference in allocation), you can put together attractive incentive packages which make employees want to participate. If the workers are participating, it is quite difficult for the trade union leadership to say that it doesn't wish to support the process.

There is a very amusing story that sometimes is told of how the Labour Party leader, Neil Kinnock, was touring a British Telecom factory in Wales. He held a meeting with the shop stewards and he explained to them Labour's policy on re-nationalizing ('returning to social ownership' as it was called) British Telecom. The shop stewards listened, nodded attentively and applauded at the right times, until one of them asked a question at the end of the presentation: 'But you don't mean you'll take back the shares that we own, do you?'

Dr Hassan Aly Khedr (Ministry of Agriculture, Egypt): I cannot understand how everyone was left happy by privatization. What I have heard is not privatization, but divesting some industries of their Government management and introducing private sector management; but efficiency-wise, this might not necessarily be the most advisable course.

Gerry Grimstone: Within the UK, the policy that went hand-in-hand with privatization was a general policy of commercializing state-owned industries: commercialization as opposed to privatization. The same people within Government were responsible for both those policies.

It is obviously better to do the commercialization within the public sector prior to the sale. The reason for this is that the process can be managed better, a more attractive company is produced, it can be done sensitively by existing employees rather than by new employees.

In British Airways, for example, it was within the public sector that the workforce was reduced from fifty thousand to thirty-five thousand; British Steel, which made large losses in the early 1980s and is still in the public
sector, is on course to make over one hundred and fifty million pounds profit this year. State-owned industries can be commercialized but you tend to need some stability of government policy. The first step, is always to put in good management. We have benefitted in the UK from the fact that the boards of nationalized industries are generally appointed on three to five-year fixed term contracts. That means that if you have a period of stability in political terms, lasting for seven years, eight years, nine years, you have gone through a process of re-appointing people to boards. There was a clear objective in this country to appoint businessmen to the boards of nationalized industries -- and businessmen at the prime of their careers.

Interestingly, once privatization became on the agenda, it was much, much easier to attract good-quality businessmen to join nationalized industries because they realized that the prize was taking those Industries into the private sector and then being responsible for managing very large private sector companies. The only way to commercialize an industry, the only way to improve its internal efficiency, is through having good management. That has to be your starting point.

Dr Khaled Sherif (Ministry of Cabinet Affairs, Egypt): What about contracting out management, where you move out the management of an existing firm and replace it with management that is outside the civil service structure, more oriented towards changing the performance or the efficiency of a particular industry. How successful has that been?

Gerry Grimstone: I think the difficulty with that is that within the kind of constitutional framework and the public accountability framework that often surrounds state owned enterprises, there are severe limits on what a manager can achieve. Hand in hand with introducing good management must be this process of liberalization, throwing out the panoply of controls that exist in every country in state-owned enterprises. There is a constant need to refer to the Treasury, to the Government, to ministers for decisions. I am afraid that in most situations, no matter how able the manager is, he cannot manage properly until those constraints are removed. Within the UK, once a company has been launched on the privatization runway, government controls and interference, have been progressively dismantled. It is also true that the strength of character of some of the men now running our nationalized industries is such that they will tell Government officials or ministers that they are not wanted. They have been brought in to make these businesses commercial. They will ignore the owners for the time being, knowing there is going to be privatization.

Unless there can be some real sort of change in relationships, and accountability, no new manager will be able to manage effectively.

Pierre Drion (Peterbroeck, Van Campenhout): How and when are the investment bankers brought in to the privatization process?

Gerry Grimstone: I think that it is very important that the advisors are brought in at a very early stage of the process. This is because many decisions have to be taken on the route to privatization. Some of those decisions may have an impact on the selling process, others may not, but it is very important that the commercial entity that is being created, the management changes that are going on, the new structures, are all structures which are attractive to investors subsequently. Normally people in government are not very good at having a market feel for what they do, so I would appoint advisors very early on.
Advisors should generally be appointed after a competitive search. There are a handful of banks worldwide, which are pre-eminent in this field, but if I were a responsible vendor I think I would always want to compare one bank with another in a structured way before deciding who to appoint.

M H Scalobah (African Development Bank): How far will you go in privatizing, where do you draw the line and do you take into consideration any future changes in government and whether this would not disrupt the whole economy?

Gerry Grimstone: My own personal belief is that commercial activities are better done outside government rather than within government. Commercial activities should be moved to the private sector: the timing of this, and the necessary packaging, clearly have to be sorted out separately in each case.

Once one moves away from commercial activities, from trading activities, the case is far less clear. I think you have to reckon that there are some activities which may need to stay in the public sector. I do not advocate mindlessly privatizing all activities that a government does. All that one can do is to examine activities one by one and say: ‘Are these activities which can be done better in the private sector or in the public sector?’ If they can be done better in the private sector one should then set up a programme to move them into the private sector. The process does not work if you start from a dogmatic statement that all government activity should be done in the private sector. It has to be a pragmatic market-driven, commonsense-driven, business-driven programme rather than a political programme.

After Televcom, which started with many million units in their hands but is now selling only a million units a year. And the best of these are very old, a third of these are not very popular that they had to replace, or at least they didn’t do very well about them, and so the financial benefit from the month in the amount that is available, is very small.

After Televcom, which started with many million units in their hands but is now selling only a million units a year, we have lost a number of American secondary offers. Avcoore, C bullish, and Michael S Porth and Porth have probably earned a half million or so. Then we had the next biggest, the second most popular offer (not the one that is available, but a popular share offer in a quoted form). We have not been able to enter that market and the market has not been receptive for that company. Even after the existing owners, none of them sold shares, that added over two million new investors. So the market does not seem to want the majority of them to sell their shares.

This year the new investors also kept their shares and the share of others that partly sold it, partly at about $1.00, $1.50, $2.00, and British Airways and British Airways. The new investors also kept their shares and the share of others that partly sold it, partly at about $1.00, $1.50, $2.00, and British Airways and British Airways.

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MARKETING PRIVATIZATION

Tony Carlisle
Director, Dewe Rogerson

I am going to talk about marketing in the context of the large flotations because it's easier to do it that way, but in fact the principles I am talking about apply on any scale. We have used the same general approach to marketing on flotations that have raised twenty-five or forty million pounds as well as flotations that have raised five and a half billion pounds.

THE SPREAD OF OWNERSHIP

Where I would like to start is the self-evident statement that Britain has fast become a nation of shareowners. The main cause of this plainly is flotations. If you go back to pre-Telecom days in this country, then we had about two million share owners. About a third of those were very old, a third of them were not very aware that they had shares (or at least they didn't do very much about them), and so the true share-owning base of this country, the active shareholders, was very small.

After Telecom, which added well over a million long-term new shareholders to this country, we have had a succession of smaller secondary offers: Aerospace, Cable and Wireless Parts II and III, Britoil Part II, and those probably added a half million or so. Then we had TSB which was the second popular offer (not strictly a privatization but a people's share offer in a classic sense). We secured three million enquiries and five million share applications for that company. Even after the scaling down to three million share owners, that added over two million new investors. So did British Gas last year -- and the majority of them is still there.

This year the pot has been kept boiling with the spate of offers that you are fully aware of: Rolls-Royce, British Airways and British Airports.

The new investors

Now before looking at why this explosion has taken place, who are the new investors? I think one of the spectacular successes of privatization here is that the new investors come from right across the country. No longer is share ownership the privileged holding of a few people who have financial connections or historic wealth.

Investor profiles

The new investors actually are characterized much more by a state of mind
than anything else. There tends to be more men among them, but that is because very often share ownership is a household decision and the man most often is the one who fills out the forms. In terms of age, there have been huge shifts, a tumbling of shareownership from being the preserve of the retired 65+ group into the 25-44 groups and even the under 25s. If you look at class there is an enormous drop in the proportion of shareowners owners that are ABs -- the upper socio-economic group -- and an enormous increase in the artisan class, the C2s. That is not to say there isn’t a bias still to the wealth groups because there is; but ownership is spreading right down the socio-economic structure. It is also reaching right across the country. There is, of course, some slight bias towards London and the South which still harbours the greater concentration of wealth in this country. But look at the rest and you are looking at a national profile: there is no significant difference in ownership in the rest of England, in Scotland, or in Wales. The new investors are everywhere.

Share ownership may be wide, and I think it is widening further but it isn’t yet very deep. Large numbers of people have shares in only one company, whereas traditional share owners might have held ten or more, and many held four or more.

So that is the picture of share ownership in this country. One of the things I think is terribly important to get into one’s mind is that share ownership is not about some general desire to own equities for the sake of it; not even in fund managers is that desire prevalent. People are not interested in some vague concept, they can be interested in particular companies which interest them and offer them a good return.

The reasons that we have a spread of share ownership in this country has to do as much as anything with the breaking down of barriers. Before Telecom, people thought that share ownership was extraordinarily complicated: it was by definition for the minority because no one had come to people and invited them to own shares. So naturally enough, they didn’t buy any. But the barriers have been broken very substantially. The numbers of people who, surveys reveal, have thought about investing in stocks and shares have grown extraordinarily since Telecom. Secondly, the real competition with share investment in this country is the building society, the traditional place where people put money they want to leave for some while. After Telecom that attitude hardly moved, but now it is beginning to change. Although the shift may not look very large, it is actually a very fundamental one: a small change could mean that very large sums of money want to move.

I think it is also illustrated if you look at the reasons for not investing. Again, surveys show that the barriers that keep people away from share ownership have tumbled.

Less than half the number who said before Telecom they didn’t know how to invest in shares still feel that. Some think shareownership too risky, and fair enough, though people are coming to accept the notion of risk in equity ownership. Others say it is too difficult to buy or sell shares though far fewer than three years ago. But what is interesting is that nowhere on the survey response list comes anything to do with political ideology. The marketing man does not have to overcome that barrier.
MARKETING TO THE PUBLIC

One central theme that wider share marketing draws on is the desire in most human beings to want to do something better with their money. Wherever they have got their money, people would love to have a better alternative. Their problem is that they don't know how to go about it, and they don't know whom to trust. If you can actually get their trust and get their confidence and offer them a package which represents something better, then can you can shift money very fast indeed. That is exactly what we have been doing in the flotations.

The second feature of wider share marketing is that it taps an additional source of money. This all started back with Telecom, with very simple thinking which acknowledged the huge scale of the deal. It was quite plain that the UK capital markets were not happy to subscribe Telecom in full. It was also plain that overseas markets could only be tapped to a limited degree for political reasons. Therefore more demand was needed. Where can that demand be found? Could it be generated from the retail public?

Wide share ownership, therefore, was a marketing imperative, and not a political one. Our marketing objective, as in all share offers, is to foster the perception of scarcity and the perception of value. If you achieve that, you have over-subscription, if you don't you have a failure.

Extravagant ideas of a wider share ownership campaign have absolutely no relevance to an individual who is asking whether to invest his own, or her own, money in order to get a decent return. People are interested in specific companies, and specific offers. The company has to be a company with which they feel familiar, for which they have regard; and the offer has to be good value. You must start with an attractive company, an attractive offer, an attractive product, otherwise you have problems.

In this country right now you can to some degree tap patriotism for the first time in a long while. That is a consequence of the Thatcher Government and partly the self-promotion of major corporations, British Airways and others, making people aware of success and not hiding their Britishness in the cupboard. But patriotism is unlikely to attract much investment. What investors want is a company with good future prospects, operating in a good industry, a company for the small investor.

The target audience

Who are we addressing this message to? We have three investor audiences: the UK institutions, the UK retail public, and the overseas markets. In the UK markets, the key influences of opinion are the analysts and the media who interact together and who will determine the nature and the quantity of endorsement to be given to an offer. In the middle are the advisors, the stockbrokers, the accountants, the solicitors who can tap the high-wealth band. (Numerically, they don't reach far in this country, half a million people perhaps; but they are important because they are part of the investment community and unless they think it's a good offer, then it counts against you.)

In terms of the investor audiences, the whole of retail marketing, for legislative and other reasons, is directed at the UK. But the scale of it for companies such as Telecom and Gas is such that it certainly creates a backcloth of awareness internationally which helps support overseas marketing.
The stages of awareness

How do you move people from an awareness of the offer towards being prepared to reach in their wallet? The answer is that you have to issue a very, very clear invitation to come into the deal. It isn't just a question of saying that a certain share offer is on; you have got to tell people that it's for them, that they are being invited to consider investing in this company.

Information: Once people are interested, the next thing that they want is to have more information, a natural instinct. That is one key reason you need a Share Information Office; it's not just an enabling device in law, it is an absolutely critical part of the marketing programmes we have run in this country.

Endorsement: Information on its own is not enough. People move from reading about the company, reading about the share offer to asking whether it is the right thing for them, and the places they are going to turn for that sort of endorsement and reassurance are the places they trust. In the main that means the financial media, the financial journalists. It is that advice that will be echoed by the intermediaries down the line.

The pathfinder: When the public is broadly aware and interested, and the buzz is beginning to go around because the offer looks good, then it is time to ensure people get their money ready, because the narrow window of an offer means that they don't have that long to sign the cheques and post them off.

Finally, on the impact day, the day on which the price is announced and the prospectus published, the communications programme needs to come to a peak and there needs to be a wide perception of a major event taking place.

Psychology and impact: an example

You can map out all of this decision-making process in quite clear detail in the sort of share purchase models we have constructed since Telecom.

If you are running a mass flotation you need to know where you are: who is interested, why they are interested, what information they want, where they want to get that information, and how many people are likely to come in.

Successful marketing needs to understand the quite sophisticated investor psychology. You can actually see it being reflected in the successful share offer advertising. Take the TSB launch commercials.

First commercial: 'At one time or another most people think how nice it would be to own a bank. Well, 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 2300 300, or come into any TSB branch. We will send you more information and reserve you a prospectus. The TSB now: it's your turn to say "YES".'

Second commercial: '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? Phone 0272 300 300 or call in at any TSB branch. We will put you in the picture and reserve your prospectus. The TSB: now it's your turn to say "YES".'
Pathfinder commercial: 'It won't be long now. Next month TSB 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. Call in at any TSB Branch. The TSB: now it is your turn to say "YES".'

Pre-offer commercial: '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 10.00 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".'

Two and a half million enquiries had come into the office by this time.

Offer period commercial: 'The TSB share offer lasts only another few days. It closes at 10.00 am on September 24th. For a prospectus and application form call at a TSB Branch or any other bank. The TSB share offer: It's on now.'

That campaign was a very soft sell, but it was an extraordinarily powerful campaign. Even though it wasn't on the same scale of spend as some of the others, it gained awareness ratings of 85%. That is higher advertising recall than for the general advertising campaign the TSB had been running for the eight years previously. It triggered an unprecedented number of enquiries and applications. It was a very elegant campaign and it more than achieved TSB's objectives, not just of wide ownership, but in terms of altering the image of the TSB.

A complete package

The sort of programmes needed in a share offer involve far more than just advertising. Flotation marketing works because you run an integrated programme. I have talked about research. Design is important: you need a symbol for the float. For the Telecom campaign we produced, with The Stock Exchange, a booklet on Buying and Selling Shares. (Remarkably they didn't have one at that time, and when asked the question of how many copies would they like, they said five thousand. When we told them we were printing one-million initial run, that put into perspective the marketing hitting the City for the first time.)

Spreading information

We need the share information office as a physical focus to handle enquiries and to act as the press office to the flotation. It is an office that releases and distributes material that has been legally cleared in advance; it helps orchestrate and organize prior agreed activities. (One of the keys to a flotation is the central control, the marketing committee that make sure that these programmes work together, and that all materials are thought through, are legally cleared and work.)

The sort of questions that people were asking about the TSB were very similar to the sort of questions people ask about any offer: Will I get all the shares? How much do they cost? How do I do it?

We can now anticipate most of the questions people ask and have the answers set up. The Share Information Office therefore divides into two sides.
One is a mass enquiry arm, which on a major sale is maybe able to handle the eight and half million enquiries we took on Gas, and the other is a much smaller office in London which is a control centre dealing with the press, with the intermediaries, and with difficult enquiries. (Of those eight and half million enquiries that went to the mass enquiry centre, very few could not be answered just by sending the information. At peak, two hundred a day couldn’t be answered that way, a very small proportion.)

Branch display is part of helping make an offer a national event, getting it out into the public. Of course, it is not always possible. With TSB, we were fortunate to have sixteen hundred bank branches. With Telecom we didn’t; we had to put the literature and leaflet dispensers in post offices and banks because it was all that one could do.

Mailing is likely to produce the highest response of all. A simple customer leaflet went out with account bills in British Gas at a rate of a quarter of a million a day from August 1st. We also followed up with another mailing, a letter from the Chairman to the sixteen million gas customers. Those two exercises were highly cost-effective and produced around five million enquiries. In TSB, mailings achieved a 34% response rate from customers. That is far and away beyond the junk mail levels of response that you get in other areas and it’s because you are dealing with people who are interested in something, you are talking directly to them, and you are being simple and adult about it.

Intermediary marketing I have touched on, but there is now in this country, a network of brokers who are skilled at coordinating communications in their territory and bringing people to the roadshows. The latter are supported by central marketing of a direct mailing type which tells people exactly what is happening and shows them the scale on which it was happening.

City communications are critical, revolving around the institutional briefings conducted by the issuing house and the brokers; broker reports; and exhibitions or events that invite the key institutional and intermediary audiences to see in one place the scale of events.

Employee communications are vital. If you don’t take your people along with you, particularly when you are asking them to do new things and accept a higher workload, you will not succeed. For TSB for example, we produced a set of briefings that were backed by videos and an extensive staff training programme to make sure they knew what was happening and knew what they were expected to do and what they were allowed to do, and that they felt good about it.

Media relations are complex, since in a mass flotation we are typically dealing with over a thousand journalists, though the core journalist audience is probably about thirty-five strong. Those are the ones who will determine the tenor of the public reaction; and you want a programme of briefings and lunches, to give them the research findings and show them the weight of demand and interest, to give them enquiry figures. The advertising works alongside.

But never underestimate how much you have got to drive home the simple points. People still miss the boat.
MERCHAND BANKS AND PRIVATIZATION

John Redwood MP
Director, Rothschilds

My experience of privatization has not been limited to the great pleasure of some two and half years advising the British Prime Minister and helping her and her ministers step up the privatization programme from five hundred million pounds per year to five thousand million pounds per year. I also managed to fit in a bit of advisory work in other corners of the world, such as New Zealand and Jamaica.

Some people argue that it was easy in London, with an active stock market already, and a society which still had a bit of enterprise left, but that other countries cannot go that route in the same way. I would say to those critics (who come from countries like Austria and Turkey), that I believe they can catch up with Jamaica if they really try. I think they might manage to do some of the things that Sri Lanka has done with such aplomb and skill. If you wish to do it, you can do it. It's good for your wealth, it's good for your economic health and it's good for your social cohesion. It creates a new class of shareholders that runs across society and gives them a stake in the nation like nothing else can possibly do.

THE RULES OF PRIVATIZATION

There are three basic rules of privatization. These are rules which I think are important when you tackle the problem.

Capital markets

The first rule is that capital markets expand to make available the amount of money a privatization programme needs. Don't agonize or scratch your heads and ask where the money will come from; one of the main purposes of privatization is to expand a capital market that is moribund or slow or small, and even to create a capital market where none exists. It can create an equity market where all that investors had in the past was a dull and tedious diet of government bonds. You would be surprised just how many people are itching to buy some equities if you explain the advantages and you package them in attractive ways.

In the UK, the annual capacity of the equity market for new equity was only some one thousand million pounds per annum before the privatization programme really began. This year it could easily be ten thousand million pounds. Five thousand million of that will go straight into the Treasury's coffers in modest compensation for the assets being released to the

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managers, to the employees, and to the wider public in the privatization programme.

So if you get long-faced bankers, brokers or financial intermediaries, worrying you about market capacity, I have one simple recommendation -- sack them and find somebody who will deliver the goods, because the money is there and it should be their job to find the money for you and act as intermediaries creating a new marketplace.

Personnel

When you are confronted with agonized people saying that the employees and the managers of the enterprise won't let you sell the enterprise from under their feet, remember this little rule. There are very rarely employers, employees, managers of any public enterprise who do not find the freedom that comes from getting away from Government (and the higher salaries that can ensue) anything but liberating and refreshing. It needs explaining, you need to persuade them, you need to carry them with you. Good communications can work a little magic in those who might at first have been hesitant about going on this course.

Bureaucracy

The third rule is if you are faced with a bureaucracy which has high standards, a great deal of probity, honourable traditions of civil administration, but seems a little reluctant to shed some of its prized functions, do not despair. I have met no single bureaucracy in the world that has succeeded in keeping out every person of talent and enterprise that might have applied for a job there. There will be, even within your civil service, a few good people who would love the message of freedom, of privatization, of asset sales, of releasing new energies in your economy. Your challenge, whether as ministers or managers of enterprises seeking sale, is to locate those people and put them into a position where they can have an impact on the process of change and the formulation of policy.

PROCEEDING WITH PRIVATIZATION

Getting on with the job

First of all, when you are setting about your task of privatization, don't go for the two-year slog or the two million pound consultancy job to work out absolutely every detail and have sixty different companies listed in order of preference. If you are seriously interested in privatizing, there is no substitute for doing it.

By all means get some external help to identify the first two or three targets that can be privatized quickly and successfully. They will probably be competitive, profitable businesses, but if you are faced with the problem that you have no profitable businesses, you will have to sell some loss-makers, or you will have to make them profitable first by contractual arrangements, balance sheet re-scheduling and so forth.

If you are in an even worse position, where you have no competitive business, where every one of them is a monopoly, then in order to avoid a political disaster I recommend you break those monopolies very quickly. You must choose the easiest ones to break and you should introduce private capital.
into those areas as quickly as you can.

Legal powers

Next, if you do need legal powers, if you find your law will not permit a sale, put a piece of legislation on the fast track to give you all the powers you need. I greatly regret that the British Government was persuaded that it needed a separate piece of legislation for every major privatization that it has carried out. That means by definition, a delay of well over a year for every major privatization target. How much better if you can go the French route and put in enabling legislation which permits you to sell any one or more of a whole list of companies or assets.

Assembling the team

When you have done that, then set up two or three teams of people, one for each of your fast-track early privatizations. As in everything in life, people are the key to success. You don’t need hundreds of people, you don’t necessarily need the most expensive people, you simply need the best, most highly motivated people who believe in the process and can not only see the problems but are interested in delivering solutions. You need the answers from people who are well aware of the extent and true nature of the difficulties you will face.

THE PROSPECTS

You can do a privatization from a standing start, in fairly difficult conditions, in three months. I say that with confidence because I have been privileged to help a country do just that: in Jamaica, the first major public offer sold into a stock market that previously traded only four hours a week and had a tiny turnover. It was done in less than three months from the first decision to draft a paper for Cabinet to the point at which all the shares had been placed.

In Jamaica, not a single foreigner was allowed to buy a single share, but the share issue was massively over-subscribed and the total size of the issue exceeded the annual turnover of the Jamaican stock exchange in the previous year.

For a relatively small issue in a modestly sized country, you can do it with a team of ten people. If you are in a very sophisticated country and if you have to surmount SEC regulations or difficult stock exchange requirements, or the Byzantine complexities of a national Treasury, then you may need fifty, or a hundred people. Most countries will fit somewhere on that scale.

For most types of privatization, you can now look around the world and see an example of almost every type of case. There is a corpus of experience and expertise that has now been built up worldwide, and there are many people more than willing to share it. It is well worth paying for if you can get the right advisor.

QUESTIONS AND DISCUSSION

Pierre Drion (Peterbroeck, Van Campenhout, Belgium): I would like to know if there is any blueprint for the team of advisors that is needed for a programme of privatization. And what type of fees do they apply for this
John Redwood: Yes there is a rough guide to the kind of advice you would need for a large scale public offer for sale in a sophisticated capital market, or in a group of capital markets.

The most difficult type of privatization you can attempt financially is, of course, privatization with simultaneous launch of shares in all the world's major markets, with all their different listing requirements. That greatly increases the complexity and also therefore, the fees.

I would suggest that you approach HM Treasury; the officials there in the Information Department, can give you a little pack which sets out the range of advice that has been used in the UK privatizations and will give you an idea of the type of people you need. The public relations consultants, the stockbrokers, the advisory bankers, the receiving agents, the lawyers, the clearing banks -- all the people that are needed to deliver a good issue.

I think there is no substitute in your own domestic market for talking to those who are going to bid for this business and finding out from them what they would charge. The fees, typically, amount in a sophisticated issue to somewhere over 5% of the total realization proceeds, split between the bank, the broker, the lawyers, publicity consultants and so on; but the range could be somewhere between one and a half and ten percent of the total proceeds, depending on the degree of sophistication of the sale and the type of market in which you are operating, and the success or failure of the government in persuading people to do it for lower fees.

Alex Tomlinson (Centre for Privatization, Washington): In the case, Mr Redwood, of the Jamaican Bank, I understand that there were a cadre of Jamaicans who were very much involved and that the sale was done solely within Jamaica. Could you explain in a few words the role that Rothschilds performed?

John Redwood: Rothschilds were there to offer advice and support to a Jamaican team of people who were carrying out the sale and I think our skill lay in providing a timetable, a discipline to the sale, and in offering a range of options or solutions to problems we thought were going to come up. The Jamaican team could choose between these and make sure they had a solution in place at the right point in the process. It was quite a light commitment of man-hours involved from this country. We spent a bit of time there with them, but the bulk of the credit (as the bulk of the risk) rested with the Jamaicans, particularly Price Waterhouse Jamaica, and with the civil servants and the officials from the company involved.

In the case of National Commercial Bank of Jamaica, the bank did not retain its own advisors. It was possible to do that because there was goodwill within a very small team of people and everybody had an interest in making sure that a successful operation would transfer to the private sector that would be able to look after its shareholders. I agree with the comment that in many cases, the company will need its own advisors to make sure its interests are truly represented, but you don't have to do it that way.

Question: There are certain government undertakings that require some action far more drastic than merely privatization -- namely, to close them down completely. Do you have such experience?
John Redwood: Yes I think all countries have that difficulty and this is where the question of how many redundancies can you accept is important. Sometimes the question is, whether the company be slimmed down first before privatization, which means that the government gets blamed but privatization does not; or whether the company should be sold to the private sector on a fairly favourable price basis, reflecting the costs and dislocation that will naturally follow from redundancies, which in part shifts the blame directly from the government but opens privatization to the easy charge that it is just a covert way of sacking the workforce.

In my own view it is best to leave privatization out of major redundancy operations. It is better for the government to be honest about those parts of the public trading sector that are no longer trading at anything like a satisfactory level and deal with the bodies where major surgery is needed.

Sir Keith Stuart (Associated British Ports): I think it's just worth adding to what John Redwood has just said that the company to be privatized also needs its advisors, because remember that the company has to live with the investors and the market long after the act of sale has taken place. The Government, as the vendor, needs its advisors as described, but so does the company that is being sold off. For every banker or lawyer acting for the government as the vendor, there is usually a mirror image of them acting for the company, to make sure that the company, once privatized, is in a conditions in which it can live happily with its investors after the act of sale.

The speed of change

Privatization has become a word with a considerable connotation. One whose implications are not yet very far-seeing, and it may well reflect better ways to compete. However, there is no doubt the idea of moving from the public to the private arena which may be some things to happen. It requires long hard work in every case for a company to ensure that they are being performed. There is a need to understand the benefits of improvement. In fact, if underperformed by anything else, they will result in additional revenue. Some quite miss the performance of public companies and themselves. The world to move efficiently both sectors of business that are very different.

At British Airways it is the case that it is the case that the cost of running the company has almost not one and a half decades which we have not not. Now we have identified the fact of running the company to the max, even where I would like to see it as a cost effective business. Eliminating the last vestiges of a statutory body.

We are still struggling with the process of modernization, in terms of making ourselves more efficient and enhancing our competitiveness in the workplace. The staff have been very effective in terms of the management and the staff level – which will take a long time yet to bring to fruition.

Privatization is something not to be lightly undertaken. The major problems of facing restructuring and dealing with image in transition, are only the beginning. Beyond these are the internal reasons of management and staff relationships, customer satisfaction, and responsibilities, the whole question of accessing the and quality as part of everyday life rather into something to be incident at all. There are a few of the things which anyone thinking about being a company private need to review. Without a top management totally dedicated to the concept and willing to withstand a long hard grind.
Chapter 5

HOW BRITISH AIRWAYS WAS PRIVATIZED

Sir Colin Marshall
Chief Executive of British Airways

THE STARTING POINT

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

The spadework

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

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

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

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

Government and management

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

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

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

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

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

The management agenda

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

1. Look at the goals and objectives of the company as they may be today.
2. Create those aims as they think they should be for success in the private sector.
3. Test the suggestions in No 2 with a number of managers in companies already engaged in that industry, and see how they fit with their own impressions.
4. Create an amended list of targets which will give them specific guidance as to what they must expect from the company as it moves out of public ownership.

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

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

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

**The political challenge for BA**

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

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

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

Throughout all this, our people -- staff and managers -- kept driving steadily to improve the Airline. To get its performance, its ability to satisfy its customers, at a higher level with each oncoming season of the year. I am proud of what they did and of their ability to stand up to four years of considerable
uncertainty while we went through all the trauma of the continuing delays and the changes in structure and style that it was necessary to make to improve our capability to function successfully in the competitive marketplace.

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

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

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

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

Competitive pressures

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

Our real competition does not come from the smaller British operators but from the big American airlines, the Far Eastern companies and several of the European airlines whose governments do not require the same return on capital employed as is expected by private investors. We still have much work to do within the Airline to make even clearer to all of our managers and all of our staff just how all-pervading the requirements of being successful in the marketplace can be.
We are currently having a very good travel summer, after one during which the fears of terrorism and nuclear contamination dropped our key North Atlantic business by as much as 25%. As witness to the successes of oncoming privatization, our competitive flexibility was such that within a matter of a few days we had designed a marketing response in the United States which was so well received that British Airways' rate of recovery in terms of speed and volume was much more than that of most other airlines on the North Atlantic.

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

THE MECHANISM OF CHANGE

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

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

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

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

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

Staff involvement

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

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

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

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

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

Regulation and the environment for growth

There continues to be regulation and it will be no surprise if I say that there is too much of it. The minimum regulation consistent with safety and the legitimate demands of more open markets should be all that is necessary. The Government has wisely given up market manipulation at the macro level and should not be tempted to reintroduce it at the micro level. Particularly it should license the British airline most able to compete successfully against our large international competitors, not seek to achieve some specious equality between British airlines.
Most of all we are free, with the flexibility to act immediately on our own decisions. Free of the stigma which inevitably attaches to government-owned businesses. It is not reasonable nor acceptable for government to be both owner and regulator. Governments have proven that they can run public utilities but not competitive businesses in the world market-place. Since we are in the latter category, I delighted that we are not any longer one of the former.

CONCLUSION

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

QUESTIONS AND DISCUSSION

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

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

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

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

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

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

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

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

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

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

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

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

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

Sir Colin Marshall: It is vitally important that the top management lead the organization, and lead it from the front. They must make sure that the direction in which the company is to go is well communicated and well understood by all of the people throughout the organization. Certainly, in the public sector, finance tends to become the overriding factor; at least at the very highest level. On the other hand, of course, it isn’t a minor factor when you are in the private sector either, because you certainly want to ensure that your finances are in good shape and that you are well prepared for what your capital requirements are going to be. We determined that we were very strong from an operational standpoint and that we were also strong in terms of our financial management and it was essential for us to change the philosophy of the Company to one of being much more caring, much more people-orientated. We went out and we hired the services of an outside firm to come in and work with our own people in developing the specific courses.
The first one, which I referred to earlier, entitled 'Putting People First', took two years to get every member of our staff throughout the Airline, all over the world, through a two-day seminar. To begin with, the people were quite cynical and very skeptical as to what all this was about and as to whether it was going to work. After about eight weeks of concentrated effort -- which included me personally going to most of those two-day seminars and actually closing them by talking to the hundred and fifty staff we had gathered there -- we began to get a change of attitude on the part of staff.

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

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

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

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

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

The Government must determine if there are certain sectors of the railway that must be maintained for social purposes and those sectors have got to be effectively split out, for financial purposes, from the rest of the railway system in order that the degree of any subsidization that is required is very clearly identified. British Rail is certainly moving in this direction. But British Rail is dealing with three trades unions, whereas we had to deal with some seventeen trades unions in the Airline; so I think that it can be done. It is a question of time, dedication, and tremendous leadership.
Chapter 6

MAKING THE PORTS PRIVATE

Sir Keith Stuart
Chairman of Associated British Ports

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

The problems

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

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

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

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

The privatization

On 1st March, 1983, when the company was offered for sale, we were one of the early cases of privatization. The price of the stock was fixed at 112p per share, which put the princely valuation of forty four point five million pounds
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on the company: about one quarter of the asset value of the company in the
books. Much of the reason for that low market capitalization was the poor
image of the industry, although that image was in fact far removed from the
reality.

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

The effect

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

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

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

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

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

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

The year 1984, as George Orwell predicted, proved a difficult year for us. In
that there was the coal miners' strike which lasted about twelve months and
quite seriously affected part of our revenue because we do handle quite a lot
of coal. There were other problems associated with that strike which had the
effect of depressing our results in the second year of privatization. The first
year it moved from a profit of five million pounds to a profit of nearly three
times that; in the second year of privatization that profit was down to just two
or three million pounds because of the effect of these various problems. This
reinforced a message which was already very familiar to us, the need for
further diversification. We had one very clear area in which our effort should
be concentrated, namely the very significant land holdings which we had at
the ports, which could be now redeveloped for purposes other than port
operations.

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

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

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

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

Dr Madsen Pirie
President, Adam Smith Institute

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

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

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

The unsung story

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

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

The Chancellor of the Exchequer received his money from the sale of the final tranche of British Petroleum, but from the underwriters rather than from the public. The novel buy-back offer sufficed to stabilize the sale, helped by the action of Kuwait in taking a large investment in BP. The Chancellor’s short term luck has been matched by his long term fortune. Very few public sales
are scheduled to come within the next two years. By the time that Water and then Electricity come to the market, he can hope that the fluctuations of the stock exchange will have steadied.

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

The early experiments

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

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

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

A landmark case

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

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

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

The National Bus Company with 50,000 workers and 14,000 buses was first exposed to competition, then privatized in its constituent companies.
Overwhelmingly, with most of the 60-odd sales already completed, the sales have been to management-led teams at a rate of several per month.

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

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

Both private and public

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

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

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

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

The immediate candidates

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

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

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

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

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

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

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

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

Polytechnics and other colleges presently under local government control could become private institutions under the leadership of their current management. The government is already trying to increase their participation with private firms and the marketing of their operations and services. Fixed term agreements between the colleges and government could launch many of them into the private sector with direct state financial support tailing off after initial grants.
More controversially there are selected state hospitals which could be surrendered to the control of their current management in order to market their services to the private sector as well as the NHS. This is by no means suitable generally, but there are some institutions which could be managed more cost-effectively if they were freed from outside political controls and allowed to operate on a commercial basis.

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

Local government services

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

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

The conclusion is that privatization will continue and that while Britain waits for the next big public flotations, it will proceed by a technique which has already proved itself to be versatile as well as successful. The management-led buyout will probably bring as much study by countries overseas as the public flotations have done. It lends itself to application across a wide range of sizes and to a variety of operations. At the heart of its success there lies the elemental truth that people work with more commitment when they have a direct stake in the outcome.
Chapter 8

THE BUYOUT AT NATIONAL FREIGHT

Sir Peter Thompson
Chairman, National Freight Corporation

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

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

THE POWER OF OWNERSHIP

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

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

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

Workers as owners

I suppose the other fear that we had was that if we were auctioned off we wouldn't know who our next bosses would be, and we quite liked ourselves as bosses. So the next basic principle that we put forward was that we wanted to majority of the equity, the majority of the shares in the company, to
be owned by the employees. We were quite adamant with all the financing institutions that we did business with, that we really wanted all the equity to be owned by the employees. We didn’t quite succeed, we finished up giving seventeen per cent away. But that objective meant that we had to take on a tremendous amount of debt. We didn’t believe that our employees would be able to raise more than five or six million. If we wanted all of the equity sitting on that five or six million, we had to gear the company up.

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

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

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

The art of persuasion

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

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

Then they insisted that the next thousand managers had also to contribute six hundred and fifty thousand between them. Finally, if we couldn’t raise four million then the deal was off. Plainly, the bank wanted involvement. They had assets, we had good people.
The workforce: Another thing that we learnt in this exercise was how to communicate with the workforce, and we have never stopped communicating since with our staff. We offered the deal to the employees and their immediate families with a minimum subscription of one hundred pounds and we prepared a prospectus, the reason being that the lawyers and the City men fully understood all the right words and legal definitions that should go into a prospectus, but the lorry driver in Stockton on Tees, really had only the vaguest knowledge of what latin tags and jargon phrases meant. So we argued that we were trying to address a group of people who have never bought a share before in their lives. So we resolved the problem by filling the first half with simple words and pictures and the back half with the usual legal terminology the City people understand but my drivers wouldn’t.

Industrial democracy

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

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

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

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

THE RESULTS

In 1981, the year that we bought the company, we had a bottom-line profit of
one million pounds. By 1986 that had gone up to thirty-seven million and the turnover has increased accordingly.

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

QUESTIONS AND DISCUSSION

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

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

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

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

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

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

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

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

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

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

Sir Peter Thompson: There were two problems that we encountered anyway. The first one is the problem of accountability. At what price to should an asset be sold? It seems to me the Government gets in trouble when it has to go to the market and determine the price. Certainly the spectre at our feast was this inability, or unwillingness, of the civil servants to recommend the price that we were offering was a fair price because the
company wasn't being put up for auction.

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

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

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

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**ISSUES IN INFRASTRUCTURE FINANCE**

There is, however, a rather general case where the private sector can make a significant contribution to the process of privatization and, indeed, at the beginning of the whole large-scale infrastructure projects. There are many possible models and these include partnership with public bodies, banks, and others and there is an advantage in that we don't have to deal with the complex systems and power systems and private generating projects.

Chronic capital shortage is a well-known problem in the public sector and is exacerbated in the UK by the present Government's commitment to cut the public sector borrowing and the proportion of GDP spent by the state.

In such circumstances, the replacement or extension of the infrastructure network becomes a pressing need. One answer is the introduction of private finance. Private finance in the world of motivation and expansion of the infrastructure needs to release the burden on the public purse, benefiting the country at large without further burdening the taxpayer.

**Risk and reward**

Private finance will, of course, be introduced only if there is an assured positive return to be earned. If the return is guaranteed by the government, then, of course, that is exactly what the private sector would expect, and we expect the public sector to be paying and nothing therefore, which need be paid. What is required is a scheme which can attract the private sector to take the risk of acceptance, based upon the provision of revenue return that we see.
PRIVATE FINANCE AND MANAGEMENT OF INFRASTRUCTURE

Patrick de Pelet
Director, Kleinwort Benson

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

ISSUES IN INFRASTRUCTURE FINANCE

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

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

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

Risk and reward

Private finance will, of course, be forthcoming only if there is an anticipated positive return to be earned. If the return is guaranteed by the government then, of course, this is merely disguised public expenditure and will count as public sector borrowing; and nothing therefore, would have been gained. What is required is a scheme which rewards the private sector for the risk it accepts, based upon the projected use of new or re-built parts of the
The introduction of risk has two great benefits: it allows the required finance to be regarded as private sector finance and not as public sector borrowing; and it encourages private funds to flow into those projects that are needed most, that is, those projects most certain of demand usage.

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

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

**Black Country setback**

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

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

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

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

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

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

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

The mandate

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

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

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

The financial package

The proposal was to form a company, the Dartford River Crossing Company, with a single purpose of contructing the new bridge and owning and operating the combined crossing, financed through a novel package. The
total of this package was some one hundred and seventy million pounds, and I will spell out its constituent parts.

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

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

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

This you might feel on first sight is a somewhat unattractive proposition, which would have been unlikely to attract many subscribers. The loan stock was in fact saleable and was fully underwritten before we submitted our bid to the Government, because it was possible to reduce the equity risk to manageable levels, where the subscribers were compensated for the risks borne by the relatively high margin on the loan stock, but were shielded from those which were unacceptable.

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

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

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

Practical issues

If it was reasonable to expect the loan stock holders to bear the commercial and operating risks of the venture, it was clear that they were less able to assess the construction risks involved in a new large-scale bridge. It was
therefore concluded that the design of the new bridge should be agreed between DRC and the Department of Transport and that thereafter it should go forward without any significant design changes.

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

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

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

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

**Lenders' security**

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

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

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

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

This is effectively the only tangible security available to lenders. Indeed, they have entered into an agreement between themselves not to individually exercise remedies that would be normally available in law, where to do so would jeopardize the interests of other lenders and thereby entitle Government to revoke the Concession without compensation.
Essentially we are talking about a project financing based on future cash flow generation.

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

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

Risk and competition

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

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

In particular I draw you attention to four main points.

1. The loan stock holders and lenders are substantially protected from cost- or time-based construction overruns. These have been off-loaded to the construction group.

2. There is an existing revenue stream from the tunnels.

3. Future revenue can be projected with a reasonable degree of accuracy.

4. There is a clear, unambiguous need for the new crossing.

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

Lastly, I would like to deal with the issue of competition. In some instances, Government will determine that a particular piece of infrastructure, which it is already committed to building, could be successfully transferred to the private sector. In these circumstances the sponsoring department is likely to set out detailed guidelines and invite the private sector to tender on a fully financed basis for its design, construction and operation. This procedure was adopted for Dartford and follows from the fact that the Department had already planned a new crossing.
However, since Dartford, ministers have encouraged the private sector to take their own initiatives and to bring forward new schemes. Where these fall outside the current Government plans or where schemes proposed are sufficiently different to those envisaged by Government, then I believe a new approach is required. If these initiatives are to be credible, and withstand the scrutiny of both Government departments and other interested bodies, they will need to have been thoroughly researched and costed.

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

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

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

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

QUESTIONS AND DISCUSSION

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

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

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

On the second question, I don’t think there were any special circumstances. Indeed, the estimate of costs is complicated by the fact that we are talking about a relatively large span bridge in a constricted area in conditions which have not yet been totally explored. There is of course experience of the river bed, both through the PLA and existing crossings, but those were for tunnels rather than for bridge piers. So there is a degree of risk, and I think it is worth emphasising that the private sector is taking risk.
Yildirim Akturk (Interbank, Turkey): What are the arrangements for repairs on the existing two tunnel crossings that are earmarked for this project? Is the maintenance of the two tunnels the responsibility of the company that is undertaking the construction? Thirdly, what is the expected rate of return on the equity investor?

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

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

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

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

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

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

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

Also, there needs to be a commitment at the highest levels to support privatization efforts. One of the features of today’s overborrowing is that there are additional equity sources through equity swaps; so in a way you can take advantage of the current situation by converting debt to equity.
Chapter 10

PRIVATIZATION IN THE DEVELOPING WORLD

Ronnie De Mel
Finance Minister of Sri Lanka

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

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

The political background

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

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

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

We have never had a strong private sector. We have not had a strong capital...
market. We have not had a strong stock exchange. So it was with this difficult background that we started to liberalize our economy in 1977. In 1977 the first budget which I introduced (I have been introducing these things called budgets for eleven years now -- a thankless task) we abolished almost all the controls. We had at that time exchange controls, price controls, import controls, export controls and various other controls that hung like a millstone round the economy, grinding it down.

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

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

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

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

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

The objectives of privatization

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

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

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

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

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

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

**Progress**

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

We had also to abolish the monopolies.

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

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

In other sectors like milk foods, flour, wheat, all the state monopolies have been abolished. As a result, all the scarcity, shortages and queues have
vanished. Fertilizer import and distribution, again, was entirely state-owned and state-controlled, as was the import of tractors and agricultural implements. All have now been opened up to competition.

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

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

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

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

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

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

**Capital Shortage:** The lack of a strong capital market is another difficulty. The British established a thing called The Columbo Sharebrokers Association
a hundred years ago, but after 1956 when the socialist government came into power, the share market became almost dead. There were no transactions at all.

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

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

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

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

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

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

**Overcoming the problems**

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

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

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

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

Helping the process

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

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

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

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