

Carnegie Council\DRT International Privatization Project

An Assessment of Privatization in the U.K.: Mistakes, Successes, and Future Prospects



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I will speak for just about twenty minutes about the U.K. privatization experience and what I would like to deal with is what the U.K. intended to derive from its privatization program; why did it do it; did it work; and what are the lessons for others who are interested in privatizing their industries? I'll deal not only with successes, but also allude to one or two of the failures and I will also try to put the privatization program in the broader political U.K. context.

Perhaps I should start with a small warning: I know there is great interest in privatization outside the U.K. because, as the U.K. was the first country in the '80s to institute a large-scale privatization program, there is a tendency to look to it as a model for others. I think it's perfectly right that one should look to the U.K. as a model because many of the things that happened in the U.K. can be implemented elsewhere. But it is equally dangerous to assume that one can simply transplant the U.K. experience. The U.K. experience took place within a very specific political, social and cultural context which is different from the social and cultural context of other parts of the world and therefore whilst it will inform what might be done elsewhere, it should absolutely not be taken as a prescription. And I say that particularly knowing that many people in North America have an interest in privatization in Latin America where cultural, political and legal frameworks differ to some degree.

Fundamentally, the U.K. government was trying to improve the efficiency of large enterprises which were in the public sector. Since the war, with both Labour and Conservative governments, it was acceptable for the public sector to be large; it was part of what we call a mixed economy. But in the '70s, when of course we had quite a severe recession in the U.K., there was growing and very intense criticism of the public sector. It was said to be inefficient: it overcharged its customers, there was a lack of competition—and so the prime objective of the government was to improve efficiency, lower prices, give better service, and introduce competition in industries which were state-owned. The criticism of the public sector wasn't entirely fair of course, but by most objective standards the economic performance of our nationalised industries, trading institutions, utilities

and other state-owned companies was poor. Now, clearly it isn't enough simply to say, "Well, in that case we'll privatize and it will all be ok". One has to have some idea, some model of what actually is going to change when you privatize. Clearly simply changing ownership per se does not change performance. And I think in the U.K. there were two prime ingredients which were expected to change the performance of our state-owned industries. The first was an improvement in the quality of management and the second was a widening of management's freedom to manage without government interference. Since these are very fundamental to the success or failure of the privatization program, I'd like to dwell on

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each in a little more detail.

First, in management: certainly in the U.K.—and I believe this is true in many other parts of the world—it was hard to attract good management into the nationalised industries. There are various reasons for that. One is that the public sector tends not to pay very well and in particular tends to find it difficult to provide incentive schemes, bonus schemes, share options, and so forth, and it is also cultural, because the culture of public service is that, in many parts of the world, you work for the sake of service rather than for financial gain. Secondly, quite apart from economic factors, in the U.K. there was something of a stigma attached to being a public servant. It's a stigma which I think has grown in the 1980's, partly as a reaction to what is perceived as poor performance, lack of motivation, and lack of incentive in the public sector. What we have found in the U.K. is that privatization has made it possible to attract good senior managers into what were once state-owned industries. Indeed, even the prospect of privatization has enabled companies to hire good senior managers before the privatization takes place. A very good example is British Telecom. Two years before British Telecom was privatized, it was possible to attract a high level chairman from the private sector, and a number of other senior executives from the private sector who may not have joined had they not known that the company would be privatized. So changes in management performance are the single most important ingredient of privatization and a privatization program which doesn't achieve that is unlikely

to succeed. I said before, however, that one can't automatically transplant the U.K. experience elsewhere. It's not true in all parts of the world that the best management usually resides in the private sector. There are many Third World countries where the best management is actually in the public sector; the best educated and indeed, in some cases, those with degrees from Western business schools, will very often

the state owned telecommunications company decided to do a deal with an overseas operation equipment supplier, the transaction would be likely to have a political dimension which could hold things up for a considerable period of time. Only by cutting telecommunications companies free from government control can one leave them free to make vital international alliances.

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be in the public sector. So one can't automatically assume that in all places privatizing will suddenly turn on a tap of management talent which wasn't previously available.

The second major change which the British government sought to make in privatizing these industries was to reduce government interference. In theory our industries, even when state-owned, were run at arms' length from the government; in theory they were separate corporations, they had separate financial objectives and targets; and in theory they were independent. But in practice, ministers found it hard to resist intervening. For example, you would find domestic consumers of electricity or telecommunications subsidized by business consumers, so you had important economic distortions created by government's intervention in pricing. Also, these companies were not able to make investment decisions unfettered by government. For example, because funds came from government, all our nationalized industries had to get approval for capital projects over a certain size. And what they used to find was that their project—let's say a power station—was on a long list of government priorities which would include hospitals and tanks for the army and aircraft and all sorts of things that have absolutely nothing to do with their industry and what to them might have been a very good decision might not have been made simply because another government priority took precedence.

The third aspect of management freedom which is very important, and which I think is more recently recognized and is particularly applicable in industries such as telecommunications, is that to survive in some industries you have to be free to make international alliances. That is absolutely clear with British Telecom; it's clear also with Singapore Telecom. Singapore Telecom is not being privatized because the Singapore government thinks it should be more efficient or because the Singapore government needs the money; it's being privatized because the Singapore government doesn't believe the telecom company can survive unless it is free to make contracts internationally. Those contracts would be difficult to make if it were publicly owned; if

I said I would try and give you some sort of tentative evaluation of whether privatization had worked, although it is very difficult because even though the privatization program in the U.K. started a decade ago, many of the companies which have been privatized were privatized only in the last three or four years. We are talking about very large organizations in which change requires huge shifts of culture which themselves take many years. So, to make an evaluation early is difficult, but the initial evidence, I think most people would agree, is favorable. There are undoubtedly very considerable increases in productivity in our state-owned industries—take a company like British Airways which was unprofitable and overmanned; it wasn't until private sector management took office that it was prepared to make difficult decisions about personnel and people losing their jobs. British Telecom is a great deal more efficient than it was. There are still complaints about service, but many fewer than there used to be and the statistics objectively do demonstrate an improving trend. There are many other examples where productivity improvements are taking place. That's not to say those productivity improvements are wholly the result of privatization because, to be fair, some of these industries were already improving before they were privatized; but nonetheless it does look as if new management and the freedom to manage is starting to have some effects.

Exposure to market forces in general is having some effect; sometimes it has an effect even before privatization. A striking example of this is the U.K. nuclear electricity industry. The conventional wisdom had always been that nuclear



Brian Pomeroy speaking at private dinner for business executives.

power was cheap. It was only during the process of accessing the business in the course of trying to privatize it that it was discovered that nuclear electricity is in fact very expensive in the U.K.; the industry simply had not counted all the costs. So market forces are at work in the analytical phase before privatization as well as after privatization.

One important objective of the British privatization program was to introduce competition wherever competition was possible. This was limited to the extent that there were natural monopolies, but monopolies are sometimes less monopolistic than they appear. For example, in telecommunications, which was once thought to be a natural monopoly, it is now clear, in light of new technology, that it is much more contestable by new entrants than one might have thought. Although the government set out to introduce competition wherever possible, it has been criticized for failing to do this in one or two early instances of privatization; for example it is now said by many people that the government should have broken up British Telecom, as indeed the telecommunications industry was fragmented in the USA, and that the government should have broken up the gas corporation, which it also did not do. It did, however, break up the electricity industry and introduce competition in generation, but some would say that the government's record in introducing competition was not as good as it might have been and that one or two opportunities have been missed.

The last objective that I want to mention is a wider po-

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litical objective, which is to inculcate a sense of ownership among the British population; a sense of property ownership. Not only share ownership, which was the particular role of the privatization program, but also of real estate ownership (encouraging people to own their houses and so forth) and the privatization program has been very much a tool of that policy. That is why you will find that many of our flotations have been very large mass marketing affairs; we have sold shares to the public using the same techniques as are used to sell washing powder or tins of tuna. Huge advertising campaigns, large publicity exercises, and a huge amount of convincing of one sort or another were used to persuade people who had never been owners of shares before to become share owners. That undoubtedly increased the number of shareholders. Whether they are long-term sharehold-

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ers, and whether their fundamental perceptions of share owning have changed is possibly more debatable. Many of them own only one share, which is the privatization share they were able to buy on reasonably favorable terms, and many who sold their privatization shares very quickly at large profits may have gained the impression that investing in the stock market is always like that, which is not necessarily a healthy way of looking at securities investment. So I think the jury is still out on that particular objective.

Finally, I think you have to see all of what happened in the U.K. as part of a much wider political thrust to redefine the boundaries of the public and private sector and shift people's perception away from acceptance of the mixed economy as I described it, (a substantial public sector coexisting with the private sector) to one in which government interferes or involves itself in economic activity as little as possible. Essentially what the government has done through the privatization program is shift the burden of proof. The burden of proof is now on anyone who believes that an activity ought to be undertaken in the public sector to demonstrate why it should be and the presumption is now that if

there isn't a good reason for it being undertaken in the public sector then it should be undertaken in the private sector. That's a very fundamental political change which changed the agenda not only of the Conservative Party, which is in power, but also of other parties. No one should underestimate the extent

to which political will, commitment, and singlemindedness was needed to implement the British privatization program. There was considerable risk-resistance by the industries that were to be privatized; considerable resistance initially on the part of employees and the labour force; and even within government there were considerable tensions and differences as to how individual enterprises should be privatized. I think it needed the engine of ideological fervor, and a strong political dimension to the program to really provide the singleminded impetus that has brought us to this stage where now all but two of our utilities have been privatized; large numbers of other companies have been privatized; and there is a continuing and far reaching search to move any activity, whether trading or nontrading, from the public sector to the private sector. ■

Questions and Answers

Q I have been working with New York City to try to help them organize a program such as this and we find tremendous resistance in terms of the unions and the civil service mentality in the civil service system. Could you please comment on how we could perhaps get around the union block and the civil service system?

A The history of union attitudes to privatization is very interesting because the trade unions initially were implacably opposed to it. That was less true of senior management of the company, who were also sometimes union members, because they foresaw the management freedoms that I have discussed and indeed the pay and incentive improvements that I have already mentioned. Interestingly, what I think transpired was that fundamentally the union leadership did not always reflect the true feelings of their members. There is a story about a meeting which took place at the time British Telecom was being prepared for privatization in which Neil Kinnock who, as the leader of the Labour Party, was giving a talk to telecommunications workers in South Wales. Part of the government's proposal was that the workers would get shares on favorable terms and at one point it is reported Neil Kinnock said to the telecom workers, "Of course if Labour is elected, we will renationalize British Telecom." Whereupon one of the employees said, "Yes, but will we be allowed to keep our shares?" And that, in a sense, said it all. So there was a lot of initial resistance by the union's leadership, less by the rank and file, and truly at the end of the day employees have themselves become large shareholders on concessionary terms and that has clearly helped them to accept the concept of privatization. Interestingly, after the early years of privatization, let's say up until about 1984 or 1985, there had been very vigorous union opposition, but after that, the opposition from the unions waned considerably.

Q I'm particularly interested in your involvement with the Polish government: it was mentioned that you are helping set up the voucher system. Would you give us your opinion on how much they have accomplished?

A Poland has about 8,500 state-owned companies which it is anxious to privatize eventually and it has already privatized some by what you might call conventional means, that is share flotations, placings, trade sales, and so forth. But it's fairly clear that it will not be able to privatize all of them in that way. For one thing, many of them are extremely difficult to value and for another, the capital market in Poland is thin and probably the only adequate source of capital will be foreign investment. So what the government has decided to do is to give away shares in a large number of state-owned compa-

nies and the way it is doing this is by giving each Polish citizen over the age of 18 (of whom there are 28 million), a voucher which will entitle them to shares. The government is encouraging international investment banks to set up investment funds, and these investment funds will be given the shares in the underlying companies and the Polish citizens will have shares in the investment funds. The idea is that the manager of the investment funds—who, as I said, will not be public servants, they will be international investment bankers—will manage these, and over time will, if necessary, undertake joint ventures with trade purchases or oversee foreign investments, and will recapitalize the companies etcetera. It will be up to the management of the investment funds to take whatever steps are necessary to improve the performance of these companies.

Q When you say the vouchers are given to the Polish citizens, are these citizens in general or employees?

A There will be a tranche set aside especially for employees. But a large proportion of the stock will be put in the funds where shares will be given to Polish citizens at large. This is a very innovative way of privatizing. It has some problems in that it doesn't produce any cash, whereas what a lot of these companies need is cash as much as anything; in fact foreign exchange is desperately needed because they need to reequip, so clearly the managing institutions will have to find funds in some way or another. But the aim is to at least start to focus private sector thinking on the companies, even though everyone expects it will be some time before there is radical change in their performance.

Q If a government were to face a situation where it had some companies, that because of their nature or obsolete technology, say steel or telecommunications, needed concessions for a private investor to take them over, but had others that could be sold at a profit, such as oil and chemicals, and lots of others somewhere in the middle of the two, how should the government structure getting these companies in the hands of the public? Should a queueing system be established so as to not crowd the market? If so, which would you put first; the easy ones, the buffer ones, or the tough ones that were hard to session?

A There are several questions there. First of all there is always the risk of crowding the market in any capital market, so there needs to be some management of the market, and clearly if the market is thin then all the more so there needs to be management of a queue. That's true whether we talk about privatization or whether we're talking about regular stock issues, new issues, or rights

issues. As far as how one deals with the question of profitable and nonprofitable industries, the truth is, you can sell an non-profitable industry but you won't get much for it. You will get more for it if you have the patience, will and ability to improve its performance before you sell it because you won't get value for its potential improvement—or you won't get much value for its potential improvement—if you sell it too early. So if the government's prime objective is to maximize proceeds, then it is better to try and turn the company around before privatization. It is possible to sell almost anything at a price, but it is really a question of how one trades off the desire, on one hand, to maximize proceeds and on the other hand, to get the company out of the public sector quickly. Certainly in the U.K. context, the inclination would be to want to sell profitable companies. There is also a danger that in a privatization program, particularly one in which there's going to be mass marketing of shares, if you sell companies which do not perform well, you will undermine the credibility of your program. If the first one or two don't go well, that may well color the perception of investors when it comes to selling other companies.

Q We don't hear a lot about the changes within the government necessary to support privatization. Would you talk a little bit about the U.K. experience and what it has meant from an infrastructure standpoint: building up regulatory bodies, whether its telecom or utilities, and has that become a growth industry?

A Many of the companies which have been sold have been public utilities with some degree of monopoly. The intention has always been to eliminate monopoly wherever possible, but so far as the residue of the monopoly is concerned, we've had to have regulatory bodies. And what we have is a separate regulatory body for each industry—unlike in the U.S. where you might have a public services commission which would cover a range of industries. They're small bodies but they are highly skilled bodies and they focus on the industry for which they are responsible. So we have a regulatory body for telecoms, electricity, water, and gas. We have, of course, had to think from scratch about how we would regulate those industries and we've adopted a form of regulation which is rather different from North American utilities regulation, which is mainly characterized as an allowed rate of return regulation. We had believed that better incentives would be given to improve performance if there was a simple price ceiling, although the price ceiling itself is set with some regard to the likely rate of return.

Q Is it true in every country that the nuclear energy industry is not profitable or that it is much more expensive than other forms of energy production? For example, in France, where they have 70% de-

pendency on nuclear energy, is it the same situation there?

A The evidence is that in France, I believe, nuclear energy is very cheap. A lot depends on the utilization of your power stations, which really means did you choose the design right and are you operating it correctly? If nuclear stations are operated at very high load factors—high utilization—then nuclear energy can be very cheap. If, as is the case with some British nuclear stations, particularly those that follow British design, the utilization is low, then the unit costs are very high and it is very capital intensive.

Q Do you have any idea of the increase of productivity through privatization and the percentage of industry that was nationalized and is now privatized in the U.K.?

A I have something on the second and not readily at hand on the first. In 1979, what you might call the state-owned trading sector, which is not all of government but that part of government which was engaged in the production of goods and services, accounted for about 9% of GNP. It's now being reduced to about a third of that. In other words, about two thirds of those companies or enterprises have been sold—I think there are about 45 or 46 companies in total. As regards the first part of your question, no, it differs between industries and, as I say, one has to be a bit careful not to oversell privatization. I try to retain a dispassionate view of it because it isn't a panacea for everything and in some cases large productivity improvements were already being made in the public sector.

Q Two questions that are very dissimilar; one is: what do you see happening with the RECs—do you see them merging eventually? And the other question regards British Gas: do you think it will be able to hold the independent power side hostage by virtue of where it's trying to set the gas pipes?



Left to right: Robert Mc Phail, partner, DRT International; Gloria Gilbert Stoga, Carnegie Council; and Stuart Butler, The Heritage Foundation.

A I think there would be important competition policy implications of RECs trying to merge. RECs are the regional electricity companies of which there are twelve, and these are distribution companies—they distribute electricity as opposed to generating it; they buy electricity from the generators. I think there will be competition policy implications from mergers and takeovers between the RECs, which is not to say it's impossible. We were saying a little earlier that there is natural monopoly in the distribution of electricity; nonetheless competitive forces can still apply through capital market competition. In other words, if one REC did particularly badly, because its costs were out of control in comparison with the other eleven, that would undoubtedly encourage major shareholders to put some pressure on management. And so even though there isn't competition between them, there is this set of derived competition in the capital markets which could conceivably lead to takeover by another REC or possibly by some other industrial concern. I think given all that has been said about competition and not wishing to have concentrations of power in utilities, that would attract political attention and might even get blocked. But it's not inconceivable. The question of British Gas is very interesting. British Gas, as I have indicated, is one of the utilities which some would say should have been broken up into regional companies and perhaps a transmission company as well. British Gas has been under a lot of criticism recently, as your question implies, for impeding new electricity generation projects. Although most of our electricity generation is coal fired, probably all new plants for some time are going to be gas fired and so there is considerable demand for gas and the major supplier of gas is British Gas. British Gas has indeed adopted some pricing policies which have been controversial, to say the least, when it comes to making price quotations to the industry. So British Gas is under a little pressure from its regulatory body not to adopt pricing policies of that sort. Our Office of Fair Trading is also having a look at British Gas. The OTF is a public body which looks at monopolies and monopolistic practices of all sorts, and it is due to report quite soon.

Q Would you comment on the impact of national policy on localities' privatization efforts and the difference between the two?

A I've been talking mainly about divestments of companies—of utilities and other companies—this morning and those have mainly been national utilities and so they have been dealt with at national rather than local government level. However, of course, the privatization program in the U.K. is much more than simply divestments. There is a lot of subcontracting by the public sector in the U.K. Much of this is occurring at local government level and for them privatization mainly



Brian Pomeroy (left) with Joe Burns, deputy COO of DRT International.

means not selling things off but bringing in a subcontractor to cut the grass or to collect the refuse. That is what privatization mainly means in local government and it is being pursued vigorously. Typically, the existing labor force is permitted to tender against the outside tenders which provides quite interesting comparisons in cost. In the borough I live in, the original local government labor force won the competition for refuse collection. But it appears to have won it at a price which doesn't enable it to actually collect the refuse, as a result of which it is being retendered, so it may well be that somebody else will be awarded the contract.

Q Do you have any experience with transportation privatization?

A I have some experience of road transportation privatization in Hungary. That's not necessarily a model for all parts of the world. In the U.K. there have been some transportation privatizations. We have NFC, a national freight company which was privatized. We deregulated bus services so that you no longer need to get a license to run one. One of the reasons for the original licensing regime was that in rural areas there was a social case for subsidizing some bus services and what happens now is simply that if a local government authority wants to run a subsidized bus service, it simply says, "We are looking for a contractor to run a bus service or a company to run a bus service from A to B," and they go out to tender for the company which requires the smallest subsidy. The major transportation privatization in the U.K. will, if it happens, be British Rail, where some work is going on at the moment but nothing is likely to happen until after the next general election. British Rail is problematic because it doesn't make a lot of money. It consists of some profitable businesses and some non-profitable businesses and there is a debate taking place about whether it's possible to introduce competition into rail. There are those who say of course it is: all you need is a track authority which will essentially sell rail time to competing operators. However, there are some problems with this; there are operational complications and there are also safety issues.

But the government is certainly looking hard at whether it is possible to have a competitive environment in railways.

Q You have indicated that in privatizations a good many people were brought in at the senior level of management changes. What about lower levels? What sort of percentage is there in management changes?

A Let me give you an example: many of our nationalized industries never had professional accountants doing accounting. They had public servants who had sort of trained in finance, but they weren't what you would call CPAs or what we would call chartered accoun-

tants. So there has been quite widespread recruitment of those specialists and they would be middle management rather than junior. I've no doubt also that at junior levels there's been some recruitment. But of course these businesses have largely been net losers rather than net gainers of people since privatization; basically the policy has been to bring the work force down. So my guess would be, though I need to confirm this with statistics, there hasn't been a huge recruitment at junior levels. Management attention is mainly focused on getting the level of manpower right—which means lower in practice—and also to try to achieve some sort of culture changes at all levels which, as you would expect, will take probably many years to bring home.

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