Her Majesty's Treasury

IMPLEMENTING PRIVATISATION: THE UK EXPERIENCE

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Governments throughout the world face mounting demands on scarce public resources. At the same time the pressures of international competition mean that they want efficient enterprises, capable of competing directly with, or delivering cost-effective services to, others. In developing countries growing populations, and the need to provide an attractive environment for business, require improved infrastructure. In developed countries there is a continuing demand for higher standards in the provision of services, whether healthcare, electricity and telecommunications or transport, and whether provided to the public or to businesses. Yet everywhere Governments are under pressure to keep control of public finances.

The disparity between the demands on the public purse and the resources available to meet them is leading Governments to look at how infrastructure can be developed, services provided, and enterprise modernised in partnership with the private sector. This partnership can take a number of forms:

- using private sector finance and skills to develop, construct and operate new infrastructure, in return for operating concessions for the asset (known as the Private Finance Initiative in the UK);

- partial sales of existing enterprises, either to a single strategic investor, or to institutional or retail investors via trade sales or public flotations; or

- the complete transfer of enterprises to private investors.

As well as securing financial benefits for the public sector, these mechanisms can introduce new management, working practices and techniques from the private sector, thereby promoting the introduction of international best practice into less efficient companies. Through any associated industrial restructuring, they can help contribute to the development of a more dynamic and competitive economy. They can increase investment in infrastructure and related services compared to the levels that could be afforded by Government alone. In addition, they allow Government to focus on specifying the required standards of a service, rather than on providing the service itself.

In the course of the UK's privatisation programme, involving the transfer of enterprises from the public to the private sector, UK-based firms have developed innovative techniques across a range of associated activities. These techniques include:

- the complete restructuring of industries to provide a greater focus on core business activities, to reduce the potential for the cross-subsidy, or to create competitive markets;

- devising and establishing regulatory arrangements for industries where a significant amount of monopoly power is unavoidable, so enabling commercial development alongside the protection of consumers; and

- creating and developing new sales techniques, including wider retail involvement in the capital markets, and innovative pricing and distribution techniques including bookbuilding, which have now been adopted around the world.

The portfolio of skills built up over the years by UK-based firms, both in the UK and overseas, give them an unparalleled grasp of the issues which arise, and of the lessons that can be learnt, from others' experience.

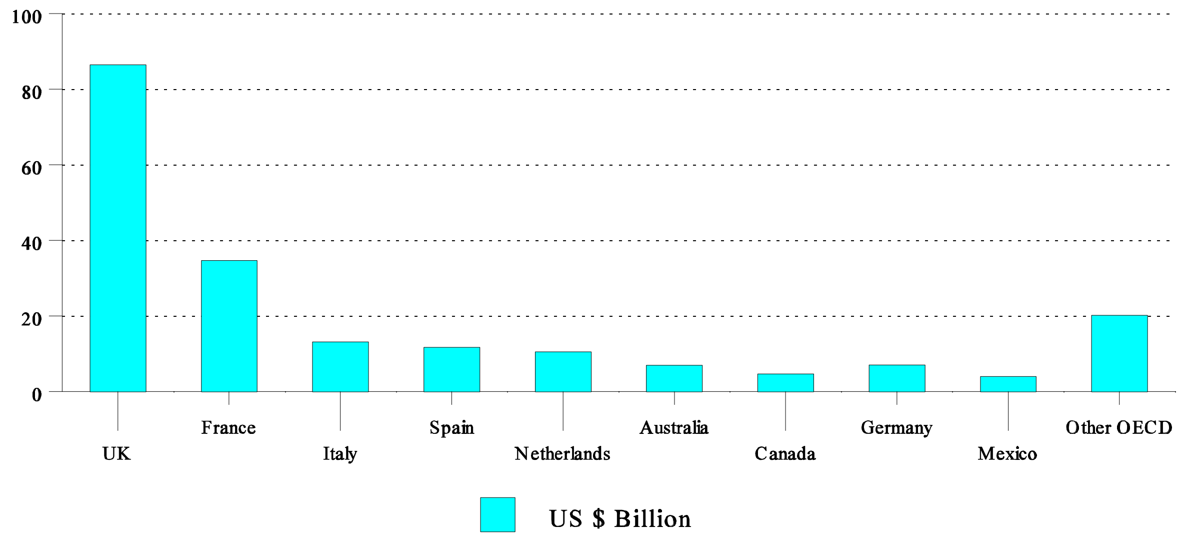
The UK Government believes that Governments and companies elsewhere should tap into the expertise which has been built up in London and make the fullest use of the wide variety of financial services which are brought together in the City of London. These not only cover privatisation and Private Finance but also public/private partnerships more generally, which are being further developed in the UK by the Labour Government, elected in May 1997.

A WORLDWIDE PHENOMENON

Privatisation is now being pursued by Governments in many countries across the world. It takes many forms, from the wide-ranging "voucher" privatisation in former Soviet Union and other East European countries, to the granting of concessions to operate water supply and sewerage treatment services in India. OECD figures show that the cumulative value of privatisation sales worldwide reached some $88 billion in 1996, and total privatisation sales revenues in 1997 are estimated to have reached some $160 billion. The UK was among the first countries to adopt privatisation and UK-based firms are now recognised as leaders in this field, having helped transform privatisation from an academic concept into practical policy which has been applied throughout the world - not necessarily following the UK model in all respects, but drawing on the lessons learnt here and elsewhere, and on the experience of key UK-based participants.

Table 1 shows the relative levels of proceeds raised by OECD countries through public flotations between 1980 and 1996, during which period the UK accounted for some 40% of the total sums raised.

Table 1: Equity Privatisation Revenues, OECD Countries, 1980 - 1996



THE UK's TRACK RECORD

In the course of the UK's privatisation programme, UK advisers have developed a number of new techniques which have been adopted, and in some cases further development, in sales around the world. These have included:

- the restructuring of industries to create financially viable and commercially focussed companies, for example the extraction of the oil exploration company Enterprise Oil from the state-owned British Gas Corporation;

- the restructuring of other industries to improve (and in some cases to create) competition between market participants, for example in creating National Power and PowerGen, the competing fossil-fuel generating companies, from the monopoly Central Electricity Generating Board;

- the creation of new regulatory structures and supervisory bodies (OFTEL, OFGAS, OFFER, OFWAT and the Office of Rail Regulator, ORR), with the aim of safeguarding the consumer interest where local or national monopoly suppliers still exist;

- the invention and refining of large-scale public offers, a technique now adopted for sales outside the UK, for example Deutsche Telekom, Electricidade de Portugal, the Indonesian telecoms company PK Telkom, the Polish copper mining group KGHM, and the Australian airline Qantas;

- the development of legal structures for sales by instalments, allowing investors to pay for shares over an extended period - now adopted overseas, including the recent offers of shares in Commonwealth Bank of Australia and Telstra;

- the introduction of "bookbuilding" techniques into privatisation offerings, allowing the vendor to obtain better pricing information from the market, so increasing value to the taxpayer;

- the refining of concession structures to allow continued subsidies from the public sector whilst introducing private sector management techniques and working practices; and

- through the UK's Private Finance Initiative, creating structures which allow private sector operators to deliver improved services by constructing and managing infrastructure and other projects, which have traditionally been the province of Government.

Privatisation programmes tend to have three stages. Broadly, these phases can be defined as;

- the initial, commercial stage;

- the more complex, utilities phase; and

- the third phase, involving the less commercial industries, possibly including those reliant on continuing state subsidy to operate socially desirable or necessary services.

The UK's experience suggests that it is important to plan privatisation as a programme. Initially the vendor Government may require early and high-profile successes, and in some cases short-term proceeds. Such individual, proceeds-driven, sales may be carried out on a case-by-case basis. However, a shift in emphasis, considering and implementing sales as part of a more coherent and planned programme, can have significant benefits. Within a longer-term framework it is possible to plan forward and prepare for the later phases of the programme, including the complex re-examination and restructuring of entire sectors which is often required to ensure success.

The commercial stage may involve the sale of companies which, although state-owned, are free-standing and already operate in a competitive fashion, whether domestically or internationally. UK examples include the sale of Amersham International, the radioactive materials manufacturing group, Briloil, the state-owned oil exploration company, as well as British Airways and Royal Ordnance. Companies of this nature can be transferred to the private sector largely in their existing form, although Governments may want to consider before sale whether their balance sheets are appropriate for their new status. Such companies may be strong candidates for trade sales to third parties in the same business sector, although to encourage competition there are often advantages in establishing the companies as stand-alone entities and selling via flotation.

The second, utilities, phase is likely to require an examination of the role of the state in providing key services, including telecommunications, power generation and supply, and water and sewerage services, where there will often be monopoly elements. This phase may also involve restructuring the existing monopoly operation to create new, competitive, markets, and competing companies to operate both within that market and internationally. It may require the creation of a regulatory system and a regulatory body to oversee the new market and, through price and service regulation, to protect the needs of consumers. The regulatory system may also provide a means of improving levels of service and increasing investment. Key UK examples of companies which, because of their monopoly nature of parts of their businesses, were sold subject to a regulatory regime, were BT, British Gas, the Regional Electricity supply and distribution companies, and the Water and Sewerage companies in England and Wales. Utilities of this kind are likely to be large companies, and this usually makes them candidates for sale by public flotation. This approach was adopted for the majority of UK companies included in this phase, although a few (including the electricity generating stations in Northern Ireland) were privatised via trade sales.

The third phase has involved the sale of companies which do not operate in a wholly commercial environment, for example, because they operate socially desirable services, often reliant on subsidy from government. In order to privatise such companies successfully, new relationships between the public and private sectors may need to be established, for example to target subsidy only at those services where direct support is essential. The nature of these businesses has meant that in some cases companies have been franchised - a form of concession - allowing private sector operators to manage public transport services while still receiving subsidies from central government for socially necessary, but otherwise uneconomic, routes. In the UK, this structure was applied to the train operating companies, while Railtrack, the rail infrastructure operating company, was sold by flotation.

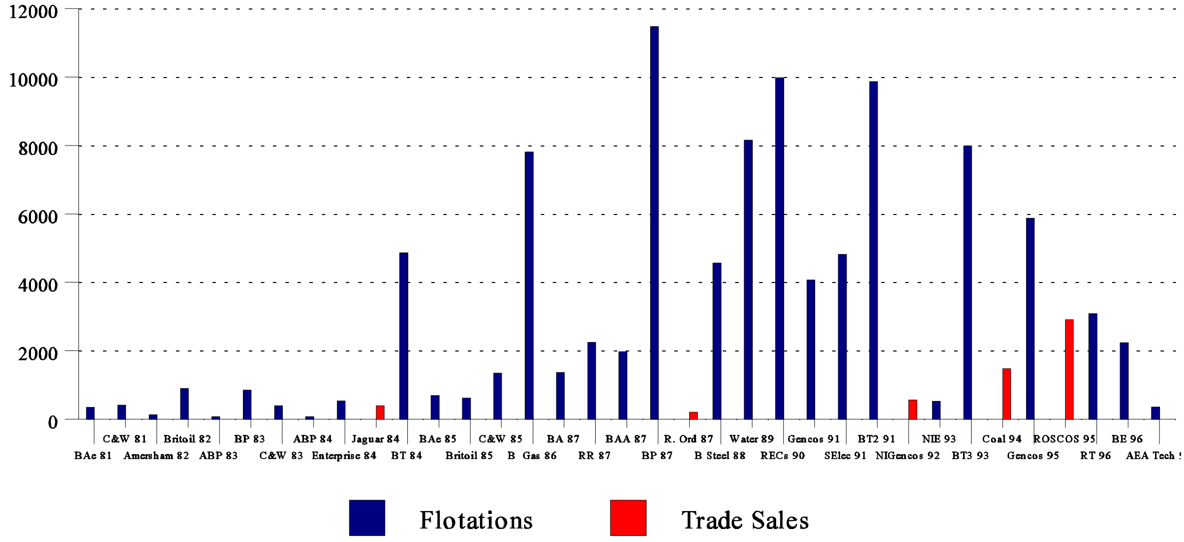
The UK also had to develop structures to deal with the circumstances of particular industries. The flotation of British Energy, the electricity generating company which owns and operates nuclear generating stations, involved creating a long-term, ring-fenced, funding structure to allow the company to provide for the liabilities associated with decommissioning nuclear power stations. And the privatisation of some central government functions entailed the Government providing the businesses with a guaranteed workload in the short to medium term, so as to enable them to adjust to their new environment before having to tender competitively for contracts from Government and new work from other sources.

As noted above, there are a number of possible methods which can be used to transfer undertakings or businesses to the private sector. These include;

- a **trade sale.** These may take a number of forms, including:
  - the sale of a (normally controlling) stake in a company to a strategic investor, often linked to commitments to new investment or the introduction of new management. This may be preparatory to the sale of the remainder of the state's interest to a wider audience;
  - bids by the existing management and workforce to buy the company from the state, known as management buy-outs (MBO) or management-employee buy-outs (MEBO); or
  - the purchase of an entire business by a third party, often (but not exclusively) operating in the same business sector;
- the granting of medium to long-term **concessions** to take over and operate a company or a service on behalf of the Government, with the new private sector management granted operational freedom to manage the business as they see fit, subject to any over-arching guidelines or regulation imposed by Government. This right to operate may be re-offered at the end of the concession period; and
- the public **flotation** of all or part of the share capital of a company, either to domestic or international investing institutions, or to individual shareholders (the "retail public"), or to a combination of the two.

Table 2 illustrates the major sales carried out, both by flotation and by trade sale, in the UK as part of the privatisation programme. Of those shown, the trade sale mechanism was used for the sales of Jaguar, Royal Ordnance, the generating companies in Northern Ireland, the assets of the UK coal industry, and the Rolling Stock Companies. Flotation has been the preferred sale mechanism for the utilities and other large companies. This partly reflects the difficulty of finding a suitable trade buyer for such companies, particularly where competition issues are paramount, but is mainly because flotation gives access to a much wider range of investors, with beneficial consequences for proceeds as well as for the development of the capital market.

Table 2: UK Privatisation Programme: Major Sales: US $ million



TRADE SALES AND CONCESSIONS

Although the UK's privatisation programme has mainly involved the listing of companies on the London Stock Exchange, and share offers to institutional and retail investors, it has also sold a large number of companies via ***trade sale***. This mechanism has largely been used for smaller companies or those which may face particular challenges to their business in the near term, or where the business's track record is too short to meet flotation requirements. This mechanism is used to a greater extent outside the UK, reflecting the smaller scale of the companies involved, the perceived need to introduce strategic investors and management changes to effect a swift change in the company's performance, and the lesser emphasis placed on the retail investor elsewhere. Interestingly this pattern has been changing in recent years, particularly where sales of the larger utility companies have been undertaken, with European and some Latin American countries focussing sales towards retail investors to a greater extent and drawing heavily on the UK's initiatives in this area. Outside the UK, trade sales often take the form of sales to ***strategic investors,*** with a significant stake in the business sold to a third party investor - usually an international company active in the same business sector - subject to commitments from that purchaser to fund significant investment for expansion or system improvements.

Such strategic investment sales can be a useful way of bringing new management and expertise into a company. They are often, although not exclusively, linked to a disposal of part of the company's share capital to its employees - which may be seen as a form of compensation for the change in their status (from public to partially private sector staff) - and to a simultaneous or subsequent listing of a percentage of the company's share capital on local or international stock markets. A particular example of the coupling of a sale of a strategic stake with a later flotation was the initial sale of 40% of CANTV, the Venezuelan national telecommunications company, in 1991. This sale of 40% of the equity to a consortium including US and Spanish telecommunications companies was linked to a transfer of 11% of shares to employees and former employees of the company - with the state holding a residual 49% of the equity. This was followed in 1996 by a sale of just over 30% of the state's shares, to international and domestic investors, thus widening the shareholder base of the company. UK-based banks played a major role in identifying the strategic investor and organising the sale. These skills have been invaluable not only in the telecommunications field but in other areas where strategic investors have taken a stake in national assets, including sales in the airline, electricity and other sectors.

Sales through ***concessions*** are now becoming more widespread internationally, with the public sector using this method to introduce private sector management and investment into companies over a medium-term period, whilst still retaining the ability to re-let the contracts to manage these services after the expiry of the concession period. In some countries, concessions are let over very long periods - for example, the 50-year concessions let by the Australian Government to manage their main airports, and by the Mexican Government to operate sections of the Mexican rail network. However, it is possible for concession arrangements to be offered for shorter periods, depending on the nature of the contract and the service involved. For example, in the UK, concessions have been let for somewhat shorter periods, normally 5 years, in the case of the bus services, and between 5 and 15 years in the case of rail services, dependent on the routes involved and the proposed levels of investment offered. Concessions in the UK have tended to feature most heavily in the transport sector. Elsewhere, the concession technique has been applied to other areas, for example water and power services.

One notable feature of the concession mechanism is that it allows the transfer from Government control of industries which remain reliant on public subsidy. The mechanism used in the UK has offered the right to run services, awarded partially on the basis of the amount of subsidy required, although the relative quality of services offered (assessed against a minimum service requirement specified by the Government) and other, predominantly investment, criteria, are also taken into account. Crucially, the contractual agreement which underpins the concession agreements specifies the amounts of subsidy to be paid to the operator over the life of the concession agreement. This will require a contractual commitment from Government to a long-term, and inviolate, funding stream, which may or may not be higher than that which existed under state control, but which will in any case not be subject to short term variation.

INDUSTRIAL RESTRUCTURING AND REGULATION

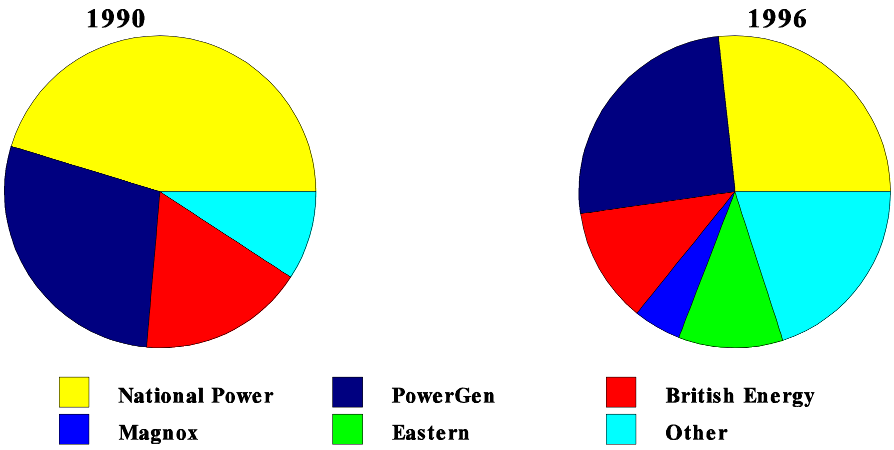
More complex companies, such as utilities, present particular difficulties which need to be addressed. Where Governments are considering the privatisation of large or monopoly utility companies, they may wish to consider how to restrict the market power of the privatised body, and to ensure that there are sufficient incentives for the industry to become more efficient. The UK aimed to develop competition wherever possible, but this could not be achieved in all sectors. Geographic and investment constraints give some industries, in particular those with substantial networks, a significant degree of natural monopoly. In these instances, and a number of other cases where the introduction of competition could not take place immediately, regulation has been used to replicate, as far as possible, the effects of competition by enforcing both restrictions on prices and higher service standards. In the UK, the various sectoral regulators, although appointed on a fixed term by the Government, act independently, at arms-length from Government.

Regulation may also be used to allow the relative performance of companies in the same business sector to be compared where direct competition is not possible, so providing a mechanism to spread best cost and service practice within the industry. This “yardstick regulation” is applied in the UK to the regional electricity and water companies.

In some cases regulation can act as a temporary substitute for competition while facilitating its development, for example in the UK electricity sector, where the regional companies’ local monopoly in the supply of electricity has been progressively reduced, so that smaller users of electricity have been able to purchase their power from different suppliers over time. Very large users of electricity - those with a maximum demand of over 1 megawatt of electricity - were given the freedom to purchase from any supplier at the time of privatisation in 1990; this limit was lowered to 100 kilowatts in 1994 and is planned to be removed altogether in 1998. This progressive liberalisation was planned as part of the overall privatisation process. Conversely, at the time of the privatisation of British Telecom in 1984, only two national operators were licensed, and the government made clear that this duopoly was expected to last until at least December 1990. As a result of direct experience of the development of the telecoms market, the Government was able to allow open, licensed, competition in telecoms in the UK (implemented in 1991).

In the electricity generation sector, the UK split the state-owned monopoly Central Electricity Generating Board into a number of smaller, competing generators in 1990, and sold shares in the two fossil-fuel generating companies (National Power and PowerGen) the following year. A third company, comprising the nuclear generating assets of the former CEGB, was withheld from sale in 1991 following concerns about the decommissioning liabilities associated with the nuclear industry. The more modern nuclear generating stations were themselves privatised, as British Energy, in 1996, while a state-owned company continues to own and operate the older nuclear generating assets. One of the Regional Electricity Companies, Eastern Group, has subsequently purchased generating plant from National Power and PowerGen in addition to being involved in consortia constructing new plant, and, as illustrated in **Table 3** below, accounted for some 11% of total electricity generation in the UK in 1996.

Table 3: Effects of Competition: Market Share of Generating Companies



Such restructuring is not restricted to the electricity sector; nor is it confined to the UK. Internationally, New Zealand, some Australian states, Argentina, and Hungary are among those who are considering, or have already implemented, the separation of the generation, transmission and supply sectors of the electricity industry. Similarly, the separation of rail infrastructure and operation is now required under EU law, with the particular model pioneered in the UK being followed in Austria, Denmark and Holland; and outside the European Union also in New South Wales, and New Zealand.

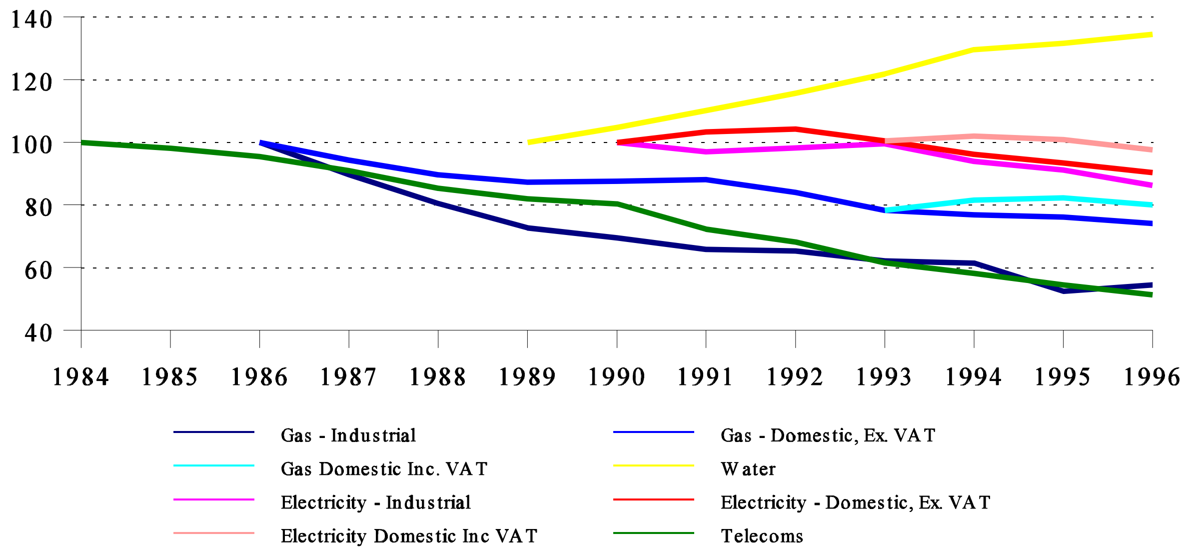
REGULATION OF MONOPOLY ACTIVITIES

Systems of regulation need to :

- incentivise companies to increase efficiency
- strike a fair balance between returns to shareholders and prices and services delivered to the consumer;
- deliver the level of investment necessary to maintain and enhance service standards in the longer term; and
- give the regulator access to commercially-sensitive information on performance, productivity and investment.

The RPI - X system used to regulate prices by the UK regulators has generally delivered lower real prices, as shown by **table 4** below:

Table 4: Trends in Real Prices Since Privatisation : Index - Year of Priv = 100



VAT introduced on domestic fuel and power in 1993 at a rate of 8%. Reduced to 5% in 1997

The exception has been water, where price rises have included an allowance for investment in the water and sewerage infrastructure, required by European Union laws on water quality.

In summer 1997, the UK Government announced a windfall tax to raise £5.2 billion from regulated companies privatised by flotation, in recognition of windfall profits made by those companies since their privatisations. The Government also announced a review of the UK regulatory system to take account of experience since privatisation. The Government's objective for the review is to set a long-term, stable framework for utility regulation which is seen as fair by all the interest groups involved, particularly consumers, and to ensure that the framework delivers value, quality and choice to consumers, while providing incentives to managers to innovate and improve efficiency.

RESULTS

Privatisation in the UK has led to greater commercial freedom for companies no longer controlled by the Government, allowing them to raise funds on the capital markets, and make decisions on staffing levels, investment requirements and the management of their particular business on a commercial basis. They are no longer subject to political control which may delay or distort investment. In the majority of cases, restructuring, competition, and price regulation, have led to reduced utility charges - and in those cases where competition is most firmly established, for example the telecommunications industry, the falls in costs have been most significant. Most indicators of service quality have improved despite the price reductions.

The move to more commercial operations has often been accompanied by reductions in the size of the workforce, or the outsourcing of functions previously carried out within the organisation. This has applied particularly in the electricity, gas and telecoms sectors, where technological developments have also promoted productivity and efficiency, and contributed to falls in employment. However, experience has been different in different industries, and across time, with some industries (for example British Airways) increasing employment following an initial fall in staffing levels. The introduction of competition has also meant that reduced employment in former monopoly companies has been accompanied by increased employment opportunities in new, competing, firms.

This is not to understate the human problems which can arise from the restructuring of previously state-owned businesses. In certain areas where high concentrations of unemployment have developed, for example in former coal-mining or steel-working areas, it is possible to ameliorate the impact through enhanced redundancy packages, community and business support grants, and training and re-skilling programmes. Nevertheless, focussing on the short-term job losses directly associated with privatisation looks only at part of the picture. The pressures to improve efficiency would have existed even if the industry had remained in the public sector. And privatisation should be seen as part of a wider programme of economic reform, which can create a more competitive economy and future jobs.

The introduction of a more competitive environment can also give rise to social or political problems as previously hidden cross-subsidies to some groups in the economy become unsustainable. Mechanisms to avoid such problems can be devised, and enforced by the regulatory regime, without damaging the development of competition, although the cost will be transparent and will have to be met by either the Government or other consumers.

GOVERNMENT RELATIONSHIP WITH BUSINESS

The partial or total privatisation of businesses provides the opportunity for governments to review the nature of their relationship with that business. In particular, it allows the state to alter its role, from provider of services to that of overseer of the market. It may therefore be able to withdraw from the input side of the industry - taking no further role in commercial decisions such as investment, staffing levels and pay - and concentrate instead on defining the appropriate outputs - prices, customer service standards and environmental criteria. Such a move may entail surrendering control over certain aspects of the management of “strategic” or “nationally vital” assets - a process which may be problematic for historic or political reasons. However, it may also allow the state to ensure greater accountability on the part of the company, both to the state itself (via regulation) and to its shareholders.

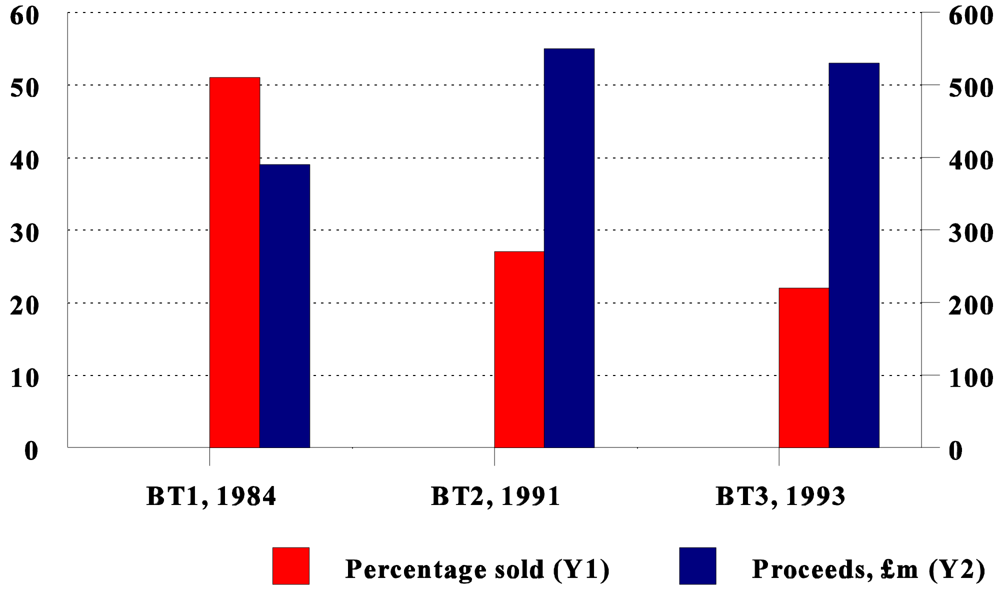
It is possible to secure national strategic interests through special (or “golden”) shares which, strictly defined, are compatible with private ownership. In the UK’s case these allowed the Government a power of veto over changes in the Articles of Association of the companies concerned, effectively blocking the ownership of more than 15% of the company by any individual or group. This acted to restrict takeovers, in the majority of cases for a short period, to allow the newly-privatised industry a period to adjust to the demands of the private sector before being exposed to possible takeover pressures. Following the expiry of these special shares, normal market practice was allowed to operate, and a number of privatised firms - particularly in the electricity sector - are now owned by overseas investors or companies. With the exception of a very few defence-related companies, special share ownership limits apply equally to overseas and domestic investors.

In all of these cases, the powers attached to special shares have been limited. Neither they, nor any minority shareholdings, have been used to control a company’s commercial behaviour in any way. The Government has been a passive shareholder, treating the remaining shareholdings as a financial asset. This policy has been set out in the share offer documentation, effectively guaranteeing a policy of non-intervention.

Privatisation in the UK has almost invariably involved the transfer of at least 51% of the shares to the private sector, so as to ensure that control passes to the private sector and that any borrowing by the company is not classified to the public sector. In most cases, the sale of the entire company was undertaken in one tranche. Only in a few cases were less than 100% of the shares sold. Early in the UK’s privatisation programme this reflected concerns that the existing capacity of the domestic capital markets might be insufficient to absorb the amount of stock offered. For example, the £3.9 billion sale of 51% of the shares in BT in 1984 was six times larger than any previous UK issue, and four times larger than any other capital-raising exercise in the world at that time.

However, 100% sales in a single tranche are not common elsewhere, and there is some evidence to suggest that sales in tranches can result in increased proceeds for the vendor Government. Successive sales of equity in BT in 1984, 1991 and 1993, support this proposition; as **Table 5** shows, the 1984 sale of 51% of the share capital raised some £3.8 billion; a further 26% of the shares sold in 1991 raised some £5.3 billion, and a broadly similar amount was raised by the sale of the Government’s remaining holding (less than 21% of the share capital) in 1993.

Table 5: British Telecom Proceeds 1984 - 1993



The vendor government is therefore able to participate an any outperformance by the company in two ways. The government will receive a dividend stream as a result of the continued holding of shares in the company. This amounted to income of over £2.4 billion between 1985 and 1993 in the case of BT. However, assuming privatisation leads to increased efficiency and a higher share price, the government will be able to achieve a higher price for any subsequent share sales than for the initial tranche. A further benefit is that these secondary sales may be priced on a much finer basis, using the existing share price as a guideline. For example, the third sale of shares in BT was achieved whilst offering no discount to institutional investors. This meant that the small (approximately 2.5%) fixed discount offered was focussed entirely on retail investors.

ORGANISING WITHIN GOVERNMENT

There are a number of options for organising privatisations within Government. These can range from specific sales teams working on only one sale, but having a detailed knowledge of the industry concerned, to a dedicated team within Government with a remit to achieve the privatisation of selected industries in a set timescale. This latter route may increase the expertise of the Government staff working on successive sales, but - since it may require staff to deal with a range of industries without a significant knowledge of the nature of those businesses - it may mean that the process requires additional, sectorally-focussed staff, to undertake any associated industrial restructuring.

The choice of organisational structure may also be influenced both by the historic structure of the industry concerned and its relationship with the government, and by the legal basis for the sale. For example, privatisations in the former Soviet Union and East European countries have in general been carried out under the auspices of general state privatisation law which may allow for the wholesale transfer of assets to individual ownership, often via a voucher scheme. In these instances sales have tended to be carried out by a central privatisation agency dealing with sales in a number of sectors. This structure may be most appropriate for the earlier stages of a privatisation programme, or where the intention is to transfer a large volume of state assets to private hands in an effectively unchanged form (as, for example, with the sales of the state assets of the former German Democratic Republic by the Treuhand agency).

In the UK, individual Departments of State have had oversight responsibility for specified state-owned industries; as a result, the relevant Department has taken responsibility for enacting legislation allowing for the privatisation of the industry concerned, and has been responsible for restructuring and selling the resulting companies. The UK Treasury has retained an overview of the process, provided continuity, and has acted as a central source of knowledge on the privatisation process. In those cases where less than 100% of a company has been sold, residual shares have been transferred to the Treasury for later disposal by a dedicated team, drawn partially from those with wider experience of the privatisation process. This has allowed the UK to apply the sectoral skills available in Departments to the complex restructuring tasks required in an initial privatisation, while drawing on the knowledge base in the Treasury for continuity and expertise on the sale process itself.

The UK has not used government staff alone in implementing sales. In every case it has used external advisers to provide expert financial, legal, accounting and sales advice, in order to ensure that privatisations are implemented as professionally as possible and that the Government can take advantage of new developments in valuation and sales techniques. The UK Government has nevertheless found that dedicated internal teams with experience of successive sales can assist advisers in innovating, as continuity between offers allows a deeper understanding of the process and receptivity to new ideas.

DEVELOPING THE CAPITAL MARKET

As outlined earlier, there are a number of mechanisms which can be used to achieve the privatisation of companies or assets. Trade sales and concessions are addressed above. But the method which has become most associated with privatisation in the UK has been conversion into the public limited companies, and the sale of shares in those companies by flotation. The UK has led the world in making these sales attractive to the smaller retail investor, not least to provide a large pool of demand to compete with institutional bidders. Through this mechanism, it has been able to expand popular participation in the capital markets and, as a result, introduce new distribution and dealing mechanisms which have, in turn, encouraged new investors to consider a wider role in the more traditional listed sectors and companies.

Sales by public flotation may not be suitable in all cases. Since the flotation method is (comparatively) more costly than disposals via trade sale, the UK has largely reserved this method for the larger, utility companies and others where government has consciously been seeking to attract the retail shareholder. However, the UK has also been able to use the flotation mechanism for relatively small sales, for example the flotation of Forth Ports for £110 million in 1991; in such cases, the extra cost of generating substantial retail demand is unlikely to be worthwhile. For this reason, the 1996 sale of AEA Technology was carried out using a placing mechanism, selling shares to a limited number of retail participants, rather than a full public offer.

The public flotation method is perhaps the most complex of the various possible procedures. It will require the services of professional advisers including financial, accounting and legal advisers, global coordinators, and public relations consultants, who, among other tasks, will advise the government on :

- an appropriate capital structure for the company or companies to be floated, including the levels of any debt vested in the company. This may require the extinguishing of existing debt owed to the government, or in some cases may mean that the debt can be injected into the company for later repayment to government. The capital structure process will need to take account of, amongst other issues;
    - an assessment of the nature of the company's business in the short and medium terms;
    - the likely future development of the market in which the company operates;
    - the scope for efficiency gains and diversification by the company; and
    - (for regulated companies) the initial price caps, which will have to be considered as an integral part of the capital structure;
- the preparation of audited accounts;
- the preparation of a legally verifiable prospectus, which will need to take into account the legal and Stock Exchange requirements in the various territories where shares may be offered;
- appropriate methods of marketing the shares, both to retail and institutional investors, whether by advertising, direct mailing campaigns, research, or roadshow programmes;

- managing the generation of demand in the international offer (a process known as bookbuilding); and

- setting the final price of the shares and allocating between investors of different classes.

An outline of the typical steps that have been taken in the larger privatisations (those of the public corporations) is shown on pages 26 to 27. It is only schematic, and each sale raised its own particular issues, in particular on the extent of industrial restructuring required.

The wealth of experience gained by UK advisers in the course of the privatisation programme can be demonstrated by the successive innovations introduced since the earliest sales in the 1980's. These include the move from underwritten fixed price offers to the use of bookbuilding to set prices; arrangements to incentivise the retail investor and to maximise the shares available to the retail sector when there is high demand; and the introduction of mechanisms to allow greater participation by the UK public in share sales. These were later refined to allow independent financial advisory firms (known as “share shops”) to act as the distribution network for shares, giving them the opportunity to build longer-term client relationships with purchasers.

EXPANDING THE DOMESTIC SHAREHOLDER BASE

The focus on the retail shareholder in the UK saw a significant increase in the number of private shareholders in the 1980's, from 3 million to some 10 million. More significantly, perhaps, this increase in share-ownership can be seen as part of a more general boost to the capital markets in the UK, with shares and other equity-related products being more widely used as savings and investment instruments. This has facilitated the Stock Exchange listing of a number of mutually-owned building societies in recent years. This growth in the strength and liquidity of the capital markets is one which has been seen throughout the world, although the contribution of privatisation has not been as great in the UK as elsewhere, given the previous breadth of the London Stock Exchange.

To encourage the smaller investor to take part in the privatisation programme, the UK developed a range of special incentives designed to enhance interest in purchasing and holding shares. A number of these have now been adopted by other governments as they also implement larger, utility company, sales, and seek to attract the retail shareholder. These incentives have taken four main forms:

- the ability to pay for the shares in instalments, over a number of months, so making the initial investment more affordable;

- a share bonus arrangement, where buyers who hold their shares for a set period qualify for additional shares, relative to their original holding, at the end of that period (which has normally been three years in the UK);

- a discount on the second and third instalments, as an alternative to bonus shares for smaller investors. When first introduced, the discount was set at some 8% of total price, although recent sales have seen this reduced to nearer 5%; and

- on some utility sales (telecommunications, gas and electricity distribution) vouchers have been issued, related to the value of the continued shareholding, redeemable against the shareholder’s utility bill. This form of incentive is, however, administratively complex, is normally only applicable where a customer relationship exists, and may cause difficulties where competition already exists or is expected to be introduced during the period in which incentives are issued.

The UK has also sought to encourage employees to take, and retain, a stake in their company at the point of privatisation. The particular mechanisms adopted have aimed to do this over both the short and medium terms; through an offer of shares at the time of sale, combining free shares (often linked to length of service) and special terms for shares purchased by employees; and through encouraging privatised companies to offer longer-term share incentives schemes to their employees. The offers at flotation have on average resulted in some 5% of a company’s share capital being held by its employees.

Further information on the form of employee offers in the UK and take-up of shares by employees is contained in HM Treasury’s publication “Information on Privatisation in the UK”.

DEVELOPING THE INSTITUTIONAL MARKET

Successive UK sales have seen developments in pricing. Following the sale of the Regional Electricity Companies in 1990, the primary underwriting of shares at a pre-determined fixed price was discontinued. Initially, a process which involved seeking underwriting commitments directly from investing institutions on a competitive basis was organised by the government's lead manager (for the sale of the English generating and Scottish electricity companies in 1991). Subsequently this was superseded by bookbuilding. This mechanism involves potential buyers making bids at a variety of volumes and prices during the marketing of the shares, so that the price of the shares is determined following the collection of this market information, rather than (as with fixed price offers) prior to marketing. Bookbuilding therefore permits the vendor's pricing to take account of market movements and creates greater competition between potential purchasers, implying a keener price. However, it operates best where there are clear comparators in the existing market to allow the setting of a meaningful initial range within which the price is expected to be set. The system has been coupled in the UK to predetermined criteria designed to encourage early and firm bidding - to give better pricing information in the bidding process - and "quality" criteria designed to reward purchasers judged likely to be longer-term holders of shares, thereby encouraging a stable aftermarket and giving newly-floated companies a more stable shareholder base.

The move to bookbuilding has been linked in the UK with changes in the selling process. Since 1991, a number of significant new developments have taken place, including:

- ending the practice of geographic "protection", so that particular territories are no longer guaranteed a certain percentage of shares on offer, regardless of the strength of regional demand - a policy which applies equally to the institutional investor in the home market. Bidders from all markets compete for shares on an equal footing: so long as all bids are of equivalent price, timeliness and "quality" (as described above) overseas investors are treated on a par with domestic investors;

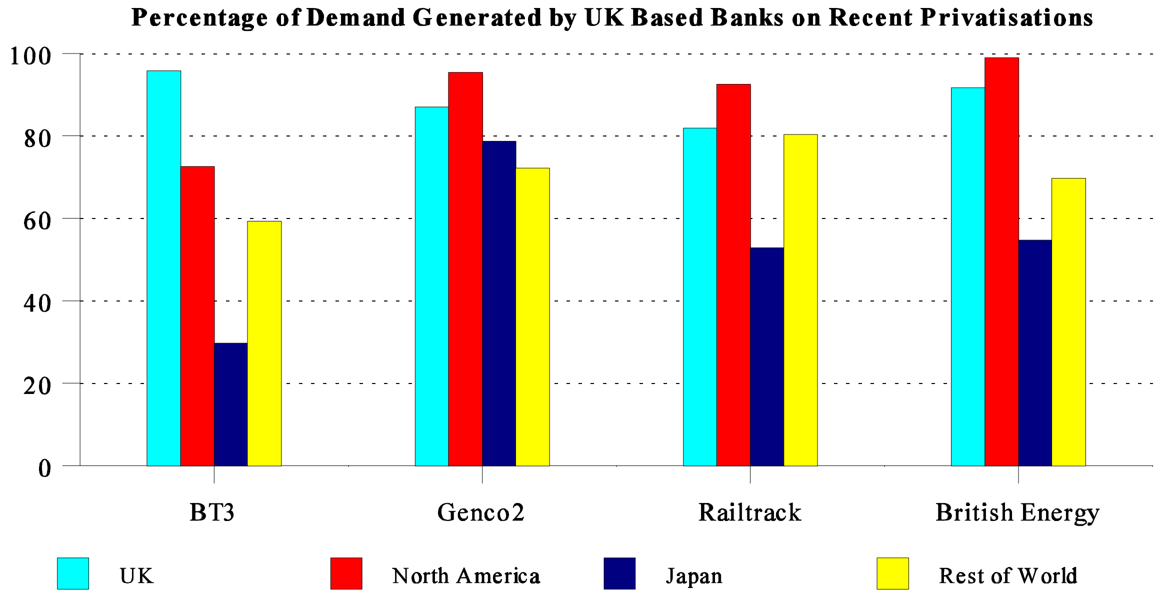
- the use of "selling syndicates", groups of investment banks who market the shares to prospective investors, either internationally or in certain designated territories; and

- increasing, structuring fees so that commissions are paid on the basis of allocations achieved, with management commissions being restricted to covering only fixed costs.

The emergence of banks with the capacity to sell shares worldwide and the adoption of a more global approach to the marketing of shares has allowed the UK to reduce the number of banks in selling syndicates from over 100 (on the secondary sale of BT in 1991) to 8 for the British Energy sale in July 1996. Banks have been appointed in later sales either on the basis of their ability to sell to investors worldwide, or because they can access high-quality investors in specific markets in, for example, Continental Europe or the Far East.

These developments have demonstrated the ability of UK-based firms to access investors in key overseas markets, in particular the crucial US market. **Table 6** shows the percentage of sales achieved by UK-based banks in the key markets of North America, Japan, the UK, and the Rest of the World in the sales of BT3, Genco 2, Railtrack and British Energy.

Table 6:


Percentage of Demand Generated by UK Based Banks on Recent Privatisations
100
80
60
40
20
0
BT3
Genco2
Railtrack
British Energy
UK
North America
Japan
Rest of World

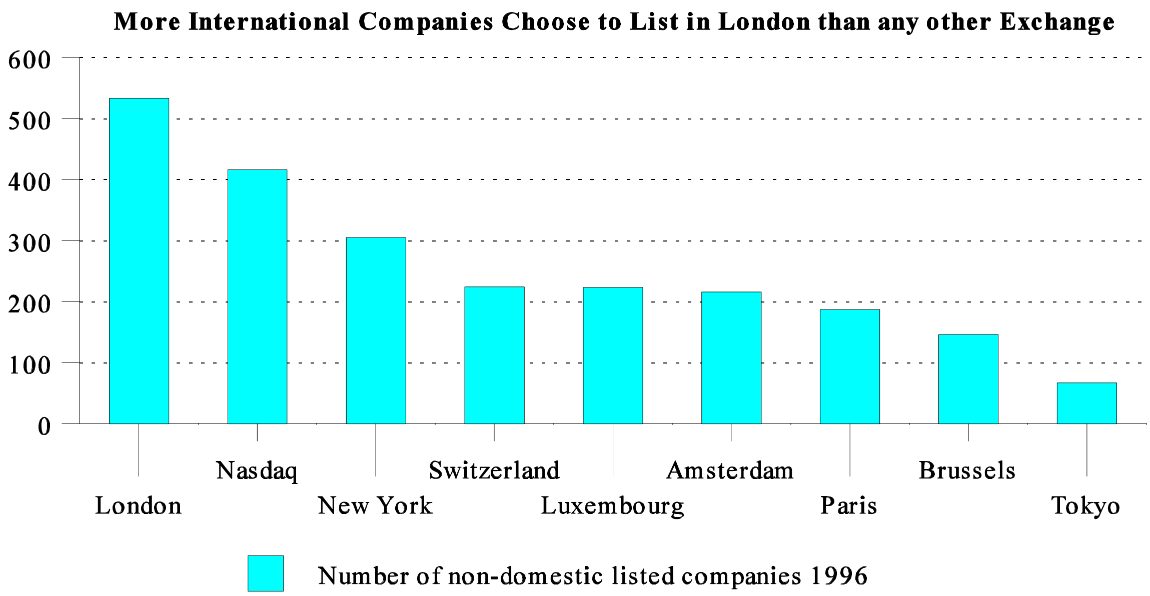
INTERNATIONAL OFFERS: THE LONDON MARKET

London is Europe's leading financial centre and together with New York and Tokyo is a natural apex of the global financial triangle. London is, for example:

- ! the principle centre for Eurobond underwriting and trading, with a market share of 75%;
- ! the world's largest foreign exchange markets;
- ! home to 70% of all international equity underwriting;
- ! the world's most active international equity market, with more international companies (over 500) listed and traded on the London Stock Exchange, than on any other exchange in the world.

London's vibrant markets have attracted the support of many of the world's leading investment houses and financial institutions. Over 550 international banks and 170 global securities houses have offices in London, providing an unrivalled pool of financial expertise available for international clients. International companies can list shares, depositary receipts and bonds on the London Stock Exchange. A London listing can enhance investor interest and confidence in the company.

Table 7:



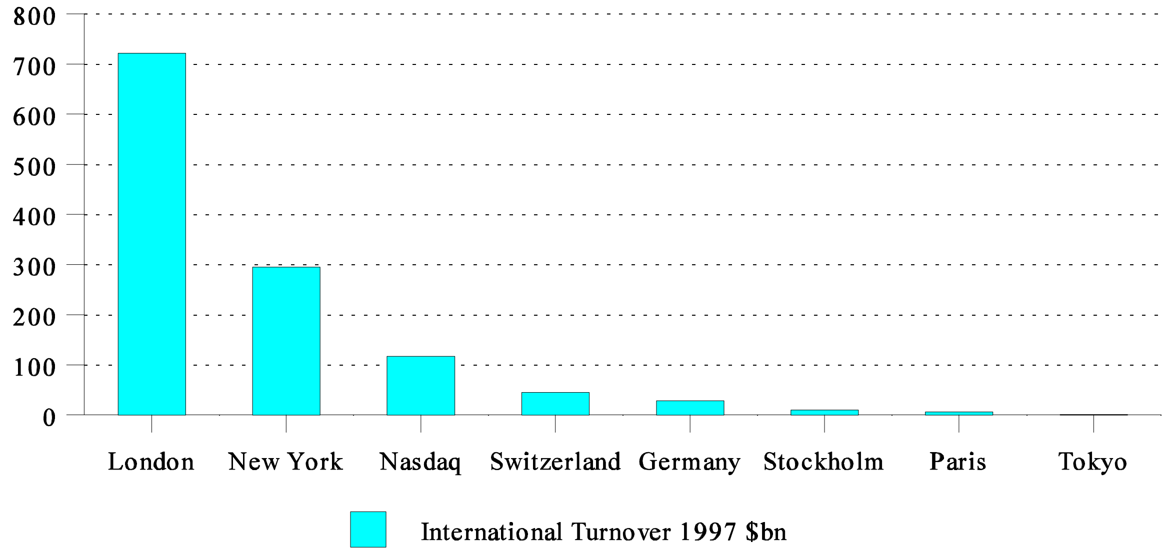
The key benefits for an international company listing on the London Stock Exchange are:

Access to the world's largest pool of international investment capital
More than a third of all worldwide institutional equity holdings are found in Europe, some $3,000 billion worth of investment capital. Within Europe, London is the undisputed centre, with over 50% more equity funds under management than its nearest rival. London is home to over $1,000

billion of institutional equity capital, over 40% of which is invested in equities outside the UK. Through London, issuers also gain access to international funds - UK fund managers manage over $600 billion on behalf of overseas investment funds, including $380 billion of US money. Institutions dominate equity investment and trading in the London market, with over 80% of all transactions being conducted by professional investors, a figure which rises to 99% for international equities. These funds are a particularly valuable source of capital for non-UK issuers because they are internationally-focussed and professionally managed.

The world's most liquid international secondary market
A liquid secondary market in international holdings of shares is vital for privatised companies' future issuance and capital raising programmes. There is more trading in international equities in London than in UK equities. An average of $11 billion of international equities is traded in London every day, over twice the average amount of international shares traded in New York
Worldwide visibility for international companies

Table 8: London is the World's Major Centre for Trading International Equities



The London Stock Exchange has a dedicated trading system, SEAQ International, for the trading of international securities, which carries live trading prices and corporate news for all international companies listed in London. SEAQ international is a computerised, screen-based trading system which is viewed by more than 10,000 institutional investors around the world, thus offering companies increased recognition and visibility outside their domestic market. This, in turn, leads to an increase in liquidity in the trading of a company's securities both on the domestic market and internationally.

High standards of regulation
London enjoys high and well-respected standards of regulation. One of the main objectives of the London Stock Exchange is to run fair and orderly markets so that investors and companies have confidence in the integrity of the market. This serves to enhance the profile of companies listed in London and their standing amongst international investors, thus attracting vital foreign investment.
An accessible market

The London Stock Exchange is the UK national authority for listing as well as the main marketplace for trading securities in the UK, which means that companies wishing to join the market have to deal with only one regulatory body. Additionally, the Exchange continually adapts its rules to meet the changing needs of international issuers and to ensure that the listing process is as accessible and flexible for issuers as possible. The Exchange's listing fees for international issues are lower than those of all the other major markets around the world.

Table 9: London's Listing Fees Are Lower Than Other Exchanges

Fees for $500m share issue (number of shares 100m; issue value $5 p/share; nominal value £1 p/share

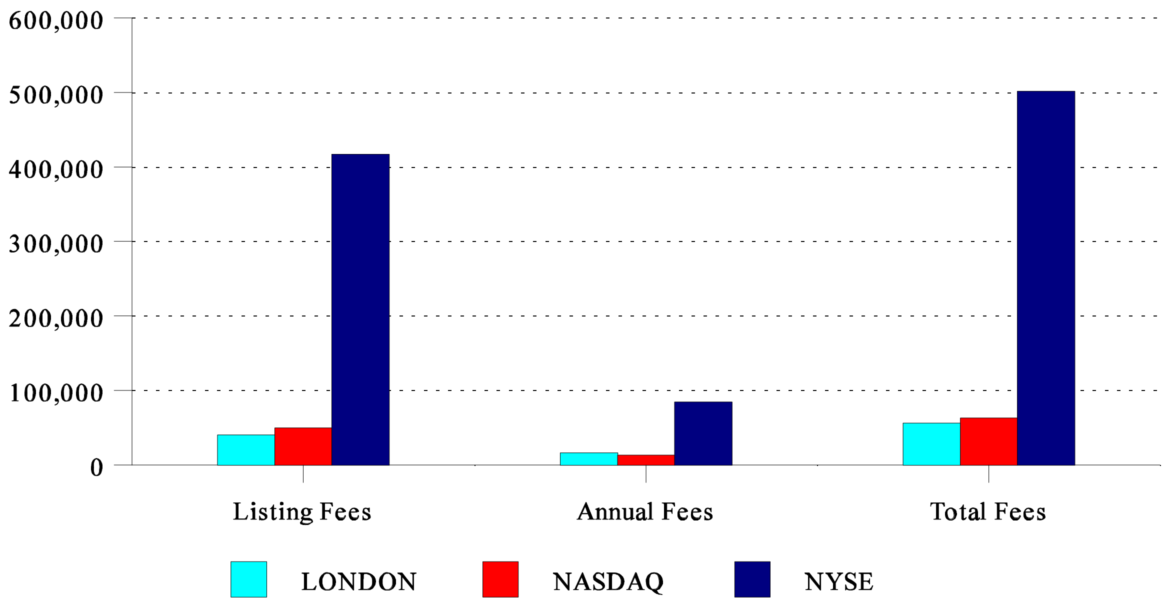
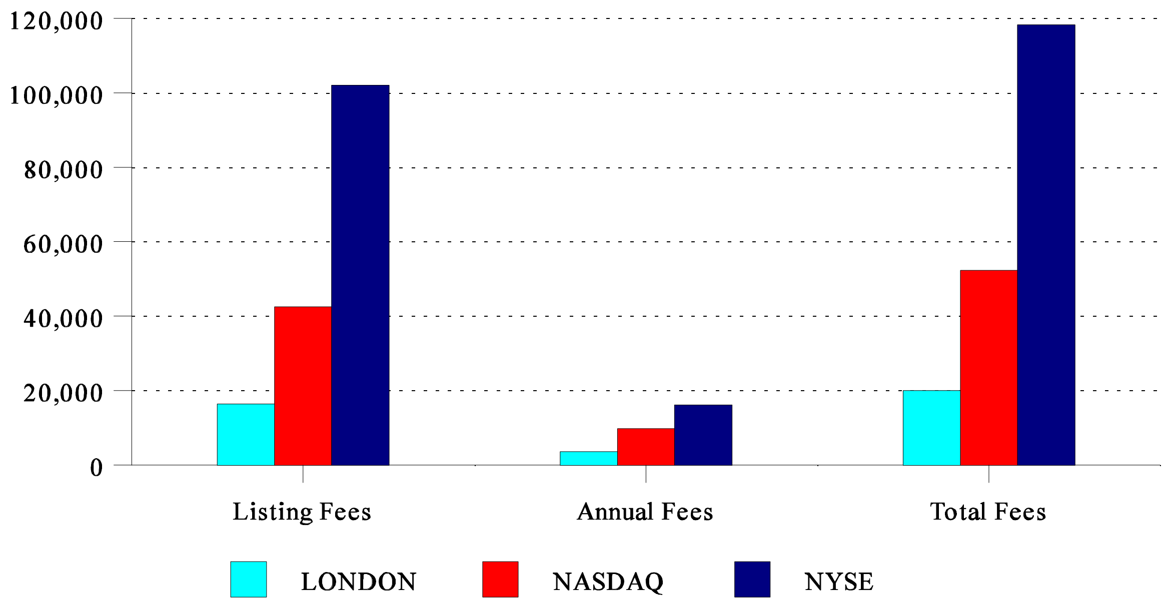


Table 10: London's Listing Fees Are Lower Than Other Exchanges

Fees for $150m share GDR issue (number of GDRs 10m; issue price $15)



CONCLUSION

This booklet has sought to explain how privatisation has been implemented, and the methods and techniques which have been developed, in the UK. The process is not always straightforward. Policies have to be developed, legislation passed, industries restructured, regulatory regimes put in place, and transactions completed. The process requires focus, commitment and skill. However, the technical skills are available; the unparalleled experience of the UK gives others an opportunity to learn from the UK's experience and draw on the skills of UK firms in developing their own approach to these issues.

The UK's new Labour Government is drawing on the skills of UK-based firms in progressing its public/private partnership approach. An early example of this approach is the proposed partial sale of the Commonwealth Development Corporation, announced by the Prime Minister in October 1997, which will see a majority stake in CDC sold to private investors, with the Government retaining a significant minority shareholding, and a golden share in the company. The Government will also continue to set the framework within which the Corporation operates, in order to preserve the unique nature and special skills of the organisation. The commercial freedom which will result from the partial sale will allow CDC to borrow on the capital markets; and the Government has undertaken that the proceeds from the sale will be returned to the overseas development programme.

ADVISERS TO THE UK GOVERNMENT APPOINTED ON MAJOR SALES

British Aerospace (privatised February 1981)	
Financial adviser	Kleinwort Benson
Legal adviser	Slaughter and May
Lead broker	Hoare Govett
Accountancy adviser	KPMG
PR adviser	Charles Barker

(Second tranche May 1985)	
Financial adviser	Lazards
Legal adviser	Slaughter and May
Lead broker	Hoare Govett
Accountancy adviser	Peat Marwick Mitchell
PR adviser	Streets Financial

Cable & Wireless (privatised October 1981)	
Financial adviser	Kleinwort Benson
Legal adviser	Linklaters & Paines
Lead broker	Cazenove
Accountancy adviser	Coopers & Lybrand
PR adviser	Dewe Rogerson

(Second tranche December 1983)	
Financial adviser	Kleinwort Benson
Legal adviser	Freshfields
Lead broker	Mullens
Accountancy adviser	Deloitte, Haskins & Sells
PR adviser	Streets Financial

(Third tranche December 1985)	
Financial adviser	J Henry Schroder Wagg
Legal adviser	Freshfields
Lead broker	Rowe & Pitman
Accountancy adviser	Deloitte, Haskins & Sells
PR adviser	Financial Strategy

BT (privatised November 1984)	
Financial adviser	Kleinwort Benson
Legal adviser	Linklaters & Paines
Lead broker	Hoare Govett
Accountancy adviser	Coopers & Lybrand
PR adviser	Dewe Rogerson

(Second tranche December 1991)	
Financial adviser	SG Warburg
Legal adviser	Linklaters & Paines
Accountancy adviser	Ernst & Young
PR adviser	Dewe Rogerson

(Third tranche July 1993)	
Financial adviser	SG Warburg
Retail adviser	Solid Solutions Associates
Legal adviser	Linklaters & Paines
Accountancy adviser	Ernst & Young
PR adviser	Brunswick

British Gas (privatised December 1986)	
Financial adviser	NM Rothschild
Legal adviser	Slaughter and May
Lead broker	Cazenove
Accountancy adviser	Touche Ross
PR adviser	Dewe Rogerson

National Bus Company (privatised 1987-88)	
Financial adviser	Price Waterhouse
Accountancy adviser	Ernst & Whinney

British Airways (privatised February 1987)	
Financial adviser	Hill Samuel
Legal adviser	Slaughter and May
Lead broker	Cazenove
Accountancy adviser	Ernst & Whinney

Rolls-Royce (privatised May 1987)	
Financial adviser	Samuel Montagu
Legal adviser	Linklaters & Paines
Lead broker	James Capel
Accountancy adviser	Coopers & Lybrand

British Airports Authority (BAA) (privatised July 1987)	
Financial adviser	County NatWest
Legal adviser	Allen & Overy
Lead broker	Cazenove
Accountancy adviser	Touche Ross
PR adviser	Charles Barker

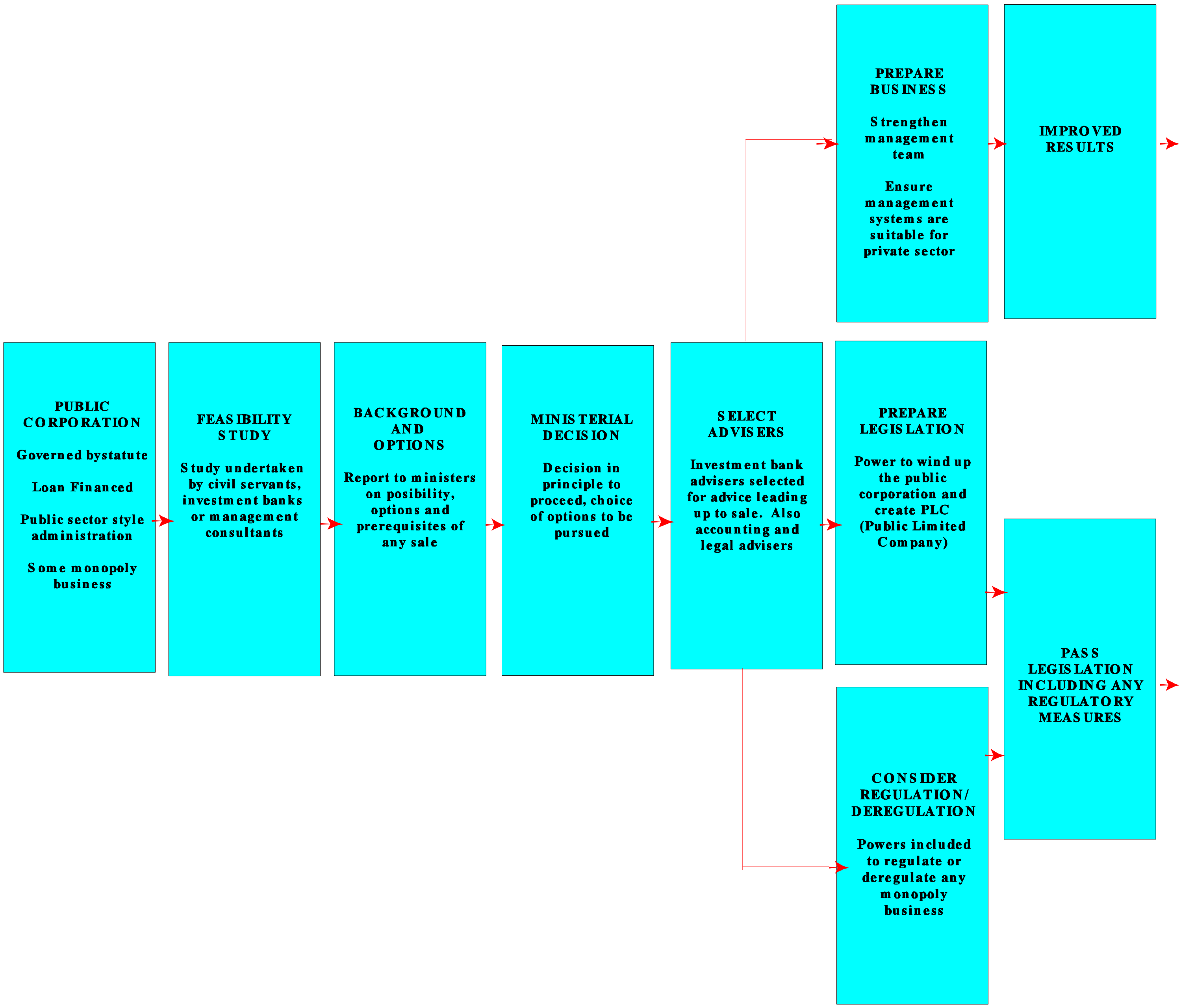
British Petroleum (BP) (Final tranche October 1987)	
Financial adviser	NM Rothschild
Legal adviser	Slaughter and May
Lead broker	Hoare Govett
Accountancy adviser	Ernst & Whinney
PR adviser	Dewe Rogerson

British Steel (privatised December 1988)	
Financial adviser Legal adviser Lead broker Accountancy adviser PR adviser	Samuel Montagu Norton Rose Rowe & Pitman Coopers & Lybrand Dewe Rogerson
Water Companies (privatised December 1989)	
Financial adviser Legal adviser Lead broker Accountancy adviser PR adviser	J Henry Schroder Wagg Clifford Chance Rowe & Pitman Touche Ross Dewe Rogerson
Regional Electricity Companies (privatised December 1990)	
Financial adviser Legal adviser Lead broker Accountancy adviser PR adviser	Kleinwort Benson Slaughter and May James Capel Touche Ross Dewe Rogerson
Generating Companies (National Power and PowerGen - privatised March 1991)	
Financial adviser Legal adviser Lead broker Accountancy adviser PR adviser	Kleinwort Benson Slaughter and May James Capel Touche Ross Dewe Rogerson
(Second tranche March 1995)	
Financial adviser Retail adviser Legal adviser Accountancy adviser PR adviser	BZW Kleinwort Benson Solid Solutions Associates Slaughter and May Ernst & Young Dewe Rogerson
Scottish Electricity Companies (privatised June 1991)	
Financial adviser Legal adviser Lead broker Accountancy adviser PR adviser	BZW British Linen Bank McGrigor Donald BZW Coopers & Lybrand KPMG Citigate PR Consultants Scotland
Northern Ireland Electricity Companies (privatised 1992-93)	
Financial adviser Legal adviser Accountancy adviser PR adviser	NM Rothschild Denton Hall Touche Ross Shandwick

Coal Industry Assets (privatised 1994)	
Financial adviser Legal adviser Accountancy adviser PR adviser	NM Rothschild Clifford Chance Touche Ross Dewe Rogerson
London Buses (privatised 1994-95)	
Financial adviser Legal adviser	BZW Freshfields
Rolling Stock Companies (privatised December 1995)	
Financial adviser Legal adviser Accountancy adviser PR adviser	Hambros Freshfields Price Waterhouse Greshams
Railtrack (privatised May 1996)	
Financial adviser Retail adviser Legal adviser Accountancy adviser PR adviser	SBC Warburg Solid Solutions Associates Linklaters & Paines Ernst & Young Dewe Rogerson
British Energy (privatised July 1996)	
Financial adviser Retail adviser Legal adviser Accountancy adviser PR adviser	BZW Solid Solutions Associates Allen & Overy Deloitte & Touche Dewe Rogerson
AEA Technology (privatised October 1996)	
Financial adviser Legal adviser Lead broker Accountancy adviser	J Henry Schroder Wagg Lovell White Durrant Cazenove Deloitte & Touche
NB: as a result of mergers and takeovers, a number of the above companies no longer operate under the names shown here	

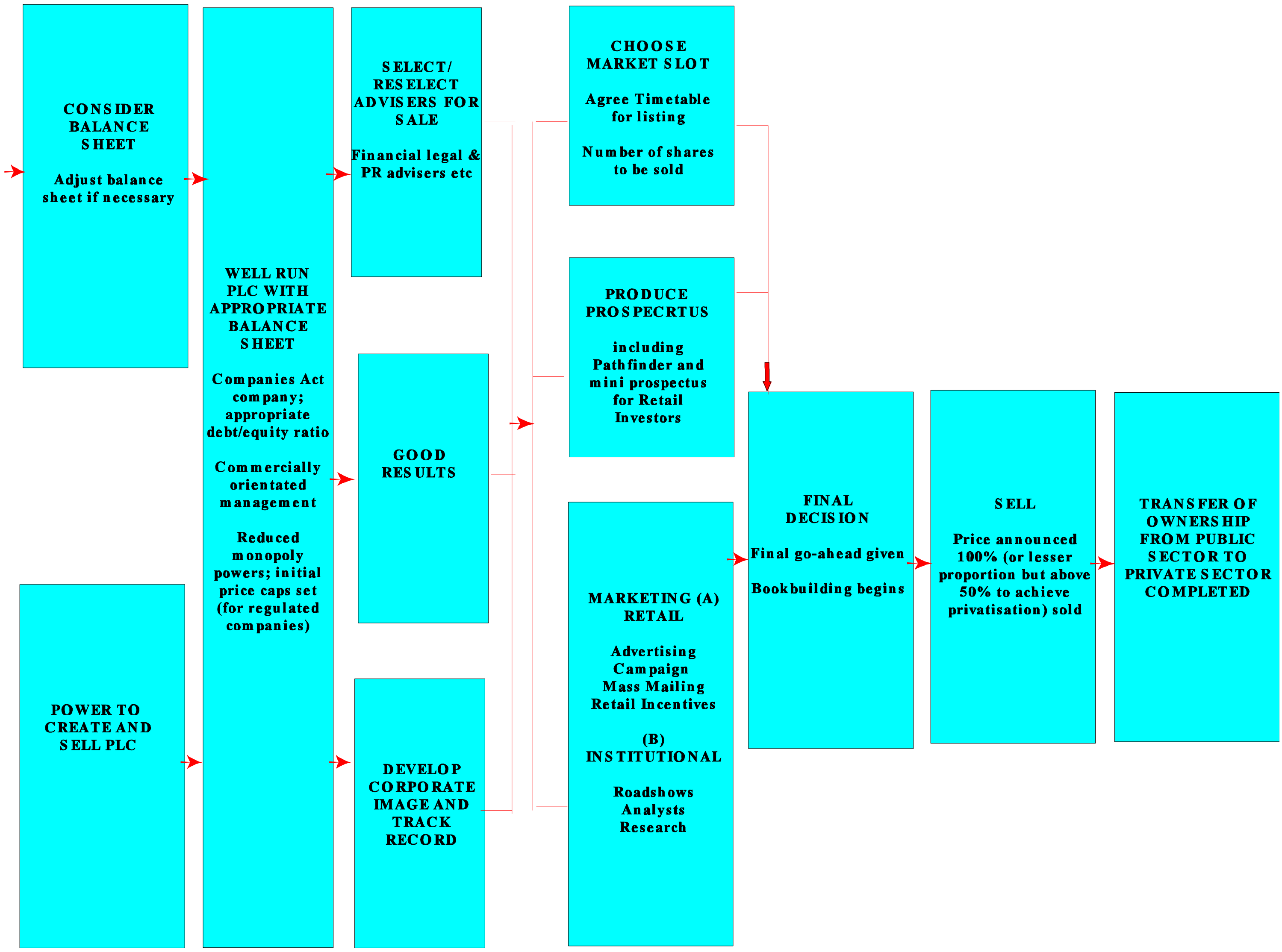
Outline of Typical Steps to Privatisation

Illustarive example
not based on a specific case



Stage 1

Stage 2



Stage 3

Stage 4

FOR FURTHER INFORMATION

Her Majesty's Treasury and the London Stock Exchange would be delighted to provide further information about Public Private Partnerships, the UK's experience of privatisation, the regulation of privatised industries and the advantages of listing in London.

Contact:
For enquiries on Public Private Partnerships, the UK privatisation programme, the regulation of privatised industries and individual firm's track records:

Peter Schofield
Public Enterprise Partnerships Team
HM Treasury
Treasury Chambers
Parliament Street
London
SW1P 3AG

Tel: (0044) 020 7270 4640
Fax: (0044) 020 7270 4974
E-mail: privatisation.info@hm-treasury.gov.uk

To find out more about how to list international issues in London, or to discuss your company listing on the London Stock Exchange, on a confidential basis:

The International Marketing Department
London Stock Exchange
London
EC2N 1HP

Tel: (0044) 020 7797 1942
Fax: (0044) 020 7334 8954