U.K

New ways of providing public services - privatisation

1. State control has often failed to satisfy expectations about the performance of public services. There is often a belief that private enterprise and private money will lead to more successful businesses and provide better services at lower cost, because of sharper incentives based on the satisfaction of customers. This is, of course, a vast over-simplification but there is evidence that privatisation, when implemented well and carried out with a commitment to improving competition, can lead to benefits.

Getting the best from privatisation

2. The three essential characteristics of a successful privatisation derived from general experience are:
   - **title** - it must be clear who owns the assets being privatised. This may sound obvious but it is not always clear, even in the UK.
   - **valuation –** it is important to value what is being privatised. Valuation is not an exact science and alternative approaches exist. The Intosai Privatisation Working Group has produced a technical case study on this subject which sets out key factors for the auditor to take into account. The important point is to have some benchmark against which likely receipts can be judged. In former communist countries the absence of functioning markets made valuation in some cases almost impossible.
   - **competition –** successful privatisation demands strong and sustained competitive pressure. Nominating “a preferred bidder” simplifies the sale process, but can lead to reduced proceeds.

3. All these points need to be borne in the mind when choosing and evaluating privatisation methods. There are three main alternatives:
   - **Flotations –** selling shares on stock markets has many attractions. It is in principle simple. But it is helped by the existence of a developed stock market and the ability to choose a good time to sell. A decision has to be made on whether to sell all the shares at once or to sell them in tranches. The Intosai Privatisation Working Group has also produced a technical case study on the management of stock market flotations. It gives an overview of the process, discusses marketing in detail and then sets out vfm issues for the auditor.

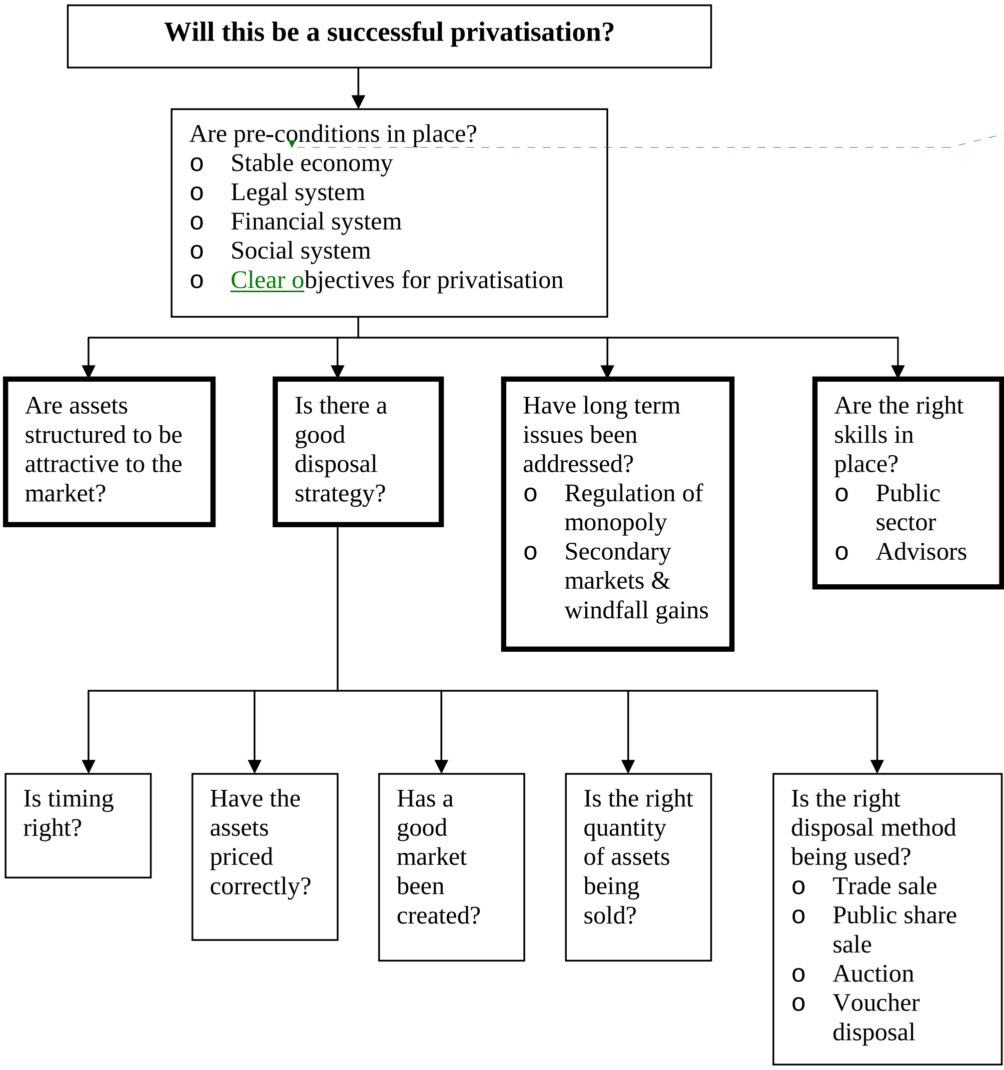
   - **Sales to trade partners or consortia of investors** (usually financial) – the assets can be put up for auction to the highest bidder. For this to work well it is necessary to have a comprehensive valuation and full and open competition. The Intosai Privatisation Working Group has also produced a technical case study on marketing a trade sale. This explains how effective marketing of a trade sale can promote competition and increase value for money. It also sets out good practice.

- **Management buy outs –** here the privatisation is accomplished by selling the public asset to its management and staff, usually backed by financial investors. The management know the business better than anyone and will naturally be keen to get it at a cheap price. Assembling data to give the government and other bidders accurate information is, therefore, a big challenge.

4. Privatisations are difficult in all countries and particularly where privatisation is one of the principal means of creating a market economy rather than being carried out in a functioning one.

5. Figure 1 sets out a high level framework for assessing whether a privatisation has been successful. It is drawn mainly from the experience of UK audit work and is based on the assumption that there has been separate consideration about the identification of candidates for privatisation. The conceptual approach comprises a series of questions that can be answered either “yes” or “no”. In practice the answer may, of course, be somewhere between the two.

Figure 1: The Four-Pillars (in bold) underpinning the successful privatisation of state assets



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The importance of having the right pre-conditions in place

6. Where international capital is desired it is usually necessary for there to be confidence in the stability of the economy in relation to public debt and inflation and exchange rates, as well as the ability to repatriate profits. Wider issues are the probity of the state organisations, policies towards corruption and the importance of good law and order generally.

7. The World Bank draws out a number of practical lessons for countries, from its experience, relevant to establishing the economic pre-conditions for successful privatisation:

- Early attention to the need for a regulatory regime where divested assets involve natural monopoly or oligopoly;
- Transparency as a key to increasing public accountability and discouraging corruption;
- The need for a systematic, rather than an ad hoc approach to public sector management reform, based on a comprehensive long-term institutional development and reform strategy;
- Measures at an early stage to enforce prudential regulations, including limits on loan concentration and related party lending;
- Strengthening of state ownership through stronger governance, tighter budget constraints, divestiture of sectors, and restrictions on the scope of banking licenses;
- High priority for training bank supervisors, lawyers and judges, accountants, auditors and other professionals. Increasing the effectiveness of bank supervision and in enforcing (not just adopting) international accounting standards as pre-conditions for external lending; and
- A focus on implementation as much as on the passage of laws.

8. While stressing that there is no absolute answer, the OECD has similarly produced a set of common features of successful privatizations, (OECD 2003):

- Strong political commitment to privatisation at the highest level to overcome bureaucratic inertia and to resolve inter-institution rivalries to move the process forward.
- Clearly identified and prioritised objectives in order to provide the policy with focus and a sense of trade-offs that may be required.
- A transparent process to enhance the integrity of the privatization process, gain credibility with potential investors and political support from the public.
- An effective communication campaign directed at the stakeholders in particular, to explain the policy objectives of privatisation and the means by which they are to be achieved in order to respond to public concerns and to gain support for the policy.
- Allocation of adequate resources, (which includes human and financial resources), in order to meet the demands of the policy for the skills and resources that are required to accomplish the many tasks involved in privatisation.

9. It also needs to be stressed that clear objectives for privatisation are needed. These may include the achievement of investment and efficiency gains. Without clear objectives, it is unlikely that the state will maximise the benefits and minimise the risks of the privatisation. These objectives are also useful for the auditor, as they provide an analytical framework. Our own reports on privatisation adopted this method.

10. Practical experience provides a number of lessons for achieving good outcomes from privatisation.

Structuring assets to maximise the success of privatisation

11. A significant issue in planning for a privatisation is whether it is beneficial to restructure the business, usually at considerable cost, and then sell it to the private sector or whether to sell it as is and let the private sector do any restructuring needed. The treatment of restructuring costs can be controversial.

12 In September 1996 the UK Department of Trade and Industry sold all its shares in AEA Technology by flotation for £228 million. AEA Technology comprised the former commercial activities of the United Kingdom Atomic Energy Authority, UKAEA, the public sector body that conducted nuclear research and development. The UK National Audit Office investigated. Restructuring and separation from UKAEA before the sale cost £121million. The Department considered that these costs were not sale costs. It said that substantial restructuring was necessary even if AEA Technology had remained in the public sector. It must remain a matter of speculation, however, when the restructuring would have taken place, what form it would have taken and how much this would have cost if the business had remained in public ownership.

13. The write off of debts is common. Before privatisation, Railtrack Group plc, the company in the UK responsible for fixed rail infrastructure such as track, signalling and stations, owed approaching £1.5 billion to the Government. The Government cancelled this old debt and created new debt, but of only £586 million, writing off £869 million. It was expected that this reduction in debt would be offset by an increase in the equity proceeds by reducing the dividend yield which investors required.

The importance of a good strategy and timing

14. Timing is usually important in achieving the best sales proceeds form privatisation. The UK National Audit Office concluded that the timing of the flotation of Railtrack probably had an adverse impact on the value achieved, since it was carried out at a time when the market was only beginning to understand the new commercial and regulatory structures within the rail industry. The market was not in a position to make a fully formed judgement. A delay to the sale of Railtrack, even only by a few months, would have helped institutional investors and analysts gain a better appreciation of Railtrack’s business within the privatised rail industry. Investors would also have had more time to understand the regulatory regime and Railtrack’s commercial relationships with its principal customers.

15. Another sale organised by the Department of Transport concerned three leasing companies - Angel Train Contracts Limited, Eversholt Leasing Limited and Porterbrook Leasing Company Limited - to three separate purchasers. The sale was completed in January and February 1996 and it raised some £1.8 billion in total. The National Audit Office investigated:

- Angel was sold in December 1997 to the Royal Bank of Scotland Group in a transaction valuing the business at some £1.1 billion, 58 per cent more than received at privatisation.
- Porterbrook was sold to Stagecoach Holdings in August 1996 for £826 million, 56 per cent more than at privatisation.
- In February 1997 the Forward Trust Group, part of HSBC Holdings plc, bought Eversholt for £726 million, 40 per cent more than at privatisation.

16. This happened in essence because the sale was carried out early . The Government saw major advantages in the early sale of these very large businesses, so they could take place ahead of the privatisation of Railtrack and the train operating companies. The chosen timing of the sale had an adverse impact on proceeds because of uncertainty over the financial prospects for the companies. The prospective customers of the rolling stock companies, the train operators, had little or no relevant track record in the to be privatised industry; and bidders were not in any case certain that the overall rail privatisation programme would be completed because there was stated political opposition to it.

Pricing

17. The pricing of assets is a difficult exercise, especially if there is no basis of commercial operation to act as a guide. In the case of the sale of another set of railway assets, the British Rail Maintenance Depots, the Department did not carry out any valuations at all. Their argument was that there were no comparable companies in the market on which financial information was available, so that a benchmark valuation would not have been helpful to the sales process and would have been poor value for money. The private sector carried out valuations on the basis of analyses of the projected cash flows of the businesses.

Establishing a good market

18. Establishing a good market with competitive bidding for state assets is of course essential to achieve a good price. To a degree this comes back to structuring the assets in the best way to attract interest, but practical considerations can intervene. The UK Ministry of Defence was unable to generate much competition in the sale of the Royal Dockyards at Devonport and Rosyth (National Audit Office 1998). The Ministry had to compare the sale arrangements with a theoretical case of what might have happened if they had continued with the Government Owned Contractor Operated arrangements at the dockyards. The consideration obtained in the end represented a significant discount on the Ministry's own valuations - a discount of 56 per cent at Devonport and 36 per cent for Rosyth.

19. The need for good provision of information is another key factor. As the 21st Century approached, the UK Government decided to build a Millennium Exhibition. The resulting Millennium Dome was one of the largest, if not the largest, single roofed structures in the world and it opened on time as the clock struck at midnight for 1 January 2000. Unfortunately the Dome was a financial failure as visitor numbers failed to meet expectations. After various false starts, a deal with a developer was concluded in May 2002. It turned out, (National Audit Office 2005), that there had been confusion among potential bidders about how much land was on offer. Information emerged to each consortium in a piecemeal and unstructured manner which did little to further the sale objectives. The Intosai technical case study on marketing a trade sale (para 3) also deals with information requirements.

Selling in whole or in part

20. It may not be clear in the early days of a privatisation programme what the risks and rewards are really likely to be. In the UK the first mass marketed privatisation was that of British Telecommunications in 1984. Market constraints and the Government's aim of avoiding large private sector profits being made at the taxpayer's expense meant only 51 per cent of shares were sold. As late as December 1990, however, the twelve regional electricity companies in England and Wales were sold in their entirety. Among the reasons for complete disposal was an Opposition statement of intent to repurchase sufficient shares to give more then 51 per cent state control of the companies, which was thought by the Government to be likely to reduce investor confidence particularly in a partial sale (National Audit Office 1992).

21. The sale of National Power and PowerGen, which at the time generated most of the electricity produced in England and Wales, took a different course in 1991. Approximately 60 per cent of the shares were sold, with the rest sold at a later date. The UK Treasury agreed that a key factor in this was findings from the UK National Audit Office about the benefit of phased sales.

The right disposal method

22. As noted above there are several ways to divest state assets and there is no simple answer to what is most appropriate. In the UK all the methods described have been used, including trade sales and sales to the public. The latter often involved offering incentives to the public such as payment by instalments and bonus shares for those who held onto shares.

Right skills

23. It is clear that the role of advisors in privatisation can be all important. Their advice is often essential in determining the right price for assets, the best sale approach and method of disposal. Advisors are not, however, infallible and they certainly add to sale costs, especially important in small sales. Advisors' costs in the sale of the Stationery Office, which publishes my reports, when

added to the sale costs of £3.1 million, were equivalent to 44 per cent of the sale proceeds of £12 million, (National Audit Office 1998).

Long term issues and the performance of privatisation

24. Governments are usually concerned about the protection of state interests after privatisation. Again the Intosai Privatisation Working Group has produced a technical case study on this subject dealing with such issues as the retention of a state shareholding, golden shares and assembling a goup of core national investors. It puts this in the context of relevant OECD guidelines. It does not deal with regulation which is a separate strand of the Group's work.

25 There is much interest in the results of privatisation. A further Intosai technical case study – on the socio economic and environmental impacts of privatisation - is also available. Key questions relate to the impact on the consumer in terms of price and service.

- In most of the UK public utilities prices fell eg telecommunications average charges fell 48% between 1984 – 1989. Improvements were not only related to the change of ownership but also as a result of technical change.
- Quality of services has improved in most privatised industries, often as the result of regulator's pressure.

In terms of employment studies usually show falls in employment due to restructuring (which may occur ahead of privatisation). In the long term employment can grow beyond historic levels.

Conclusion

26. The auditor will often need to assess the effective implementation of a privatisation and, less often, the wider impact of it. Knowledge sharing through the Intosai Privatisation Working Group can help. The Group has also developed a number of products which are available on the website. In terms of the big picture, it is important to recognise that change of ownership on its own may be less significant than changes that are facilitated by the privatisation such as a more competitive market, improved investment and the better harnessing of technical change.

Eurosai Arabosai Meeting
1 and 2 December 2006

BEST PRACTICE PRIVATISATION AUDIT
INTOSAI GUIDELINES

Patricia Leahy | Director | UK National Audit Office
Head of Secretariat | INTOSAI Privatisation Working Group

NAO
NATIONAL AUDIT OFFICE

CONTENT

1. Role of the Privatisation Working Group
2. Application of privatisation guidelines
3. Best practice in the audit of privatisation
4. Future priorities of the Working Group

ROLE OF THE PRIVATISATION WORKING GROUP

- Established in 1993 to share experiences and good practice, 41 members
- Now covers privatisation, PPP, regulation
- Four best practice audit guidelines:
  - privatisation
  - public private finance and concessions
  - economic regulation
  - risk in PPPs
- Other products and activities

ROLE OF THE WORKING GROUP
OTHER PRODUCTS/ACTIVITIES

- Six technical case examples developed
  - valuation of the business
  - marketing a trade sale
  - managing a stock market flotation
  - socio economic impacts
  - protecting state interests afterwards
  - PPP accounting
- Privatisation dictionary
- Notice board on website

PRIVATISATION WORKING GROUP
APPLICATION OF GUIDELINES

- Context is crucial
- The constitutional powers of SAIs to conduct privatisation audits differ
- Members have diverse audit methodologies
- The Guidelines are used as best international practice in audits
- They can also be used as a basis for an enhanced audit role
- Not a manual
- Generic audit frameworks can also be helpful

BEST PRACTICE
PRIVATISATION AUDIT

- Identify audit responsibilities
- Understand the business and the objectives of the privatisation
- Develop audit framework and methodologies
- Find the specialist skills needed
- Monitor post sale events

BEST PRACTICE
PRIVATISATION AUDIT

Preparation for privatisation

- Did the vendor have the necessary expertise?
- Was the business restructured?
- Were the objectives for the privatisation clear?

The method of sale

- Were all feasible options assessed?
- Was the market given sufficient information?
- Was the process competitive?
- Was the marketing effective?
- Were bids evaluated objectively?

BEST PRACTICE
PRIVATISATION AUDIT

Other key issues

- Was the timetable realistic?
- Were external factors that could affect the market monitored?
- Was the business valued before the price was agreed?
- Was the treatment of management and employees balanced fairly?
- Were the costs managed effectively?

PWG FUTURE PRIORITIES

- Continue to share experience through the Working Group
- Revise the PPP guidelines
- Joint audit through a network of experts
- More case studies – managing advisors, access rights, tariff reviews, failed PPPs
- Develop less resource intensive training methods
- Understand the pros and cons of real time audit