International Experience in Privatization

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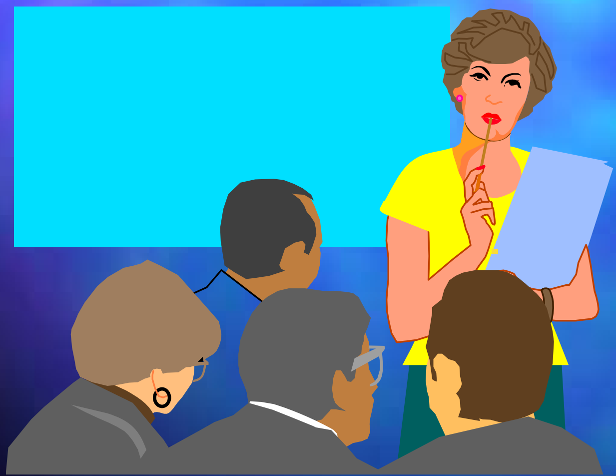
International Experience in Privatization

- Privatization Proceeds by Region
- Privatization Proceeds by Sector
- The Privatization Wheel?
- Four Objectives of Privatization
- World Bank on SOE Reform
- Privatization: 3 Broad Areas
- Privatization Routes
- Determinants of Outcome
- Common Criticisms
- Vocal Constituencies

International Experience in Privatization



- Some Common Pitfalls.....
- And Their remedies......
- Valuation
- International Evidence
- Foreign Investment and Privatization
- Lessons from Mexico
- Corporate Governance & Privatization
- International Evidence on Privatization and Labour
- Designing Labour Restructuring
- Financing Severance Payments
- Severance Payments

International Experience in Privatization

- New Regulatory Framework for Natural Monopolies
- Competition & Universal Service
- Bottleneck Access
- Ramsey Pricing
- Rates of Return & Price Caps

Privatization Proceeds in Developing Countries: By Region 1988-96 (US$ B)

Latin America & the Caribbean	82.6	(53%)
Eastern Europe and Central Asia	30.6	(19.6%)
East Asia & the Pacific	27.1	(17.4%)
South Asia	8.0	(5.1%)
Sub-Saharan Africa	3.9	(2.5%)
Middle east & North Africa	3.5	(2.2%)

Privatization Proceeds in Developing Countries, 1990-96 (US$ B): By Sector

Infrastructure	65.5	(42.1%)
Industry	37.1	(23.8%)
Agriculture & Mining	25.8	(16.6%)
Financial Services	22.2	(14.3%)
Other Services	5.2	(03.3%)
TOTAL	155.7	(100%)

The Privatization Wheel ?

- 1. Entrepreneurial consolidation
- 2. Regulation of fees/franchise
- 3. Decline in profitability
- 4. Withdrawal of capital and services
- 5. Public takeover
- 6. Public subsidies
- 7. Declining Efficiency
- 8. Dilemma: Subsidy Cuts, Fee Increases or Service Cuts
- 9.Privatization
- 1. Entrepreneurial Consolidation

Four Objectives of Privatization

- 1. Enhance efficiency in production and resource allocation
- Strengthen the Role of the private Sector in the Economy
- Improve Public Sector Health
- Free Government Resources for stepping up Social Sector Investment.

World Bank on Successful SOE Reform

- *Divested* More
- Increased *Competition*
- Hardened *budgets*
- Reformed their *financial Sector*
- Political opposition the most serious obstacle: Reforms must be *desirable*, *feasible* and *credible*.

Privatization : 3 Broad Areas

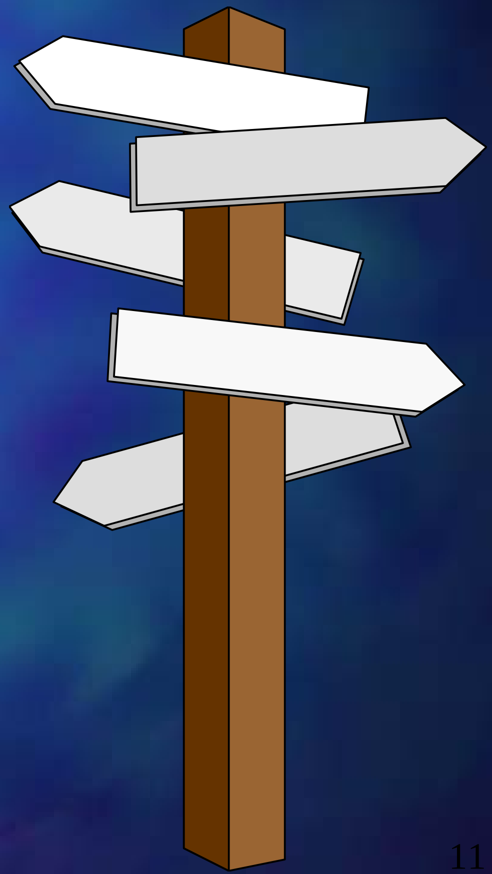
– Simple privatization: SOEs where markets are inherently contestable. Anti-trust bodies to *curb anti-competitive practices.*

– Natural Monopolies/Core Infrastructure Sectors: Where the entire World had State monopolies till recently (telecom, power, roads, airports, etc.) Privatization combined with regulation so as to *mimic competition.*

– Periodic franchising of Public Services such as Jails, water systems,etc: *Competition "for the market".*

Privatization Routes I

- Mass (voucher) Privatization
- Strategic Sales
- Public Offerings
- Mixed Sales
- Concessions



Privatization Routes II

VOUCHER

- Politically easier
- Speed
- Fair & transparent

* No revenue to government
* No new tech/management
* No improved Corp.governance
* Drawbacks in weak cap. mkts

STRATEGIC

- The obverse of Voucher programmes

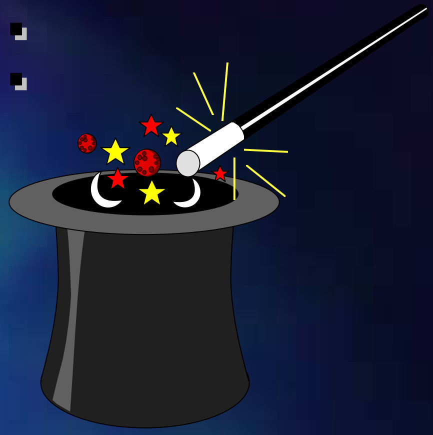
* Foreign takeover fears

SIP

- Large SOEs can be sold
- Revenue for government
- Politically easier
- Develops capital markets

* Difficult in underdeveloped K Mkts.
* Tech. & Mgt gains do not accrue
* Underpricing of shares

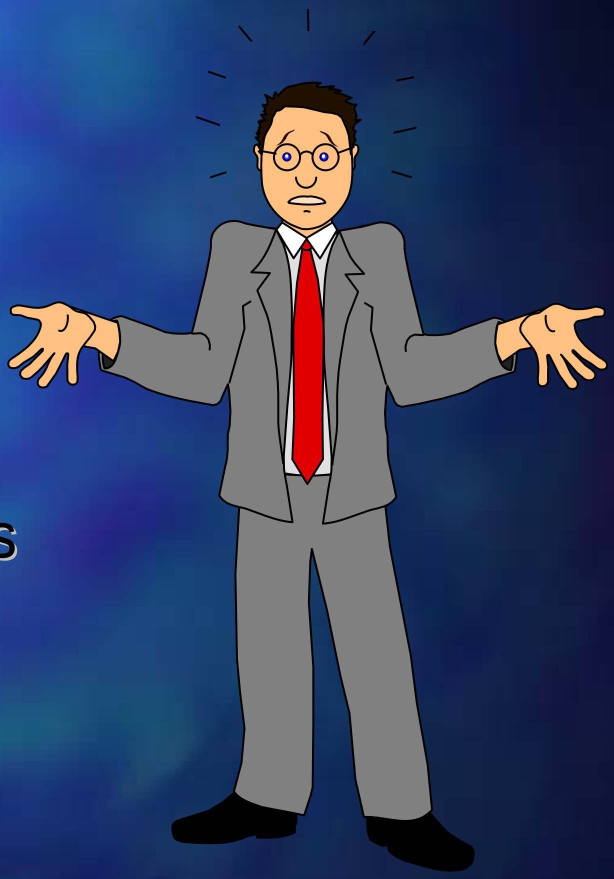
Determinants of Outcome : Designing Privatization



- Clarity in Objectives
- Strong political commitment
- One Government office clearly in charge of the process
- Transparency of the Process
- Simple bidding process
- Market contestability: public and private monopolies
- State of Markets: Product, Labour & Financial
- Corporate Governance: explicit/
- implicit shareholder protection
- State of the Infrastructure

Common Criticisms

- Sale of family silver
- Promotes corrupt practices
- Reduction in jobs
- Underselling government assets
- Foreign ownership
- Reduced consumer welfare: Prices increase and “universal service” affected.
- Jeopardizes government role in planning



Vocal Constituencies

- Legislators
- Unions
- Employees
- Domestic Companies fearing competition
- Government Ministries
- Senior public servants
- Foreign investors who lose the bid

Some Common Pitfalls……..

- "Low-balling" and renegotiation
- The "White Knight" syndrome
- "Winner's Curse"
- White Elephants & Sovereign Guarantees
- Asset stripping by employees/management
- Complex bidding process
- Restructuring prior to Privatization

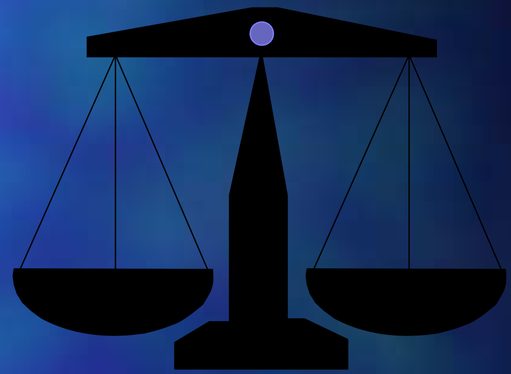
.....And Their Remedies

- Simple, transparent Process
- Second Price Bids
- Bidding on LPVR basis
- Standardizing all variables and bidding on Price only
- No fresh investment in restructuring prior to privatization
- Changing CEO and Board

Valuation of SOEs

- Extreme case: Planned economies where no market valuation possible.
- However, even in UK, valuation became a major political issue: assets sold too cheap?
- Various ways of valuation
- Controversial because problems with each Method
- Price discovery through market most transparent?

Types of Valuation



- Existing market price
- Asset valuation
- Replacement cost
- Discounted Cash Flow
- Book-building: Market clearing price
- Lowest Present Value of Revenue

Existing Market Price

- Problems:
  - can be manipulated
  - trading levels may be low
  - May not exist at all (100% SOEs)
  - In public monopolies even market benchmarks may be unavailable

Asset Valuation

- Problems:
  - Assets may be bundled
  - market sensitive to size of assets
  - No debits for negative assets/risks
  - Used only in strategic sales
  - Not a market clearing price

Replacement Cost

- Problems:
  - Can be used only in strategic sales
  - Not a market clearing price
  - likely to inflate value because of
    - technology differences
    - economic scale differences

Discounted Cash Flows

- Problems:
  - variable assumptions regarding
    - volatile price movements
    - exchange rate movements
    - Tariffs
    - investments and returns
    - discount rates
  - takes no account of market valuation of risks
  - May not be a market clearing price
  - Used only in strategic sales

	31/3/1998	31/3/1999	31/3/2000	31/3/2001	31/3/2002	31/3/2003	31/3/2004	31/3/2005	31/3/2006	31/3/2007
Operating profit (E)	13546	14122	15403	16563	16839	17158	17450	17708	17926	18096
Operating profit (N)					3900	5100	5100	5100	5100	5100
Operating Profit (T)	**13546**	**14122**	**15403**	**16563**	**20739**	**22258**	**22550**	**22808**	**23026**	**23196**
Fin.Charges	666	622	741	915	883	729	624	532	483	434
Depreciation	4000	4000	5000	5000	5000	5000	4000	3000	2000	1000
Tax	3108	3325	3382	3727	5199	5785	6274	6747	7190	7617
PAT	10438	10797	12021	12836	15539	16473	16276	16061	15836	15579
PAT + Dep	9772	10175	11280	11921	14656	15744	15652	15529	15353	15145
Amortisation	746	746	1121	1496	1496	1318	750	750	750	750
Capital Expenditure		5500	5500	5500						
Free Cash Flows	**9026**	**3929**	**-3239**	**-3269**	**3703**	**4467**	**5524**	**5997**	**6440**	**6867**
Dividend	2088	2159	2404	2567	3108	3295	3255	3212	3167	3116
Cash balance		38731	38731	38731						
TV										27466
TOTAL CASH FLOWS	***9026***	***3929***	***-3239***	***38029***	***3703***	***4467***	***5524***	***5997***	***6440***	***37449***
with 50% cap.redn	9026	3929	-3239	13629	3703	4467	5524	5997	6440	37449
Realisation by Govt.										
DCF				**67,202**						
51% sale value				**34273**	***34273***					
DCF after 50% cap.redn.				**45417**						
after 50% cap. redn.				**23163**	***47563***					

Book-Building

- Problems:
  - Only useful in capital market sales
  - Big, strategic players may end up with the shares

LPVR

- Problems:
  - Only applicable in certain kinds of concessions
  - May not entirely eliminate “winner’s curse”

International Evidence I

- SOEs in competitive environments have not performed better than Privately owned Companies, *ceteris paribus.*
- Important efficiency gains through privatization in competitive sectors: But increases in profitability = increases in efficiency only in competitive environment.
- Fully privatized firms performed better than partially privatized firms, *ceteris paribus*.

International Evidence II

- Privatization improved public sector financial health (lower deficits and debt)
- Privatization reduced net transfers to SOEs, and became positive through taxes.
- Privatization developed the financial sector.
- Short term negative impact on employment, long term positive impact.

International Evidence III

- Four studies on OECD and Transitional economies show that 3 years following privatization:
  - Profitability
    - rose 100% and 45% respectively
  - Efficiency
    - Increased 16% and 11% respectively
  - K Expenditure/Total sales
    - rose 70% and 44% respectively

International Evidence IV

- Telecom privatization in Jamaica, Venezuela, Argentina and Mexico yielded between 1-3% of the GDP
- Airline and Telephone privatization in Argentina reduced external debt by 10%
- Fiscal deficit in Egypt reduced during years of rapid privatization
- Public sector debt in Mexico declined from 80.7% of the GDP in 1986 to 29% in 1996

Foreign Investment and Privatization

- Between 1988-95 about 45% of privatization proceeds in Developing Countries came from foreign investment.
- Of this, about three-fourths were in the form of Foreign Direct Investment, and one-fourth in the form of portfolio investment.

Lessons from Mexico I
218 Privatizations in 49 Industries

- Firing CEO increased Price
- Labour cuts had no impact on price
- Debt absorption had no effect on price
- Investment programmes decreased prices significantly (33% of sales price)
- Foreign participation increased price
- Penalty for 1 year's delay was 36% of net price
- Net prices would have increased by 140% if divest ment was done in one year less than the average, and firing the CEO the only restructuring done

Lessons from Mexico II

218 Privatizations in 49 Industries

- Analysis of profitability gains: price increases (5%); lay-offs (31%);productivity gains (64%).
- Profits rose by 40%
- Output rose by 42%
- Costs per unit down by 18%
- Employment down by 20%
- Blue Collar wages rose by 120%
- White collar wages rose by 78%

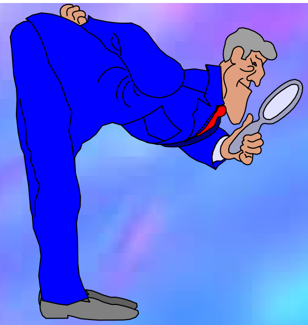
Corporate Governance and Privatization

- Common Law Countries (UK, US)
- Explicit Investor Protections
- Developed Capital markets
- Ownership dispersed
- Privatization through Capital markets

- Continental Europe, Latin America
- Implicit Protections: agents with hold-up power
- Weak Capital markets: Bank finance critical
- Ownership concentration
- Privatization through asset sales -failure of east European mass privatizations

International Evidence on Privatization and Labour I

- A major obstacle and least addressed issue: Has stalled or slowed privatization in many Countries such as Columbia, Uruguay, Brazil, Egypt, etc.
- Problem greater where labour markets are inflexible and SOEs not exposed to competition.
- Fears of massive job losses real
- White collar more adversely affected than blue.
- Over the long term privatization and liberalization created jobs in sectors with large investment backlog.
- Voluntary separation programmes universally used, but overwhelming majority of separations involuntary.
- Problems more acute in single company townships and where social benefits provided by Company and not by the State.

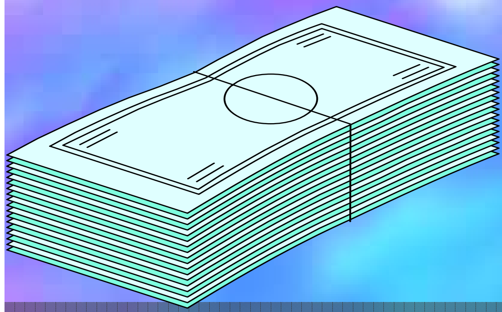


International Evidence on Privatization and Labour II: Pitfalls

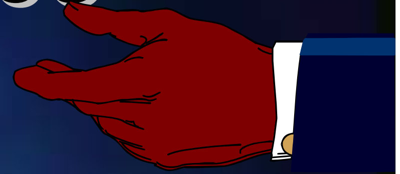
- Re-hiring of separated workers by the public sector defeating the objective of privatization.
- Voluntary separation : adverse selection as in Pakistan, Bangladesh and Argentina. Evidence on targeting mixed.
- Involuntary separation:high adjustment costs and politically more difficult.
- Employment guarantees (a) set an uncomfortable precedent in early privatizations (b) deter investors and restrict their ability to improve performance (c) absorption of huge surplus labour depresses sales price and strengthen allegations about public assets being sold cheaply (d) credibility: Will adequate severance payments be paid at the end of guarantee period ?

Designing Labour Restructuring

- Separation pre-privatization: excessive redundancy and post-privatization:modest redundancy
- Inform and Involve workers
- Make workers share the gains of privatization through sale of shares
- Well designed and generous safety net programme with participation of all stakeholders essential.
- Help Workers on targeted basis to reintegrate into labour market.
- Concurrently, labour market reforms to make it more flexible/eliminate obstacles to private job creation.

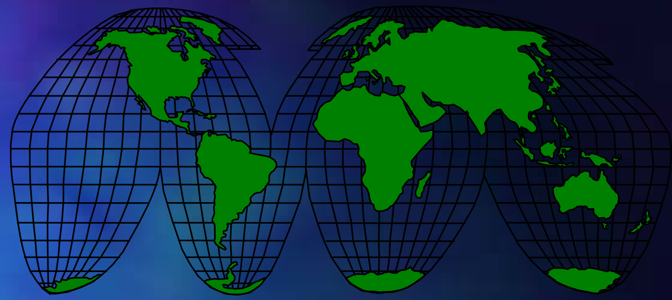


Financing Severance Payments



- Prompt payment crucial as delay affects credibility
- Sequestering privatization proceeds for severance payments
- Selling profitable candidates first
- Budgetary sources
- WB finance since 1996
- Sharing the burden with new buyer
- Part finance through sale of shares to employees (Chile)

Comparative Data on Severance Payments



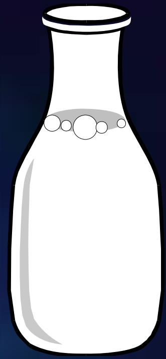
- Argentina (Railways Telecom, Steel)
- Bangladesh (Jute: BJMC)
- Brazil (Railways)
- Ghana (Food Processing, Textiles, Others)

- 2 years salary
- 3 years salary
- 1.5 years salary
- 0.5 - 4 years salary

New Regulatory Framework for Natural Monopolies

- ***Premise I:*** *Regulation should facilitate or mimic competition.*
- ***Premise II:*** *Returns should have incentives for reducing costs but exceed marginal costs*
- Competition and Universal Service
- Bottleneck Access: ECPR
- Ramsey Pricing
- Rate of Return & Price Caps

Competition and Universal Service

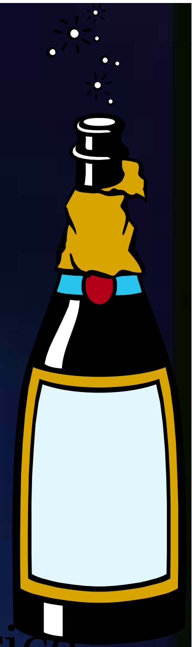


- Uniform Prices for utilities ensured through cross subsidies
- Competition leads to “cream skimming”, reducing prices in profitable areas
- Surpluses for cross-subsidy dry up
- A problem that continues to haunt privatization even in the West
- A powerful argument for maintenance of monopolies: Railways and Post Offices in Britain

Bottleneck Access: The Efficient Component Pricing Rule (ECPR)

	Route AB		Route BC	
Town A	(Bottleneck)	Town B		Town C

	MC (AB)	MC(BC)	JC	Access Price	Price
Incumbent	5	5	10		20
Efficient Entrant		4		15	19
Inefficient Entrant		6		15	21



Problem Addressed: *The transmission monopolist, if unrestrained, can charge a price so high for the bottleneck segment so as to drive rivals out of business. Does ECPR make unbundling unnecessary and and a less efficient policy tool?*

Ramsey Pricing:Maximizing Consumer Benefit

Coal

Cost=4

Cost=10

Economies of Scale & Scope

Total Cost=17

Cost=3

Wheat

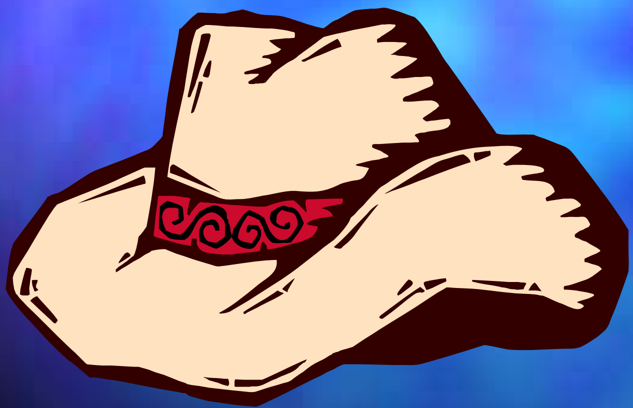
	Coal	Wheat
Stand Alone cost	14	13
Incremental cost	4	3
Allocated cost	9	8
Willingness to pay	12	6
Ramsey Pricing	11.5	5.5

<u>Inverse Elasticity Rule</u>

Lower the elasticity, higher the mark-up price

<u>Price:</u> Between incremental and stand alone costs

Rate of Return, Price Caps and Productivity



- Prices regulated on Rates of Return have no incentive to reduce costs or inject technological innovation
- Should be substituted for ceilings on total earnings (Price Caps) rather than on Profits
- Regulation of Price Caps less expensive than Rates of Return
- Price Caps indexed to inflation and fixed for a specified time, and readjusted to industry norm from time to time

International Experience in Privatization

Thank You For The Patient Hearing