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Dear Andrew

THE SUCCESS OF PRIVATISATION

E(A)(85)26 said that the Chancellor had asked the Financial Secretary to consider how best to present the arguments in favour of extending the privatisation programme to natural monopolies. The Financial Secretary is speaking to a City audience shortly about privatisation and you and other colleagues might like to see the attached speech he has prepared. It sets out in some detail the achievements of privatised companies and the case for extending privatisation to natural monopolies.

I am sending a copy of this letter to the Private Secretaries of E(A) Members and to Sir Robert Armstrong.

Yours sincerely
F P Bogan

MISS F P BOGAN
(Assistant Private
Secretary)

THE SUCCESS OF PRIVATISATION

1. Privatisation is bringing about a fundamental change in the operation and efficiency of key sections of the UK economy. Its success - like the sale of council houses - is self-evident. Its previous opponents are trying to climb on board. The policies that we have developed are being increasingly imitated throughout the world. I want today to set out what our achievements have been to date, the reasons why I think that we have been so successful, and our plans for the future.

Background

2. When we assumed office in 1979, the state-owned industrial sector in Britain accounted for no less than 10½ per cent of Gross Domestic Product (GDP). The growth of creeping state corporatism had meant that the number and spread of major industries and companies in Government hands was at its highest ever peacetime level. These industries and companies employed around 1¼ million people; their turnover amounted to £55 billion; and their annual investment was around £7½ billion. The last two figures are particularly significant. Because of the inefficiencies inherent in state ownership and because of the constraints

put on the industries, the business activities of these industries were being held-back. The level of their investment was at times governed more by the state of the public sector borrowing requirement than by the realities of the market place. Depending on the state of the economy and political imperatives, feast or famine alternated with the result that investment at times was too little, too late, and in the wrong place. And the effect? The United Kingdom's overall economic performance was diminished, individual achievements within the industries were seen to count for very little, and industries' customers suffered. Depressingly, until we came to office in 1979, the process of increased state intervention seemed irreversible.

3. I have rehearsed previously how this state of affairs had come to pass. The founding-fathers of nationalisation mistook idealism for reality and failed to see that running an industry involved very special skills and disciplines quite different from those needed to organise a Trade Union or a political rally. They were quite frankly experimenting. Not in a laboratory but with a key section of the British economy.

The results were poor returns on capital, low productivity, high costs and prices, and inadequate service. The experiment clearly failed.

4. Despite this, the Labour Party continued to argue in 1979 for more state control, more intervention, and, in practice, for more interference. Their aims were straightforward:

[Labour Party
Campaign Handbook]

"we need to extend public ownership into profitable and dynamic manufacturing industry if we are to regenerate British industry"

It does not take an economist - or any special expertise - to know that the results would not have been greater profit and dynamism but losses and inertia. The public understood this and voted accordingly.

Privatisations

to date

5. We came to office in 1979 determined to invigorate and liberate the state sector. To date, we have privatised twelve major companies and a number of other enterprises. State shareholdings in private sector

companies have also been substantially reduced. Around 400,000 jobs have been transferred to the private sector. The number of shareholders in the United Kingdom has probably been doubled. A third of a million employees have acquired shares in the firms in which they work. And the Exchequer has benefitted from over £6 billion of receipts which within our overall economic framework have helped to keep government borrowing lower than it would otherwise have been.

Reasons for

Success

6. I believe that privatisation is proving successful because our policies are based not on dogma but on common sense. First and foremost, Governments are not very good at owning or controlling businesses. The priorities, the pressures, and the time horizons are entirely different. Lord King, who in preparing BA for privatisation has turned it into one of the world's most successful airlines, has recently summarised why this is so:

[Price Waterhouse
Lecture, Cardiff
15 May 1985]

"The role of the politician should not include that of industrialist because he has a perfectly natural conflict

of interest. For instance, it is inevitable that a Departmental Minister and his civil servants will interfere in the conduct of the business for which they have been made responsible. They will do this - not because of a form of perverseness - but because they, and perhaps the Treasury, may have a different use for available funds than satisfying an individual application from one of their businesses. This could be to the considerable detriment of a particular company and its customers and - in due course - to the competitiveness of the industry itself."

Speaking as a politician, I absolutely agree.

7. We have made great strides since 1979 in improving the performance of state-owned industries whether or not as part of the preparation for privatisation. But I am convinced that state ownership is never the preferred alternative. Public sector culture is quite different from that found in the private sector. Marketing and risk-taking are not skills which the public sector always values highly. We are trying

through performance-related pay schemes and other means to improve incentives for those who are running the industries which must at least temporarily stay in the public sector but the results can never be more than second best in the long-term.

8. It is also true that public ownership generally leads to confused objectives for a business. Social and commercial objectives are intertwined to the detriment of both. Costs and benefits are blurred by cross-subsidy and management responsibilities become opaque and confused. Privatisation liberates managers and employees and allows them to reach their full potential.

Objectives of
privatisation

9. In developing our policies we have taken care to be as practical and pragmatic as possible. Our policies have been specifically designed to further a number of objectives. They are designed to lead to greater efficiency and this is demonstrated by the subsequent achievements of the companies which we have already

sold. They reduce the role of the public sector and provide substantial sale receipts. They allow employees to take a direct stake in the companies in which they work and this leads to major changes of attitude. And, importantly, they provide a major stimulus to wider share ownership.

Achievements of
privatised
companies

10. The success or failure of the policy can best be judged by the effects on the companies themselves. Sufficient privatised companies have now been long enough in the private sector for the proof of the policies to be put to the test. The results in human as well as financial terms are quite startling. The increased turnover of privatised companies is leading to higher profits and more investment which in turn should create more jobs. It is also becoming clear that the attitudes of both employees and management are changing profoundly. For example, involving employees in the ownership of the companies in which they work has given them a direct personal interest in company profitability. Share price graphs are being displayed in company canteens; and trade union negotiators are

starting to cross-examine management about the effect of prospective decisions on the company's share price. The significance of this on the companies' future performance can hardly be over-estimated. But let me quote some specific examples.

The National Freight

Corporation

11. The formerly state-owned National Freight Corporation was brought into the private sector in February 1982 by a management-led employee buy-out and is now an employee-owned business. Around half the total work force are shareholders and the value of their shares has increased 12 fold in the last three years. Since privatisation, there has been a virtual doubling of investment in the business, the first-ever growth in turnover in real terms, a more than doubling of trading profits in two years, and an increase of total staff numbers after years of decline. The NFC is now pursuing an expansionist business policy at home and abroad fuelled by a £500 million investment programme planned over the next five years.

12. A business like the NFC whose essential function is service relies enormously for

its success on the attitudes of its employees. If the employees believe in the company, so will the customers. When the NFC was state-owned, its annual corporate plans did not even refer to employees, let alone emphasise their role. Nowadays, the company's employee-shareholders are positively encouraged to tell top management their views. The company's annual plans fully consider implications for employees of all major decisions. What a telling testament to a remarkable change of emphasis! No wonder, the NFC's industrial relations are now excellent.

13. This is fine for the NFC and its employees, but how does it benefit the rest of Britain? The answer is straightforward. Because NFC is Britain's biggest road freight, storage and travel business, a successful NFC helps create a successful Britain.

British

Telecom

14. Consider British Telecom. The BT sale was not only the largest ever and most successful public flotation in the world, it is leading to a revolution in the development of telecommunications in the United Kingdom. Our policies have opened

up telecommunications markets to new entrants. They have actively promoted the emergence of a direct network competitor to BT. They have created an explicit regulatory environment via the licensing system with the powers of OFTEL, the MMC, and, in the last resort, the Courts to police it. They have subjected BT for the first time to the full constraints of competition and fair trading legislation. They have ensured that its regulated tariffs will be cut on average by at least three percentage points in real terms each year for the next five years. They have allowed BT access to the world's capital market. And they have brought about dramatic changes within BT.

- [Quilter Goodison
Lecture 1985]
15. Sir George Jefferson, the Chairman of BT, has graphically set out the effect that privatisation has had on his company. Before privatisation, BT was an administration, not a business. Its staff were effectively district commissioners administering a government-controlled service through a board consisting principally of part-timers who tried to take quite detailed decisions on most things centrally. By 1980, despite a turnover of around £4 billion and

increasingly diverse customer needs, BT had only one profit centre; its accounts had been qualified for years and were still Civil Service-type cash book accounts. Staffing arrangements, promotion, and pay owed more to hierarchy and ease of negotiation than the desire to motivate people to contribute and to take risks successfully. The commercial development of the business was centred on engineering concepts rather than market and commercial needs. The overall effect was quite clear. The customers certainly did not call the tune.

16. What has changed? 96 per cent of BT's employees are now shareholders in the business and over 80 per cent have invested significant sums of their own money. In addition, 36 per cent of BT's staff are making substantial monthly savings to buy further share options to add to their holdings. Even one-third of BT's pensioners are directly shareholders in BT plc.

17. A cultural revolution is occurring. The old vertical hierarchies are being broken down. Methods of appointment and promotion are being changed to emphasise suitability

and ability and managers are being encouraged to manage. As Sir George Jefferson himself says, the qualities of people in the business were generally as good or better than those of their counterparts in the private sector. This does not surprise me and is true in many state industries. But state ownership had never allowed them to realise their full potential.

18. Other privatised companies are also being transformed. Jaguar created 530 new jobs last autumn to meet increased overseas demand and 600 more early this year to increase production yet further. Jaguar's present production figures beat all previous records and it is currently laying plans to double car production by 1990 which will lead in due course to further increases in the workforce. Investment in 1986 is planned to be around 50 per cent higher than it was in 1984. It is this process which taken nationwide in due course will help to reduce the scourge of unemployment. In the longterm, state ownership does not create jobs. It destroys them.

Cable and

Wireless

19. Many other examples can be quoted of the dramatic effect that privatisation has had on attitudes and performance. It has released management from all kinds of artificial restraints and red tape. For example, Sir Eric Sharp, the Chairman of Cable and Wireless, has commented that the freedom to negotiate deals and joint ventures as a principal with other Governments and major companies was invigorating for management and wholly beneficial for the development and growth of his company. I am not surprised. Cable and Wireless recent successes in the People's Republic of China bear witness to this as does their completion in 4 days - from start to finish - of arrangements last year to acquire the Hong Kong Telephone Company. Imagine the time that a nationalised industry, a sponsor Department, and the Treasury would have taken!

20. Cable and Wireless was never allowed to

develop its full potential when in the public sector. The then Chairman told the Select Committee on Nationalised Industries in 1978 that, prior to 1974, his company was instructed not to pursue business "actively" in the UK. This was relaxed in 1974 provided the company "consult the Department about any major expansion or developments of any expansion which might be politically or generally sensitive." It is no wonder that since privatisation in 1981 removed these constraints, turnover has almost trebled, profits nearly quadrupled, and employment is increasing. In terms of market capitalisation, Cable and Wireless ranked number 38 among British companies when it was privatised. It now ranks number 13.

Other

achievements

21. Although I do not claim that privatisation is the universal panacea for all ills, it is hard not to find success stories in privatised companies. Privatisation does seem to provide the best basis for secure long-term wealth and employment creation.

22. The Chairman of Amersham International

and Associated British Ports have both remarked how the image and standing of their companies has improved after privatisation. As well as producing extra pride in the job, this aids recruitment and helps attract customers. As one Chairman has recently remarked, there are better ways to spend senior management time in business than continually checking Hansard in order to gauge the correct political mood.

Securing the
national
interest

23. Moving industries from the public to the private sector is a complex process which has led to the development of new skills inside and outside Government. It was no accident that the early stages of the privatisation programme involved virtually self-contained companies already trading on the fringes of the private sector. In order for the programme to move into the heartlands of the public sector, novel techniques have had to be developed to ensure that vital national and public interests could be reconciled with private ownership. The fact that we are now able to do this and to guarantee that the nation

and the consumer are fully protected represents a major advance, the significance of which is not always fully appreciated.

24. Privatised companies are, rightly, indistinguishable in company law from other companies. However, it is possible to circumscribe the framework within which companies operate without in any sense diminishing their independence or blunting their commercial instincts. For example, the license under which British Telecom operates the public telecommunications network within the UK requires it to carry out certain functions which, left to its own devices, an unlicensed private company might not consider worth doing. These include the provision of rural call-boxes and the emergency 999 service. The nature of these non-commercial obligations is made absolutely specific in the terms of the license and, legally, BT has no alternative but to comply. The public interest is thus absolutely safeguarded.

25. A company's internal affairs are regulated by its Articles of Association. It is right and proper that the generality of these articles in privatised companies

shall be the same as in the private sector. However, in certain key limited areas, the national interest - and indeed possibly the interest of the company itself - requires that certain articles shall only be amended with the consent of the Secretary of State. The so-called "special share" arrangements have been developed to secure this in a way which is, I should stress, absolutely consistent with general UK company law. Where these arrangements are necessary, they are tailored to the circumstances of the company concerned and might, for example, protect a company from takeover in the early years of its life, prevent ownership from passing overseas in cases where UK control is seen as being of paramount necessity, or block material disposals of assets without the Secretary of State's consent. In two cases, Cable and Wireless and British Aerospace special share arrangements were inserted after privatisation with the full recommendation of the companies' boards and the approval of their shareholders.

26. The third area where development of policy has made it possible to ensure that non-commercial objectives are sustained is

in subsidy arrangements. For example, some rural bus services in the United Kingdom are only viable if subsidised. It is clearly in the public interest however, that these subsidised services are tailored to the needs of their customers and that subsidy is kept to the minimum consistent with this. We now intend, and are in the process of requiring, that in future subsidies will be subject to competition. Local authorities will be required to advertise their intention to subsidise a service, and to seek tenders in the open market. They will be obliged to accept the lowest tender consistent with the specified standard of service. We are hoping to see lower fares, lower subsidies and better services. What a triumph of practicality over dogma that would be!

27. Here, as elsewhere, privatisation produces transparency. It forces decisions out into the open and lets people see whether something is being done for social or economic reasons. I believe that such transparency encourages sensible decision-taking and advances economic and social objectives.

Extension to natural

monopolies

28. Privatisation has proved of such major benefit over the last five years, we have decided that it is right to extend it progressively to the so-called "natural monopolies". These are the monopolies where economies of scale and barriers to entry are such that it would be artificial, wasteful, or impractical to break them up. The cheapest means of producing or supplying a commodity in these circumstances may well be a natural monopoly. We believe that it is possible to privatise natural monopolies in such a way that their customers, their employees, and the economy as a whole will all benefit. The privatisation of British Telecom, with its virtual present monopoly of domestic telecommunications, showed the way. Gas, airports, and, possibly, water are next. Let me explain why.

29. Conventional wisdom was that monopolies were so powerful, so prone to take advantage of their customers, so liable to become fat and inefficient, that the only safe place for them was in the public sector. Only politicians and civil servants could be entrusted with monopoly power because

only they would exercise it with restraint, justice, and good sense. What nonsense this proved to be! Experience over the last forty years has surely taught us that, from the customer's point of view, the State is just as likely to abuse a monopoly position as a private owner. And worse, when it does, despite Ministerial responsibility and Parliamentary accountability, the customer has little effective redress. Contrast the security given by effective regulation such as provided by OFTEL, the MMC, and, as a last resort, the right to challenge abuse directly in the Courts.

30. Although the size and extent of natural monopolies has clearly to be constrained to what is truly "natural", I firmly believe that where competition is impractical privatisation policies have now been developed to such an extent, that regulated private ownership of natural monopolies is preferable to nationalisation. Those who criticise the decision to privatise utilities as being a Treasury-inspired fund-raising exercise have just not considered the facts.

31. First, privatisation increases productive efficiency whether or not a monopoly is involved. Pressures from shareholders looking for a return on their investment - considerably enhanced when these shareholders are also managers and employees - give a clear incentive to privatised companies to organise their internal affairs as efficiently as possible and seek the maximum competitive terms from their suppliers. The enhanced competition amongst suppliers as well as benefitting the privatised company also benefits the UK economy as a whole. Suppliers who fight others for orders are likely to compete more aggressively in overseas markets and also be more likely to seek out technical innovation.

32. Secondly, the extraordinary success that privatisation now has in creating a wide distribution of shares, produces shareholder pressures quite unlike those faced by nationalised industries or conventional companies. The existence of large numbers of shareholders who have both paid for their shares expecting a reasonable return and are customers interested in good service at a fair price

is an irresistible combination and a powerful lobby in favour of both efficiency and price restraint. Giving people shares free in these companies - as some have suggested - would completely negate this effect.

33. Thirdly, private sector companies able to draw on capital markets to finance efficiency or expansion face circumstances different from those faced by industries in the public sector. We have been able to find the finance to allow nationalised industries to invest in worthwhile projects and their Chairmen said last year that the present levels and patterns of investment spending were broadly consonant with the proper development of their businesses. The industries have however not always been as fortunate and I do not blame them if they think that the financial markets are likely to be a surer source of funds over a period of time than the political capital market funded by public sector borrowing.

34. Maybe surprisingly, the counterpart of private sector finance is a continuing discipline which in practice may be far

more effective than that which can be applied in the public sector. State-owned industries escape scrutiny by analysts and bankers, and may fall into the habit of thinking that they have the Government available in the last resort to bail them out. This tends to undermine financial disciplines, financial control, and internal accounting techniques. Privatisation brings with it fundamental improvements in these key areas.

35. Fourthly, the establishment of OFTEL shows how regulatory arrangements can be developed which are tough, transparent, and provide full protection to customers as well as other businesses. Some regulation has however in the past had an undeservedly bad reputation when used insensitively and we have deliberately set out to learn from the experiences of others. We will avoid regulators becoming too associated with any particular company in order to pre-empt "regulatory capture". We will ensure that the regulatory regimes which are adopted will encourage efficiency, and we will make certain that regulation does not stifle innovation and technological advance. I am confident that this can be done.

Future Plans

36. Our future policy on privatisation in the UK is quite straightforward. We will continue to return state-controlled industries to the private sector. We will encourage competition where appropriate but where it does not make business or economic sense, we will not hesitate to extend the benefits of privatisation to natural monopolies. When this is done, we will ensure that they are subject to tough, transparent, effective regulation to the benefit of their customers and the economy as a whole. We will continue to offer incentives to employees and seek their participation in the success of the companies in which they work. We will structure the sales to give the greatest possible incentives to wider share-ownership. And we will use the sale receipts to further our overall economic strategy.

37. By the end of this Parliament we hope that, subject to Parliamentary approval where necessary and satisfactory market conditions, at least another eight major state businesses will have been transferred out of state

control and into the private sector in the full sense. These include the activities of the National Bus Company, British Airways, Shorts, Unipart, Rolls Royce, Royal Ordnance, the British Airports Authority, and the British Gas Corporation. This will mean that, since the programme started in 1979, the proportion of GDP in the hands of state industries will have dropped from 10½ per cent to around 6½ per cent. Compared to 1979, the number of state employees will drop by one-third. Over 600,000 jobs will have been transferred to the private sector. £23 billion of turnover and £3½ billion of investment will be freed from Government control. In the course of two Parliaments, we will have nearly halved Government involvement in state-owned business and liberated a substantial portion of economic activity from suffocation by the State. I have no doubt that the successful conclusion of this Parliament's programme will produce an irreversible shift in attitudes and achievement which will bring lasting benefits to the United Kingdom.

