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ECONOMIC REFORM, CORPORATISATION AND PRIVATISATION

Introduction

New Zealanders know about privatisation. From 1984 to 1992, their once heavily regulated economy has been radically reformed. The principles of private enterprise, initiative and competition have been widely applied to improve economic performance and, more recently, to target social assistance and investment.

The economy is now one of the least regulated in the world. The important agricultural sector is now genuinely farming without subsidies. Assistance to industry has been reduced, and border protection is low overall. Income tax rates have been reduced and the tax base broadened. Price stability has been achieved.

A great deal of Government activity has been made more commercial and much of that sold into private ownership and management. The economic reforms have been comprehensive; the privatisation process in New Zealand has involved more than selling off Government assets and enterprises. It has been based on the application of private sector principles of organisation, efficiency and market competition to improve performance.

The benefits from reform can now be seen. Inflation, at around 1 percent, is among the lowest in the world. Interest rates have declined. Exports have grown strongly. Unemployment, although high, has begun to fall. Savings ratios are rising. A virtuous cycle is replacing the vicious cycle of the recent past as economic growth is becoming evident.

New Zealand has built up considerable experience in all aspects of privatisation. The model developed has proved an outstanding success in improving efficiency. Much of the expertise gained in the development and implementation of these economic reforms is directly relevant to the needs of former centrally planned economies implementing similar reforms.

The Setting

In the early 1980s New Zealand had one of the most pervasive Government sectors in the OECD. Government trading departments and companies accounted for more than 12 percent of gross domestic product and 20 percent of gross investment, but managers were expected to pursue contradictory objectives. Management practices were therefore poorly focused and wasteful of resources. Many were losing money, which added to public debt, and the Government was constrained in borrowing to finance their capital development and expansion.

Government involvement reflected geography and history. When Europeans first colonised the country in the mid-nineteenth century, Government developed the infrastructure. Railways and mines were nationalised early. Airlines and radio broadcasting followed in the 1930s. The state set up a bank for loans to small farmers, general and life insurance businesses, a small depositors bank and an office to execute wills. The Government ran electricity generation and locally elected boards retailed it. Local authorities controlled ports and hospitals. The motivation for this involvement was mostly pragmatic: to solve a problem or to do what private enterprise was reluctant to do.

By the 1980s, the New Zealand economy was badly unbalanced, with persistent and intractable inflation, balance of payments and budget deficits and rising unemployment. Pervasive regulation, protection and cross-subsidisation had led to serious misallocation of resources, thereby severely constricting private initiative and economic growth and, as a result, social harmony. A Government attempt in the early 1980s to break out of the bind by stimulating and part financing a huge heavy industrial programme added to high debt burdens. Foreign debt in 1984 was 190 percent of annual export income and public debt 64 percent of gross domestic product, with both increasing.

Most of the Government "trading departments" were not run as businesses, and when debt and budget needs forced a serious examination of trading departments, in most cases there was found to be no obvious or compelling reason for their retention in public ownership. They required clear commercial objectives, they needed to be subjected to competitive forces, and their managers needed the power to manage.

The Reforms

The reform process for trading activities involved three elements, usually in the following sequence:

- To improve efficiency of operation, the considerable assets of these enterprises were exposed to full competitive pressures.
- In recognition of the difficulties associated with running a business operation where profit motive had become

confused with other objectives, a state-owned enterprise (SOE) model was developed to clarify these objectives.

- Finally, to cement in the gains which resulted from the SOE approach, the enterprises were prepared for sale and a sale process evolved to facilitate the transition to private ownership.

There were difficult regulatory and ownership issues to address, and this was part of the process.

The process to privatisation was a continuum, with different enterprises moving through the process at different speeds. It is therefore difficult to isolate and attribute the benefits of reform to any one step. The three components of competitive pressures, corporatisation and finally privatisation operated as an integrated package.

While there was a strong political mood for economic reforms, these changes were in direct contrast to the traditional values which had been built up over successive generations. This resulted in a political constituency opposing the sales on philosophical grounds even in the face of evidence demonstrating the potential and actual gains.

Mistakes were made. Early on it was considered important to take advantages of opportunities when they presented themselves as distinct from seeking to refine the process further. Reform takes time. For New Zealand, time and leeway were limited. And, importantly, credibility is crucial; faltering in the mid term of reforms extended the time span of adjustment and accentuated the cost. This point was clearly appreciated by the architect of the New Zealand reforms, Roger Douglas, the Minister of Finance during the pioneering part of the process.

Competition

The precondition for privatisation had been to introduce competition or at least contestability (the threat of competition). This approach was developed by Treasury officials, who applied to public sector trading activities the principles universally applied to private firms. From 1985 most sectors of the economy, including Government trading departments, were progressively deregulated.

The guiding principle was that, where practicable, constraints on all businesses were to be limited to the operation of the market or, if the market proved imperfect, to a revamped Commerce Act which barred individual companies or cartels from dominating an activity. In general, the New Zealand model has been one of light regulation.

Generally, this competition approach improved both efficiency and service. For example, the now privately owned Telecommunications Corporation (Telecom) must allow its trunk and international competitor, Clear Communications, reasonable access to its local networks. The Government owned Electricity Corporation (Electricorp), now obliged to operate commercially, still controls the national transmission grid, but must allow competing generators, when they emerge, access to the grid.

Competition on trunk domestic air routes, when Air New Zealand lost its monopoly in 1987, cut fares by 8 percent on average in the first 18 months and produced numerous innovations and improvements in the quality of service. Under the threat of competition, Telecom in 1987-1988 cut long-distance charges by around half and dramatically improved services. The Electricity Corporation in the five years to mid-1992 cut the real price of electricity by 14 percent. Its protection removed, the Railways Corporation cut freight rates by 43 percent in real terms between 1984 and 1990 and moved only 14 percent less freight with 60 percent fewer staff. In the ports stevedoring costs dropped by between 20 and 60 percent in the year after competition was introduced in 1989 and turnaround times for ships were cut by half or more.

Competition was regarded as a vital ingredient of the privatisation process. Without competition, efficiency gains are either not achieved or not maximised, even under private ownership.

Commercialisation and Corporatisation

This involved the reorganisation of Government businesses along private enterprise lines, with instructions to maximise profits and efficiency. From April 1, 1987, seven trading departments were converted into nine stand-alone SOE corporations, with boards composed mainly of successful private sector business operators. Others have been converted to corporations since. The Railways Corporation, already in the form of a corporation, and Air New Zealand, in company form, were instructed to act strictly commercially.

Although the Government retained the power in the SOE legislation to specify and pay explicitly for social objectives, in practice SOEs were required to run as if they were private sector businesses conforming to commercial objectives alone. This was reinforced from 1988 with a general instruction to ready themselves for sale - that is, to maximise their profits and net worth.

They did. New Zealand Post went from a loss of $6 million in 1986-87 to a profit of $141 million in 1987-88 and $43 million in 1988-89; PostBank went from a loss of $46 million in 1986-87 to a profit of $113 million in 1988-89; the Coal Corporation went from a $14 million loss in 1986-87, its 20th in 22 years, to a $6 million profit in 1989-90; the Forestry Corporation converted a $70 million loss in 1986-1987 into an operating

surplus of $138 million in 1989-90. Even the Railways moved into operating profit in 1991-92 in tough trading conditions. (*Note: In October 1992 NZ$1 was worth US$0.54).*

The application of private sector management and financial management principles, though not profit objectives, was extended into social services delivery agencies, notably hospitals and also to a limited extent schools. This has occasioned vigorous political debate. To the extent that it has been practicable and relevant, elements of the same approach have been applied to "core" (non-trading) Government departments. Thus departments work to specified objectives, pay a charge on their assets and have considerable flexibility in choosing the most cost-effective inputs, including personnel. Chief executives of departments have an arm's-length relationship with their ministers in matters of administration, which reduces the scope for detailed interference from politicians. In April 1992, the Government pioneered the publication of a balance sheet consolidating the core Government accounts.

Logically, in time this approach will separate "agency" activities from those involving policy advice or monitoring and regulatory functions. Gradually, some agency activities are becoming contestable. An example is the calling of tenders for the operation of two new prisons, previously exclusively the preserve of the Justice Department.

Electricity Corporation of New Zealand

Since its establishment as an SOE in 1987, the Electricity Corporation has

- reduced real unit costs (c/kWh) by 28%
- reduced real average wholesale electricity prices by 13%
- increased productivity, as measured by GWh/ employee, by 71%
- achieved a 187% lift in profit after tax to $404 million in 1990/91

ECNZ increased station availability, a measure of efficiency, across all 40 power stations to above international standards. It also brought in on time and within budget several large capital expenditure projects, such as the new inter-island DC link.

It reduced staff numbers from 6,076 in 1986 to 3,366 by September 1991. The number of days lost due to accident or injury has fallen dramatically. In spite of New Zealand's recent recession, the corporation was able to increase electricity sales and its share in the total energy market (from 43% to 50%).

Privatisation - the Final Step

The Theory

In some other countries such as the United Kingdom and France, early sales of state assets were designed to popularise privatisation by putting shares into the hands of ordinary people. In New Zealand, shareholding was already widespread, and the underlying philosophy driving privatisation has been to further the dramatic efficiency gains made under corporatisation and reduce the Government's fiscal risk. It was therefore a logical extension of the economic reforms, which started with a first-principles look at the role and function of government in a modern society.

Although the compelling reason for selling enterprises is economic efficiency, reducing debt can be important. There is a fiscal gain, as the loss of dividends is balanced or outweighed by the cut in interest payments on retired debt and the higher tax stream. This argument was used from 1989 in response to critics who argued that the newly profitable SOEs should be kept in public hands to provide a return on the taxpayers's investment. It is also argued that the proceeds from selling a monopoly might be greater than those from an enterprise facing competition, but maximising the receipts has been clearly subordinated to the efficiency objectives.

A World Bank study of privatisation results in early 1992 found that "experience from[several] countries demonstrates that private ownership itself makes a difference. Some state-owned enterprises have been efficient and well-managed for some periods, but government ownership seldom permits sustained good performance over more than a few years... Privatisation has helped to improve enterprise performance, reduce the fiscal burden and country debt and improve consumer welfare - when sales are properly structured and implemented and the market or regulatory environment ensures competitive behaviour".

The study pinpointed "pressure for renewed government intervention" in New Zealand Post and Electricorp as an example of the difficulty of maintaining efficiency after the initial reform period under government ownership.

The advantages of privatisation are not easily quantifiable. Simple figures of improved efficiency are inconclusive, since New Zealand's SOEs might well have gone on making efficiency improvements had they remained in public ownership. The benefits appear to lie mostly in intangibles.

Directors and managers of private businesses are single-focused and highly motivated. They do not have the spectre of a political dimension to decision making which over time can divert managers from a strictly commercial orientation.

Privatisation has enabled them to sharpen their customer focus and to plan strategically with greater confidence.

Another constraint removed by sale is the inherent inflexibility of the Government as shareholder. Businesses sold have access to capital, technology, skills and contacts their new owners are able to provide. The ANZ Banking Group, for example, has been able to draw on its international expertise in marketing, credit and management techniques to develop new products for PostBank, the former Post Office Savings Bank which it bought in late 1988. Telecom reports that as an SOE it was restricted in its ability to diversify or to do significant offshore business, one of the ambitions of its American part-owners. A significant amount of Telecom's revenue growth now comes from new ventures.

Critics of the Telecom sale feared that the massive investment programme which rapidly modernised the telecommunications system during corporatisation would stop under Bell Atlantic-Ameritech ownership. In fact, Telecom is maintaining the momentum as a private company: in the current year its planned investment is $700 million, about 1 percent of the country's gross domestic product, and it intends to continue heavy investment.

Conversely, still Government-owned New Zealand Post is constrained in developing business opportunities because the Government will not raise debt finance to increase capital. Investment is therefore lower than it would likely be in private ownership. The same goes for the state-owned broadcasting companies, Television New Zealand and Radio New Zealand.

But that does not mean sell at all costs. In some countries the private sector is relatively small and/or inefficient. This makes it more difficult to obtain efficiency gains prior to sale, and also reduces the opportunities for sale. However, in such a situation it is all the more important to maximise the efficiency of the state trading activity and its contribution to the economy. Timing and the method and process of a sale are crucial under these conditions.

The Process

There are a range of options open to governments wishing to sell an enterprise. These range from a public share offer, as followed in the United Kingdom, through to a direct negotiated sale after a competitive tender round. The process as developed in New Zealand normally involves these stages:

- The Government's own public service advisers carefully examine the regulatory environment to allow for the maximum possible competition while at the same time protecting the public against monopoly practices, and the earlier steps of placing the business on a sound commercial footing are carried out. These are essentially the two steps outlined in the previous sections. This minimises future regulatory uncertainty and helps in clearly defining the rules of the sale process.
- Public sector advisors and their consultants "scope" the enterprise, assessing its present value and the degree to which its value would be enhanced by potential private owners. Any special public policy factors that may impact on a sale are assessed by public servants and a full report on the Government's ownership options prepared.
- The availability of the enterprise for sale is widely notified at home and abroad to companies thought likely to be interested and able to bid.
- Interested bidders are invited into a competitive tender, with equal information available to all bidders at each stage in the process. A shortlist of bidders is then selected on the basis of these indicative bids to make a final binding bid for the asset.
- Commercial advisors and public servants prepare the sale documents, screen bidders, monitor the due diligence by shortlisted bidders, evaluate the relative merits of the bids, and make final recommendations to ministers. All day-to-day management of the sales process up to this stage is delegated to government officials or their private consultants to avoid perceptions of the process being influenced by political considerations.
- Ministers decide on the basis of advisers' recommendations whether and to whom to sell. Post-sale guarantees or special conditions are usually avoided, and a cash purchase is required, to ensure a clean sale, with no subsequent recourse by the buyer or others to the Government. Preferences by the enterprise's board or management are ignored.

This process is now closely adhered to, unless there are exceptional circumstances. Experience has guided policymakers towards the model.

For instance, the partial floats of the Bank of New Zealand and the Petroleum Corporation (Petrocorp) in 1987 created a problem for subsequent selldowns by the Government because some minority shareholders objected to the sales. If the Government wants widespread ownership, it has followed the route of requiring the new owners to float shares as a condition of sale. This has been the case with Telecom and Air New Zealand.

Another lesson was learnt when difficulties with an attempt by British Gas to obtain warranties after its selection as preferred bidder for Petrocorp in February 1989 caused the Government to abort the sale in favour of local conglomerate Fletcher Challenge. This persuaded policymakers to tie up as

much of the details as possible before selection of the purchaser. In the case of the ultra-smooth sale of Telecom in 1990, detailed terms were negotiated with each shortlisted bidder before the winner was chosen.

The overruling in December 1988 of a recommendation to sell the Bank of New Zealand on the grounds that the highest offer was too low, proved wrong when six months later the bank had to be rescued. This convinced ministers that they should neither deviate from the highest price maxim nor second-guess the best time to sell.

Many people are also sceptical of the merit of first restructuring or refinancing a company before sale: after spending $2.3 billion reconstructing New Zealand Steel, the sale price was $300 million.

Privatisation can be highly sensitive politically. For example, the Telecom sale was opposed by overwhelming majorities in public opinion polls. People feared that the telephone service would deteriorate or rise in price under private ownership. The Government took two steps to mollify that opposition.

One was to retain a "kiwi share", modelled on the British "golden share", under which the company pledged to maintain certain levels of price and service, such as the price of residential phone rentals which are not to rise by more than inflation. The kiwi share also gives the Government a veto on major share transfers. A kiwi share also secured Air New Zealand in 65 percent domestic ownership to ensure its access to internationally negotiated bilateral landing rights.

The second step was to insist that ownership by the major Telecom partners - Bell Atlantic and Ameritech - be restricted to less than 50 percent and that 40.1 percent of the shares be floated by the new owners within three years. A similar public float of 30 percent of the shares was a part of the Air New Zealand deal in 1988.

The Results

The following is a brief summary of some of the efficiency gains to date.

Air New Zealand, long recognised as one of the premier service airlines internationally, has greatly improved management understanding of commercial disciplines based on financial targets.Productivity is estimated to have increased by an estimated 28 percent, based on10 percent staff reductions and increases in passenger kilometres flown. Privatisation has enabled the shedding of some loss-making domestic routes which had been retained for political reasons, and the potential conflicts between government as an airline owner and aviation regulator and negotiator of international rights have been avoided. The airline is now in a position to seriously consider expansion into the recently deregulated Australian market and capitalise on expanding Asian traffic routes.

Telecom, perhaps the most successful of the privatisation examples, is now unrestricted in its ability to diversify and/or to contemplate offshore opportunities. Over a two year period from its sale, Telecom's net earnings rose 56 percent, increasing the return on shareholder funds from 10.6 percent to 15.2 percent. This has arisen from productivity gains and cost reductions. Overall charges dropped 25 percent in real terms over a three year period, with consequential business growth rather than price increases.

PostBank has experienced several gains in its operational efficiency. Customer service has improved, and the synergy from being associated with a larger group and able to coordinate many operational areas has resulted in economies of scale. The Bank no longer is constrained by the real risk of government intervention on non-commercial grounds.

Petrocorp, one of the sales early on the learning curve, has seen productivity gains resulting from clearer commercial objectives. Between 1990 and 1992 unit production costs for urea and methanol decreased by 10 and 1 percent respectively, and Petrocorp's profits have grown by 264 percent. The sale of the Government Printing Office in July 1990 has also seen a consolidation and enhancement of the efficiency gains made prior to its sale.

Other sales have been New Zealand Steel, Health Computing Services, the Rural Bank, the Development Finance Corporation, the Shipping Corporation, Landcorp and Housing Corporation mortgages, Communicate New Zealand, the National Film Unit, State Insurance Office, Tourist Hotel Corporation, Maui/Synfuels, rights to forestry cutting, Export Guarantee Office, and Government Supply Brokerage Corporation.

Issues for the Future

The Government is now developing techniques for privatising subnational public entities such as ports and electricity distribution authorities, both run in pre-privatisation days by elected boards. There is a partial parallel to problems faced in privatising businesses in former centrally planned countries, in that ownership is unclear.

The technique for electricity distribution authorities is permissive. Trustees for the authorities must develop ownership plans, to be submitted for public consultation. These plans may include trusts, giveaways to the public or outright sale of shares to private companies or some combination of those options.

These moves have run into public opposition similar to that in the sale of Telecom. Electricity is a vital service and people fear the supply may become less reliable or prices may rise. The original proposal in November 1991 to give shares amounting to probably $2000 a residential customer met opposition based on fear that price rises over time would negate this giveaway.

In late 1992 the Government agreed to a move towards separation of Trans Power, the company that operates the high voltage grid, from Electricorp. All interested parties would then have open access to the national grid. The Government believes the move will enhance efficiency in distribution and, in time, lead to Electricorp facing competition in the area of generation.

The operation of New Zealand Post, still in Government ownership, raises similar regulatory questions. Although 70 percent of its business is now fully contested in unregulated markets, the 30 percent that involves carrying letters is widely seen as a public service entailing considerations beyond the mere commercial.

Exporting New Zealand's Experience

There are several features of the New Zealand experience which are directly applicable to other countries reforming their economies. The poor trading performance of most of the Government's trading activities, coupled with a need to alleviate the debt problem, resulted in asset sales being a major component of the comprehensive policy of economic reforms which successive Governments have followed since the mid 1980s. The results of the package are bearing fruit.

New Zealand now has a pool of professionals in the public sector and in private law firms, merchant and investment bankers, stockbrokers and other consulting firms in valuing businesses, calling tenders and managing the sales process. This includes consultants who at the time of corporatisation worked to help employees adjust to the very different culture of a commercially oriented business and to help those who were displaced (50 percent on the first day in the Coal Corporation's case; whole communities in the case of the Forestry Corporation). The World Bank and experienced observers say this is important to gain acceptance of privatisation.

"There is quite a healthy and developing industry within New Zealand on spreading the message abroad", says Finance Minister Richardson. New Zealand consultants have undertaken work for governments in Central and Eastern Europe, the former Soviet Union, Asia, Latin America and the Pacific, often under the auspices of the World bank and other international agencies.

Initially, the New Zealand Government relied heavily on foreign consultants. Now local officials and consultants have equal or better credentials thanks to the learning experience of the last few years. Bidders for scoping studies and management of the sale process are left to form their own teams with locals.

There are special attributes of New Zealand consultants. For developing countries, fearful they may be swamped by foreign advice and influence, New Zealand is a very small country with no colonial aspirations. And, importantly, consultants from New Zealand are likely to have had considerable practical experience in several or all aspects of the privatisation process. They bring an ability to see a programme through to implementation.

They also have some fellow feeling. Though New Zealand is a developed country and is a member of the OECD, it is still heavily dependent on exports of primary produce and commodities. Consequently, they know from first-hand experience something of the problems facing many developing and industrialising countries. That is rare among consultants on offer these days.