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Report to the Honorable
Scott Klug, House of Representatives

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The Honorable Scott Klug
House of Representatives

Dear Mr. Klug:

This report responds to your request that we review the divestiture experiences of central governments of several other nations. Specifically, we examined issues relating to (1) the privatization process, (2) the valuation and preparation of the assets for sale, and (3) the use and display of the sale proceeds for budgetary purposes.

In the United States, the term "privatization" can refer to a broad range of activities that, to varying degrees, lessen the government's involvement in the provision of goods and services. In common discourse, the privatization spectrum can include contracting out, public-private partnerships, vouchers, and franchising, as well as the actual sale—divestiture—of government assets and operations. Our review focused on the last activity, the transfer of ownership from the government to the private sector. Specifically, we studied the divestiture of entire operations, a process which involves the sale of an ongoing concern along with the physical assets associated with the operation. We did not address concessioning, which is a process by which the government sells the right to operate property.

A variety of divestiture proposals are currently under consideration in the United States—including selling the Naval Petroleum Reserves, the United States Enrichment Corporation, four Power Marketing Administrations, and the Helium Program.[1] These proposals raise a number of economic, policy, and budgetary issues related to the management of the process, structuring the entity for sale, the role of continued regulation, and the use of sale proceeds.

Since the U.S. government has limited prior experience with the divestiture of assets[2] you asked us to look at governments with more experience with divestiture to see if lessons from their experiences may prove useful to the United States. For this study, we reviewed the

[1]Some of these proposals are discussed in other GAO reports. See the list of related GAO products at the end of the report.

[2]The principal divestitures the U.S. government has undertaken are the sale of Conrail in 1987, and the sale of the Great Plains Coal Gasification Plant in 1988. The details of these sales can be found in appendix I.

divestiture experiences of five countries—Canada,[3] France, Mexico, New Zealand, and the United Kingdom. Many of the industries in the countries reviewed have always been part of the private sector in the United States. Nevertheless, we found certain common elements in the privatization process in each country reviewed. Table 1 summarizes the types of entities, by industry, that each of these countries has sold.

Table 1: Types of Entities Privatized by Country and Industry

Country	Types of major industries fully or partially privatized						Cumulative sale proceeds as percentage of gross domestic product[a]
	Agricultural services	Mining and construction	Manufacturing	Transportation and public utilities	Finance, insurance, and real estate	Services	
Canada	Fishing	Mining Oil	Aircraft	Airline Trucking Telecommunications		Hotel	0.6 (1984-1990)
France		Oil	Petrochemical		Financial services Insurance		1.5 (1983-1991)
Mexico		Mining	Automobile Steel Iron Cement Petrochemical Foodstuffs	Airline Trucking Toll roads Telecommunications	Financial services	Hotel	6.3 (1989-1992)
New Zealand	Forestry	Oil	Steel Printing	Airline Shipping Rail Telecommunications	Financial services Insurance	Hotel	14.1 (1987-1991)
United Kingdom		Oil	Automobile Steel Ordnance Aerospace Foodstuffs	Airline Airport authorities Trucking Shipping Harbors Bus companies Telecommunications Water Electricity	Financial services	Hotel Public housing	11.9 (1979-1991)

[a]Cumulative sale proceeds are divided by the average annual GDP for the years indicated for each country.

[3]The references to Canada relate only to the federal government and not to the activities of the provinces, which may have different mechanisms in place for their divestitures.

Results in Brief

The Privatization Process: In the governments examined for this study, the goals for the privatization program were central to the process and influenced how and what entities would be offered for sale. For example, privatization in the United Kingdom was based on the belief that the private sector could generally operate commercial enterprises more efficiently than the public sector. Within the overall goal of increasing efficiency, officials in the United Kingdom said they valued entities for sale to maximize the proceeds from that particular sale rather than to determine if the entity should be sold. In contrast, officials in New Zealand said they used valuation to compare what an entity would be worth if it were sold to its worth if it were retained by the government because both economic efficiency and debt reduction were their primary goals. Generally, the government in New Zealand would only sell entities if the return from the sale was greater than the value to the government if it retained the entity.

Valuation and Preparation for Sale: The governments in this study used a combination of valuation techniques. A few used "clawbacks" or other types of warrants to help protect taxpayers against undervaluation. Clawbacks are stipulations that under certain conditions, will require the buyers to return a share of profits—or losses—to the government. They have been used by these governments to protect against unanticipated windfall profits accruing to the entity's purchasers after privatization. The use of clawbacks, however, decreases the sale price and may constrain the entity's commercial behavior.

All governments we contacted used private sector financial advisors to assist Treasury or Ministry of Finance staff in the valuation process. In some countries, the entity to be sold hired its own private sector financial advisors as well.

As part of restructuring, most of the governments we studied attempted to remove liabilities or obligations from entities to be privatized. Debt, in particular, was usually restructured, with the government often retaining at least some of these liabilities. Most of the governments also paid for unfunded employee obligations in advance of the sale. Some of the governments retained other liabilities, such as those relating to environmental clean-up, to remove risks that would reduce the anticipated sale price of the entity. Restructuring also included breaking up monopolies prior to their sale.

The Use and Display of Sale Proceeds for Budgetary Purposes: Most of the governments in this study used any proceeds that resulted from privatization primarily to reduce debt and interest costs and many did not permit the cash received to be used to offset ongoing spending.[4] The New Zealand and Mexican governments displayed annual budget deficits and surpluses both with and without the proceeds from privatization. Despite this general policy to use proceeds for debt reduction, various government officials told us that some governments may have used sale proceeds to offset ongoing spending in particular instances.

The ways in which the governments we studied implemented privatization programs and the lessons policymakers learned could help the United States in evaluating and, ultimately, carrying out divestitures currently under consideration. The matters for consideration section of this report discusses specific practices of other governments that could be particularly relevant to issues the United States faces today.

Scope and Methodology

To identify budgetary issues and concerns, we examined existing divestiture proposals in the United States, reviewed earlier GAO reports[5] and proposed legislation relating to asset divestiture in the United States, and conducted a literature search of budgetary issues related to privatization.

We selected industrialized countries for our study that had a history of selling government-owned assets and for which we could gain access to appropriate staff and written information. Based on these criteria, we selected Canada, France, Mexico, New Zealand, and the United Kingdom.

To review the divestiture experiences of these countries, we conducted telephone interviews with a wide range of government officials directly involved with divestiture and with experts outside of government who were responsible for specific aspects of divestiture, such as valuation. We also reviewed literature on privatization in the five countries and official government documents. We did not verify the accuracy of all of the information provided to us nor did we evaluate the sales' relative success in achieving national goals.

[4]A country cannot actually begin to reduce its nominal government debt unless it is in fiscal balance or has a budget surplus. However, when a government sells assets, the sale proceeds will reduce the country's borrowing requirements from what they would have been, and as a result, the debt servicing costs will also be reduced.

[5]See the list of related GAO products at the end of the report.

We concentrated our discussions on cross-cutting, rather than industry-specific, issues we had identified that would be of interest to the United States as it examines its own divestiture efforts.

We conducted this work in Washington, D.C., from June 1995 through November 1995 in accordance with generally accepted government auditing standards. Privatization experts in each of the countries reviewed our material and we have incorporated their comments where appropriate.

The Privatization Process

Privatization in the five countries we studied involves a number of complex steps. The government selects candidates for sale and determines which must be restructured prior to divestiture. The government may choose to create a central unit to be responsible for coordinating and implementing the transfer of ownership from the public to the private sector. To assist it in the privatization process, the government usually hires financial advisors. The advisors are expected to represent the government's and the taxpayers' interests, as well as provide guidance on how to value and sell the entity. The government's overall objectives for privatization heavily influence how these steps are carried out.

Clear Goals Are the Cornerstone of the Privatization Process

We found that the government's goals, either for its overall privatization agenda or for individual privatization initiatives, influenced what entities would be privatized, how they would be valued, what type of sale would be used, and who would be eligible to purchase the entity. All the governments we contacted undertook privatization for a variety of reasons but all stated that they used privatization primarily to increase economic efficiency and reduce the size of the public sector. Most also stated that they used privatization to assist in reducing their public debt. Some governments clearly placed a higher priority on increasing economic efficiency, while others gave a higher priority to debt reduction.

In the United Kingdom, privatization was grounded in the belief that, generally, the private sector could operate commercial enterprises more efficiently than the public sector. Because the decision to sell had already been made, the entity's present value under continued government ownership was usually not estimated. The government was willing to sell an entity even if it would generate more money for the government as a public entity than the government would receive from its sale. The United Kingdom has also tried to increase share ownership of stock among the general public and has sold many entities through public offerings. The

government has generally sold shares at a discount to employees and the public and, as an incentive, offered installment plans to pay for the shares.

New Zealand undertook privatization to improve economic efficiency, reduce the government's exposure to commercial risk, and decrease government debt. To help achieve these goals, sales were open to the largest possible number of bidders and foreign ownership of privatized assets was not restricted. We were told that privatization has greatly enhanced the performance of certain inefficient sectors of the economy such as the telephone industry, which in turn has helped to make privatization more acceptable to the public.

During the 1980s and early 1990s, the Progressive Conservative government in Canada privatized government corporations to increase economic efficiency, reduce the demands that public enterprises exerted on government management and financial resources, and reduce government intervention in the economy. The size of the public debt has become a growing concern in Canada and, according to a public debt expert, the current Liberal government has begun to portray privatization as a way to alleviate the deficit and debt situation in Canada, particularly through two public offerings, the Canadian National Railroad and Petro Canada. In the past, Canada has limited foreign participation in asset sales, but the most recent public offering of Canadian National placed no restrictions on foreign ownership.

According to documents provided by the French Treasury, the French government sought to develop the Paris financial market through its privatization program. The use of public offerings has enabled privatization to play a decisive role in shifting personal savings into the equity market. While preferential treatment is provided to French residents at the time of sale, there are few legal limits on share ownership in public offerings. Except for companies operating in the health, safety, and defense sectors, the only legal limit is that non-European Union investors may not acquire securities representing more than 20 percent of the company's equity at the time of the initial sale. In subsequent sales, there are no limits on foreign purchases.

Privatization in Mexico was part of a larger strategy to increase the efficiency and competitiveness of the economy and increase its credibility on the international markets. Debt reduction has been essential for Mexico, particularly to reestablish credibility with its creditors.[6] To help

[6]Deficit Reduction: Experiences of Other Nations (GAO/AIMD-95-30, December 13, 1994).

meet its goals of increased economic efficiency and debt reduction, the Mexican government closed, merged, or sold 1,008 out of 1,155 public enterprises between 1982 and 1992. The government deposited most of the proceeds from privatization in a separate Contingency Fund and used the funds to retire government debt. While some of the entities that were privatized in Mexico were very profitable, many of the entities the government sold or shut down were money losers. The subsequent discontinuation of subsidies also helped to improve the government's fiscal position.

Mexico's constitution identifies strategic areas that must remain within the domain of the federal government. The constitution has been amended over time, however, to permit certain strategic areas to be privatized. For example, railroads were strategic at one time and can now be privatized. And, while Petroleos Mexicanos (PEMEX)—the national oil company—remains a strategic firm, an official told us that the basic petrochemical operations of PEMEX are now being offered for sale.

The Mexican government restricts the level of foreign capital that can be invested in the country, although foreign investment regulations were liberalized at the end of the 1980s and majority foreign ownership is allowed in most sectors. We were told that the level of foreign investment that should be allowed in each industry is currently being debated by the government.

Centralized Approach to Privatization Is Common

A central agency or commission holds primary responsibility for the management or oversight of the privatization process in all of the countries in this study. This structure has enabled a stable core of staff to develop expertise in managing the privatization process. It has also allowed the governments to implement a governmentwide approach to privatization. Table 2 shows the entities controlling the privatization process in each of the governments we studied.

Table 2: Responsibility for Control of Privatization Process

Country	Entity controlling privatization process
Canada	The Crown Corporation and Privatization Sector group, jointly managed by the Treasury Board and the Ministry of Finance, manages the sale.
France	Treasury manages the sale. Privatization Commission manages valuation.
Mexico	Interministerial Commission determines how an entity should be privatized. Privatization offices within the Ministries of Finance and Communications, and Transport administer the sale.
New Zealand	Treasury manages the sale.
United Kingdom	Treasury oversees and assists responsible ministry with the sale.

In the United Kingdom, a privatization unit within the Treasury oversees and assists the responsible ministry with the sale of public enterprises. The Treasury plays a coordinating role to ensure consistent decisions across individual privatizations. According to a Treasury official in the United Kingdom, the government's privatization efforts have led it to recognize the value of having a group of dedicated officials oversee most divestitures.

Canada had no central authority for the privatization process prior to the late 1980s; each ministry was responsible for developing its own privatization proposals. Because of dissatisfaction with the management and pace of privatization, a central authority, the Office of Privatization and Regulatory Affairs, was established in 1986. The current Crown Corporations and Privatization Sector group, which reports to both the Treasury Board and the Ministry of Finance, was created in 1991 to oversee the management and disposal of Crown corporations, which are wholly owned government corporations. The Treasury Board monitors the management of the budget and serves as a budget scorekeeper.

Corporatization Frequently Precedes Privatization

The countries we studied generally converted (1) government agencies or functions into a corporate form prior to privatization or (2) primarily privatized entities already in a corporate form. The definition of a government corporation or enterprise varies from country to country. Government corporations are generally commercial in character, self-sustaining or potentially self-sustaining, and may be exempt from a variety of personnel and regulatory restrictions applicable to government entities. In some countries, government corporations pay taxes.

New Zealand has used corporatization as a way to increase the efficiency and competitiveness of an entity while it remains within the government and as a stepping stone for privatization. We were told that New Zealand state-owned enterprises (SOE), which are entities that have been commercialized and corporatized, are very similar to their private sector counterparts. They pay taxes to the government, are not subject to government budget and personnel rules, must borrow from the private sector, and have private sector boards. The government, however, remains the sole shareholder. While the government does not guarantee the debt of SOEs, we were told that there is some concern that offshore debt holders may assume that some form of implicit guarantee exists.

New Zealand primarily has privatized entities that have already been transformed into SOEs. The government in New Zealand has used corporatization as an opportunity to clean up an entity's outstanding obligations prior to privatization. Experts stated that the performance of entities that were corporatized and then sold has been better than those that were not corporatized prior to privatization. These experts also said that the government learned it was much more difficult to privatize a department without the restructuring and debt reduction that corporatization engenders. The existing obligations and liabilities of a department complicate the sale and, as the entity has no track record as a commercial enterprise, it can be difficult to value.

The United Kingdom has primarily sold nationalized industries, which are already in a corporate form. Canada has primarily divested Crown corporations. The governments in the United Kingdom and Canada have also begun to divest departmental activities. France has almost exclusively sold public enterprises, and the Mexican government sold either SOEs or their fixed assets.

Valuation and Preparation for Sale

The valuation process is complex—it involves not only the mechanics of valuing the entity, but also determining the appropriate type of sale and the best financial and/or organizational structure for the entity at the time of divestiture. All of this occurs within the overriding context of the country's privatization goals.

Valuation is not an exact science. It requires a great deal of experience and depends to some extent on the professional judgment of those conducting the valuation. Different valuation methods may result in different ranges of expected values depending on, for example, the assumptions about the

future performance of the entity, the expectation of future earnings, and the level of investor interest.

Officials in most of the countries told us that because of this complexity, the centralized agencies responsible for the management of privatization hired financial advisors to assist with the valuation process. In the United Kingdom and France, the entity being sold often hired its own financial advisors to represent the entity's interests, such as the desire for a generous capital structure. Neither the entity nor its advisors, however, took the lead in managing the sale process.

Government Goals for Privatization Affect Use of Valuation

All the governments we studied employed a combination of valuation techniques to estimate the value of the entity being sold and to forecast the proceeds. Most used present value analysis, but other approaches were also used to develop an overall valuation.

In the governments we studied, the valuation process served a variety of goals. For example, valuation entered into some governments' decisions about whether to sell an entity. Valuation was also used to determine the appropriate financial and organizational structure to maximize proceeds.

The United Kingdom used valuation primarily to maximize proceeds because the decision to sell had already been made. In New Zealand, the government relied on valuation to determine whether to sell the entity to meet its goals of improved economic efficiency and debt reduction. Many of the countries also used valuation to determine a minimum acceptable price or a price range. We were told that, in general, none of the governments in this study included estimated future tax revenues from the entities sold in their estimate of future returns to the government because many of the entities already paid taxes and it is generally difficult to forecast tax revenues.

France primarily uses valuation to gauge the market, minimize market risk, and maximize the proceeds from a sale. The French privatization law of 1993 specifies what will be privatized; the government, therefore, does not use valuation to compare the return to the government of retaining as opposed to selling the entity. Valuation is done using a variety of analyses, including net present value analysis.

In determining whether to privatize an entity, New Zealand conducts studies to estimate the market value of the entity if it were sold compared

to the returns accruing to the government from retaining the entity. The government's advisors conduct a cash flow analysis to determine if the entity is worth more under government ownership or private ownership. When valuing the entity both under continued government ownership and as a private sector concern, the government uses a commercial discount rate appropriate for the industry in which the entity is located. If the returns from selling the entity do not exceed the returns from government ownership, then the entity generally is not sold.

In Canada, the government uses valuation to assist in pricing rather than to determine whether or not to privatize an entity. Valuation is used to develop a range of expected proceeds and not a minimum acceptable price. The government has not generally sold entities where the sale would have been uneconomical, although money losing entities brought low returns. According to a privatization expert, the government has reduced the number of people who know the details of the privatization transactions during their final stages to help maintain the integrity of the process.

In Mexico the government first determined whether an entity was indispensable; if the entity was not, the government closed, merged, or sold it. In cases where the entity was to be sold, the government used valuation to maximize the proceeds from the sale. We were told that the government often uses the current value of future cash flows to value an entity. The advisors develop a minimum reference point for the price the government should expect to receive for the entity. The majority of transactions have been at a price equal to or greater than the recommended minimum amount.

Clawbacks Used to Protect Against Undervaluation

Both the United Kingdom and New Zealand use "clawbacks" to address uncertainty in specific valuation situations, for example, where assumptions crucial to the valuation may change. Clawbacks in the United Kingdom have been used to protect the government (that is, the taxpayers) from new owners realizing unanticipated windfall profits[7] after privatization from the sale of surplus property. A typical clawback may specify that if the entity sells a certain property over a period of 10 years for values at a specified amount greater than the original value, a portion of the proceeds will go to the government. The United Kingdom's

[7]Such protections are not unprecedented in the United States. In the 1980s, warrants were issued to give the government a share in Chrysler's future profits in return for the risks the government incurred in offering guaranteed loans as part of the Chrysler "bailout." Warrants represent options to purchase stock for a specified time and price.

experience underscores the importance of identifying and valuing land owned by public entities which are to be sold. In some instances, such land has far less value to government than to the private sector, which may develop it.

We were told that the United Kingdom takes a cautious approach when using clawbacks because it recognizes that their use can decrease the sale price as well as constrain the entity's commercial behavior. For example, if the government "claws back" certain gains, it may reduce a firm's incentive to find and use new productive resources. According to a government official, clawbacks have been used when the value of the property has increased after privatization, not when operating profits were higher than expected.

In New Zealand clawbacks have been used in a broader range of situations. For example, according to documents from the New Zealand Treasury, the Petroleum Mining Licenses contract includes clauses whereby the government receives more money if oil prices rise above the benchmark levels used in the valuation or if reserves prove to be in excess of the present expected reserves estimate. New Zealand also used a clawback in the sale of the gas reticulation system. An official told us that the provision specified that if the share price increased to a specified amount by a certain date, then the company would pay the government a certain amount, but if the price decreased, then the government would buy back shares. The price did in fact decrease and the government had to buy back a percentage of the shares.

Economic Factors and Privatization Goals Helped Determine Method of Sale

The governments we studied used several of types of sales in their privatization efforts, including public offerings, private sales to companies or individual investors, and management/employee[8] buyouts. The type of sale can be linked to the size of the entity being sold and the country's financial markets. Public offerings are generally used in fairly well developed financial markets and for the sale of large assets with established financial track records. Significant administrative costs are typically associated with a public offering, such as developing the prospectus and marketing the sale. In situations where the entities to be sold are relatively small or lack a financial track record, or where the country's financial markets are less developed, private sales are used.

[8]According to the World Bank, a management/employee buyout is a technique whereby the managers and employees acquire a controlling interest in the company. The buyout may involve the use of credit to finance the acquisition, with the assets of the acquired company generally used as security.

The United Kingdom and France used public offerings to increase share ownership and develop financial markets, respectively. Mexico has primarily used private sales because of the limited size of its financial markets; New Zealand has typically used private sales rather than public offerings, which, according to government officials in New Zealand, are more costly to administer and involve greater risk. Canada has relied on both public offerings and private sales, based primarily on the size of the entities being sold. According to officials in each of the five countries we spoke with, the governments used advisors for assistance in determining the most appropriate type of sale.

The United Kingdom's major privatizations have been through public offerings. According to the government's financial advisors, public offerings develop the greatest price competition and thus allow the government to obtain the most value for the entity being sold. Initial public offerings were carried out with traditional methods, involving underwriters and fixed price offers. However, the United Kingdom has moved away from using underwriters and now uses "book building." Book building involves establishing a syndicate to ask institutional buyers how many shares, and at what price, they will purchase. This establishes a range of prices and enables the offering to be more accurately priced, in contrast to a fixed price offer in which the share price is determined prior to the actual offering.

The United Kingdom has used private sales for entities where it would not have been appropriate or cost effective to use public offerings. In addition, the United Kingdom used management/employee buyouts to increase employee share ownership. In private sales, the government's financial advisors typically conduct a discounted cash flow analysis to establish an internal benchmark for acceptable bids, which is not disclosed. An official told us that the government may accept a price that is below the benchmark because the government's main objective is to increase economic efficiency through privatization, and maximizing the return to the taxpayer is secondary. The final price is determined by a competitive bidding process, in which the highest bid is usually accepted. The government encourages management/employee buyouts, and price preferences have been offered to management to assist with buy-out costs. Both the National Freight Corporation and Vickers Ship Building and Engineering were sold to their former employees. In addition, provisions are made to encourage employee participation in share offerings. For example, the government may issue free shares or offer discounts to

employees. Shares were purchased by 99 percent of British Gas employees and 96 percent of British Telecom employees.

According to a government official, New Zealand has conducted its divestitures mainly through private sales, rather than through public stock offerings, because such sales are less expensive to administer, require fewer warranties and indemnities, result in a maximized return and minimize the risk of over- or under-pricing. In order to maximize returns, New Zealand sold entities to the highest bidder and was willing to sell to foreign owners. Management/employee buyouts are permitted, but only as part of the competitive bidding process. We were told that buyout bids are rarely the highest bids and are therefore usually unsuccessful.

In Canada, the government uses both public offerings and private sales, depending on the size and type of entity being sold. The government uses underwriters for public offerings and large offerings have been completed in several stages. According to a privatization consultant, the Canadian government always tries to pay attention to employee interests because if this is not done, employee concerns can potentially derail the sale. We were told that management/employee buyouts had not been used at the time of our review.

Mexico has primarily used private sales for its privatizations because it has not yet had the capital markets to support public offerings. The sales are conducted through a competitive bidding process with a sealed bid. Since the price is the most important consideration in the assessment, the highest bid generally wins.

France generally uses public offerings to sell public enterprises, but it has also used negotiated sales (private sales on an auction basis). Financial advisors provide the Privatization Commission with a range of expected prices, from which the Commission determines a minimum acceptable value. The government then uses book building to gauge the market, facilitate placement of the offering, and reduce market risk. The sale price the government will accept cannot be below the minimum value.

In France, the government is required to include employees in public offerings. A 10-percent quota of the shares sold on the open market was reserved for employees of the privatizing entity. Price rebates, up to a maximum of 20 percent, could be granted. However, if the price rebate exceeded 5 percent, the employees had to retain the shares for a specified period, which was generally 2 years.

Restructuring for Sale

Public entities were often restructured to improve their salability or to engender competition. Financial restructuring might be needed to mitigate the entity's debt and/or existing liabilities, such as pension obligations and environmental liabilities. Organizational restructuring might also be necessary to break up a monopoly and introduce competition. Determining both the current and future status of an entity's existing obligations was therefore often considered a necessary step in the valuation process. For these five countries, such obligations included underfunded pension commitments, post-retirement health benefits, environmental cleanup costs, and debt. Governments decided whether to retain responsibility for the remaining liabilities or to sell them with the entity. The market price can be expected to increase for an entity sold with fewer liabilities, particularly liabilities with uncertain costs. Organizational restructuring may also be necessary. If the entity is a monopoly, it may need to be broken up prior to the sale or regulations may need to be put in place to protect the consumer. Whether or not an entity is sold as a monopoly may also affect the price the government receives from the sale.

Restructuring of Debt and Liabilities Usually Occurs Prior to Corporatization or Sale

Governments determine, either on a case-by-case basis or as an overall policy, how an entity to be privatized will be structured for sale. The market price of an entity is reduced by the liabilities that come with it; the price may be reduced further by the risk premium associated with any uncertain liabilities. All governments in this study retained some amount of debt associated with entities to be sold, and generally paid the balance on under-funded or unfunded employee obligations.

All of the governments used public resources to restructure entities in an attempt to make them viable competitive firms. Officials in all of the countries, however, stated that the government does not generally put a significant amount of new investment in an entity prior to sale and many stated that this was because the private sector is believed to be better able to make investment decisions.

The United Kingdom has undertaken substantial restructuring of debt and liabilities to make the entities economically attractive to investors. According to an official in the United Kingdom, the government may retain a portion of the entity's debt. In addition, the government ensures that pension programs are properly funded prior to the sale of the entity. For example, prior to the sale of the National Freight Company, the government paid 47 million pounds into the pension fund; the government

also retained 1,250 million pounds of British Telecom's underfunded pension liability.

New Zealand generally restructures entities when they are converted into a corporate form (that is, into a state-owned enterprise). Since the government usually corporatizes before selling an entity, it addresses issues pertaining to outstanding obligations and liabilities during the corporatization process rather than during sale preparation. The government decides whether to retain or transfer these obligations and liabilities to the newly created SOE on a case-by-case basis. According to a privatization expert, pensions in New Zealand are not underfunded, but the personnel and liability issues that remain, such as the transfer of the pension plans to the private sector, are sorted out during the corporatization process.

We were told that in France public enterprises are under commercial law and public enterprise employees do not generally have civil service status; thus, there are few changes for the employees as the result of a sale. A government official told us that France, with a few exceptions, only sells entities that are in good financial condition and that most of the enterprises that have undergone privatization have not required major financial restructuring.

The Canadian government tries to ensure that the entity to be sold is commercially viable. In preparing Crown corporations for sale, the government usually retained some of the debt and other liabilities, but this varied depending on the entity being sold. The goal of the government is to reduce liabilities to the point where the corporation is able to operate viably in the private sector. We were also told that the Canadian government provides generous severance payments and that their cost can be significant.

In Mexico, the government identifies the entity's unfunded obligations prior to the sale of the entity. We were told, however, that this does not mean the government will necessarily retain the liability or pay off the unfunded costs. The government quantifies the existing liabilities so that the bidder knows the status of the entity that is for sale. In some privatizations, the government may retain all of the debt or liabilities, while in other instances the government clearly identifies the liabilities and/or debt and the prospective owner agrees to pay the costs. In some cases, the entity would not have been saleable if the government had not retained its large debt.

An official in Mexico told us that any employee layoffs usually occurred after a firm was privatized. An employee who is dismissed is entitled to a minimum of 3 months pay plus a seniority bonus, which is equal to as much as 20 days per year of service. When a firm with staff having above average seniority is sold, the potential for the seniority bonus is disclosed in the sales transaction.

Existing and future environmental liabilities can also represent a large cost. We were told that in Mexico the government performs an audit to document existing environmental liabilities and provides the written report to the bidders. In some instances, the government will assume responsibility for the clean-up, and in other cases the bidder will buy the entity with certain liabilities intact. In either case, uncertainty about these liabilities has been reduced.

Governments Try to Ensure Competition

Officials we interviewed said that the presence or absence of competition is very important in determining how and what to privatize. Some of the governments that sold monopolies either (1) tried to create competition by eliminating the monopoly statutes that had prevented competitors from entering the market or (2) broke up monopolies, thereby injecting competition. Governments in France and New Zealand will not privatize monopolies. New Zealand will not sell natural monopolies[9] because they are economically inefficient. France does not sell monopolies because the government believes that certain public functions, such as the provision of public utilities, require a monopolistic structure to ensure equal access to high quality service. As a result, France has not privatized certain entities that other countries have privatized.

The United Kingdom has sold natural monopolies, but in each case it established a regulatory body with the responsibility of preventing the abuse of monopoly powers. An official stated that during the early stages of the United Kingdom's privatization program, the government sold natural monopolies along with the monopolies' related business units. For example, the gas industry was sold as one company, meaning that the pipe network (the natural monopoly) was sold with its business units, such as those that bought gas or those that distributed gas. Thus, the natural monopoly was in a strong position to abuse its power because of the vertical and horizontal integration. The United Kingdom has learned from

[9]A natural monopoly arises when the entire output of an industry can be most efficiently produced by a single firm, for example, when the firm has significant economies of scale. For this reason natural monopolies are often regulated or government run. Statutory monopolies are monopolies where an exclusive right to sell is granted by law, and may include natural monopolies.

this experience and now tries not to privatize natural monopolies with their related business units. The government tries to break up the monopoly so that the portions that could be competitive are separated, thus leaving only the natural monopoly to be regulated.

A privatization expert in Mexico stated that the government has learned important lessons from the sale of intact monopolies. The telephone company in Mexico (TELMEX) was sold intact. The government received significant revenues from the sale of the monopoly, and therefore, initially considered the sale a success. However, the taxpayer benefitted little in terms of prices or service. The government's policy is now to attempt to update the regulations and the structure of the industry or entity prior to its sale.

We were told that the New Zealand government has a policy not to sell natural monopolies. It will, however, sell statutory monopolies once the legislation that created the monopoly has been removed and the entity has been restructured to allow competition in the industry. We were also told that even though entities with monopoly rights generate a higher price, New Zealand has decided not to sell monopolies because they would not enhance economic efficiency if transferred to the private sector.

For example, New Zealand Telecom was de-monopolized and new firms were encouraged to enter the market prior to its privatization. Also, an official told us that New Zealand sold its railroad, but only after repealing the law requiring rail freight transport for distances exceeding 100 miles. This, in effect, permitted other forms of transport to compete. In contrast, the air traffic control system, which is a natural monopoly, has been corporatized, but there are currently no discussions of privatizing it.

France has not included monopolies in its privatization program. According to Treasury documents, this decision stems from the premise that certain activities must be strictly regulated if overall effectiveness is to be reconciled with consumer protection. For this reason, France's major public services, including electricity, gas, telecommunications, and rail transport, have not been privatized. The monopoly statutes of some of these services, however, are due to expire in the near future. A Treasury official in France told us that the government is considering the privatization of some of these entities, including France Telecom, whose monopoly statute will expire in 1998.

Competition is a factor in Canada in determining whether or not to privatize, but the government has in some cases privatized where no competition exists. In these cases, the government established a regulatory regime prior to the sale. This is discussed in greater detail in the next section.

Regulation Continues to Play a Role in Privatized Industries

Many of the countries we spoke with continued to regulate their former monopolies, even after breaking them up. These governments expressed the view that some degree of continued control of rates and services in what were previously public functions was necessary to protect the interests of the consumer and ensure economic efficiency.

As discussed above, the United Kingdom establishes a regulatory body with responsibility for regulating natural monopolies and promoting competition. For example, price formulas are used that in most cases limit the annual price increases to no more—and usually less—than the rate of inflation. In addition, competition is encouraged by breaking out the potentially competitive segments of the monopoly and restricting their activities, thus allowing other firms to enter into the market.

The New Zealand government has used "Kiwi Shares" to protect consumers. According to a government official, a Kiwi Share is a single share of the privatized entity that is held by the government and provides the government with regulatory authority to enforce conditions of the sale. However, the Kiwi Share has no voting or income distribution rights. For example, in the privatization of New Zealand Telecom, a Kiwi Share was used to protect rural telephone service. It was feared that once New Zealand Telecom was sold, rural service would either decrease or its price would increase significantly. The Kiwi Share limited future price increases for rural service to no more than the annual rate of overall price inflation.

The sale of Teleglobe Canada, a Crown corporation with a monopoly on international communications, is an example of Canada's sale of an intact monopoly. The corporation was not subject to regulation prior to its sale, and the privatization process was long and complex, particularly because of unresolved issues, including questions relating to regulatory policy. The government knew that higher rates would raise the value to the bidder and the government. Higher rates, however, were unpopular with the Canadian public. The final regulatory agreements allowed Teleglobe to retain its monopoly status for at least 5 years, but required it to reduce its rates.

Budget Display and Use of Sale Proceeds

Most of the governments in this study use any cash proceeds that result from privatization to reduce debt and interest costs and do not permit proceeds to be used to offset ongoing spending. However, according to various government officials, proceeds have sometimes been used to finance ongoing spending. Many of the governments display proceeds from privatization both within and distinct from their government's annual budget deficit or surplus numbers. How a government incorporates privatization proceeds into its budget has important implications for deficit reduction. If the proceeds are included within the budget, the government's deficit for that year will be reduced by the nonrecurring privatization proceeds. In concept, this could lessen the pressure to identify spending reductions in ongoing operations. Decreasing the spending levels of ongoing operations can result in long-term budgetary savings, while the proceeds from privatization provide only a one-time offset to the deficit.

Although governments talk of using privatization proceeds to reduce debt, technically, a country cannot actually begin to reduce its nominal government debt unless it is in fiscal balance or has a budget surplus. Nevertheless, when a government sells assets, the sale proceeds will reduce the country's borrowing requirements from what they would have been and, as a result, the debt servicing costs will also be reduced.

Privatization Proceeds Reserved to Reduce Public Debt but May Finance Ongoing Spending

Mexico has earmarked most of the proceeds from privatization for debt reduction. Government officials in Mexico told us that they strongly believe that nonrecurring revenues from privatization should not be used for ongoing operations. The government created a Contingency Fund in which the revenues from privatization have been set aside as reserves to deal with external shocks or to cancel public debt. Government officials told us that most of the proceeds from privatization have been placed in this fund and used to retire government debt. According to a budget official, the government presents its budget and deficit numbers with and without the proceeds from privatization in order to discourage using the proceeds for ongoing operations.

New Zealand has also used proceeds from privatization primarily for debt reduction. The government displayed the sale proceeds on-budget but drew a line to signify that they were not included in what the government called the "adjusted deficit." The proceeds were used to reduce the government's borrowing requirements when the government was in deficit, thus reducing debt servicing costs; when the government reached

budget surplus, the proceeds were used to buy down debt. The proceeds were not used to offset expenditures and the deficit reduction that results from privatization appears in addition to planned spending reductions.

France has generally used the proceeds from privatization to reduce its borrowing requirements. According to documents provided by the Treasury, between 1986 and 1988, about two-thirds of any proceeds from privatization were earmarked for debt reduction. More recently, however, these same documents state that the proceeds have been used for general budget appropriations and to sustain the economy through a period of reduced growth. A substantial portion of the proceeds from the current privatizations is being used to retain programs designed to cushion the impact of a recession by assisting the unemployed in finding new jobs.

In Canada, the impact of privatization on the reported budget deficit is the difference between the realized proceeds of the sale and the recorded value. For example, according to a government official, if an entity is recorded in the public accounts at Can$1 billion and the proceeds from the sale equal Can$1 billion, the sale will have no on-budget effect on the reported deficit. If the proceeds exceed the recorded value, for example, if they equal Can$1.2 billion, the reported deficit will be reduced by the amount that is greater than the recorded value, that is, by Can$0.2 billion. This Can$0.2 billion must, by law, be deposited in the Debt Servicing and Reduction account. The funds in this account are to be applied to the annual interest costs on government borrowing and ultimately to buying down debt. The proceeds are used to reduce the government's borrowing requirements.

In the United Kingdom, privatization proceeds are considered negative expenditures. The proceeds are not earmarked for specific purposes, however, but are generally deposited in the Consolidated Fund along with other government receipts. Government officials stated that the proceeds are used to decrease the public sector borrowing requirement, which in the United Kingdom is defined as all receipts and expenditures at all levels of government, including borrowing by nationalized industries, debt interest, and privatization proceeds. The Treasury does not use the proceeds to make room for additional expenditures in programs that have a cash limit, but one official stated that he believed that the privatization proceeds have weakened the downward pressure on expenditures that Treasury tries to apply.

Matters for Congressional Consideration

The ways in which governments we studied implemented privatization programs and the lessons those policymakers learned could help the United States in evaluating and, ultimately, carrying out divestitures currently under consideration. As the debate over such proposals suggests, there are issues in the United States regarding how best to evaluate a proposal to sell, who should manage the valuation and sale processes, how to estimate future proceeds, how the sale should be structured, and how the proceeds should be treated in the budget.

The experiences in the governments we examined suggest that often no single answer is widely applicable to all governments in all situations. Nonetheless, the information these governments provided may help the United States smooth the transfer of viable operations from the public to the private sector. Further, some specific elements of other governments' practices may have particular relevance to issues the United States faces today.

Consistent Management

All the countries we studied kept management or oversight of the privatization process in their Treasury or central financial ministry. A government representative in one country told us that doing so allowed the government to build upon early divestiture experiences. The representative also noted that because the management of the entity to be sold had different and sometimes conflicting interests than those of the central financial agency, the latter maintained responsibility for most aspects of sale structuring.

External financial advice was also necessary. The governments we consulted rely heavily on private sector expertise in estimating market values and structuring sales. These advisors generally reported to the finance ministry charged with managing the divestiture, not to the entity being sold.

The U.S. government has embarked on only two large divestitures in the recent past and, therefore, has had little reason to create a centralized process for managing such sales. The Department of Transportation was responsible for managing the sale of Conrail and the Department of Energy oversaw the Great Plains Coal Gasification sale. More recently, the Department of the Treasury has played an active role in concurring with key decisions in the sale of the United States Enrichment Corporation

(USEC); however, as we observed in our report on these preparations,[10] the privatization plan USEC prepared clearly states that USEC and its board of directors will play the lead role in determining how and when the key decisions will be made.

Although the U.S. government cannot privatize as many operations as other countries such as the United Kingdom and New Zealand have, more such proposals are under serious consideration in the United States. This suggests that considering a consistent management process would prove beneficial. Assigning responsibility for all divestitures to a single agency could take advantage of the "learning curve," as these other governments did, by applying expertise gained from earlier privatizations to subsequent sales. Doing so unambiguously could also help clarify who represents the government in the sales transactions and remove any appearance of conflict. This continuity of experience could also provide the expertise required to identify situations in which the use of special techniques such as clawbacks or warrants on windfall profits would be appropriate. In our report on USEC's privatization plan, we stated that the Treasury should have the lead role since Treasury officials, unlike USEC's managers and its board, will not be directly affected by the privatization and will therefore be better able to protect taxpayer interests. The experience of other governments also suggests that the U.S. government might usefully consider assigning the lead role in all divestiture preparations and management to a central financial agency, such as the Treasury Department.

Budget Incentives

According to officials, the stated policies of most of the governments we studied do not permit the proceeds from asset sales to offset ongoing spending; however, such offsets have apparently occurred from time to time. These policies exist for the same reason that current U.S. budget rules do not permit proceeds from asset sales to be scored: using one-time revenues to finance new spending allows the appearance of balance in the short run while creating greater imbalance in the long run.

A major issue under current U.S. budget law pertains to the fact that congressional committees that have jurisdiction over entities being privatized are not permitted to "score" the proceeds from asset sales for budget enforcement purposes; this means that they cannot use the

[10]Uranium Enrichment: Process to Privatize the U.S. Enrichment Corporation Needs to Be Strengthened (GAO/RCED-95-245, September 14, 1995).

proceeds to offset additional expenditures within their budget allocation.[11] The privatization proceeds reduce the government's current borrowing requirements from what they might otherwise have been, but do not, however, "count" towards the deficit reduction goals specified under the Budget Enforcement Act of 1990, as amended. These scoring rules may result in a non-neutral budget situation. While the proceeds are not scored, any outlays—such as those necessary to fund underwriters for the sale—or revenue losses associated with the sale of a revenue-generating entity are scored.

Therefore, concerns that U.S. budget rules carry disincentives to privatize have merit. Because the costs of divestiture—including the loss of the entity's stream of future net revenues—are counted while sale proceeds are not, in this budgetary environment, it is difficult to sell money-making operations unless an offsetting change in receipts or mandatory spending can be found. Current budget rules favor retaining profit-making operations—the very entities most likely to appeal to potential buyers and least likely to require government subsidies—regardless of the economic or even fiscal arguments for moving these businesses to the private sector.

We found that budget rules that prevent the use of one-time proceeds to finance ongoing spending are widely used. However, budget rules should not dominate the divestiture decision; the decision to privatize should be made on other grounds. Therefore, the Congress may wish to consider ways to neutralize the scoring. It would be possible to alter budget rules to permit the use of sale proceeds only to offset any costs associated with implementing the sale plus any loss of net revenues now and in the future. Remaining proceeds could be used to reduce the government's current borrowing requirements.

We are sending copies of this report to the President of the Senate, the Speaker of the House of Representatives, and the Chairmen and Ranking Members of the House and Senate Budget Committees. We are also sending copies to the Director of the Congressional Budget Office, the Secretary of the Treasury, and the Director of the Office of Management and Budget. Copies will be made available to others upon request.

This work was performed under the direction of Barbara Bovbjerg, Assistant Director. Other major contributors were Hannah Laufe,

[11]In the United States, liabilities held by the government are not generally recognized in the budget, nor are they recognized if retained as a condition of the sale.

Evaluator-in-Charge, and Sheri Powner, Evaluator. Please contact me at (202) 512-9142 if you or your staff have any questions.

Sincerely yours,

Susan J. Irving
Associate Director, Budget Issues

Previous Divestitures of U.S. Government Assets

Conrail

In 1987, the Department of Transportation (DOT) sold Conrail through a public offering, which resulted in net proceeds to the government of $1.575 billion. The government's goals for privatizing Conrail included providing for the long-term viability and continuation of rail service in the Northeast and Midwest, protecting the public interest in a sound rail transportation system, and, to the extent not inconsistent with these purposes, securing the maximum proceeds possible from the sale. The government met its primary goals for the sale of Conrail, in that it ensured the continuation of viable rail service, but only after spending about $8 billion creating, subsidizing, and preparing Conrail for sale.

Conrail was created in 1976 as a for-profit government corporation resulting from the consolidation of seven bankrupt railroads. The government was given an 85-percent common stock interest in the company. The other 15 percent of Conrail's common stock was held through an employee stock ownership plan. The Congress, however, spent over $7 billion on Conrail-related activities through 1988. This included funds to purchase the properties of the bankrupt railroads, operating subsidies and capital improvements, and employee buyouts.

By the end of 1980, however, Conrail had accumulated substantial operating losses. In 1980, the Congress passed the Staggers Rail Act which authorized substantial deregulation of rail transportation. In 1981, the Congress passed the Northeast Rail Service Act (NERSA) to help Conrail reach profitability. NERSA enabled Conrail to expedite abandonment of unprofitable lines and transfer commuter services to other operators, established a government-funded severance program, provided funding for certain supplemental unemployment benefit payments, and exempted Conrail from state taxes. After these measures were enacted, Conrail began reporting operating profits.

NERSA also authorized DOT to hire an investment advisor and, if Conrail was found to be operating profitably, to sell Conrail. DOT favored a sale to a single buyer whose financial strength would ensure Conrail's future in the private sector. However, Conrail management and some Members of the Congress favored a public stock offering. On October 21, 1986, the Congress provided authority for the public offering through its passage of the Conrail Privatization Act, which required DOT to select six investment banks to manage the sale of the government's interests in Conrail. On March 26, 1987, DOT made a public offering of Conrail's stock.

The Great Plains Coal Gasification Project

The Great Plains Coal Gasification Project was designed to produce pipeline quality synthetic natural gas from coal. In 1982, the Department of Energy (DOE) awarded a loan guarantee to a partnership of five energy companies for the plant's construction and start-up. In 1985, the partnership defaulted on its DOE guaranteed $1.5 billion loan from the Federal Financing Bank, and DOE acquired control of and then title to the project. Operation of the plant continued under the original plant operator for the next 3 years. During this time, the plant was profitable, and project revenues exceeded expenses by about $110.3 million.

In 1986, DOE announced it would sell the Great Plains project and subsequently hired Shearson Lehman Hutton, Inc., to assist it in doing so. In 1988, DOE selected the Basin Electric Power Cooperative as the preferred purchaser for the Great Plains project. Basin was one of nine prospective purchasers that submitted firm offers. According to DOE, Basin provided the highest offer and the strongest commitment to the project. DOE received $85 million at the sale closing and a commitment for DOE to share in future revenues from plant operations.

Related GAO Products

Sale of NPRs and Oil Shale Reserves (GAO/RCED-96-28R, October 17, 1995).

Federal Electric Power: Operating and Financial Status of DOE's Power Marketing Administrations (GAO/RCED/AIMD-96-9FS, October 13, 1995).

Uranium Enrichment: Process to Privatize the U.S. Enrichment Corporation Needs to Be Strengthened (GAO/RCED-95-245, September 14, 1995).

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