

Privatization Revisited

Nigel Hawkins



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About the Author

Nigel Hawkins is an investment analyst who specializes primarily in the electricity, gas, water and telecoms sector; he also covers several other sectors. He has worked in the City since 1988, notably for Hoare Govett (now RBS), Yamaichi and Williams de Broe (now Evolution).

He is a regular features writer for Utility Week and Cleantech magazines and frequently contributes to the financial media. In addition, he undertakes various research projects on energy, water and economic policies for Westminster-based think tanks. For the Adam Smith Institute, where he is a Senior Fellow, he has written four previous publications:

- *Privatization – Reviving the Momentum;*
- *Re-energizing Britain (UK electricity);*
- *Ten Economic Priorities;*
- *The Party is Over – A Blueprint for Fiscal Stability.*

Prior to joining the City, he worked for six years in politics, including three years as Political Correspondence Secretary to Lady Thatcher at 10 Downing Street. In 1987, he stood in the general election as Conservative Party candidate in Sedgefield against Tony Blair.

He was awarded a degree in law, economics and politics from the University of Buckingham and subsequently qualified as an Associate of the Institute of Chartered Secretaries and Administrators (ACIS), whilst working as Export Sales Manager for Marlow Ropes, Hailsham, East Sussex.

Executive Summary

- Whilst privatization has continued overseas, privatization in the UK – where it began – has stalled. The UK's interest charge on its national debt is currently c£120 million per day, and to pay off this debt a renewed privatization policy is needed. Like any other over-extended organization, the government should sell off surplus assets. This report analyses likely privatizations, which could raise over £90 billion for the coalition government.
- Following the near collapse of the UK banking system in 2008, the government, through UKFI, now owns 83% (including B shares) of Royal Bank of Scotland (RBS) and 40% of Lloyds. These two shareholdings (assuming RBS's B shares are valued *pari passu*) are currently worth over £63 billion.
- Once market conditions are favourable, these stakes should be progressively sold down – starting with the placement of a tranche of Lloyds shares. The government should also aim to return RBS – in its entirety – to the private sector by the time of the planned General Election in 2015. This will be a very challenging task.
- Despite its £8+ billion pension deficit, Royal Mail remains a privatization candidate. Its core Post Office division needs additional funds for expansion – it has trusted access to c27 million UK addresses. EU mail delivery deregulation has boosted the overseas activities of both Germany's Deutsche Post and the Dutch-based TNT.
- Eleven other support services businesses, including the Met Office, Ordnance Survey and the Royal Mint, are also suitable for privatization.
- Following the ongoing High Speed One sale, a restructured Network Rail should return to the stock market; it could raise up to £12 billion. The scope for greater efficiency on the UK rail network is considerable.
- The government's 49% stake in NATs, which runs the UK air control network, should also be sold. This sale may need to post-date a new regulatory regime for the aviation sector, which ought to include a slot auctioning system at Heathrow. Elsewhere in the transport sector, the larger Trust Ports, led by Dover Port, should be sold off.
- Water privatization has delivered an £85 billion investment programme since 1989. In Scotland and Northern Ireland, the water companies remain publicly-owned, whilst Glas Cymru in Wales is a not-for-profit business. The case for replicating the 1989 flotations – or for trade sales – is strong, although privatizing NI Water is not an immediate option. Within the energy sector, the government's 33% stake in Urenco should also be sold.
- In the media sector, Channel 4 and a demerged BBC Worldwide should be privatized. A high priority should also be accorded to ensuring that the timetable for the UK Spectrum Auction, planned for late 2011, does not slip once more.
- Further attractive privatization candidates include CDC (formerly the Commonwealth Development Corporation), the Tote (via an auction), various small defence businesses, British Waterways, and some Forestry Commission assets.
- More generally, with the 2007 Public Asset Register placing a £337 billion value on the public sector asset base, there is real scope to sell part of this vast property portfolio. This £337 billion valuation may be a material underestimate, so even a 10% disposal rate should generate proceeds of at least c£30 billion.

Background

There is little doubt that privatization has been one of the most influential developments in economic policy over the last 30 years – not only in the UK but throughout the world. It has been replicated not just in traditionally capitalist-driven economies but also in those countries where communism has prevailed – even Cuba has adopted some elements of privatization.

To a large extent, privatization in the UK was a response to the dreadful economic situation of the 1970s, a period when widespread strikes, especially in the public sector, caused immeasurable damage to the overall economy.

As a policy, privatization dates back to the first government of Margaret Thatcher, who became Prime Minister in 1979. When promoted as a policy, privatization attracted major scepticism across the political spectrum. It was widely opposed for being both doctrinaire and as a means to ‘sell off the family silver’. To that extent, it was seen as a radical economic policy that few believed would deliver material benefits.

Although there were some sales of state assets in the early 1980s – notably of the then British Aerospace, of Associated British Ports and of a large minority stake in Cable & Wireless – it was the unprecedented sale of a 51% stake in British Telecom in 1984 that became widely regarded as the world’s first mass privatization.

The thrust behind that flotation was not simply to raise much-needed funds for the government: there were two other major policy drivers.

First, it brought British Telecom into the private sector and directly led to a genuinely competitive telecoms market that eventually delivered far greater choice for consumers as well as large price cuts. It also helped to kick-start the mobile telecoms market and the rise of Vodafone, which started from virtually nothing within

Racal Electronics. Subsequently, within a generation, Vodafone had become the fourth most valuable company in world history.

Secondly, the British Telecom privatization was unashamedly populist in that it sought – and succeeded – in attracting millions of people into private share ownership. This scenario has endured but has not proved to be as long-lasting – or as widespread – as its most fervent advocates had hoped.

Within a few years, the British Telecom privatization had been followed by that of British Gas – which now comprises Centrica, BG and the Transco division of National Grid – British Airways and British Airports Authority (BAA). BAA, currently owned by a Spanish-led consortium, has attracted major criticism in recent years: its operational performance at Heathrow in particular has been undeniably poor.

The Conservative government’s mass privatization policy was extended further with the flotation of 10 regional water companies and the 12 regional electricity distribution companies. In all cases, their customers were given priority in terms of share allocation. Shortly afterwards, the fossil-fuel generators – National Power and PowerGen – and the two integrated Scottish electricity companies were floated.

In the years following the flotations of the regional water and electricity distribution companies, some of the benefits of privatization were delivered, notably through increased efficiencies. Although water charges rose, there was a step-change upwards in investment levels. In the electricity sector, efficiencies were far more discernible. Indeed, prior to the surge in gas prices in 2003, which pushed up fossil-fuel generation costs, there were major cuts in electricity prices.

During the mid-1990s, UK privatization seemed to lose its way. Admittedly, the most attractive businesses had already been

sold and the privatization cupboard was looking rather bare. Nonetheless, there were still some valuable assets that remained within public sector ownership – a scenario that remains to this day.

There was also increasing concern about the preservation of monopolies, especially during the earlier years of privatization. Competition to British Telecom was minimal, at least until mobile telephony arrived. BAA, despite having recently sold Gatwick Airport, still owns both Heathrow and Stansted Airports, and continues to attract criticism.

Whilst later privatizations, especially those covering electricity generation and supply, sought to focus more on creating competition, the monopoly culture still prevails in certain sectors.

Undoubtedly, the two most high-profile privatizations of the mid-1990s both encountered serious setbacks. Railtrack, which was publicly floated in 1993, was controversially put into administration in 2001; it re-emerged subsequently as a not-for-profit company – Network Rail.

Although the separation of railway line ownership from the operation of individual railway franchises had been undertaken in Japan and to an extent in Europe, it was widely regarded as being a serious policy error for the UK. Competition on virtually all lines was a non-starter, once the franchises had been awarded.

Moreover, it was not clear where the responsibility lay for the many operational shortcomings on the railway network, whilst the legal complexities were immense. Crucially, too, the capital expenditure backlog worsened, culminating in the Hatfield disaster in 2000 in which four people were killed.

British Energy, comprising the UK's eight most modern nuclear power plants, was publicly floated in 1996. Initially, British Energy prospered but the introduction of NETA (New Electricity Trading Arrangements) caused electricity prices to fall sharply – a scenario for which it was ill-prepared. In 2003, a debt-for-equity swap took place. Subsequently, the shares were re-listed and now British Energy is majority-owned by France's EdF.

Whilst UK privatization over the last 15 years has visibly wilted, the opposite has been the case elsewhere. In the US, the telecoms and utility businesses, with the exception of water, have generally been privately-owned. However, in mainland Europe, telecoms, electricity and gas privatization has continued virtually unabated.

Privatization of telecoms services has – as in the UK – provided mainland EU consumers with many benefits, although shareholders have had far more of a roller-coaster ride. Deutsche Telekom, France Telecom, Spain's Telefonica and Telecom Italia

– the incumbent private sector operators of the four leading mainland EU countries – are all publicly quoted. However, much greater competition has seriously eroded their fixed-line margins to the benefit of consumers. This decline has been materially offset by impressive growth levels in their mobile operations.

The European electricity industry has also seen far-reaching changes and greater competition since privatization was undertaken. Germany's top two integrated electricity companies, E.ON and RWE, are leading EU players, though EDF, with a generation capacity of over 130 GW, is the largest with most of its electricity output being generated in French nuclear power stations.

In EdF's case, its privatization process is far from complete, with the French government still owning over 80% of its shares, but the Italian government, by contrast, has been progressively selling down its stake in ENEL.

In these three key EU markets – France, Germany and Italy – real concerns remain with domestic and EU competition authorities about the degree of competition in the electricity and gas sectors. Over the last few years, consolidation amongst the leading electricity companies in the EU has continued to the detriment of competition, despite the EU Commission's efforts to bring about the progressive unbundling of monopoly assets, including transmission.

Much – though not all – of the UK privatization programme was completed many years ago. To that extent, its impact can be assessed in the light of experience.

On the deficit side, there has unquestionably been a very large number of job losses as a result of the increased private sector-orientated drive for efficiency. Furthermore, whilst prices of many privatized services have fallen, this has clearly not been the case in the water sector, where steep price rises have helped to finance much enhanced investment levels. Recent surges in gas prices have also pushed up retail energy prices, both for gas and for electricity – much of the latter is now generated from gas.

Benefits of Privatization

Nevertheless, it is apparent that the many advantages of privatization significantly outweigh its drawbacks. Many of the most notable benefits of the UK's privatization policy are set out below:

1. *Substantial price cuts in the retail telecoms market;*
2. *Pronounced cuts in electricity and gas prices until this trend was reversed by large increases in wholesale gas prices from 2003 onwards;*

3. *Far better service levels in all utility sectors;*
4. *The creation of much greater choice for consumers through a shift to privately-owned utilities;*
5. *The emergence and growth of Vodafone, the world's leading international mobile player;*
6. *Enhanced competition in the electricity generation market, which has delivered very substantial efficiency savings;*
7. *The unveiling of the massive subsidies that the nuclear industry had enjoyed during its time as a subsidiary of the Central Electricity Generating Board (CEGB);*
8. *Major investment in new fossil-fuel power plant, most of which has been gas-fired;*
9. *An £85 billion investment programme in the water sector since privatization in 1989;*
10. *Heavy investment in new airport facilities by BAA, especially at Heathrow, Gatwick (which it recently sold) and Stansted;*
11. *The turnaround of British Airways' fortunes, which has enabled it to surmount – unlike some other European carriers – the industry challenges of recent years;*
12. *The payment to government of many £10 billions of proceeds arising from the privatization programme, along with the large Corporation Tax bills that privatized companies pay each year;*
13. *“The private sector financing of large pension liabilities at BAE Systems, British Airways and – in part – British Telecom which would otherwise have fallen on the public sector;”*
14. *The scope for privatized UK companies to expand their operations overseas;*
15. *The development of many UK companies supplying these privatized businesses;*
16. *“The very impressive shareholder returns from most – though not all – privatizations have boosted pension fund valuations;”*
17. *The substantial earnings, especially in the City and consultancy sector, that the UK earns from exporting the privatization policy around the world.*

Of course, irrespective of ownership, some of these changes would have taken place anyway. However, the scale and speed of change would have been far slower without privatization.

The Way Ahead

Despite the many privatization initiatives in the UK since 1984, considerable scope still remains for further initiatives, which this report addresses.

The sub-prime credit crisis has been a key factor in driving down UK economic growth projections, which will inevitably put further pressure on the government's Public Sector Net Borrowing (PSNB) targets. These have been consistently missed in recent years. Consequently, re-invigorating the policy of privatization looks increasingly attractive – and not only on deficit-funding grounds.

The impact of the recent recession on the UK's public finances has been devastating. The combination of increased and rising public expenditure and much lower tax revenues than expected has seen PSNB soar. An indication of the very rapid deterioration of the UK's public finances is provided by the 2007 Budget projections, which were presented in March of that year.

For 2009/10, a PSNB figure of £28 billion was forecast, with a £26 billion projection for the current year. The reality, of course, has been very different. Last year's PSNB was c£170 billion – an astonishing figure. For the current year, the government is forecasting an out-turn of c£150 billion.

Inevitably, this massive surge in borrowing has seen the UK's public sector net debt (PSND) soar. In the 2007 Budget figures, the 2010/11 PSNB forecast would have kept the PSND/GDP ratio below 40%. Instead, with PSND now forecast to be c£150 billion for this year, net debt would be close to £1 trillion: the PSNB/GDP ratio would exceed 60%.

Against this background, it is no surprise that one of privatization's abiding benefits – the raising of substantial funds on behalf of the government – has become increasingly popular. Of course, most of the more straightforward privatizations have already been undertaken. But, as this report seeks to demonstrate, there are still many attractive commercial operations still in the public sector.

Nevertheless, recent stock market turbulence has dampened Treasury expectations of successful privatizations. However, whilst shares in several sectors have fallen sharply – notably in banking,

housing, property and technology – others, such as oil, utilities, pharmaceuticals and food retailing, have been relatively robust.

Furthermore, some recent stock market flotations have been disappointing, notably Ocado's, but Betfair's latest offering has proved popular. Hence, any new privatizations involving a public flotation will need to be very carefully priced.

In particular, this report focuses on businesses in which the government either has overall control or maintains a sizeable shareholding. Given the very considerable benefits of UK privatization over the last 30 years – notwithstanding some clear policy errors – there are still large gains to be achieved if further privatization initiatives were undertaken.

1. Banks

In the banking sector, the government, through UK Financial Investments (UKFI), owns two particularly valuable stakes. Following the near-collapse of the UK banking system in autumn 2008, the government injected over £65 billion of taxpayers' money into Royal Bank of Scotland (RBS) and Lloyds. Its stakes in these banks are now 83% (including B shares) and 40% respectively. The two other leading High Street banks, HSBC and Barclays, did not require direct government funding although both benefited materially from the various initiatives to shore up the very shaky banking system.

83% Stake in Royal Bank of Scotland

Given RBS's shocking experience in 2008, as a result of which an unprecedented £45.5 billion of public money was invested in the Bank, it will be no simple task to sell down this stake in its entirety.

Figure 1 shows the vast scale of public funding that has been necessary to ensure the viability of RBS.

Aside from the capital injections, RBS has also placed £282 billion of its so-called toxic assets into the Asset Protection

Scheme (APS). Under the APS, RBS is liable for the first £60 billion of losses; the overwhelming proportion of any additional losses lies with the government as contingent liabilities.

As part of its participation in the APS, the government acquired 51 billion B shares in RBS. Their status is slightly different from RBS's ordinary shares. The B shares rank *pari passu* in the event of a winding up or liquidation of RBS and are eligible for enhanced dividends over the ordinary shares: this latter benefit falls away if RBS's share price reaches 65p. (Note: *Pari passu* is a technical term which denotes that a particular class of shares is treated in the same way as other classes of shares.)

For valuation purposes, this report has deemed RBS's B shares to be the equivalent of the ordinary shares in issue. If these B shares are considered as part of RBS's total capitalization, the government's shareholding equates to 83%. If they are excluded, the percentage shareholding falls to 68%.

The government has also set up the Banking Commission which is due to report in September 2011. Part of its remit focuses on whether the banking sector should be split up between retail deposit-taking banks and investment banks – compulsory separation now seems increasingly unlikely.

Figure 1 – HM Treasury Holdings in Royal Bank of Scotland

Investment	Date	Shares (m)	Total Investment (£m)	Investment per Share (p)
Initial Recapitalization	12/2008	22,854	14,969	65.5
Preference Share Conversion	4/2009	16,791	5,058	31.75
APS B Shares	12/2009	51,000	25,500	50.0
Total Investment		90,645	45,527	50.2 (av.)

Source: UK Financial Investments Ltd

The other part of the Commission's remit covers the level of competition in the banking sector. RBS has already sold part of its retail branch portfolio at the instigation of the EU in return for the emergency public funding that it received in 2008.

Along with the recent Basel III bank capital proposals, both these issues will undoubtedly affect any market valuation of RBS, as well as other more obvious trading metrics, including the level of bad debts. Consequently, the government will need to tread carefully in seeking to sell down its stake.

There is a strong case not to proceed at all until the market has been tested both by the planned Initial Public Offer (IPO) of the Spanish-owned Santander, which is expected to take place in 2011, and by at least a part placing of the government's 40% Lloyds stake. If both of these market operations attract sufficient investor interest, then placing an initial tranche of RBS stock would be a feasible option.

For political reasons, the government will be keen to avoid crystallising any loss from its colossal RBS investment. Its average entry price is 50.2p per share so – assuming this principle is upheld – it is unrealistic to expect any sale until a material premium is achieved over this average purchase price.

The government should set a long-term target of returning RBS – in its entirety – to the private sector by the time of the planned General Election in 2015. Given the size of RBS, this will be a challenging task. Only the recent near-\$70 billion Petrobras rights issue in Brazil is of a comparable size.

Valuation: The current market value of the government's 83% stake in RBS is £43.2 billion if B shares are included. If a 10% discount were applied to this valuation, the sale of the entire stake could be expected to yield almost £39 billion.

40% Stake in Lloyds Bank

Lloyds Bank also faced massive financial challenges in 2008 – and subsequently – following the highly controversial acquisition

of Halifax, which was at one time the UK's largest Building Society. In total, Lloyds received £20.3 billion of taxpayers' money to ensure its ongoing viability.

As a result of its successful December 2009 rights issue, for which the government subscribed, Lloyds did not need to sign up to the APS; originally, it had planned to do so.

However, Lloyds' future trading operations, which are heavily UK-based, will be impacted by any recommendations from the Banking Commission, especially in respect of competition. Following its acquisition of Halifax, whose finances were severely extended, Lloyds held a c32% share of the UK mortgage market – this percentage has fallen slightly of late. The government could well act to reduce this strong retail position, which would adversely impact the valuation of Lloyds.

Given the government's minority status, Lloyds' non-participation in the APS and various other relevant factors, it should be less difficult to place part of the Lloyds stake than that of RBS. There will be some concern about the impact of the Basel III bank capital proposals. Nevertheless, such a placing should precede a material reduction of the government's shareholding in the latter.

Nevertheless, it would be prudent to assess market demand for the planned Santander IPO, especially as the latter business – notably in respect of its high UK mortgage exposure following the Abbey National acquisition – has many similarities to Lloyds's lending portfolio.

Whilst the Lloyds share price has rallied recently, partly due to its strong cash resources, the government will be keen to ensure a substantial premium over its adjusted entry price, which was 73.6p.

Valuation: The current market value of the government's 40% stake in Lloyds is £20.2 billion. However, if a 10% discount were applied to this valuation, the sale of the entire stake could be expected to yield £18.2 billion.

Figure 2 lists the various cash injections into Lloyds since January 2009.

Investment	Date	Shares (m)	Total Investment (m)	Investment per Share (p)
Initial Recapitalization	1/2009	7,277	12,957	182.5
Preference Share Conversion	6/2009	4,521	1,506	38.43
Rights Issue	12/2009	15,810	5,850	37.0
Total Investment		27,609	20,313	73.6 (av.)

Source: UK Financial Investments Ltd

100% Stake in Northern Rock plc

In 2007, the collapse of Northern Rock – the promoter of the notorious ‘Together’ mortgage that lent up to 125% of the property’s value to borrowers – was the first obvious sign of the storm that was about to engulf the UK banking system.

Having taken Northern Rock into the public sector, the government has now divided it into two separate elements:

- Northern Rock plc is a well-capitalized, deposit-taking and mortgage-providing bank;
- Northern Rock (Asset Management) holds and services the closed mortgage book; it neither holds deposits nor offers additional mortgage lending.

Northern Rock (Asset Management), which now incorporates the residual assets and liabilities of Bradford and Bingley, is very unlikely to be suitable for sale.

However, Northern Rock plc, into which the government injected £1.4 billion of new capital at inception, is a viable candidate to be privatized once confidence returns to the banking sector. Alternatively, it could be sold directly to a competitor, possibly outside the existing High Street banks, especially if the government retains its stance to create more retail lending banks.

Valuation: Placing a valuation on Northern Rock plc is very difficult given the lack of financial data that is in the public domain. However, a central case estimate for 100% of the business is £1.5 billion.

2 Support Services

In the support services sector, the most obvious candidate for privatization is Royal Mail, which is facing testing challenges on many fronts.

Royal Mail/Post Office

The publicly-owned Royal Mail Group (Royal Mail) operates the mail services and Post Office network in the UK. Because of the political sensitivity of the issue, successive governments have avoided undertaking major structural reform of the key businesses within Royal Mail. However, the recent publication of the Hooper report set out a near unequivocal case for major reform of Royal Mail.

Indeed, in early October 2010 the government presented a Postal Services Bill to Parliament. Within this Bill, there are provisions for majority ownership of Royal Mail to be undertaken by the private sector. Furthermore, at least 10% of its shares are planned to be allocated to employees on preferential terms.

Currently, Royal Mail has four core businesses – the key data, based on 2009/10 figures, is set out in Figure 3 below:

In recent years, Royal Mail has suffered serious competition, especially from the rapid growth of e-mail, in its core business operations. In 2009/10, total volumes of inland addressed mail were down by 7.3%. Average daily mail volumes in 2009/10 were 71 million against a peak in 2005/06 of 84 million.

Whilst there have been efficiency gains, there are far more to come, especially with greater use of machinery in sorting offices. In 2009/10, labour costs amounted to £5.7 billion, equivalent to 64% of Royal Mail's overall costs. To that extent, a rigorous focus on reducing the cost base is a top management priority. However, as a people-dominated business – especially on the doorstep – there will be limits to staff reductions, unless customer service levels are significantly reduced.

Irrespective of the challenges on the operational front, there is no doubt that, like many publicly-owned businesses, significant capital expenditure increases will be required. In 2009/10, the capital expenditure outturn was £441 million.

Importantly, Royal Mail's finances are heavily influenced by regulation, which is implemented by Postcomm – expected to be integrated shortly into Ofcom.

Figure 3 – Key Royal Mail Data.

Business	Staff	Revenues (£m)	Op. Profit (£m)
Royal Mail (Letters/Packages)	155,312	6,564	121
GLS (Pan EU Logistics)	12,885	1,487	112
Parcelforce Worldwide	4,434	399	17
Post Office (11,905 Branches)	8,209	838	72

Source: UK Financial Investments Ltd

Having extended its present price control until March 2012, Postcomm recently published 'Laying the Foundations for a Sustainable Postal Service'. This consultation document put forward various proposals regarding the basket of regulated services covered by its price controls. The expectation is that part of the new regulatory system may be implemented next year, when the costs of first-class and second-class stamps are set to rise slightly in real terms.

There is also a need to review the Universal Service Obligation (USO) which Postcomm is fixated on. After all, there is no necessity for identical pricing nationwide, a regime that does not apply to most other utility services. In the water sector, for example, South West Water consumers pay an average charge of £487 per year compared with £303 for Thames Water consumers.

There is a case for introducing a pricing structure which is based on zones. This would better reflect the costs incurred and this policy is backed by Royal Mail. Current stamp rates could apply for post being sent to addresses in the same county with higher postage rates being applicable for elsewhere. Alternatively, a postal code methodology could be devised.

The permitted charges for first-class and second-class stamps are crucial in determining Royal Mail's overall financial returns. Arguably, there should be substantial increases in stamp charges, partly to fund the capital expenditure bill, but they should be offset by productivity gains. In 2009/10, c90% of Royal Mail's core revenues were subject to price regulation.

Increasing competition in postal services provision is a firm aim of Postcomm. Yet, Royal Mail is currently delivering 99% – in volume terms – of the addressed letters market. In time, there will be greater competition – not necessarily from domestic organizations, such as UK Mail, but more from leading overseas post office businesses, such as Germany's Deutsche Post and Holland's TNT. TNT currently has a market capitalization of over £6 billion.

Both these companies, who have spearheaded postal services competition in mainland Europe, are keen to expand. They are both currently operating in the UK in the business sector of the postal services market. It seems likely that in time they will want to participate in the entire delivery chain.

Under EU legislation to promote competition in mail delivery markets, which in some cases has been delayed, increased competition seems inevitable. Royal Mail, in particular, faces challenges for which it needs to be more prepared, both operationally and financially.

In addition to addressing its capital expenditure programme and its operating cost and revenue bases, there is a more general need for an overhaul of Royal Mail's finances.

Within this proposed restructuring, the long-standing pension fund deficit issue needs to be resolved by putting the pension fund on a firmer financial footing. At March 2010, the pension fund deficit had soared to over £8.0 billion, whilst the employee contribution rate at 6% has remained unchanged for many years.

This proposed financial restructuring will enable Royal Mail to be more prepared for a public flotation, which would enable raise further funds to be raised for business expansion.

In preparing Royal Mail for a public flotation, careful analysis will need to be undertaken regarding the appropriate debt/equity structure. In March 2010, Royal Mail reported a net debt figure of £788 million.

A public flotation of Royal Mail, in which private equity funds could also participate, would allow it to be better funded than at present, and also to expand. After all, members of its staff have trusted access to virtually every business and house in the UK, amounting to c27 million addresses.

With that unique level of customer contact, the potential for cross-selling is considerable. Furthermore, the online deliveries market is a rapidly growing segment of the retail market in which the Royal Mail could be a leading participant.

Valuation: To ascertain Royal Mail's value, comparisons have been made with currently-quoted postal businesses, such as the Dutch-based TNT, and recent private equity valuations. Royal Mail's underlying value should be at a considerable premium to the c£2.3 billion Regulatory Asset Value (RAV) that had previously been applied to its core business. Assuming that the £8.0+ billion pension fund deficit remains within the public sector, Royal Mail's value is probably c£4 billion.

Other Support Services Businesses

Within the support services sector, there are twelve other publicly-owned businesses that have some attractions for private sector investment – Covent Garden Market Authority, Export Credits Guarantee Department, Forensic Science Service, the Land Registry, the Met Office, Ordnance Survey, Partnerships UK, Royal Mint, the Student Loan Book and three Industry Training Boards.

There is no reason why the Covent Garden Market Authority (CGMA), which is responsible for the operation of the 57-acre

New Covent Garden site in London that was founded in 1974, should still be in the public sector. Once primary hybrid legislation is approved, it should be auctioned off, with leading property companies being obvious buyers for a business with annual revenues of c£13 million.

The Exports Credits Guarantee Department (ECGD) provides insurance and facilitates the availability of finance for the sale of capital goods. It offers a valuable service for many small and medium-sized enterprises (SMEs). Recently, ECGD's revenues have fallen as defence-related sales have stalled. In 2009/10 its net premium income was £58 million. ECGD's future is under review, but full privatization – under certain specified criteria – is an obvious solution, perhaps via a trade sale. Substantial adjustments to its current financial profile would be needed.

The Forensic Science Service (FSS) is the leading provider of forensic criminal services within the UK criminal justice system. Currently, FSS is owned by the Home Office, but it could play a pivotal role in the growing forensic science services market if sold to the private sector, preferably by a trade sale. FSS's revenues in 2008/09 were £126 million.

The Land Registry was founded in 1862. Its primary role is to register ownership of land in England and Wales and to record any subsequent dealings. Currently, 73% of such land has been registered by 22.5 million title holders. The Land Registry employs around 6,500 people and has net assets of just over £400 million, which includes a net cash balance of over £200 million. In 2009/10, it reported a fee income of £328 million and an operating profit of over £20 million. Given these figures and its solid income stream, it should certainly appeal to private equity investors if it were made available for sale.

The Met Office, which is part of the Ministry of Defence, is the official national meteorological service. It provides weather and climate-related services to many UK and overseas clients, notably the BBC. Revenues in 2009/10 were £192 million, which gave an operating profit of almost £7 million. The government should seek to sell the Met Office through a trade sale.

Ordnance Survey has a similar high profile as the UK's national mapping agency. It is also responding to the impact of new technology on traditional mapping systems. In 2009/10, its revenues were £114 million, which gave rise to an operating profit of over £16 million (before exceptional items); the business has proved its resilience during the recent recession. Ordnance Survey is an obvious privatization candidate, with a trade sale being the most likely option.

Partnerships UK seeks to assist government in delivering improved public services at the local and national level. Currently, the private sector has a 51% stake in Partnerships UK, with the public sector owning the remaining shares. With wide-ranging changes and deep cuts in public expenditure – especially for capital expenditure projects – the role of Partnerships UK is somewhat nebulous. Revenues in 2008/09 exceeded £23 million, boosted by investment (soon to be cut) in education infrastructure. The best solution for this business is its integration into another public sector-orientated quoted company.

Royal Mint's principal activity is the manufacture and issuance of coins that circulate in the UK. There is considerable commercial potential despite the decline in demand for coins in the UK, as credit cards become more popular for small transactions. Revenues in 2009/10 were £173 million, which gave rise to an underlying operating profit of over £8 million. Whilst there are some counterfeiting risks, Royal Mint should be sold via a trade sale. The obvious comparator is the publicly-listed De La Rue, which is a leading printer of bank notes worldwide.

The Student Loan Book has been available for private sector purchase for some time. But there are real concerns about potential liabilities, especially in terms of bad debts. Moreover, there remains considerable uncertainty at present about future university funding. The government should increase its efforts to secure a private sector buyer, probably a bank.

According to documents leaked to the media, three Industry Training Boards (ITBs) are expected to be privatized by the government. The largest of the three is the Construction and Skills Training Board, which reported revenues of over £300 million in 2008: the majority of these revenues arose from industry levies. Its net assets at December 2008 were almost £45 million.

The two other ITBs are the Engineering Construction Training Board, which reported net assets of £17 million at December 2009, and the much smaller Film Industry Training Board. All three of these ITBs will probably be the subject of trade sales.

Combined Valuation: Despite the difficulty of placing an accurate value on ECGD, the total value of these twelve support services organizations probably lies within the range of £900 million and £1.7 billion. Some of these companies bear names with a worldwide reputation, including the Met Office, Ordnance Survey and Royal Mint. Consequently, privatization should improve their commercial prospects.

3 Transport/Travel

In the transport/travel sector, there are some valuable publicly-owned businesses that should be privatized in addition to High Speed One – the owner of the Channel Tunnel Rail Link – that has already been put up for sale, with estimated proceeds of c£2 billion.

Network Rail

Network Rail, which was set up in 2002, is a not-for-profit company. Its predecessor was Railtrack, which had replaced the former publicly-owned British Rail; Railtrack had been floated in 1993 and subsequently prospered financially.

However, following abiding concerns about its ability to finance very large investment requirements, which soared in the wake of the Hatfield disaster in 2000, Railtrack was effectively nationalized. The Labour government prevented the Rail Regulator from implementing major changes to the financial parameters that might have allowed Railtrack to continue as a viable business.

Network Rail itself runs, maintains and develops 20,000 miles of railway track in the UK, the signalling system, 40,000 bridges/tunnels and operates 18 core stations.

At present, Network Rail is undergoing a £35 billion five-year investment programme, with completion due for 2014. Despite the heavy investment over the last decade, notably the c£9 billion West Coast Main Line project, much of its asset base remains in a poor condition, especially many of its railway bridges. Consequently, formidable investment levels – notwithstanding any new high speed railway expenditure – seem inevitable for the foreseeable future.

Given the controversial collapse of Railtrack in 2001 and the step-change upwards in capital expenditure, ownership changes

may divert Network Rail from its key operating and investment priorities.

Nevertheless, the prodigious level of cash consumption in recent years and the bureaucratic governance structure suggest that there is real scope for efficiency improvements that privatization could deliver. Furthermore, heavy infrastructural investment in recent years has greatly improved much of the track network, a process driven forward by the Hatfield disaster.

Any return to the private sector would need to take careful account of Network Rail's capital expenditure requirements, which are already the subject of in-depth analysis under the existing regulatory regime. The impact of any regulatory revisions, which could arise as a result of substantive changes to the existing railways network financing regime, would also be very relevant.

Prior to any privatization initiative, Network Rail's finances would need some restructuring. In March 2010, Network Rail had net debt of £23.8 billion, compared with a Regulatory Asset Value (RAV) of £37.2 billion, thereby giving a RAV gearing ratio of 64%.

These figures would certainly have investment attractions for some infrastructure funds, especially if reasonable dividends were being paid. Seeking to return Network Rail to the private sector as a conventional privatized company would be politically controversial, so it would be preferable to undertake the process in staggered tranches. An initial offer of shares to leading financial institutions, in order to gauge the appetite of investors, would be a prudent first step.

Valuation: On the above basis, Network Rail's implicit equity value – assuming it traded in line with its RAV – would be £13.4 billion. Given its very chequered past, its major investment programme and its dated asset base, a discount to RAV would be expected.

Hence, a 15% discount has been assumed, which would give rise to a valuation of between £11 billion and £12 billion.

East Coast Main Line

Another outstanding issue on the UK railway network, the controversial franchise system, is the subject of in-depth investigation by the Department of Transport. The more immediate priority should be to re-franchise the East Coast Main Line (ECML), which was returned to public control following the decision of National Express to surrender the franchise for which it had grossly overbid – agreeing a £1.4 billion payment over a decade.

Despite the dearth of obvious bidders, the auction process for re-letting this franchise should start at the earliest opportunity – on the basis of awarding a long-term operating franchise subject to light regulation. However, since no material tangible assets are being sold, the ECML franchise is included under the franchise grouping proceeds – estimated at £2 billion in total – in Figure 5 at the end of this report.

National Air Traffic Services

National Air Traffic Services (NATS) was established in the early 1960s. As UK civil aviation expanded, NATS' role as a unified national air traffic control organization has become increasingly important. In recent years, major investment has been undertaken in order to modernize the air traffic control infrastructure, which has had to adjust to stricter security criteria.

Following the privatization of US air control services in the 1980s, privatization of NATS was widely mooted in the early 1990s. Instead, NATS' ownership was transferred to a Public/Private Partnership (PPP) in 2001.

The key investors in this PPP were the government with a near 49% stake and the Airline Group – a consortium of seven airlines – with a 46% stake. The remaining shares were allocated to NATS' Employee Share Trust with a 5% stake. After 9/11, BAA took a 4% stake in NATS, with the Airline Group's interest falling to just below 42%.

Given the solidity of its long-term revenue flow, the level of which is principally determined by regulators at the Civil Aviation Authority (CAA), NATS would offer real attractions for long-term orientated private equity and infrastructure funds. Moreover, there is no obvious reason why the government needs to retain its 49% stake in the business.

If the government offered its stake for sale, there would undoubtedly be interest from investors, especially if a more favourable regulatory regime were also implemented. In reality, the government could either sell its stake directly to the Airline Group and its shareholders or to a third party via a trade sale. Alternatively, it could offer its stake to outside investors through a public flotation.

A more radical option would be to undertake a public flotation of the whole business, a policy that the Airline Group, whose seven shareholders are airlines, might welcome. It would place a clear value on a formidable long-term revenue stream, whose attractions should be more appealing than was the case when the PPP was completed in 2001.

In its 2009/10 financial year, NATS reported revenues of £755 million. Its pre-tax profit, prior to exceptional items, was £101 million whilst net debt at March 2010 amounted to £520 million.

More generally, there is a compelling case for a fundamental restructuring of UK aviation finances. Such a review might also consider the auctioning of slots at leading airports, especially at Heathrow and possibly also at Gatwick. It should also include the overhaul of the CAA/CC regulatory regime so that it is specifically tailored to long-term airport investment and is more closely aligned to international levels of airport landing charges.

Under any new airport regulatory regime, there should be an increased focus on providing incentives for delivering operational economies from the comparatively high cost base – without, of course, compromising aviation safety.

On the basis of substantive regulatory changes being undertaken, NATS' finances may need fundamental reassessment. Ideally, regulatory reform should precede any sell-down of the government's 49% stake in NATS. If, however, any major regulatory changes are deferred for some years, the government should offer its NATS stake for sale prior to these proposed reforms being implemented.

Valuation: Based on a 10% premium over a RAV of c£1.1 billion, NATS's value, after deducting net debt of £520 million, is estimated at c£700 million. Any sale of the government's 49% stake, after a small discount for its minority status, could be expected to realize c£300 million.

Trusts Ports

Following several acquisitions in recent years, very few UK ports companies remain publicly quoted. Associated British Ports (ABP),

P & O and Mersey Docks are now all owned by private equity funds. In the case of ABP, Admiral Acquisitions, a Goldman Sachs-led consortium, acquired it for £2.8 billion in 2006. A key attraction was its valuable property portfolio, much of which is located by water.

However, there are currently over 100 ports, some of which are no longer operational, that are classified as Trust Ports. Under this special legal status, they are run by independent statutory bodies, governed by their own local legislation and controlled by an independent board rather than by shareholders.

Between 1992 and 1997, seven former Trust Ports – Clyde, Dundee, Forth, Ipswich, Sheerness, Thamesport and Tilbury – were sold. Reviewing the ports sector, the previous government asked PricewaterhouseCoopers (PwC) to undertake a study of how to improve efficiency and services. In May 2007, PwC submitted a report that contained 23 separate recommendations.

The fundamental basis of these recommendations is the need for the Trust Ports to embrace modernization. In particular, ownership and management structure remain a central issue. Although PwC did not advocate any particular form of ownership, it concluded that the privatization of Trust Ports should only be considered for those medium and larger ports that are commercially viable.

Significantly, six of the leading Trust Ports – Dover, Harwich, Milford Haven, Poole, Port of London Authority (PLA), and Tyne – had been reclassified as Public Corporations in 2001. The PLA has specific responsibility for various activities on the River Thames.

The most high-profile of these six Trust Ports, Dover, has annual revenues of c£60 million: many of the smaller Trust Ports have comparatively modest revenues. The leading publicly-quoted ports company, Forth Ports, reported annual revenues of £173 million for 2009. Its stock is highly rated with an enterprise value of £870 million. However, despite negligible property revenues at present, much of its underlying value lies in its property portfolio in Leith, near Edinburgh, rather than being solely dependent on its ports operations, which include Tilbury.

Consequently, any valuation for the privatization of the leading Trust Ports – whether via a public flotation or via a trade sale – would need to be based on a rather less aggressive market rating. It is also the case that any ownership change affecting the Trust Ports would be a protracted legal process: it would clearly raise doubts about the true owners of individual Trust Ports. Nonetheless, given the need for ports modernization, any privatization initiative should ultimately benefit the ports concerned.

Indeed, Dover has been leading the process for privatization, despite strong opposition from some of its key customers

who have accepted higher charges to facilitate the port's modernization, rather than to boost its valuation at privatization, currently estimated at £300 million.

Valuation: On the basis of privatizing the five Trust Ports identified above, along with the PLA, proceeds of c£1.0 billion are anticipated. This figure represents a discount to the multiples currently applicable to Forth Ports, but they could be boosted by aggressive property revaluations.

Dartford Crossing

The Dartford Crossing provides road access across the River Thames – between Dartford and Thurrock – through two tunnels and over a bridge. This link remains a major bottleneck, which regularly causes severe traffic jams, not only in the vicinity of the 27 toll-booths but also for vehicles seeking to join or leave the M25 orbital motorway. Currently, 150,000 vehicles a day use the Dartford Crossing, equivalent to 54 million vehicles per year.

The first of the two tunnels was completed in 1963. A second tunnel, to the west of the first tunnel, suffered prolonged construction delays and was not completed until the early 1980s. Despite this enhanced capacity, it was recognised that both tunnels would be overloaded within a few years.

Consequently, it was decided to build another bridge across the River Thames. This project began in 1988 and was completed in 1991 at a cost of £86 million. To finance the construction of this bridge, a tolling system was introduced under the Dartford-Thurrock Crossing Act 1988. Once the bridge recouped its construction and financing costs, its ownership would revert to the government: this financial target was achieved a few years ago.

However, the government has decided to continue the tolling system, both to raise funds generally and, more specifically, to deter – through the road-charging mechanism – an unacceptably high volume of traffic.

Locally, there is widespread support for the removal of the tolls and the booths that are widely blamed for the persistent traffic jams. Nevertheless, there is no obvious reason why the Dartford Crossing should remain publicly-owned. However, any privatization system – probably through a time-limited franchise arrangement – should include a series of requirements that are placed upon any private operator, especially with regard to reducing traffic congestion.

Hence, a franchise auction should be held, similar to that used for allocating railway franchises. Placing a value on the Dartford

Crossing depends very largely upon the permitted level of tolls. Currently, annual revenues are c£60 million per year. A projection of the proceeds from any franchise auction to manage the Dartford Crossing has been made in the franchise grouping in Figure 5 at the end of this report.

Road Network

The UK roads infrastructure includes c2,000 miles of motorway and c5,000 miles of dual carriageway, virtually all of which is open access without any supplementary charges. Only the M6 motorway currently charges road tolls. With the exception of a limited Congestion Charge area in the historic centre of Durham, London is the only UK city to levy a Congestion Charge, which applies in the busiest part of the capital.

There is in stark contrast with much of Europe, such as France which charges a substantial toll on many of its motorways. As a result, the UK's road costs are effectively funded out of general taxation, with part of the costs being paid for by non-drivers.

It has been suggested that the UK's roads should be taken out of the hands of the Highways Agency and franchised out to private contractors, who would be responsible for road maintenance and other related services. To finance these activities, private contractors would be permitted to levy charges against motorists.

To collect these charges, toll booths would probably need to be erected, which would surely produce long tail-backs on some roads. Alternatively, charges could be paid via the Internet – on a similar basis to London's Congestion Charge – using an electronic vehicle recognition system.

Projections by organizations, such as investment banks, that have analysed such a scheme in depth suggest possible one-off proceeds of up to £100 billion – a vast sum, but one that it very

difficult to project, especially since it would be highly dependent upon the level of charges applied.

The reality is that this form of road privatization would be widely seen as an alternative – or perhaps additional – road tax. To that extent, it would be very different from any other privatization. Consequently, it has been excluded – for the moment at least – as a potential privatization business, a conclusion similar to that apparently reached by the Department of Transport in recent months.

London Underground

As was widely anticipated, the desperately complex long-term PPP contracts have not provided the much-needed stability for the modernization of London Underground. Serious problems have arisen with the very large capital expenditure programme. In particular, there have been numerous disagreements with Transport for London (TfL) – the client – and the Office of Rail Regulation, which has often had to adjudicate between the competing claims.

Metronet, which held two 30-year contracts worth a total of £30 billion for capital expenditure work on the majority of the Underground's lines, collapsed in 2007: the work has subsequently been transferred to TfL.

With regard to Tube Lines, which had a 30-year PPP to modernize the Jubilee, Northern and Piccadilly lines, there were fewer serious problems. Nevertheless, Tube Lines, in which Amey and Bechtel were the major investors, was also recently transferred to TfL.

Given all the inherent challenges of this major work schedule, the highly complex ownership arrangements and the many financial liabilities within the PPPs, any attempted privatization of London Underground in the short-term would probably be self-defeating. In the longer term, its full privatization should be on the agenda.

4 Utilities/Energy

In the utilities/energy sector, there is still further scope for privatization, especially with regard to UK water. Investment in the regulated water sector has become increasingly popular for long-term investors, thanks to its low commercial risk.

Scottish Water

When the nine English water companies and Welsh Water were floated in 1989, the ownership of the Scottish water industry was left in public sector hands. North of the border, opposition to water privatization had been particularly trenchant.

In the intervening two decades, water privatization has encountered fewer problems than some other privatized industries and, in most cases, it has actually delivered. An £85 billion – to date – capital expenditure programme has been undertaken, financed in part by substantial price increases. Had these 10 water companies remained in public ownership, it is very doubtful whether the major investment backlog, dating back to the mid-1970s, would have been cleared.

Whilst it is true that Welsh Water's parent company, Hyder, over-extended itself – resulting in Welsh Water becoming a not-for-profit business, Glas Cymru – the remaining nine English water companies have generally prospered.

Importantly, too, many fund managers now accord an increasingly high priority to solid long-term earnings and dividend streams – financial criteria that the utilities sector, especially regulated water companies, can generally offer.

Scottish Water, which was formed from the consolidation of three regional water businesses, has undergone considerable re-organization in recent years but would benefit from further private sector disciplines and incentives.

Hence, there is a strong case to extend water privatization to Scotland, an issue that would assuredly give rise to complex legal debates between the UK government and the devolved Scottish government.

Undoubtedly, efficiency has improved at Scottish Water. However, water charges in Scotland are partly subsidised by public expenditure. For many years, Scotland has received a disproportionately high allocation of public funds via the Barnett formula which was devised in the 1970s.

The nearest English comparator for Scottish Water is Yorkshire Water, which is now owned by private equity funds: Scottish Water's average combined water and sewerage charge is £324, compared with £327 for Yorkshire Water consumers.

In order to ensure that any public flotation attracts both political and financial support, a priority for the allocation of shares should be accorded to Scottish financial institutions and to Scottish Water consumers.

Alternatively, a trade sale could be pursued. Scottish and Southern Energy, currently capitalized at £10.6 billion, is a possible bidder – and should be very acceptable politically. In the past, it has indicated some interest in investing in Scottish Water – providing the price could be justified to its shareholders. However, with net debt of £5.3 billion and a heavy electricity investment programme, its scope for further acquisitions is now far more limited than previously.

Significantly, too, there is some support within the devolved Scottish Executive for Scottish Water to become a not-for-profit company on the Glas Cymru model (see below).

Valuation: Scottish Water has a RAV of c£5.4 billion as at March 2010. Clearly, any privatization value to taxpayers would depend

upon the level of debt in its restructured balance sheet. If unchanged from the current net debt figure of £2.9 billion, the sale of Scottish Water should raise c£2.5 billion.

Glas Cymru

Glas Cymru is a not-for-profit company that was established following the collapse in the late 1990s of Hyder, whose core businesses were Welsh Water and Swalec. Most of the latter became part of Western Power Distribution – the electricity supply business was sold separately – while the Welsh Water business, which was first privatized in 1989, was transferred to Glas Cymru.

Undoubtedly, Glas Cymru has performed well, especially according to the operating data collected by Ofwat. But there remains scope for further improvements, which the disciplines of private sector ownership are best placed to deliver.

Glas Cymru's current hybrid status is unusual in that it is entirely debt-funded rather than being partly equity-funded. In time, Glas Cymru should be conventionally privatized – with equity participation – either through a trade sale or via a flotation. Under the latter scenario, Welsh financial institutions and local consumers should receive priority. At March 2010, Glas Cymru's subsidiary, Dwr Cymru, had a RAV of c£3.7 billion.

Valuation: Based on a 10% premium to its RAV and after stripping out its £2.6 billion net debt at March 2010, any eventual privatization of Glas Cymru should be able to raise c£1.5 billion.

NI Water

Fundamental changes are currently underway in the supply arrangements for water and sewerage services in Northern Ireland, which are under the control of the publicly-owned NI Water that was set up in April 2007. Recently, progress has been slowed by deep-seated disagreements amongst NI Water's directors. Several have now resigned.

The issue of water charges is very sensitive in Northern Ireland, to such an extent that the NI Executive has decided to postpone the introduction of domestic water charging; it was originally due to start in April 2007.

In common with Scotland, there is a formidable capital expenditure programme to be financed by NI Water as it gears up to achieve higher standards and to comply with EU Water Directives.

To promote efficiency and on other grounds, there is a strong case to undertake a public flotation of NI Water once the charging regime issue has been satisfactorily resolved. Higher initial debt would need to be injected into NI Water, which would put it more in line with today's more leveraged financial structure than was the case when the English and Welsh water companies were floated in 1989.

In fact, utility privatization would not be new to Northern Ireland. In 1993, Northern Ireland Electricity, predominantly a transmission and distribution business, was successively floated. Its transmission and distribution assets, which were bought by the Bahrain-based Arcapita in 2006, are now being acquired by the Irish Republic's dominant electricity business, ESB.

As would be the case with the proposed flotations of Scottish Water and Glas Cymru, potential local investors – both institutions and consumers in Northern Ireland – should be accorded a very high priority in the allocation of any shares in NI Water.

Valuation: In time, given annual revenues of c£360 million and some balance sheet restructuring, NI Water might command a value of c£500 million. This figure is subject to material variance, partly due to the debt structure that is eventually determined.

Urenco

The most valuable nuclear energy asset still in the public sector is the government's 33% stake in Urenco, the uranium enrichment business. The previous government had confirmed its intention to sell it.

Urenco's putative value has risen very appreciably due to plans for a large build-out of new nuclear plant worldwide and the increased fuel volumes that will eventually be consumed as a consequence. Urenco has a current order book worth c£16 billion.

However, selling this 33% stake will not be straightforward since the Dutch government also retains a 33% stake in Urenco: the remaining 33% shareholding is owned by two German energy companies – E.ON and RWE. The approval of these three shareholders will be required for any disposal; they also have a first right of refusal.

Valuation: Placing a value on both Urenco generally, and more specifically on the government's minority 33% stake, is complex, especially given the first refusal options held by the three other shareholders. Nonetheless, Urenco's total valuation should be at least £3 billion, with the government's stake, after allowing for its minority status, worth c£900 billion.

Other Energy Businesses

Despite the recent sales of its most valuable nuclear assets, the government still owns four significant nuclear businesses: British Nuclear Fuels (BNFL), the National Nuclear Laboratory (NNL), the Nuclear Decommissioning Authority (NDA) and the United Kingdom Atomic Energy Authority (UKAEA). Two of these businesses – NNL and part of UKAEA – are suitable for privatization.

Following the emasculation of BNFL as a result of the £2.7 billion sale of its highly regarded Westinghouse nuclear business to Toshiba in Japan, BNFL now owns virtually no assets though there are some liabilities to be paid off to the Treasury. BNFL is widely expected to be wound up shortly.

NNL, a former BNFL subsidiary, does have some attractions for potential investors. In effect, NNL undertakes much of the UK's nuclear research and development capabilities. It also has a key role in dealing with nuclear waste and with new nuclear-build projects. In 2008/09, NNL reported revenues of £75 million. In time, it will be suitable for sale although the government will be keen to ensure that its core nuclear research and development activities are maintained.

NDA's core mission is to ensure that the UK's civil public nuclear legacy sites are decommissioned and effectively cleaned up. Whilst its revenues reached almost £2 billion in 2008/09, its liabilities are massive, notably at the Sellafield complex. Given this latter factor, there is virtually no realistic prospect of NDA being sold to the private sector.

UKAEA embraces various nuclear-orientated businesses, including the decommissioning of the fast-breeder nuclear reactor site at Dounreay in Scotland as well as the facilities at Harwell and Winfrith. UKAEA also undertakes site licensing along with most of the UK's nuclear fusion research at the Joint Energy Torus (JET) facility at Culham.

Importantly, too, UKAEA has some commercial operations; only the latter seem suitable for privatization. Indeed, a commercial arm, UKAEA Ltd, has been created from the overall UKAEA business, most of which seems destined to be publicly owned for the foreseeable future.

Combined Valuation: Neither of the two privatizable nuclear energy businesses discussed above is expected to yield substantial proceeds if they were sold; in Figure 5, they are categorised under others.

5 Media

In the media sector, there are two clear candidates for some form of privatization – Channel 4 and parts of the BBC.

Channel 4

Channel 4 was launched in 1981 and has always been owned by the government. Its public ownership has often been justified on the basis that it enabled Channel 4 to commission programmes that private sector businesses might not otherwise have done.

Hence, its Public Service Remit (PSR) was defined in the following terms: ‘The Public Service Remit for Channel 4 is the provision of a broad range of high quality and diverse programmes....’ Four specific criteria, which Channel 4 is required to promote, were set out: innovation, appeal to a diverse audience, education and a distinctive character.

However, Channel 4’s finances are not strong. Its 2009 revenues amounted to £830 million, most of which accrued via advertising. This revenue figure compares with £906 million in 2008: it has shown no increase since 2005. With almost £550 million having been spent on programme commissioning and other content costs in 2009, it is not surprising that Channel 4’s operating margins are low – last year’s pre-tax profit was just £2.2 million.

Against that background, it is clear that a new injection of finance – through whatever means – would clearly benefit Channel 4, especially in the run-up to the switch-over to digital broadcasting in 2012.

However, prior to privatizing Channel 4 – most probably by a trade sale or possibly via a public flotation – there is a strong case for re-wording or removing altogether the PSR, which seems both

outdated and incompatible with some of Channel 4’s recent TV commissions.

In terms of privatizing the business, decisions would have to be taken about both the due process and, more specifically, whether three companies with major media interests should be allowed to participate.

Any acquisition of Channel 4 by ITV would reduce private sector competition within the UK TV market; because of that, ITV might be designated as an ineligible bidder.

The position of News International is less clear-cut. As a 39% shareholder in BSkyB, it would probably be interested in acquiring Channel 4, which would nicely complement BSkyB’s satellite TV operations.

Many commentators would argue that the media influence of News International, which is already considerable through both its TV and newspaper operations, is excessive and should be prevented from being further extended. Nevertheless, as News International currently has no significant terrestrial television presence, its ownership of Channel 4 would not be harmful to competition.

Significantly, the Channel 5 Group was recently bought for £104 million by the owners of the Daily Express and Daily Star. There seems little reason why the latter should not be allowed to acquire Channel 4 at an acceptable price.

Valuation: In terms of valuation, Channel 4 is probably worth c£500 million, a figure boosted by the reported £202 million cash balance at December 2009. This valuation is based on a comparative analysis with the much larger ITV, which has faced serious problems in recent years. But ITV’s share price has recently rallied and the market currently values it at £2.5 billion.

The BBC

The BBC continues to face major change following the imposition of the six-year TV licence agreement, which was due to expire in 2013. This licensing formula was based on a 2% cash increase for both 2011/12 and 2012/13 over the current £145.50 cost of a standard colour TV licence. However, the BBC has recently offered to freeze its licence fee until 2016/17 and thereby waive its right to the previously agreed increases.

Nevertheless, for the BBC to operate within this tighter regulatory formula will mean substantial cost reductions, a process that is currently underway: the BBC's large pension deficit is a particularly intractable problem.

Against this background, any privatization of the BBC would be even more complex. However, irrespective of the rest of its operations, the BBC Worldwide subsidiary is prospering and, subject to the imposition of various regulatory obligations, is well-suited to be moved into the private sector.

BBC Worldwide recently reported impressive figures. Revenues rose to £888 million in 2009/10, from £704 million in 2008/09. The operating profit performance is particularly strong, with a return of £140 million compared with just £44 million in 2008/09.

The separation of the commercial operations of the BBC from its public service element is probably the best way forward. Such a scenario might well fit in with recent proposals to allow part of the licence fee revenue to be allocated to other organizations that undertake public service broadcasting activities.

In any event, the BBC's purchase – albeit at a modest price – of the Lonely Planet Guide business in 2007 illustrates the developing commercial aspects of much of the BBC's activities, which are best undertaken in the private sector.

Valuation: Partly because of its undoubted trophy asset status, the privatization of BBC Worldwide would attract very strong interest both in the UK and overseas – and command a significant premium over other broadcasting media assets. Its sale should raise at least £2.0 billion.

6 Telecoms

Between 1980 and 2000, most of the UK's telecoms sector was privatized: Cable and Wireless, British Telecom and the Hull-based Kingston Communications were all publicly floated. Vodafone, which emerged from Racal Electronics and is now a world-leader in telecommunications, has never been publicly owned.

In recent years, the most important commercial initiative in the UK telecoms sector has been the holding of the 3G auction in 2000, which raised an astonishing £22.5 billion, way beyond the government's most optimistic expectations.

A further auction of additional bandwidth has been planned for some time and has been the subject of considerable delay. It is now scheduled to be held in the second half of 2011.

Two slices of bandwidth will be offered. First, the 800 MHz component has become available due to the switch from analogue to digital TV. Secondly, the 2,600 MHz component will be an attractive purchase given its potential in urban areas.

In the lead-up to this auction, there have been disagreements on several fronts. In particular, final decisions have to be reached about both the dominant role of Everything Everywhere – the UK joint venture of the French-owned Orange and the German-owned T-Mobile – and the status of the existing 2G spectrum holders.

The four leading UK mobile telecoms operators – the Spanish-owned O2, Vodafone, Everything Everywhere and Three – have very different views on the planned spectrum auction and how the contentious issues should be resolved.

In any event, holding this auction should be a high priority. It is not possible, at present, to project – with any certainty – the level of proceeds. They are likely, though, to lie within a range of £500 million to £2 billion. In Germany, a similar auction recently took place, which raised c£3.5 billion. Within the franchise grouping estimate of £2 billion in Figure 5 at the end of this report, there is an allowance for the projected proceeds from this auction.

7 Leisure

In the leisure sector, there are three publicly-owned businesses that seem suitable for privatization – the Tote, British Waterways and the Queen Elizabeth II Conference Centre.

Tote

The Tote was set up in 1928 and currently owns c550 betting shops, equivalent to a 6% market share. The Labour Party Manifestos in both 2001 and 2005 undertook to sell the Tote to a Racing Trust in order *‘to allow it to compete commercially’*.

Despite prolonged negotiations with the Treasury and a £320 million bid in 2006 from the horseracing industry that was declined, the Tote’s future still remains unresolved. Importantly, too, its valuation has fallen in line with the lower returns generated by betting on horseracing.

Nonetheless, in 2008/09 the Tote reported revenues of £2.9 billion, which yielded an operating profit of over £22 million. Pre-tax profits were £16.4 million, prior to its contribution to racing, and just over £6 million after this contribution.

There is a strong case for selling the Tote outright to the highest bidder, especially since the horseracing industry has been given every chance to make acceptable counter-bids. Two potential bidders, Ladbrokes and William Hill both own and/or operate over 2,000 betting shops each in the UK and Ireland.

There are other likely bidders, although Gala Coral, which once considered paying over £400 million for the Tote, has struggled of late; it has recently been re-financed. Gala Coral’s latest valuation of the Tote is reputedly between £200 million and £250 million.

Whether in the long-term the Tote is viable against a very strong bookmaking fraternity is debatable. In several other countries,

where bookmaking is either weak or non-existent, a central betting monopoly prevails, such as the Paris-Mutuel in France.

The reality is that the biggest challenge currently facing UK bookmakers, apart from fending off calls for further tax increases relating to the annual disagreement about the Betting Levy, is the surge in on-line betting. It is this phenomenon, driven by the recently-floated Betfair amongst others – rather than by the Tote – that the big players like Ladbrokes most fear. Betfair’s current market valuation comfortably exceeds £1 billion.

Valuation: By selling off the Tote to the highest bidder, the government should net c£250 million, as well as bringing an end to the painstaking negotiations with the horseracing industry that have lasted for so long.

British Waterways

As a public corporation, British Waterways manages some 2,200 miles of inland waterways in the UK, mainly navigable rivers and canals. Given that the late 18th century canal-building era predated the mid-19th century railways boom, it is no surprise that many canals have received little investment and are in a very poor condition.

Nevertheless, the growth of the leisure sector over the last two decades has benefited the canal network and has brought about a much-needed increase in investment, some of which has been government-generated.

Whilst British Waterways has gradually become more commercial, there is still much to do. The 2009/10 accounts reported a small operating deficit after a near £28 million cost of capital charge. However, the revenue line was materially boosted by government grants of £70 million that supplemented commercial income of £101 million.

Significantly, property rents continue to be the largest single element of trading income, accounting for over £31 million. Revenues from way-leaves and easements raised over £21 million during the year.

Arguably, it is property that holds the future for British Waterways. Whilst the property market is still recovering from falling prices, many of British Waterways' sites offer an attractive water environment, with a low flooding risk.

The scope for development tie-ups with property, building and leisure companies, including pub businesses, is now considerable – and something that should be strongly encouraged. In March 2010, British Waterways reported investment assets of £377 million, of which £370 million was attributable to freehold land, building and other structures.

The government has announced its intention to replace British Waterways with a new charitable body. But its adoption of more commercial techniques would create greater benefits if there were a target date for some form of privatization, which would help raise the considerable funds needed to restore the worst parts of the inland waterways network.

Given British Waterways' current trading and financial position, any imminent privatization initiative seems improbable. But a five-

year plan to turn round its finances, so that it could realistically undertake a public flotation or be the subject of a trade sale, should enable British Waterways to generate real interest amongst potential investors. In particular, its water-side assets should generate considerable value in the same way that ABP's underlying value was materially boosted prior to its sale to Admiral Acquisitions.

Valuation: If British Waterways were to be sold, the proceeds would be largely dependent upon its £377 million of investment assets – as recently re-valued in the accounts. On this basis, the sale should be able to raise over £300 million although the extent of legacy liabilities would also be very relevant to any valuation.

Queen Elizabeth II Conference Centre

Given its prime location in central Westminster, a sale of the Queen Elizabeth II Conference Centre should not be difficult. As an operating facility, the building should be put up for sale at the earliest opportunity and sold to the company or individual that offers the best price commensurate with meeting any suitability tests.

Valuation: Compared with other businesses in this report, the proceeds for the sale of this Centre will be quite modest: they are accounted for under others in Figure 5.

8 Investment Trusts

In the investment trust sector, the CDC Group (CDC) is an obvious candidate for a conventional privatization, although the government should also consider selling its 40% stake in Actis, which was spun out of CDC in 2004.

CDC Group

CDC was formed in 1999 out of the Commonwealth Development Corporation. Whilst it remains government-owned, it is now more financially-orientated and runs a fund of funds. CDC manages equity funds, which invest in the emerging markets of Asia, Africa and Latin America – but with a pronounced emphasis on low income countries in South Asia and sub-Saharan Africa.

The results for the 2009 financial year show a net asset value of £2.5 billion, which includes a portfolio of investments worth over £1.4 billion; most of the remainder was accounted for by a £957 million net cash balance.

In terms of ownership, there will be some concerns that any transfer to the private sector may cause a switch in the investment strategy to the possible disadvantage of less well-off countries. Safeguards can be imposed in any privatization arrangement, which should ensure that major exposure to these countries remained. However, if too constrained these might be counterproductive to the sale of CDC.

Given the nature of CDC's business, a trade sale to a fund management company would seem to be the most obvious way to deliver value for the government. It might also give rise to a more active investment policy.

It should be added that CDC has faced a considerable amount of adverse publicity in certain parts of the UK press. To that extent, governance issues will need to be addressed if it is to be privatized.

Valuation: With a net asset value of £2.5 billion at December 2009, which includes a net cash balance of £957 million, any sale of CDC should be able to raise proceeds of close to the former figure.

Actis

In its short existence, Actis has reported impressive returns and attracted considerable controversy, having been sold for a negligible amount via a management buy-out in 2004.

Over the last six years, Actis has become a leading private equity investor; it promotes and manages private equity funds in Africa, Latin America, China, India and elsewhere in Asia. To date, Actis has invested over £5 billion, of which £2 billion has been directed into emerging markets over the last decade.

Following the management buy-out in 2004, private investors continue to own 60% of the business; the remaining 40% – equivalent to an 80% economic interest until 2013 – is held by the government. In time, but before the 'clawback' provisions expire, this minority stake should be sold.

Valuation: For various reasons, placing a value on the Government's 40% stake in Actis is complex. However, an estimate of the proceeds from such a sale has been made under others in Figure 5.

9 Defence

In the defence sector, there are no major public sector businesses that seem suitable for privatization; there are, though, three smaller businesses that have some commercial exposure and are possible privatization candidates.

Defence Science and Technology Laboratory

The Defence Science and Technology Laboratory (DSTL) provides scientific and engineering research as well as analysis to the Ministry of Defence (MOD) and to the Armed Forces. Its prime aim is to ensure that the effectiveness of the Armed Forces is maximized.

In 2009/10, DSTL's revenues were £435 million, almost 90% of which arose from the MOD. An operating profit of just under £21 million was reported: net cash at March 2010 was £11 million.

Clearly, DSTL is exposed to the impact of both the planned cuts at the MOD and to the Strategic Defence and Security Review (SDSR), which may result in fundamental changes being implemented to the operations of the MOD and the Armed Forces. Of course, there are also sensitive security issues, which might be compromised by any sale to the private sector.

Nevertheless, some form of privatization should be considered, preferably through a trade sale. There is also the precedent of QinetiQ which, despite some controversy, proved a popular privatization.

Defence Support Group

The Defence Support Group (DSG) was created by the merger in 2008 of the Army Base Repair Organization (ABRO) and the Defence Aviation Repair Agency (DARA). DSG is the in-house

provider of skilled maintenance, repair, overhaul and upgrade services to the UK's Armed Forces.

In 2009/10, DSG's revenues were £233 million, slightly above the 2008/09 figure. There was an operating profit of over £12 million and a net cash balance of almost £5 million.

Like DSTL, DSG is likely to be impacted both by the expected cuts to the MOD's budget and by the SDSR, which will inevitably address the role of back-up service providers – and their costs – to the Armed Forces. Security issues, too, may well be a concern, especially with respect to maintaining some of the high tech equipment currently in operation.

In the case of DSG, some form of privatization should also be considered, with a trade sale being an obvious route. Clearly, potential investors would have to make an allowance for DSG's limited customer base and its heavy dependence upon MOD revenues.

UK Hydrographic Office

UK Hydrographic Office (UKHO) is a leading supplier of maritime navigational information and services. Its role is particularly crucial to the Royal Navy and it also supports the Maritime and Coastguard Agency. Encouragingly, too, its commercial activities have grown in recent years.

In 2009/10, UKHO reported revenues of £115 million (excluding those from discontinued activities). Pre-tax profits (and pre-exceptional items) were £27.7 million and it had a net cash balance of £39 million.

In terms of future ownership, privatization would enable the commercial operations of UKHO to grow: a trade sale would be

an obvious route. There may be some security issues that would need to be addressed, given its close relationship with the Royal Navy.

Combined Valuation: Based on the recent trading performances of these three defence-related businesses – none of whom has net debt on its balance sheet – a combined valuation of c£400 million would seem justifiable.

10 Forestry

Whilst the official paper/forestry sector has long since disappeared, there are still a few quoted companies involved in these operations: a privatized Forestry Commission is not expected to join them.

The Forestry Commission

The Forestry Commission, especially in Scotland, is a major landowner that should be profiting far more from recent increases in EU timber prices. However, the various Forestry Commission organizations have modest revenues and minimal returns.

To that extent, short of any major restructuring of UK forestry, full privatization looks unlikely. However, the Department for the Environment, Food and Rural Affairs (Defra) is expected to announce a planned sale of part of the 1.85 million acres of

woodland overseen by the Forestry Commission: such disposals would take place over a decade.

Any major disposals of Forestry Commission assets would be controversial. On the regulatory front, many of the activities currently undertaken by the Forestry Commission could be combined with those of the Environment Agency, with the more commercial aspects being separated. A similar split-up preceded the implementation of water privatization in England and Wales in 1989.

Valuation: It is very difficult to determine the level of any proceeds from the part sale of the Forestry Commission's estate and much would depend on the percentage of the woodland sold. In the 1990s, valuations of between £1.4 billion and £2.3 billion were placed on the Forestry Commission's estate. In Figure 5 – under others which totals £1 billion – an allowance has been made for proceeds arising from Forestry Commission sales.

11 Real Estate

The government owns a vast portfolio of assets, which the National Asset Register of 2007 valued at over £337 billion. Over 87% of this asset base was listed as tangible; hence, for the purposes of this report, these assets are listed under the real estate heading.

Key details, on a departmental basis, of these assets are set out in Figure 4. (Rounded to the nearest £1 million.)

Within this publicly-owned asset base, two figures stand out – the c£81 billion estimated for Department of Transport tangible fixed assets and the c£70 billion estimated for Ministry of Defence (MOD) tangible fixed assets. Whilst the large majority of this asset base is operationally necessary, some of it is not.

If just a small fraction of this asset base were sold, the one-off proceeds would be very considerable. Of course, the figures quoted in the National Asset Register 2007 are inevitably very speculative, especially since property prices have moved quite sharply in recent years. It should be noted, too, that there may be some double-counting involving other publicly-owned assets discussed – and valued – in this report.

Hence, every effort should be made to sell off surplus land and building assets, especially by the MOD, which has argued in the past that there is relatively modest scope to dispose of part of its valuable property portfolio.

After all, a small percentage sale – 10% for example – of the National Asset Register's total asset base would result in very substantial one-off proceeds – of perhaps £30 billion.

Projected Government Proceeds

Aside from the many operational benefits that would accrue from undertaking the privatization programme outlined in this report,

the government's finances would also benefit very substantially from the receipt of privatization proceeds. Given the current economic slow-down, notwithstanding the massive PSNB projections, such an inflow of funds would certainly be most welcome.

In pursuing further privatization initiatives, the Government would simply be emulating the conventional policy of any over-extended private sector business.

In total, estimated proceeds of over £90 billion could accrue if this programme were pursued in its entirety, although it is recognized that there may be compelling reasons why a particular privatization cannot be undertaken.

Moreover, this report has not attempted to analyse in detail the various land and property disposals that comprise a substantial element of the sales proceeds that the Treasury has been seeking to realize. But the summary of the Public Asset Register 2007 below provides an indication of the scale of the proceeds that could accrue through a major disposal programme.

Also excluded from the total projected proceeds are those arising from the ongoing sale of High Speed One, which is expected to raise c£2 billion shortly.

Inevitably, it is very difficult to place precise figures on the likely proceeds from any privatization. Apart from the current stock market instability, there is also the need to restructure many balance sheets, a procedure that privatization candidates, such as Scottish Water, would need to undergo.

However, on various assumptions, Figure 5 below provides estimates of the projected proceeds if the various privatization sales discussed in this report were undertaken. To determine an approximate valuation, the finances of sector comparators

have been analysed. In the absence of such publicly-quoted comparators, less rigorous estimates have had to be used. For the smaller publicly-owned businesses, prospective valuations have been aggregated.

Figure 4 – National Asset Register (2007)

Department	Tangible Fixed Assets (£m)	Intangible Fixed Assets (£m)	Fixed Assets Investment (£m)	Total Asset Base (£m)
Attorney General	58	1	0	59
Cabinet Office	241	1	0	242
Chancellor of the Exchequer's Depts.	1,457	39	1,640	3,136
Communities and Local government	295	3	136	433
Constitutional Affairs	2,365	0	857	3,222
Culture, Media and Sport	4,179	21	219	4,420
Defence	70,385	22,648	352	93,385
Education and Skills	239	12	41	291
Environment, Food and Rural Affairs	4,230	18	58	4,305
Foreign and Commonwealth Office	1,519	2	0	1,521
Health	39,737	370	112	40,219
Home Office	6,825	22	36	6,883
International Development	75	0	2,521	2,597
Northern Ireland	38,723	19	57	38,798
Scotland	20,843	37	2,119	22,998
Trade and Industry	10,164	894	8,097	19,155
Transport	80,664	361	0	81,025
Wales	11,991	1	1,612	13,604
Work and Pensions	786	26	0	812
Total Asset Base (£m)	294,776	24,473	17,855	337,104

Source: National Asset Register 2007

Conclusion

This report sets out a radical programme to re-invigorate the privatization policy that proved so successfully during the period of the Thatcher government (1979-1990). If the programme were implemented in full, many benefits would accrue, especially in terms of efficiencies. And, based on the estimates in this report, it would also yield proceeds for the government of over £90 billion (over 40% of which relates to the 83% shareholding in RBS, including B shares).

Privatizing many of the companies discussed in this report would certainly not be easy. In some cases, primary legislation will be needed. Nevertheless, there is a need now for the government to complete UK privatization – outside the health and education sectors. In embracing such an opportunity, it would not only raise very substantial proceeds – to the benefit of the UK's desperately stretched public finances – but would also recreate the drive that lay behind the original privatization policy that has been replicated worldwide.

Figure 5 – Projected Privatization Proceeds

Organisation	Government Stake (%)	Sales Proceeds (£m)	Methodology
Royal Bank of Scotland	83 (inc. B Shares)	38,900	Market Quote – 10%
Lloyds	40	18,200	Market Quote – 10%
Northern Rock	100	1,500	City Projections
Royal Mail*	100	4,000	TNT/CVC Comparisons
Other Support Services	Various	1,300	Revenues/Returns
Network Rail	Not-for-Profit	11,500	RAV – 15%
NATS	49	300	RAV + 10%
Trust Ports	Various	1,000	Forth Comparisons
Scottish Water	100	2,500	RAV
Glas Cymru	Not-for-Profit	1,500	RAV + 10%
NI Water	100	500	Sector Comparators
Urenco	33	900	PER Analysis
Channel 4	100	500	ITV/ Channel 5 Comparison
BBC Worldwide	100	2,000	Sector Comparators
Tote	100	250	Sector Comparators
British Waterways	100	300	Net Assets
QE II Centre	100	50	Property Valuation
CDC	100	2,500	Net Assets
Actis	40	400	Private Equity Valuation
Defence Businesses	Various	400	Revenue/Returns
Franchises**	Various	2,000	Projected Bids
Others	Various	1,000	N/A
Total		91,050	

* Pre £8+ billion pension fund deficit;

** Dartford Crossing, ECML and Spectrum auctions;
Closing prices as at 8/10/2010 have been used.

Source: Nigel Hawkins Associates

