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THE SCOPE AND IMPLICATIONS OF AIRLINE PRIVATISATION

JACOBUS PETRUS JONKER DIETZSCH

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A RESEARCH REPORT SUBMITTED TO THE FACULTY OF BUSINESS ADMINISTRATION, UNIVERSITY OF THE WITWATERSRAND, JOHANNESBURG, IN PARTIAL FULFILMENT OF THE REQUIREMENTS FOR THE DEGREE OF MASTER OF BUSINESS ADMINISTRATION

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ABSTRACT

This research report describes the process of privatisation with particular reference to the airline industry. Most airlines have been operating within the ambit of the public sector. However, a number of airlines have recently been either partly or fully transferred to the private sector. Moreover, several governments have recently publicly announced that they intend to privatise their national airlines.

The concept of privatisation surfaced during the late nineteen-seventies, and several countries are still gaining experience in respect of the application of privatisation. Privatisation is a complex phenomenon which necessitates meticulous attention to the various aspects of the organisation which is being privatised. The privatisation process needs to be carefully approached in order not to endanger the strategic position of the public sector company which is being privatised.

Privatisation represents change. The interests of the various stakeholders in an organisation which is being privatised, need to evaluated be and appropriately dealt with.

The introduction briefly outlines the emergence of privatisation and the relevance of privatisation to the airline industry. It also sets out the objectives of the research report and the reasons why the research is considered to be important.

The characteristics of the airline industry, both strategic and operational, are discussed in depth with the aid of a literature survey. The major issues in respect of the airline industry are examined, culminating in the key success factors for the airline industry.

The theory and application of privatisation are examined in depth with the aid of an extensive literature survey. The argument in respect of the desirability of privatisation, as well as the process of privatisation is extensively discussed. The discussion culminates in the identification of the key success factors for privatisation in general.

A set of propositions for privatisation in the airline industry is developed from the consideration of strategic and operational characteristics of the airline industry, as well as from theoretical and practical considerations of privatisation in general. This set of propositions is tested and evaluated with regard to a number of airlines which have already been fully or partly privatised.

The research methodology is set out after the theory in respect of the airline industry and privatisation in general, as well as a hypothesised framework for airline privatisation, are covered. The research methodology establishes the link between the theory examined and the objectives of the research study. The research methodology essentially entails interviews which were conducted with key individuals from various privatised airlines. The findings of the research study are discussed and analysed in respect of the hypothesised framework formulated for airline privatisation.

The report ends with conclusions drawn from the research. Recommendations for further research suggested by the study are listed.

DECLARATION

I hereby declare that the research report entitled:

THE SCOPE AND IMPLICATIONS OF AIRLINE PRIVATISATION

is my own unaided work, except to the extent indicated in the acknowledgements and references, and by comments included in the body of the research report.

I further declare that this research report, or any part thereof, has not been submitted in the past, or is being, or is to be, submitted for a degree at any other university.

The information used in this research report has not been obtained by myself while employed by, or working under the aegis of, any person or organisation other than the University of the Witwatersrand.

JACOBUS PETRUS JONKER DIETZSCH

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TO MY PARENTS WHOSE INTEREST AND CONCERN I WILL ALWAYS APPRECIATE.

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CHAPTER 1

INTRODUCTION

1.1 THE EMERGENCE OF PRIVATISATION

Privatisation, as a national economic policy, surfaced during the mid- to late seventies, principally as a reaction against the increasing direct involvement by governments in their respective economies. In many countries, twentieth century economic policy brought about encroaching socialism which increasingly resulted in the displacement of the private sector by the public sector. However, the general public became increasingly disillusioned with the performance of public sector business enterprises. These public sector business enterprises, in many instances, not only proved unable to fulfil the functions and objectives for which they were created, but in fact also constituted a serious drain on the financial resources of the Treasury.

In a number of countries, evolving public opinion demanded a restructuring of national economies. In particular, electorates in the United Kingdom and the United States elected governments committed to the reduction of the role and extent of the state sector in the economy. In New Zealand, a nominally socialist government was elected, but 'paradoxically', this government has been pursuing a vigourous privatisation policy. Even in the People's Republic of China, the emergence and development of a private sector received encouragement from political leaders. Privatisation represents the systematic transfer of productive resources from the public sector to the private sector.

In Britain, the industrial economy has been substantially restructured as a result of the privatisation policies pursued by the Thatcher government, since it assumed power in May 1979. Grimstone (1988,p10) states:

> 'When the Conservative government, led by Margaret Thatcher, came to power in 1979, the state-owned industrial sector accounted for just over ten per cent of the country's gross domestic product. Nationalised industries employed around one and three-quarter million people and they dominated the transport, energy, communications, steel and shipbuilding sectors of the British economy. Eight years later, nearly half of the previously state-owned industrial sector has been privatised. More than twenty thousand million pounds has been raised for the Exchequer. Over six hundred thousand people have been moved to the private sector and the proportion of people who own shares has more than trebled.'

Within the global context, the philosophy of privatisation gained considerable momentum as a result of the achievements of the restructured British economy since 1979. Although the Thatcher government is ideologically committed to the superior performance of the private sector, the philosophy of privatising state-owned enterprises has nevertheless spread to many other countries which are far less committed to, and enthusiastic about free market economics. In particular, many governments are increasingly confronted with the realities of a fiscal squeeze, especially as the demand for social services appears to be unlimited, whereas the ability of governments to attract funds in order to finance such expenditure is clearly limited. This realisation put the notion of state ownership of production facilities into a different perspective as these governments could no longer obtain sufficient financial resources to subsidise loss-making public sector business enterprises. The fiscal priorities of many governments clearly changed. Privatisation has not become only desirable from an ideological point of view, but has also become a fiscal necessity.

The reasons for the shortcomings of the public sector are complex. Grinstone (1988,p11) continues:

> 'In many cases it can be seen that the fault lay not with the management and the workers but with the system. The industries were continually open to political and bureaucratic interference. Social and commercial objectives became confused to the detriment of both. The industries' finances were underwritten by the government and it became clear that success was not necessary for the industries to survive.'

Clearly, the pursuance of social and public objectives featured highly in nationalised companies. In fact, a multitude of politically inspired objectives were pursued as governments attempted to placate their various constituencies. The managers of these public sector companies became far more sensitive to the sentiments of their political masters, rather than to the realities of the market-place.

Privatisation seeks to reduce the extent of political influence on the purely commercial and business decisions of managers of public sector business enterprises. A privatisation policy must consequently take cognisance of political realities. At the macro-level, privatisation tends to elicit vociferous opposition from ideologues committed to a socialist economy. At the micro-level, privatisation may be opposed by a variety of interest groups that perceive that they may be disadvantaged if privatisation actually does occur. The different internal and external interest groups include, inter alia, politicians who control the destiny of at least a few areas of the economy; managers and employees who fear changes that will take place once the firm has been privatised; consumer groups who realise that they may be disadvantaged if the privatised firm charges market-related prices for its products rather than extensively practiced widespread

cross subsidisation, trade unions who would no longer be able to gain political capital from an industrial dispute; as well as suppliers whose industrial marketing practices may need to be significantly adapted. Privatisation thus involves certain dramatic changes for the respective stakeholders. A central tenet of privatisation theory is that the political processes emanating from privatisation policy must be carefully managed.

Privatisation represents a major strategic reorientation for a public sector enterprise. A privatised company may indeed lose protection afforded by state-ownership, but many new business opportunities may become available to a privatised business. Privatisation may consequently materially affect the future strategic direction of a public sector business enterprise.

1.2 THE RELEVANCE OF PRIVATISATION TO THE AIRLINE INDUSTRY

The international airline industry, with the notable exception of United States' carriers, has traditionally operated within the ambit of state ownership. State ownership, as well as the regulatory framework established by the respective governments in order to protect their national airlines from a potentially highly competitive environment, clearly circumscribed the objectives and parameters guiding the strategic positioning, as well as the operating characteristics of individual airlines concerned. These objectives and parameters, however, are very often influenced by political, rather than commercial motivations.

However, in a number of countries such as Australia, Canada, the United Kingdom, France and Japan, private airlines have operated alongside major public sector national airlines. These privately-owned airlines include, inter alia, Ansett Airlines in Australia, Canadian Airlines International in Canada, British Caledonian Airways and British Midland Airways in the United Kingdom, UTA in France, Toa Domestic Airways and All Nippon Airways in Japan. In a few countries such as the Netherlands, Germany and Switzerland, the respective national airlines, namely KLM, Lufthansa and Swissair respectively, have had a degree of private shareholding in addition to majority or minority state shareholding. Although the financial performance of some of these privately- or semi-privately owned airlines may not always have been exemplary, the existence of these airlines nevertheless bestowed credence to a notion of a viable private sector airline industry.

The global trend towards privatisation of major industries has consequently also affected the airline industry. In particular, the airline industry has been identified in an number of countries as one of the first candidates for privatisation. A number of airlines such as British Airways, Malaysian Airline System, Singapore International Airlines, Alitalia, KLM and Lufthansa have recently been either partly

or fully privatised. Moreover, airlines which have been suggested as prospects for privatisation include Air France, Air Canada, Air New Zealand, Alia Royal Jordanian Airlines, Australian Airlines, Qantas, South African Airways, Mexicana and Aerolineas Argentinas.

Privatisation in the airline industry, however, presents a number of unique features. These unique features emanate from aspects such as the extensive framework of regulation which has an all-pervasive impact upon the operations and strategies of airlines; the substantial amounts of capital required by airlines; the high degree of labour intensity of the airline industry resulting from airlines being a service industry; as well as the extent of the public profile of the industry. There are, however, factors which would facilitate privatisation of the airline industry. In particular, even although state-owned airlines may form an integral part of the public sector, these airlines have clearly the defined identity of a business enterprise. The prominent public profile of the airline industry also appears to engender some considerable interest from the investment community.

1.3 THE OBJECTIVES OF THE RESEARCH REPORT

The main objective of this research report is to establish a framework for airline privatisation. A set of propositions was developed from analytical consideration of the characteristics of the airline industry, as well as from an evaluation of the theoretical and practical considerations of privatisation in general. These propositions form the guide-lines of the hypothesised framework for airline privatisation. The set of propositions were consequently tested and evaluated against the practical experience of a few airlines which have recently been either fully or partly privatised.

The research report sought to identify some of the peculiar aspects appertaining to privatisation in the airline industry. The theory of privatisation clearly states that full cognisance of the unique institutional, social, political, economic and commercial factors present in a specific country, industry or firm is an essential prerequisite for successful privatisation.

An objective of the research report is to make a contribution to the evolving literature based on privatisation, particularly with regard to the airline industry. Finally, as the research report sought only to establish a framework for airline privatisation, the guide-lines emanating from this framework require further detailed research.

1.4 THE IMPORTANCE OF THE RESEARCH

Privatisation is a world-wide trend, whereby several governments are endeavouring to restructure their national economies, in order to meet the challenges of the evolving global economic system.

The theory of privatisation emphasises that a business enterprise has no right to long-term existence unless the business operates profitably. State-owned enterprises, however, do not need to operate profitably in order to secure long-term existence. The absence of capital market discipline, as well as the extent of political interference in the management of state-owned enterprises, may necessitate extensive restructuring of public sector businesses before they can be privatised. Privatisation may consequently be a rather complex issue. In particular, privatisation involves a reorientation of public policy. The political considerations and consequences of a privatisation policy must therefore be carefully and skilfully handled.

Privatisation is, however, a relatively novel concept. The experience and literature relating to privatisation is therefore rather limited. This research report aims to provide a framework and guide-lines in respect of the application of privatisation with particular reference to the airline industry.

1.5 THE SCOPE AND LIMITATIONS OF THE RESEARCH

The research aims to establish a framework for airline privatisation. Privatisation, however, constitutes a complicated and extensive phenomenon. The wide variety of aspects involved in privatisation in general, and airline privatisation in particular, have been identified, but would require further research.

Although some of the issues concerning the desirability of privatisation in general are considered, the research report focuses on the process of privatisation in airlines after a decision has been taken in favour of privatisation. The research report consequently does not consider the debate concerning the merits of privatising an airline in any detail.

South African Airways has recently been suggested as a prospect for possible future privatisation. The research report does not cover specific issues with regard to the possible privatisation of South African Airways, but rather considers issues with regard to the airline industry in general.

The research study imposed certain limitations in respect of the generality of some of the research findings. The limitations result inter alia, from the following aspects:

a. The sample size of airlines which could be researched was relatively limited.
b. Circumstances and conditions within the airlines which were investigated differed vastly as a result of institutional factors.
c. Privatisation is a unique experience for the specific airline involved. It is therefore an experiment that cannot be repeated for another particular airline.
d. The definition of privatisation entails both full and partial privatisation. The implications of full and partial privatisation, however, appears to be significantly different.

The sample of airlines chosen represents the major different approaches to airline privatisation. Consequently, the detailed analysis of the privatisation process in the chosen airlines is regarded as adequate for a generalised framework for airline privatisation to be developed and tested.

1.6 THE FRAMEWORK OF THE RESEARCH REPORT

Chapter Two examines the strategic and operational characteristics of the airline industry. The discussion emphasises the changes that are currently taking place within the airline industry.

Chapter Three outlines major theoretical considerations with regard to privatisation in general. Some of the major issues in respect of the privatisation debate are discussed.

Chapter Four explains the practical aspects with regard to the implementation of privatisation in general.

Chapter Five outlines the key success factors for privatisation in general.

Chapter Six outlines a generalised framework for privatisation in the airline industry. A set of propositions, which were developed from an assessment of the contents of Chapters Two to Five is listed.

Chapter Seven sets out the research methodology and approach used to establish the validity of the hypothesised set of propositions for airline privatisation.

Chapter Eight discusses the practical experience of a sample of airlines with regard to the hypothesised set of propositions for airline privatisation.

Chapter Nine contains the conclusions and recommendations.

CHAPTER 2

THE CHARACTERISTICS OF THE AIRLINE INDUSTRY

2.1 INTRODUCTION

The objective of this chapter is to identify and describe the strategic characteristics of the airline industry, and to provide a theoretical and practical framework for strategic decision-making within this airline industry. The environment in which the airlines operate has, in recent years, become increasingly demanding, particularly with regard to competition intensifying between different airlines. Deregulation is a fundamental contributing factor to the altering of traditional operating procedures and strategic relationships within the industry. State-ownership of airlines has also been an essential feature of the industry although airline privatisation has in recent years become an increasingly important strategic issue for airline management to consider. Privatisation represents a major strategic repositioning of airlines which have hitherto operated within the ambit of the public sector, and has contributed to the airline industry being in a state of flux.

A strategic analysis of the airline industry must take into account the competitive driving forces within the industry. Porter, (1980,p.4) states that:

> 'Knowledge of these underlying sources of competitive pressure highlights the critical strengths and weaknesses of the company, animates its positioning in its industry, clarifies the areas where strategic changes may yield the greatest payoff, and highlights the areas where industry trends promise to hold the greatest significance as either opportunities or threats.'

Competitive forces consist of the threat of new entrants, substitute products or services; the bargaining power of suppliers and buyers; as well as rivalry amongst existing firms. The current strategic posture of the airline industry is a direct result of the way in which individual airline companies adapted individually and collectively to these competitive forces. In particular, the history of the airline industry has been one of progressive evolution. Competition amongst airlines has intensified recently as a result of deregulation emerging as a major political issue in many countries.

During the past thirty years, airline passenger travel has been growing at an average rate in excess of eleven percent per annum. During this period considerable route expansion took place, new airlines were created, and new

marketing philosophies were introduced. All this took place during a period in which the world economy in general, and world trade in particular, were expanding at an unprecedented rate.

With regard to the structure of the airline industry that evolved during this period, between forty and fifty percent of the airline industry's current output on a world-wide basis occurs within the international environment (Table 1). With the exception of a few large countries such as the United States, the Soviet Union, Brazil and the People's Republic of China, the output of international air services tends to exceed the output of domestic operations which are measured in terms of tonne kilometres performed. As a result, the major airlines in most countries tend to be primarily concerned with international air services, and many airlines only operate internationally. In spite of the international orientation of the airline industry, aviation policy is characterised by being of a highly nationalistic nature, which has effectively prevented the emergence of a truly global airline.

TABLE 1
INTERNATIONAL AIRLINE OPERATIONS AS PROPORTION OF TOTAL WORLD AIRLINE OUTPUT (1986)

AIRLINE OUTPUT MEASUREMENT	INTERNATIONAL OPERATIONS OF TOTAL OUTPUT
Passengers Carried	20.6%
Freight Tonnes Carried	43.3%
Passenger Kilometres Flown	41.4%
Available Seat Kilometres	42.6%
Passenger Tonne Kilometres	42.3%
Freight Tonne Kilometres	74.5%
Available Tonne Kilometres	49.8%

Source: World Air Transport Statistics. 1986, International Air Transport Association, Geneva, June 1987.

In all countries except the United States international scheduled air transport services tend to be dominated by one particular airline, which is recognised as the national flag-carrier. The national carriers are in most instances either wholly or partly owned by their national governments. Some countries such as Canada, France and the United Kingdom have, however, pursued a conscious policy of allowing limited entry of a second scheduled airline on long-haul routes. These airlines, in contrast to the national flag-carriers, tend to be owned by private shareholders. Also, during the past few years, a number of governments have either wholly or partly divested their shareholding in their national airline.

This chapter addresses a number of issues, namely the objectives of the airline industry, the performance of the airline industry, the stakeholders in the airline industry, the dynamics of the airline industry, competitive issues in the airline industry, the cost structure of the airline industry, the market characteristics of the airline industry and the key success factors of the airline industry.

Considerations in respect of the objectives of the airline industry are discussed because the objectives which airline management strives to achieve are major determinants of strategy formulation and implementation within an airline. In particular, airline management does not seem to be unanimous in their pursuit of the profit motive. The motivations as well as behaviour patterns of airline management have a significant impact upon the performance of the airline industry, measured in terms of the rate of return earned on capital investment. The airline industry is characterised by being relatively marginally profitable. The financial performance of an industry tends to be a major determinant of that industry's ability to attract new investment capital.

The dynamics of the airline industry is described because the dynamics of an industry is indicative of the ability of such an industry to adjust to a changing environment. In particular, the airline industry is currently being affected by changes emanating from the deregulation policies being pursued by a number of governments. The ability of airlines to adjust to a new environment of deregulation, depends crucially upon the cost structure of the airlines, as well as the ability of the airlines to satisfy the needs and requirements of consumers in the marketplace. Finally, the key success factors of the airline industry are listed.

2.2 OBJECTIVES OF THE AIRLINE INDUSTRY

Although neo-classical micro-economic theory postulates that profit-maximising behaviour drives decision-making within a business organisation, no firm should expect to pursue a set of entirely coherent objectives. According to Cyert and March (1963), a firm should not be treated as a single-goal decision-making unit, but rather as a multi-goal, multi-decision making organisational coalition. A firm is thus perceived as a coalition of different groups which include inter alia shareholders, management, employees, trade unions, customers, suppliers, financial institutions and the government. Each group pursues its own set of goals and objectives, independently, as well as inter-dependently. Whatever the nature and extent of such internal and external political and organisational conflicts, all firms should eventually reach decisions based on a set of relatively coherent goals and objectives. Ultimately, the goals of a business enterprise are decided by the firm's top management. These goals provide the strategic direction that an organisation will pursue.

An analysis of airline behaviour indicates that the strategic and operational direction of the airline industry is governed by a set of goals and objectives which may not appear to be entirely complementary and consistent (Shaw 1981,p.77). These goals and objectives appear to emanate from the realities of the internal political bargaining process, as well as the perception of the external environment by the respective decision-makers.

The multitude of objectives pursued by different airline companies consist of the following, inter alia:

- Profit maximisation
- Revenue maximisation
- Maximisation of market share
- Satisfaction of consumer needs
- Efficient resource utilisation
- Promotion of commercial and industrial development
- Employment generation
- Tourism development
- Support of a home aerospace industry
- National defence
- Minimisation of social costs

It is generally assumed that the objectives of p ivately owned airlines are based on long term financial success, expressed by profit maximising behaviour. This view, however, ignores the wider social and political concerns which may need to be taken into account by the airline management in their decision-making processes. Although many state-owned airlines are given written objectives requiring acceptable profit levels, non-profit objectives may indeed be dominant considerations for airlines operating within the ambit of the state sector. The role that governments tend to attach to their airline industries, as well as the external benefits derived from infra-structural airline operations makes the pursuance of parochial profit maximisation unlikely to be the sole and single driving force of the various industry participants. Profits are, however, vital for the continued long-term existence and growth of privately, as well as state-owned airlines.

Few airlines can pursue profitability if they are oblivious to market-share considerations. Maximisation of market-share may indeed be entirely compatible with profit maximisation. However, in respect of international aviation, governments exercise total control over market entry. An airline which does not meet national balance of payments and foreign exchange requirements by obtaining a satisfactory share of the market, runs the risk of its own national government licensing new carriers to compete with it, or even withdraw its route licence altogether.

Although consumer-need satisfaction is a major marketing consideration in an airline's operations, it is increasingly becoming a political issue. Shaw (1981,p.78) states 'there are strong emotional aspects in the demand for air travel'. Many people contend that they have a right to low-cost vacation travel, and to be able to visit friends and relatives in distant countries at affordable prices. In recent years, the consumerist movement has affected the airline business more significantly than many other industry. An airline which fails to ensure that all actual and potential segments of its chosen market are provided with services that more or less match the requirements demanded, runs the risk of competitive new entry being allowed.

Doganis (1985,p.207) asserts, that most international airlines generally lack a single overriding objective with regard to their pricing policies. Pricing policy is aimed to achieve a number of internal objectives, which may be further constrained by externally imposed objectives. The endeavour to simultaneously produce different pricing objectives may create conflicts and contradictions, which may be exacerbated by pursuing diverging objectives on different parts of a route-network. Profits may be maximised on some routes, especially those experiencing little or no competition, whilst on other routes the prime objective may be to improve market-share, or to stimulate market growth. Inevitably, within any airline, a multitude of pricing objectives will prevail at different times and in different areas of its operations.

The pursuance of profit-maximising behaviour may have a different temporal dimension in different airlines. Some airlines may be concerned with current profits, whilst others may emphasise longer-term profitability. The latter carriers may be prepared to forego profits in the short term, in order to ensure the attainment of their longer-term objectives.

Cyert and March (1963) postulate that a business enterprise is an adaptive organisation in the sense that it learns from its experience. The airline industry operates within a highly dynamic environment, which emanates from the changing nature of the economic, social, political and technological forces that have an impact on the industry. Also, the internal relationships within an airline are constantly in a state of flux. Airline management meets the challenges thus imposed by adapting and redefining the goals and objectives being pursued. Recently, a number of governments decided to privatise their hitherto state-owned airlines. This represents a major strategic re-orientation for the airlines affected and may result in a significant redefinition of the goals and objectives propagated by their management.

2.3 PERFORMANCE OF THE AIRLINE INDUSTRY

During the past thirty years, the airline industry has experienced a rate of expansion unrivalled by any other form of public transport. The rate of technological innovation has been exceptional, resulting in costs and fares declining substantially in real terms, which in turn have stimulated very rapid growth in the demand for airline services. Also, for most of that period, scheduled airlines enjoyed considerable protection from both internal and external competition. Rapidly growing demand for services and the protection given against competition, however, have not resulted in healthy profits. A few airlines did indeed manage to remain highly profitable, but the industry as a whole has only been marginally profitable (Tables 2 and 3).

TABLE 2
WORLD SCHEDULED AIRLINE' SYSTEM FINANCIAL RESULTS
(In million United States Dollars)

YEAR	OPERATING REVENUE	OPERATING EXPENSES	OPERATING PROFIT	NET PROFIT
1975	38309	37579	730	-67
1976	43400	41244	2156	825
1977	50344	47715	2629	1656
1978	58769	55669	3100	2412
1979	70755	70019	736	588
1980	87665	88294	-629	-919
1981	93013	93680	-667	-1150
1982	93292	93399	-107	-1300
1983	98330	96201	2129	-730
1984	105410	100337	5073	2000
1985	112261	108164	4097	2100
1986	123038	118547	4491	n.a.

Source : World Air Transport Statistics (1975-1986), International Air Transport Association, Geneva

TABLE 3
WORLD AIRLINE INDUSTRY RETURN ON OPERATING REVENUES

YEAR	OPERATING PROFIT	NET PROFIT
1975	1.9%	-0.2%
1976	5.0%	1.9%
1977	5.2%	3.3%
1978	5.3%	4.1%
1979	1.0%	0.8%
1980	-0.7%	-1.0%
1981	-0.7%	-1.2%
1982	-0.1%	-1.4%
1983	2.2%	-0.7%
1984	4.8%	1.9%
1985	3.6%	1.7%
1986	3.7%	n.a.

Source : World Air Transport Statistics (1975-1986), International Air Transport Association: Geneva

There is no simple explanation for the apparent contradiction between the industry's rapid growth and its marginal profitability. For the individual airline, financial success is dependent upon matching supply and demand in a way that is both efficient and profitable. Airline management has considerable control over the supply of air services, but relatively little control over the demand.

Doganis (1985,p.92) asserts that in order to achieve a profitable matching between supply and demand, it is crucial for airline management to have a thorough understanding of the fundamentals of its chosen market. An inter-relationship exists between supply and demand. Demand for an airline's services is influenced by aircraft types and speeds, departure and arrival times, frequency of services, air fares, in-flight services, as well as the quality of ground handling. Conversely, the demand will itself affect those supply features. The density of passenger demand, its seasonality, the purpose of travel, the distance to be travelled and the nature of the freight demand should influence supply and will consequently have an impact on costs. The relationship between supply and demand is described as the load factor that is achieved. Airline profitability is highly sensitive with regard to the load factor achieved. Load factors tend to vary substantially during the different phases of the business cycle, which implies that airline profitability tends to be highly cyclical.

Although the airline industry is noted for being one of the world's least profitable industries (Shaw 1981,p.71), this state of affairs apparently has not significantly constrained its ability to attract, with relative ease, sufficient investment capital. A number of theoretical arguments have been put forward in an attempt to explain this obvious paradox.

Firstly, the product life cycle theory postulates that many products experience an initial period of relatively high profitability as a result of comparatively few firms entering the market at that time, and the products still having some novelty value. Such early profits tend to attract many new firms into the industry. The development of intense competition tends to depress profitability as the industry approaches maturity. Further expansion of the industry can only be sustained by attracting investment capital to the industry with the prospect of future prosperity resulting from an expanding market. Finally, during the mature stage of the product, growth in demand slows down, and may even stagnate. Consequently, the industry may be consolidated as existing participants come together either by merger or market collusion in order to reduce the severity of competition. Under such emerging oligopolistic market conditions, profits may tend to rise to more acceptable levels.

Secondly, it is also argued that the airline industry can be sustained by a rate of return on earnings significantly lower than required by almost all other industries (Shaw 1981,p.73). This emanates from the nature of investment in the airline industry. Airlines typically tend to invest mainly in aircraft that have been produced according to standardised specifications by a relatively small number of manufacturers. Resale value of these aircraft may be more or less guaranteed, especially during periods when demand for capacity is buoyant.

In addition, airlines generally incur very few fixed costs for terminals and other airport facilities. Such facilities are paid for as user charges levied by the airport operators and the air traffic control agencies. This situation is in contrast with almost any other manufacturing industry, which would require large amounts of capital to be invested in fixed facilities that have few alternative uses, and therefore negligible scrap values. Under such circumstances, a lender of capital will accordingly face substantial losses should a business fail. The risk profile of the airline industry thus tends to be more acceptable to the investment community than many other manufacturing industries. Hence, the airline industry has the ability to attract investment capital on a long-term basis at a relatively low rate-of-return.

Thirdly, many airlines, in particular state-owned airlines, do not operate according to a set of objectives based purely on profitability measured by the return on investment. Such carriers would therefore not necessarily deem high profits to be indicative of satisfactory performance. The pursuance of a complex set of social

and national economic objectives may induce a national government to afford protection for such an airline, thereby ensuring its continued viability through either loan guarantees or subsidies.

The flexibility of the scheduled airline industry is constrained by the necessity of operating according to fixed schedules that have been planned in anticipation of a certain level of market demand. Short-term fluctuations, or even medium-term aberrations in the anticipated market demand, clearly limit the ability of scheduled airlines to maximise profits on a sustained basis. Many of these airlines operate within a regulated environment, which at least guarantees high profits on some of the routes.

Fifthly, the aircraft manufacturers have been rather innovative in designing financial packages in order to induce financially strapped airline companies to acquire new airliners. This has aggravated the financially insecure position of a number of airlines, as their debt-equity ratios have continued to worsen. The financial institutions have proved unwilling to face the consequences of pushing these airlines into bankruptcy.

Finally, it is being contended that regulation of the airline industry has been responsible for low levels of profits being achieved. Regulation tends to reduce the scope for effective competition between airline companies. Airlines have accordingly tended to concentrate their competitive efforts to an excessive extent, on those aspects where the regulator has allowed competition to continue. This in turn has resulted in a general tendency towards high costs in the industry, with these costs rising inexorably to neutralise almost all of the guaranteed revenues emanating from such regulatory efforts by the authorities.

It is argued (Doganis 1985, p.16) that the traditional measure of profitability, namely the rate of return on assets employed, may not be applicable to the airline industry as a whole. This stems from the difficulty in estimating real asset values for airlines with varied depreciation policies, using varying proportions of leased equipment and often receiving direct or indirect government subsidy in various forms. The measures of profitability normally used among airlines are either the annual operating profit or loss expressed as a percentage of the total operating revenue, or the total operating revenue expressed as a percentage of the total operating expenditure. The latter measure is known as the 'revex ratio'.

A revex ratio of at least one hundred and ten percent is deemed to be necessary for an airline to be regarded as adequately profitable, (Wheatcroft and Lipman, 1986, p.34). Such a margin is required in order to make provision for interest on loans, dividends to shareholders, taxes, and a reserve which the capital market

(debt, as well as equity markets) will consider as a reasonable self-financing contribution to the future acquisition of equipment. Few airlines though have been able to achieve such a ratio consistently over a considerable period of time.

2.4 STAKEHOLDERS IN THE AIRLINE INDUSTRY

The airline industry in general, as well as the various airline companies in particular, are governed by the actions of a number of groups of individuals and organisations, motivated by their own parochial interest in the workings of the industry. Through their diverse activities and roles, these stakeholders contribute to the dynamics of the industry.

A number of these stakeholders can be identified. They include, inter alia:

- Government in its role as guardian of the national economy
- Government in its role as regulatory authority
- Government in its role as shareholder
- Shareholders of airline companies
- Managements of airline companies
- Employees of airline companies
- Trade unions active in the airline industry
- Airport authorities
- Providers of air traffic control and navigation facilities
- Equipment manufacturers
- Fuel companies
- Financial institutions
- Travel agents
- Freight forwarders
- Consumers
- Airline trade organisations
- Competitors

Governments tend to take a keen interest in the fortunes of their airline industries because of direct, as well as indirect impact of airline activities on their national economies. In many countries the airline industry makes a major contribution to the Gross National Product. In addition, national as well as local economies derive substantial indirect benefits from the activities of airlines such as those benefits affecting the country's balance of payments, and the employment implications that stem from the purchasing power of the employees of airline companies, as well as the employees of infrastructural facilities and equipment manufacturers.

International aviation may have a significant impact on the balance of payments position in all countries. The balance of payments effects derived from air transport are, however, often so complex that a single event can produce both a positive and a negative impact.

In particular, the complexity of the impact of foreign exchange from the international commercial operations of airlines, arises from the fact that revenues may be earned and costs incurred in different currencies. In terms of balance of payments considerations, the sale of aviation equipment is also important. In particular, the USA enjoys a large balance of payments surplus and almost every other country a deficit. Aviation fuel, especially since the escalation of fuel prices during the 1970's, has been responsible for a growing negative trade contribution in all countries that are not self-sufficient with regard to oil supplies. In particular, the airline industry represents one of the major customers of multinational fuel companies.

The international airline industry has been a catalyst for the development of international tourism. Currently one of the world's major growth industries, international tourism, holds the promise of becoming the largest industry in world trade before the end of this century. This holds significant foreign exchange and employment implications for a number of national, as well as local economies. In particular, many hotel and tour operators derive their economic well-being both directly and indirectly from the activities of the world's airlines.

Air transport represents a valuable infrastructural link in the economic structure of a country, and contributes to the development of international, as well as domestic trade and commercial links, with resulting employment and economic growth being generated by the trade. Regional accessibility to remote areas is also promoted, thereby stimulating regional economic development.

As a major industry, aviation competes for resources, thereby having broadly-based consequences for other markets and industries in the general economy. High consumption of aviation fuel for instance may have an impact on the prices of other petroleum based products. Also, state-owned airlines in particular, tend to be dependent upon their national governments for investment funding. The use of such investment cash for airline finance implies that it is not available for use elsewhere, and this may be contrary to public policy considerations. Indeed, if investment cash is used for the import of foreign aircraft, in a sense it represents a drain on the national economy.

The aviation industry is a competitor for land resources because of the size of modern airports, these tend to be located close to cities where land is a scarce commodity in the truest sense. In most countries, the provision of airport facilities tends to be the responsibility of national or local governments. Whenever airlines

formulate their marketing strategies, the implications of these strategies for the airport and air traffic control facilities must be fully taken into account. Lead times for new investments by airlines tend to be relatively short. In contrast, lead times for new investments by air traffic control, and especially airport operators, have been known to extend over periods of several years or even decades before such investment plans have been brought to fruition. Moreover, in recent years, new airport developments have been constrained by the actions of ecological pressure groups.

A country's inhabitants may find their national security enhanced by its air transport industry.

Many nations also perceive their image and prestige to be enhanced by its airline industry, as is evidenced by airlines operating on routes purely for the sake of flying the flag.

The significance of the airline industry for the general economic well-being of a country has led many governments to institute regulations on the domestic, as well as international operations of their airlines. In particular, within the international arena, airlines are directed to actively pursue public policy considerations as dictated by their national governments. This may include aspects such as actively supporting a foreign trade campaign or strengthening cultural relations by operating routes which may not be profitable. Domestically, governments may exercise their regulatory authority by restricting entry into the market. This provides protection to an incumbent airline, but also reduces the dynamism of a developing industry. Moreover, a regulatory regime reduces the scope for management action and managerial discretion.

The role of management in an organisation is manifold. It includes inter alia tasks such as:

a. To set the goals, objectives and strategy of the firm;
b. To seek out a competitive strategic advantage for the business
c. To identify all internal and external stakeholders whose actions may have an impact strategically or otherwise on the organisations;
d. To recognise and resolve the conflicting interests between the various groups within an organisation;
e. To reconcile the conflict within the goals and objectives of the business enterprise and the interests of the individual groups;
f. To take decisions in order to implement the set strategy.

Within the framework of the airline industry, the roles of management must be exercised within the guide-lines set by an airline's shareholders. In the United States, various airlines are owned by private investors, and the shares of the major airlines are actively traded on the New York Stock Exchange. In contrast,

TABLE 4
AIRLINE OWNERSHIP PROFILE

AIRLINE	NATIONALITY	STATE HOLDING
Aer Lingus	Eire	100.0%
Aerolineas Argentinas	Argentina	100.0%
Air Canada	Canada	100.0%
Air France	France	99.4%
Air New Zealand	New Zealand	100.0%
Alitalia	Italy	66.6%
American Airlines	USA	0.0%
Ansett Airlines	Australia	0.0%
Australian Airlines	Australia	100.0%
Austrian Airlines	Austria	99.0%
British Airways	United Kingdom	0.0%
British Caledonian Airways	United Kingdom	0.0%
Canadian Airlines	Canada	0.0%
Cathay Pacific	Hong Kong	0.0%
Delta Air Lines	USA	0.0%
El Al	Israel	100.0%
Finnair	Finland	76.1%
Iberia	Spain	99.8%
JAL	Japan	0.0%
KLM	Netherlands	39.4%
Lufthansa	Germany	75.0%
MAS	Malaysia	52.0%
Pan Am	USA	0.0%
Qantas	Australia	100.0%
Royal Air Maroc	Morocco	92.7%
SAA	South Africa	100.0%
SAS	Scandinavia	50.0%
Singapore Airlines	Singapore	55.5%
Swissair	Switzerland	23.1%
TAP - Air Portugal	Portugal	100.0%
TWA	USA	0.0%
United Airlines	USA	0.0%
USAir	USA	0.0%
UTA	France	0.0%
Varig	Brazil	0.0%

Source: Interavia. October 1987

most of the international airlines outside the United States, especially those designated as national carriers, are partially or wholly owned by their national governments (Table 4). Recently, however, several government have decided to shift their national airlines from the public sector into the domain of the private sector.

Private shareholders generally require that a business enterprise be managed with a view to increasing shareholder wealth. Although governments as shareholders may have similar motivations, there exists an irresistible temptation to employ shareholder power in order to strengthen a government's political

agenda. The trend towards privatisation in the airline industry may thus result in management needing to redefine their role on the basis of the aspirations of new shareholders.

Despite appearances to the contrary, brought about by the substantial capital requirements of the airline industry, almost all airlines are characterised by being markedly labour intensive. It is estimated that nearly two and a half million workers are employed directly by the world's airlines. Airline employees tend to be highly unionised, and Shaw (1981,p.55) states that:

> 'Airports have always proved suitable places for the development of intensive trade unionism. This has been due to the large numbers of people working in close proximity and the power possessed by many groups within airlines to shut down operations.'

In those countries where free wage bargaining prevails, the interaction between the supply and demand for the various categories of labour required by an airline, together with the strength of particular unions, will broadly establish the airline's various wage levels. In other countries wage levels may be set by national agreements between governments, or employers' associations and the trade unions, whilst in some cases governments themselves virtually dictate the wage levels to be paid and impose them on employers and employees alike. Negotiations between airline management and trade unions on wage related matters do take into account the prevailing wage levels in the country concerned.

Doganis (1985,p.95) states that an interesting by-product of deregulation in the United States was the way in which largely non-unionised airlines undermined the power of established airline unions, including the pilots' union. The new carriers had no trouble in finding employees willing to work at much lower salaries and under stricter working conditions. Established carriers were forced to either induce their employees to accept wage cuts, which were indeed effected by several airlines, or to introduce a two-tier wage structure whereby new employees were taken on at much lower salaries than existing ones. Both options contributed to deteriorating industrial relations between management and their employees in some airlines.

An airline can obtain capital from a number of sources. Internally, an airline company's sources of finance include retained profits, depreciation, and tax deferrals, whilst externally it can obtain debt finance or near debt finance such as leases and equity finance from the stock market.

Airlines would generally prefer to be self-financing, but may only be able to do so to a limited extent due to the huge amounts of capital required for re-equipping aircraft fleets. The benefit of equity finance is that an airline need only pay

TABLE 5
AIRLINE EMPLOYEES : 1986

AIRLINE	EMPLOYEES
Aer Lingus	6000
Air Canada	22234
Air India	17458
Air New Zealand	7484
Alitalia	20433
American Airlines	51700
Australian Airlines	8671
British Airways	38939
British Caledonian	8899
Cathay Pacific Airways	7656
Delta Air Lines	38801
Finnair	5435
Iberia	22152
Indian Airlines	20192
Japan Air Lines	20367
KLM	20262
Korean Air Lines	10000
Lufthansa	37920
Malaysian Airline System	10798
Northwest Airlines	33427
Pacific Soutwest Airlines	5347
Pacific Western Airlines	2725
Pakistan International Airlines	19000
Pan Am	21599
Qantas	12501
Scandinavian Airlines System	19773
Singapore Airlines	10270
Swissair	17657
Trans World Airlines	27442
United Airlines	59000

Source: Gilbert, T., International Airline Industry: A Survey of Corporate and Financial Reporting. Ernst & Whinney International, 1987

dividends if a profit is made. Most of the international airlines outside the United States are government-owned. Governments have, however, been loath to invest new equity capital to finance aircraft acquisitions. Private shareholders have also been hesitant because of the poor financial performance of the airline industry.

According to Doganis (1985,p.8), two developments enabled the airline industry to acquire new sophisticated aircraft.

a. Aircraft manufacturers became increasingly involved in raising capital for their customers, either through commercial banks in their own countries, or through special export trade banks such as the United States Export-Import Bank. Manufacturers vigourously competed with

each other to devise more attractive financing packages for their clients. The terms of such purchase loans became increasingly important for airline management when deciding upon aircraft types.

b. Consortia of banks purchased aircraft which they in turn leased to the airlines. These consortia enjoyed tax concessions, whilst also retaining ownership of the aircraft.

In recent years, the debt-equity ratio of many airlines has continued to deteriorate as a result of their increasing dependence upon external debt to finance aircraft purchases. A number of airlines consequently find themselves currently under-capitalised and in need of an injection of equity capital in order that their interest burden can be kept within manageable proportions. Financial institutions have, however, also preferred to reschedule such loans rather than to force airlines into bankruptcy and as a result be left with aircraft that cannot be easily sold.

The increasing reliance on debt finance may, however, have been a mixed blessing for airlines concerned. It induced airlines to invest when they ought to have pursued an austerity policy, which resulted in many major airlines becoming heavily over-indebted. When traffic growth forecasts did not materialise, these airlines were incapable of servicing their huge debts. Several carriers, such as Braniff and Laker in 1982, collapsed suddenly as their creditors ran out of patience and refused to reschedule debt repayments.

The production of equipment for the airline industry constitutes one of the world's major manufacturing industries. Manufacturers of airframes and aero-engines, as well as electronics and avionics producers concerned with air traffic control and air navigation systems derive their fortunes almost entirely from the air transport industry. Moreover, this industry is dominated by a relatively small number of firms and production is concentrated in a few industrialised, developed economies. The high technological nature of such production, combined with the employment of labour and the foreign exchange generated by firms such as Boeing and Airbus Industrie makes this industry highly susceptible to interference from and directives issued by national governments.

The distribution channel for airline services is dominated by travel agencies and freight forwarding agencies. World-wide, more than seventy percent of all international airline tickets are sold through agents. Travel agencies can offer a number of services in a very cost-effective way which is invaluable to both the providers and the users of airline services. Agents save airlines large sums of money through reservations and ticketing procedures. They also allow airlines to carry out their selling activities at a lower cost because they reduce the extent to which a carrier requires to establish and operate ticket offices. The advantage

that a travel agency has over an airline is that it can sell tickets on behalf of all airlines, tour organisers, and others willing to appoint it as an agent for their services. The air travel consumer is provided with a personalised source of airline tickets (and packaged holidays) and is able to go to a single location and make a selection from a comprehensive range of travel products.

Freight forwarding agencies control the distribution channel for air freight services to an even greater extent. Freight forwarding agents are able to offer a door to door service, which airlines would only be able to equal if they were willing to invest in a widespread road transport infrastructure. The air freight industry does not generally enjoy a competitive advantage over surface transport, especially over shorter distances. Freight forwarding agencies are consequently in a position to offer freight transport service that encompasses different modes of transport, thus enabling customers to choose a most suitable mode.

The control that agencies exert over the distribution channel for airline services is becoming an increasingly controversial issue. The extent of commissions payable to agents increasingly brings the role of agents into question.

The role of the travel agent, and the structure of the travel agency industry, is currently undergoing significant changes. In recent years, technological developments, particularly in the field of direct access to airline reservations computers, have fundamentally threatened the role of the agent. A series of airline product developments such as the shuttle concept and standby ticket, have contributed to diminishing the role of the agent in selling.

Consumers of air transport include air passengers, as well as shippers of air freight. The desires of consumers are manifold. The major interests of consumers concern the availability of a safe airline product at a reasonable price, which more or less meets their needs. In recent years, it has become evident that consumer groups are increasingly vociferous in their opposition to the airline industry. The consumerist movement has consequently exerted more pressure on the airline industry than on many other industries, mainly because emotional demands for cheaper airline travel tend to enjoy universal appeal.

Since the inception of the airline industry during the early part of this century, the significance of various segments of the air transport market has been fundamentally transformed. In the early days, air postal services dominated, whereas in the aftermath of the Second World War, the business travel segment became dominant. Recently, the leisure travel market has become an increasingly important market segment. These developments are as a result of the enormous social, economic and technological changes that occurred during the twentieth century and contributed to the dynamics of the airline industry. The air transport industry is, however, still growing which means that there is a large group of

unexploited potential consumers. These people have a desire to use airline services, and are willing to pay a reasonable price in order to do so. However, the correct type of airline products and services have yet to be made available to them.

Airlines have organised themselves into a number of airline trade organisations, one of them being the International Air Transport Association (IATA). IATA has been, and to some extent still is, an extremely controversial organisation, mainly because of its role in establishing international air fares. IATA has consequently become the symbol of international air transport regulation. In recent years, the influence of IATA has declined considerably, resulting in its role being redefined to include aspects such as cooperation of a more technical nature. The clearing house services of IATA is also extremely valuable to the airline industry in the sense that it facilitates interline travel between different airlines.

The International Civil Aviation Organisation (ICAO), is a branch of the United Nations Organisation which concerns itself with the more technical aspects of international aviation, such as air navigation facilities. It accordingly formulates policies and standards of a technical nature which airlines of the world are required to adhere to.

The nature of competition within the airline industry is changing as pressure to deregulate the airline industry mounts in different countries. Full-scale competition between various airlines is however, constrained due to a number of factors such as restrictions on foreign shareholding which hamper the emergence of truly global airlines; the international airline industry being seen by many governments as an instrument of foreign policy; state shareholding in airline companies; and in some instances a lack of trust in the market as a mechanism for allocating scarce resources. The trend, however, is for competitive forces to become more intense as an growing number of countries are either pursuing or propagating an 'open skies' air transport policy.

2.5 DYNAMICS OF THE AIRLINE INDUSTRY

Developments in the air transport industry have continued to fundamentally restructure the strategic and operational relationships within the industry. The economic, social, political, technological and competitive environments in which the airline industry operates, have in recent years been in a constant state of flux. This dynamic is evolving new strategic opportunities, but at the same time presenting the industry with a host of strategic threats. As a result, the economics of the industry are consequently continuously being redefined, and airlines are being presented with the challenge to strategically and operationally adjust their internal and external relationships.

It has been observed in many industries that costs follow a downward trend during the transition from an infant to a mature stage. The Boston Consulting Group found that, 'every time the cumulated experience in manufacturing a given product doubled, the total unit value added cost, expressed in real terms declined by a constant and predictable percentage.' (Robinson 1986, p.168) This phenomenon is known as the experience curve. This effect has also been present in the airline industry and has contributed to fundamentally changing the economics of the industry.

Unit cost levels, within the international airline industry, displayed a consistently and very pronounced downward trend over a long period of time. During the past four decades technical changes and innovation in aviation have been progressing at a pace equalled in few other industries. In the context of operating costs, the impact of such technological advancement has been phenomenal.

Cost reduction as a result of technical progress resulted from a number of sources:

a. The change-over from piston to turboprop and jet propulsion resulted in a considerably improved consumption of fuel. Bearing in mind that fuel represents a major input cost for the airline industry, these technical developments had a significant impact on the economics of the industry. In addition, new propulsion technology, it is claimed, will offer fuel saving of between twenty-five to thirty percent over technology currently being employed.

b. Maintenance costs have also been reduced because turbine-powered aircraft can be maintained at costs well below piston-engined airliners. Moreover, a lower frequency of maintenance is required.

c. The increasing range capability of aircraft has also resulted in a reduction of costs associated with intermediate stops.

d. The increasing size and productivity of aircraft has contributed most significantly to reductions in unit cost levels. In particular, many of the costs associated with aircraft operations do not rise in proportion with aircraft size.

Technological developments in aviation, whilst beneficial in terms of their impact on operating costs and safety, also pose some serious problems. New aircraft were often introduced in response to competitive pressures from other airlines. These newer airliners were often larger, and flew at higher speeds, resulting in a

strong downward pressure on load factors in anticipation of market growth. Also, whilst operating costs per capacity tonne kilometre were falling, the capital costs for acquiring these new aircraft were escalating very rapidly.

The extremely rapid development of aviation technology since the Second World War has not only succeeded in dramatically reducing unit costs, but also in creating new market opportunities. These market opportunities resulted from the fact that larger payloads (passengers and freight) could be carried faster and at reduced costs by successive generations of airliners. This lower level of costs, translated into a reduction in the level of fares and tariffs in real terms, as well as the rising level of general prosperity in the economy as expressed by real per capita income, resulted in very rapid growth of the air transport industry. During the past twenty-five years, the industry's output has increased nearly twenty-fold.

The post-war period has also seen a fundamental structural change in the composition of the air travel market. Whereas business travellers in previous years constituted the major market segment, price and income-elastic leisure travellers dominate nowadays. In 1950, less than twenty percent of all passengers on world airlines were travelling for pleasure. It is estimated that by the end of this century more than ninety percent of all passengers will be travelling for pleasure related reasons. This development represents a major dynamic for the airline industry in the sense that this huge leisure market segment will exert pressure on governments world-wide to deregulate the airline industry, thereby resulting in air travel becoming increasingly competitive.

Social and economic philosophy emerging during the 1980s has been the political consensus of reducing government intervention in the working of the economy. Shaw (1981,p.103) states that:

> 'The airline industry, given both its intrinsic importance and its emotional appeal to many people, was always likely to be a prime target for the deregulator's attention.'

The recent trend towards privatisation of the airline industry in a number of countries is evidence of this new political environment.

Throughout its history, the geographical distribution of growth in the demand for air transport services has been highly uneven. In recent years, the long-established markets of the United States and Europe have seen their airline industries expanding at a somewhat slower rate. In contrast, within the countries of the Pacific rim, reflecting higher levels of economic development, airline services have been expanding at a particularly rapid pace. It is consequently expected that during the next decade, the relative significance in global terms of North Atlantic routes will decline substantially in favour of Pacific routes.

Rapid development of information technology is contributing to fundamentally alter strategic and operational relationships within the airline industry. The increasing automation of activities such as reservations, ticketing, schedule planning, pricing and distribution, is enabling airlines to cut costs and improve productivity. It is generally recognised within the airline industry that sophisticated computerised reservation systems currently being developed and expanded by some airlines, are major strategic tools that will enable these airlines to effectively control the distribution channel for airline services. The physical purchase of tickets will also change dramatically. Use of computers to sell tickets will allow the airlines to control the distribution channel more closely by taking these services out of the airport and travel agencies and placing them closer to their various customer groups

A major strategic threat to the airline industry is the question of security. Key questions in this connection are whether the concern for terrorism could dampen long term demand for flying, and whether the intensive security controls being imposed will impede prospects for opening new routes.

A recent development, particularly in the United States, has been the development of mega-airlines, i.e. very large airlines created either through mergers and acquisitions, or to a lesser extent through high rates of internal growth. The objective of forming these mega-carriers has been mostly to reduce competition within a deregulated environment, and also to be a stated objective to compete more effectively within a global context. It is not expected that a full-scale global airline will emerge during the next few years as most, if not all, governments are intent on pursuing a parochial nationalistic aviation policy with regard to international air transport.

2.6 COMPETITIVE ISSUES IN THE AIRLINE INDUSTRY

The freedom of action in the air transport industry is circumscribed by a unique regulatory environment. Regulation of air transport operations can be defined as the purposeful attempt by governmental authorities or their appointed agencies to ensure that certain objectives are being met, which might not be achieved under the operation of market forces. Regulation consequently constitutes government intervention in the working of the airline industry, thereby fundamentally influencing the economics of the industry. Lissitzyn (Shaw, 1981) asserts:

> 'Probably no other world-wide economic activity of comparable magnitude is more thoroughly regulated, less free of official restraint and guidance, than is world air transport.'

The advanced level of aviation technology, the need to ensure passenger safety, as well as the international nature of much of the airline industry, have all favoured introduction and development of a more complex and wide-ranging regulatory regime than those found in most industries.

Airline regulations are broadly of two kinds. Firstly, there is a whole host of technical standards and regulations, the prime objective of which is to achieve very high levels of safety in airline operations. Secondly, international air transport is governed by a multitude of national, bilateral and multilateral regulations and agreements whose objectives are the economic, and on occasion, the political regulation and control of the industry.

Technical, or non-economic regulations include aspects such as:

a. Aircraft airworthiness in terms of its design and production standards, and also in terms of its performance under widely different operating conditions.

b. The quality of maintenance and overhaul work, as well as the training and qualifications of the engineers responsible for such work.

c. The number and type of flight and cabin crew, their duties, training, licensing, work-loads and schedules.

d. Flight preparation and in-flight procedures.

e. Aviation infrastructure such as airport facilities, meteorological services and en-route navigational facilities.

Air transport has always been considered to have unique safety issues. Regulation of markets that restrict entry to those firms which can demonstrate their ability to operate according to generally accepted safety standards has been and remains non-controversial. However, an opinion exists that a high degree of competition is in itself dangerous as airlines would tend to neglect appropriate aircraft maintenance. An argument to the contrary states that airlines have a strong commercial self-interest in safe operation.

Technical standards and safety procedures tend to raise the cost structure of airline operations. Such controls are however, essential for maintenance of high safety standards. Significantly though, all airlines are more-or-less equally affected since there is very little potential for circumventing national or international safety regulations for any substantial period of time.

Economic aspects of the regulatory regime governing the international airline industry have remained largely unchanged over an extended period of time. Such economic regulation has been based upon bilateral air services agreements negotiated between governments regulating the exchange of traffic rights, inter-airline agreements controlling capacities and frequencies and tariff agreements negotiated within the IATA framework. The significance of these economic controls, unlike the technical standards outlined above, is that all airlines are not affected equally.

From a marketing point of view it may be perfectly correct for management to support the imposition of regulatory control over an industry if it is felt that such regulation will be to its advantage in meeting corporate objectives. Therefore, in many instances, the support for regulation, which has come from a large part of the airline industry, may have been entirely correct. However, in supporting a regulatory framework for the airline industry, airline management has brought upon itself two important consequences. Firstly, competitive opportunities against rival airlines have been sharply reduced. Secondly, management has lost its freedom to respond quickly to changing market conditions as regulations have been based on the twin processes of inter-airline ...er-governmental negotiation and compromise.

Economic regulation has constrained freedom of action of individually scheduled airlines in a number of ways:

a. Airlines generally do not enjoy freedom to access markets and routes at will, thereby making the airline dependent on action and support from its national government in order to obtain the necessary traffic rights. Government action though, is directed by national policy considerations which may not necessarily conform to the interests and objectives of the airline concerned.

b. The level of output or production of an airline may not be entirely at the discretion of its management. Production may be limited either through provisions contained within bilateral agreements circumscribing capacity, or through inter-airline agreements on revenue sharing and capacity. Either airline within a duopolistic market environment may be unable or unwilling to increase their own capacity, thereby vetoing the other airline's expansion plans. Such action is normally supported by its respective national government. Shaw (1981,p.97) notes that, 'the all-embracing nature of bilateral agreements mean that marketing in scheduled airlines' international services has been carried out in an environment of government regulation which is tighter than that facing any other major world industry.'

c. Regulation has impinged on pricing as a marketing decision. The aim of the imposition of many regulations has indeed frequently been to reduce price competition amongst industry participants. Within the international environment, tariffs have traditionally been set as a compromise within the multilateral framework of IATA. Also, governments generally have the responsibility of approving or disallowing all domestic and international tariffs. Airline pricing is thus subject to a multitude of political considerations.

d. Other aspects of economic regulation include such diverse aspects as the type of service provided, the quality of cabin service which might be offered, as well as the type of equipment which might be operated.

e. In some instances, the elimination of competition is taken to the ultimate degree by an insistence that carriers should operate a pooling agreement, whereby at the end of each year revenues, costs or profits are shared out according to an agreed formula.

Economic argument in favour of regulation of both international and domestic air services, is based upon:

a. The market for air transport services is characterised by the presence of strong oligopolistic tendencies. Such an oligopolistic market structure emanates from the industry's peculiar cost structure which displays a relative lack of economies of scale, as well as the nature of the airline product being relatively homogeneous. An absence of an appropriate regulatory regime would consequently lead to wasteful competition as new entrants are tempted to establish themselves by undercutting fares. A price war with adverse consequences would accordingly result.

b. A second economic argument in favour of the economic regulation of the air transport industry, is based upon the notion that the industry is a public utility, or at least a quasi-public utility. External benefits arising from civil aviation are assumed to be not only of an economic, but also of a strategic, social, as well as political nature. The industry needs to be regulated accordingly in order to ensure that such benefits are not jeopardised. In addition, the airline industry plays a significant role in promoting regional accessibility within a country, in providing the essential communications for international trade and commerce, and, through air freight, providing the physical means by which an increasing amount of trade can be accomplished.

The public utility nature of the air transport industry has, rightly or wrongly, been considered so important that most countries have concentrated on developing one major scheduled operator, usually with direct government participation. The same carrier often operates domestic services and acts as the designated foreign carrier. These countries have tried to avoid conflict between private commercial needs and 'national interest' by having a monopolistic structure in air transport, with a strong direct or indirect government influence on the national airline. It was, and still is, a natural extension of this point of view to believe that free and unregulated competition on international air routes would endanger national interests because of the possibility of adversely affecting the national airline.

c. The public service features in operating a scheduled air transport service impose costly obligations on the airlines concerned. This aspect makes the scheduled airline industry particularly vulnerable to price competition from airlines not committed to operating according to fixed schedules.

It is argued that free competition may result in scheduled services being undermined. Demand for airline services is highly variable in respect of time of day, day of week, as well as month of year. In the absence of regulatory controls, it is thus plausible that routes may tend only to be well served at peak times when many carriers perceive opportunities for worthwhile participation. During off-peak periods, however, service may tend to be discontinued, resulting in no true scheduled provision, and in particular a degree of inconvenience to all those wishing to travel outside peak periods.

Within a regulated environment, scheduled services can be guaranteed by affording protection from competition for a limited number of airlines on the explicit understanding that regular, reliable year-round service would be offered. High returns earned during periods of peak demand should compensate for losses incurred during periods of relatively slack demand, thereby ensuring an overall profitable operation.

d. The theory of perfectly competitive markets not only requires freedom and ease of entry, but also freedom of exit in order that loss-makers may leave the market to more efficient carriers. In practice, on international air routes, the loss-makers tend to continue operating in spite of losses incurred. State-owned airlines may receive direct subsidies or government guarantees to enable them to raise further

loans, allowing such unprofitable airlines to stay in business. Even if privately owned, the losses incurred by unprofitable airlines might be mitigated by selling off non-airline assets.

e. It has been suggested that regulated market conditions would more likely ensure the existence of a wide route network than free competition would. It is argued that in a regulated environment, market entry will only be granted to a limited number of carriers if market potential is deemed to be limited. These airlines might then be able to enjoy reasonable traffic levels and to exploit such available economies of scale. Free market conditions on the other hand, may tend to encourage a large number of carriers to enter a particular route or market. Costs may be forced up as carriers duplicate investments such as those in ground handling facilities. The available traffic may also be shared rather thinly between the competing airlines. A plausible consequence might then be that all carriers would find it impossible to maintain a viable profitable operation, resulting in the abandonment of the route.

Regulation may also provide a solution to the problem of maintaining an air transport service on thin routes, which is unlikely to be profitable, even for efficient airlines. If market entry is restricted on dense routes, thereby enabling airlines which are granted entry to earn abnormally high profits, it is argued that regulators may then be able to insist that such airlines also operate some unprofitable routes, on a basis of cross-subsidisation. Regulation would thus tend to ensure the development and maintenance of an air transport infrastructure according to the political, social and economic objectives of a national government.

f. The airline industry still exhibits some of the features of an infant industry. These are manifested in the existence of substantial differences in efficiency and competitive ability between industry participants. The wide array of social and economic influences emanating from air transport is a strong motivating force for a country, with a relatively weak national airline, to impose a regulatory regime in order to protect its national interests.

g. Weak nations have tended to regulate airline competition, and also, directly or indirectly, to subsidise their flag-carrier's operations. Airlines from more powerful countries have consequently complained that they face unfair competition from both subsidisation and edicts from governments placing pressure on their citizens to use the

national airline. The result has almost always been an acceptance of regulated competition being the best compromise achieved under these circumstances.

Economic regulation of the airline industry has elicited criticism on a number of grounds. These include inter alia, the following:

a. The convenience of a scheduled product is only really needed by business passengers and those travelling on urgent family matters. The needs of the market segment that consists of leisure travellers and holiday-makers, may indeed be better served by low prices rather than a high degree of scheduled convenience. Shaw (1981,p.92) concludes that, 'a decision to regulate air transport in order to protect scheduled services is therefore a value judgement that the interests of one section of the travelling public should be placed before those of another.'

b. Regulation of international airline operations has resulted in large amounts of airline marketing resources being spent on co-operative discussions with other airlines, whereas it might be argued that the airlines' marketing activities should rather have been focused on planning, developing and selling their products in order to attain a competitive edge. Also, the all-pervasive practice of concluding pool agreements, has tended to consume large amounts of executive time. An airline however, still needs to attain a superior competitive position in order to strengthen its negotiating stance at annual pool discussions.

c. Regulation may not have had the effect of significantly reducing the extent to which airlines compete. Many airlines are guided by corporate objectives which demand achievement of competitive success against their rivals. A consequence of regulation has therefore been the redirection of competitive effort to those areas such as cabin service and promotional expenditure where competition has remained possible. Revenues that are ensured by regulated prices have been used to pay for evermore costly non-price competition.

d. Regulation of the airline industry has resulted in blunting airline initiative in respect of responding to emerging market opportunities, particularly in those instances where an airline has enjoyed monopolistic protection. Regulated air transport markets consequently display a lesser degree of dynamism than deregulated markets, as is evidenced by the experience of the United States airlines since deregulation.

e. Imposition of a regulated environment may have resulted in a less than efficient allocation of scarce resources because airlines may have been less responsive to changing market signals when afforded protection from competition.

f. An economic analysis of market structures indicates that certain costs emanate from the imposition of regulation of markets. In particular, the ban on new entrants has led to higher costs as suppliers of labour and other services, such as airport and air traffic control facilities, have bid away the monopoly rents that protection from competition confers on airlines.

g. Regulation is administratively cumbersome and costly.

The regulated environment in which the post-war airline industry has been operating, has brought about a number of beneficial consequences:

a. It has provided a stable basis for the progress of the industry from its earliest stages to its current level of development.

b. Bilateral agreements have continued to provide a pragmatic basis for air services to operate between countries where the competitive strengths of the airlines in the two countries are fundamentally different.

c. Regulation has enabled airlines to meet the needs of the segment of their market consisting of business travellers and those flying on urgent personal matters.

d. Regulation has brought about a consistency of services.

e. Regulation has promoted a comparative simplicity of fares and easy interline arrangements as a result of all airlines working with a single, commonly-agreed tariff.

f. The widespread existence of revenue pooling agreements, which theoretically at least, have enabled airlines to schedule flights at off-peak times without fear of losing revenue to their competitors.

g. The high fares charged to business and urgent personal travellers have enabled airlines to offer large capacity, thereby facilitating the availability of seats, whenever required.

According to the economic theory of perfectly competitive markets, products are required to be of a homogeneous nature. New suppliers should be able to enter and exit the market with relative ease, and be able to operate without price or capacity controls constraining their operations. The said theory also requires that consumers ought to be fully aware of prices being offered by different suppliers.

The homogeneous nature of the airline product has a number of consequences for airline operations:

a. In competitive markets, airlines are induced to make costly efforts in trying to differentiate their product from their competitor's products. This is done, inter alia, by introducing new aircraft types, increasing frequency of service, spending more money on in-flight catering and by advertising extensively.

b. The emergence of entirely new airlines or the incursion of new airlines on existing routes is facilitated.

Theoretical arguments put forward by protagonists of deregulation, are based upon the potential existence of a perfectly competitive market for airline services. Airlines would primarily compete in terms of price, but also in terms of frequencies, departure times, in-flight services, as well as cities served. Airlines that were inefficient, either because they were unable to capture sufficient market share or because their costs were too high in relation to the prevailing tariffs, would make losses and withdraw from the market. The more efficient, low-cost airlines would remain in the market operating at tariffs that were lower than those in pre-competition days, but were nevertheless profitable. Even if only one or two airlines remained, they would be inhibited from increasing tariffs in order to obtain excessive profits for fear of new entrants coming onto the routes. In this competitive environment, consumers would be better off. They would enjoy lower tariffs and a wider range of services and product features.

Deregulation of the airline industry has, since the mid-seventies, been included in the political agendas of a number of governments, particularly the United States, and more recently the United Kingdom, Japan, Canada, Australia, New Zealand and interestingly enough the People's Republic of China as well. Although deregulation is mainly restricted to the domestic operations of the respective countries' airlines, attempts have also been made to promote competition on international routes. International airline operations are, however, a highly contentious political issue, and few governments, if any, will allow free competition when its national airline might be hurt by such competition. In international markets, regulation remains based fundamentally upon the granting of traffic rights under the strictly controlled conditions of international bargaining.

Arguments in favour of a reduced level of regulation of international air transport operations tend to ignore the realities of parochial national self-interest. Shaw (1981,p.109) notes:

> 'Aviation has always been an intensely political industry in which nations have acted to protect their own interests. It is probable, therefore, that, once reduced regulation has had several years for its long-term effects to become apparent, those nations whose airlines are shown to be losing under the new freedom will change their policies. They will either try to halt the process by a re-imposition of regulation, or else bolster their airline by subsidisation.'

In the vast majority of international airline sectors, competition is limited to the designated national carriers of the two countries involved. In a limited number of instances, one or more, fifth freedom carriers may be licensed to operate on a particular international route, but in most cases these airlines only supply a relatively small proportion of the total capacity available.

The duopolistic market structure of most international markets has created a strong incentive for formal or informal agreements amongst the duopolists, to share out the market. This is achieved by the wide array of pooling agreements between airlines. Where one of the two competing airlines is much weaker or smaller than the other, pooling is a mechanism that guarantees the share of capacity and revenue of the weaker airline. In those instances where neither of the two carriers enjoy an obvious competitive advantage over the other, pooling is a way of pushing up load factors by restricting the amount of capacity and frequency offered. Consequently, costs are reduced and schedules rationalised. In the absence of pooling agreements, competing airlines tend to concentrate departures at peak periods of demand, whereas if all revenue were shared, airlines might be willing to operate some flights at less attractive times. Pool partners can collectively plan their schedules in order to offer a good range of departure times throughout the day. This practice seems to benefit passengers and tends to stimulate demand.

The emergence of consumerism as a very vocal political force in many countries, combined with the development of tourism as a major world industry, is likely to ensure that the regulated regime of airline marketing activity will in future be very different from the tightly controlled regime of the past. All trends, however, do not point in that direction. Arguments in favour of the re-imposition of regulation have recently become increasingly voracious in the United States, mainly as a result of the increasing concentration of the United States airline industry, and the declining levels of service particularly with regard to the on-time performance of the American airline industry.

In those instances where airlines operate in both liberalised and highly competitive markets, problems may occur in the competitive markets because those airlines may be tempted to utilise the excess profits earned in regulated markets to strengthen their competitive position against their rivals, as they do not have access to the profitable regulated markets.

The future of a deregulated airline industry is dependent upon a number of critical conditions:

a. Stable world economic conditions, thereby ensuring that participating airlines enjoy reasonable financial health.

b. The ability of airports and air navigation facilities to handle the ensuing incremental traffic.

c. The existence of a political consensus that deregulation will afford benefits to the national economy.

d. The ability of the airline industry to sufficiently meet demands of the various market segments in respect of quantity, as well as quality of service provided.

e. Declining equity participation by governments in their national airlines as is evidenced a world-wide trend towards privatisation in the airline industry.

2.7 COST STRUCTURE OF THE AIRLINE INDUSTRY

The cost structure of the airline industry is influenced by a multitude of factors which may be grouped into three broad categories on the basis management's ability to exercise control over them:

a. Prevailing wage levels, fuel prices and airport and navigation user chargee are generally assumed to be beyond the control of an airline's management. An airline must accept these as more or less given, and may only marginally mitigate their impact through negotiations with unions or fuel suppliers.

b. The geographical location of an airline's home base, the bilateral air service agreements signed by its government, the traffic density on its routes and other such factors will strongly influence the type of aircraft required and the network to be operated. Although an airline's management may exercise some discretion in the choice of the type of

aircraft used and the route network operated, management is only able to influence cost levels emanating from these factors to a limited extent.

c. Management has more-or- less total control over costs incurred through its marketing activities and financial policy. In particular, managerial efficiency and effectiveness are significant cost determinants, and are crucial in the sense that they determine the degree to which the impact of the other factors mentioned above, whether favourable or unfavourable, can be modified for the benefit of the airline concerned.

For most international airlines, wage costs represent between twenty-five and thirty-five percent of their total operating costs (Table 6), although this figure is lower in many Third World airlines. Since wages represent a high proportion of total costs, variations in the average level of wages paid have a direct effect on an airline's total costs, and may also lead to appreciable cost differences between airlines. However, salaries and wages paid by an airline depend primarily on prevailing salary levels and the labour market in its home country rather than on the negotiating skills of the airline's personnel department.

TABLE 6
LABOUR COST AS A PROPORTION OF TOTAL OPERATING COSTS 1986

AIRLINE	%
British Airways	23.9
KLM	33.5
Lufthansa	32.1
Singapore Airlines	19.3
Swissair	38.6

Source: Airline Annual Reports

A number of institutional arrangements exist whereby airline wage levels are determined. In some countries the interplay between supply and demand for various categories of labour required by an airline, together with the strength of particular unions, will broadly determine the level of wages. In other countries wage levels may be set by national agreements between the government or

employers' associations and the trade unions, whereas in some instances governments themselves virtually determine the levels to be paid and impose them on employers and employees alike. In all cases the prevailing wage levels are related to the standard and cost of living in the country concerned.

The ultimate cost of labour depends not only on the wage rates paid, but also on the productivity of that labour. Airline productivity is a highly complex issue dependent upon institutional factors such as working hours per week, maximum duty periods for flying staff, as well as upon operational factors such as size of aircraft, stage length and frequencies operated. Within these constraints, the role of management is to achieve as high a level of productivity as possible amongst its various groups of workers.

As a result of deregulation in the United States, some new largely non-unionised airlines succeeded in undermining the power of the established airline unions. These new carriers experienced no difficulty in attracting employees willing to work at much lower salaries and under stricter working conditions. Some of the established airlines induced their employees, either voluntarily or involuntarily, to accept wage cuts, whereas others introduced a two-tier wage structure whereby new employees were taken on at far lower salaries than existing ones. Some airlines also offered shares to their employees in exchange for wage concessions. The objective of these actions was to bring the wage costs of established airlines more into line with the new emerging low cost carriers.

Fuel costs currently comprise between ten and twenty percent of airline operating costs. The airline industry is extremely vulnerable to events in the international oil market. The unstable conditions that prevailed in the world oil market in 1974/75 and again in 1979/80 created tremendous problems for the airline industry as it attempted to structurally readjust to a fundamental new cost structure. Recently, however, as a result of an over-supply of crude oil in the international oil market, the oil price, and in particular the price of aviation fuel, has fallen resulting in a substantial reduction in airline operating costs. The price of aviation fuel is one of the major determinants of short term fluctuating airline profits.

The price of aviation fuel depends partly on the pricing policies of fuel companies and partly on the fiscal policies of the government of the country concerned. Although the price of crude oil and refinery costs are similar world-wide, the distribution and handling costs tend to vary considerably. Oil refineries are widely scattered around the world but only a relatively small number of refineries refine aviation fuel. The supply of fuel to some airports may involve lengthy and costly transportation, especially if the airport is a fair distance from a port. Transportation and handling costs also vary in relation to the volumes handled. A

government can influence the price of jet fuel by imposing import duties or other kinds of tax on the fuel, or by fixing the price of fuel as a matter of government policy.

Few airlines though, pay the posted price of aviation fuel. Major airlines are normally able to negotiate quantity discounts. The level of the discount will also be influenced by the number of fuel suppliers at a particular airport. If there is only one oil company providing fuel, then the scope for pushing down the price is clearly limited. Recently, however, some international airlines have succeeded in negotiating packages for supplying fuel on a world-wide basis.

Although an airline's management is only able to influence the basic price of fuel marginally, an airline can lower its fuel costs by endeavouring to consume fuel as efficiently and effectively as possible. This is achieved inter alia, by trying to reduce the weight of the aircraft by using lighter equipment in the cabin, and less paint on the outside of the aircraft, avoiding carrying more fuel than is required by the safety minima on a particular sector, as well as by reducing aircraft cruising speed. An increasing use is also being made of airliners employing more efficient technology in respect of fuel consumption.

The price of aviation fuel is denominated in United States Dollars. Fluctuating exchange rates thus may have a major impact on the fuel costs of a non-United States airline. In particular, the impact of a fluctuating Dollar on the operating profitability of those airlines which earn relatively little revenue in United States Dollars, may be quite substantial. Airlines may, however, by applying financial mechanisms such as hedging, reduce the risks and impact of fluctuating oil prices and currencies.

Airline depreciation costs depend upon the depreciation policy pursued. In particular, the depreciation period adopted and the residual value assumed are determined by an airline's financial policy. In many countries legislation or accounting convention may require the adoption of a particular depreciation policy or may impose certain minimum requirements. Most international airlines, however, have some flexibility in deciding on the effective commercial life of their aircraft and their residual value at the end of that life. This type of flexibility is important and may significantly affect reported operating profits. This aspect makes comparisons between international airlines somewhat difficult. The increasing utilisation of leasing and other off balance sheet financing methods to acquire new aircraft also tends to affect the level of depreciation charges incurred by a specific airline.

The deteriorating debt-equity ratios of many airlines have also resulted in an increasing interest burden faced by these airlines. State-owned airlines, which in recent years have received very little capital infusions from their governments and consequently have had to rely on debt capital to finance their aircraft acquisitions, are particularly vulnerable in this regard. Financing charges can only effectively be controlled by financially restructuring the capital structure of the airline concerned. In many instances, this is easier said than done.

Airlines have very little control over the level of user charges such as landing fees and air navigation charges. Although the airline industry as a whole, acting through IATA, may try to hold down increases in landing fees or en-route charges in a particular country, an individual airline has no scope for negotiating better rates for itself. These costs currently account for approximately seven percent of total airline costs and have been the fastest rising portion of total costs during the past decade. In order to combat security risks, airlines are confronted with increased costs in respect of security control functions, as well as rising insurance premiums.

Once an aircraft is scheduled for a particular flight, the total cost of that flight is only marginally influenced by the number of passengers, or the amount of freight carried by that flight. The cost characteristics of an individual flight operation of a scheduled airline, have contributed to the view that the cost structure of the airline industry is of an extremely fixed nature. An industry rule of thumb states that the variable cost of adding additional passengers amounts to only ten percent of the fare paid by that passenger. The short-run cost characteristics of airline operations, as well as the highly perishable nature of the airline product, are mainly responsible for the price wars seen in highly competitive markets.

However, according to Doganis (1985,p.89), the cost structure of the airline industry is characterised by a high proportion of variable costs. In the short term, significant cost savings can be achieved by cancelling a flight or a series of flights. Moreover, many costs previously considered to be of a fixed nature, are in fact variable. Doganis (1985,p.89) contends that as much as ninety percent of total costs can be varied in the medium term either by discontinuing all operations, or by a partial withdrawal of certain operations. This view of airline costs, however, presupposes an active and flexible approach to cost and operations management in an airline.

Such a high proportion of variable costs has important implications for airline operations planning. In the short term, substantial cost savings can be achieved by cancelling a flight or withdrawing from a route. Costs can be adjusted by selling redundant aircraft , thereby reducing depreciation charges, reducing or redeploying staff, closing down non-performing sales offices or selling off

headquarter buildings. Airlines can generally adjust their operations more easily than most other forms of public transport because they do not normally have fixed investments in navigational aids, runways or terminals.

The cost structure of the international airline industry is significantly affected by the role and actions of national governments. Firstly, government subsidisation has been a feature throughout the industry's history. Such subsidies have tended to the airlines in two forms, either directly or indirectly. Direct nationalisation has resulted in those instances where the losses of a state-owned airline have been written off, or where an airline has been granted an exemption from paying taxes. Also, in many cases, governments have made low-interest rate loans available to airlines in such a way as to have a direct impact on the particular airlines' financing costs. Indirect subsidies have been even more common. In order to establish and develop a country's physical infrastructure, many governments have as a matter of public policy provided funds for airport development. Also, the cost of air traffic control and air navigation services to airlines has often been well below the cost of provision.

With regard to operational aspects, the three most significant considerations which have an impact upon the level of operating costs are:

a. The stage length of the sectors and routes operated by an airline.
b. The traffic volumes on these routes.
c. The size of the aircraft operated on these routes.

Airlines operating a predominantly long haul route structure have a different cc structure from an airline operating a predominantly short haul route structure. The differences in the cost structure emanate from, inter alia, the type and size of the aircraft required to operate a specific route structure, the difference in crew productivity, landing costs and air navigation charges, as well as the utilisation of the aircraft fleet.

Unit cost levels are crucially influenced by the traffic density on a particular route and consequently by the size and type of the aircraft chosen for that route. Route traffic density also determines the frequency of services which are needed, thereby influencing the annual aircraft utilisation, that is the number of hours flown by each aircraft. The higher the utilisation, the lower the level of unit costs. Traffic density also has an impact upon the level of station costs per passenger or per tonne of cargo, since station costs do not rise in proportion to the amount of traffic handled.

Aircraft size influences airline costs in two ways. Firstly, certain aerodynamic benefits result from increased size. Larger aircraft have proportionately lower drag and more payload per unit of weight. At the same time, larger and more efficient engines can be used. Secondly, other economies of size are related to

the use of labour. Labour costs, particularly with regard to maintenance staff and crew, do not rise proportionately in relation to aircraft size. The cruising speed of an aircraft and the range or distance that an aircraft can fly with a full payload, together with an aircraft's size are the essential determinants of an aircraft's productive potential. This has a crucial impact on the cost structure of an airline.

Higher costs are likely to result if an airline has not standardised in respect of its fleet of aircraft. These higher costs result, inter alia, from the costs of spares holding, training flight crew and maintenance staff. Also, maintenance costs would be particularly high for small fleets if engines and aircraft were to be sent elsewhere for major overhauls. Such small fleets may preclude the installation of more advanced local maintenance facilities. Pilots are certified for only one aircraft type at a time, which means that a larger number of flight crew per aircraft would be required. This implies that an airline with a small mixed fleet faces a cost disadvantage.

Doganis (1985,p.132) states:

> 'The quality of management affects the efficiency with which the management of an airline brings together the various factors of production at its disposal in order to meet different levels and types of demand in different markets. In theory it is management ability, or the lack of it, which should explain cost differences between airlines which cannot be attributed to variations in input costs, aircraft types operated, stage lengths or any of the other cost variables.'

2.8 MARKET CHARACTERISTICS OF THE AIRLINE INDUSTRY

The demand for airline services is a derived demand in the sense that it is dependent upon other activities such as business communication, holidays, sport fixtures and general trade and commerce. In order to understand the nature of the market segments that the airline industry endeavours to satisfy, the characteristics of these other activities must be assessed and evaluated.

The peculiar nature of the airline product has created a strong incentive for airlines to integrate vertically into other areas of the travel industry such as hotels, travel agencies, car hire firms and tour operating companies. The objective is principally to exercise greater control over the nature of the total travel product, as well as to have some control over the distribution channel for the airline product. Also, airline marketing techniques are frequently oriented towards selling and promoting a value-added product comprising a total travel package, rather than merely selling and promoting a particular airline journey.

The purpose of most air travel is either for business or leisure reasons. Business travel involves a journey necessitated by one's employment. The main determinants for business travel tend to be the level of trade and commercial interaction between two cities. The leisure market can be subdivided into two distinct categories, namely holiday travel and travel of which the primary purpose is visiting friends or relatives. The business and leisure market display some very different characteristics which, inter alia, emanate from the fact that the leisure traveller invariably pays for his own travel, whereas the business traveller's the journey is normally paid for by a business organisation. The leisure segment of the air travel market is, however, expected to grow at a much faster rate than the business travel sector. This phenomenon is related to the growing affluence and changing demographics in industrialised countries, as well as the fact that the general population has an increasing amount of leisure time at its disposal.

Doganis (1985,p.162) states that in recent years there has been a growing awareness amongst airline managers that the simplistic approach to market segmentation based on trip purpose, has some very serious shortcomings. In particular, too much emphasis is placed on the demographic and socio-economic features of the passengers, rather than appreciating passenger needs and requirements when travelling by air. Doganis (1985,p.162) asserts that:

> 'Surely it is more important for an airline to know whether a passenger will cancel his reservation at the last moment or whether he is prepared to pay a lower fare for an inconvenient departure than to know his sex or age?'

Also, traditional market segmentation tends to oversimplify and ignore the motivational factors involved in travel decisions. These motivations are intimately related to the specific requirements and needs of a specific business or leisure traveller. The rationale behind a more complex market segmentation approach is that each segment should have distinctive needs and expectations, such as the need to alter reservations, to make stop-overs, the ability to pay particular fare levels, expectations in terms of in-flight service and comfort. An improved understanding of the motivations and consequently the needs of the air transport market is essential for appropriate product planning and pricing by the airline industry.

The demand for airline services is determined by the interaction of a large number of variables which have different impacts on the various market segments. These variables fall broadly into two categories, namely the general economic and supply-related factors that influence demand in all markets, and the more peculiar factors that influence demand in specific markets only.

The phenomenal growth in the demand for airline services during the past thirty years can largely be attributed to the fact that the price of airline services has declined substantially in real terms, and to rising general affluence in many countries as exemplified by the growth in personal disposable income. The world economic climate, and the rate of economic growth in particular countries or regions of the world, influence demand in a rather complex way. They determine the level of industrial and economic activity in each country, and more generally the level and nature of international trade. The level of economic activity and trade determines the growth in the demand for business travel. Indirectly, it also influences leisure demand since it affects the level and growth of personal income. These economic factors must be assessed within a demographic context. The size and distribution of populations served by a route impose a major constraint on the level of potential demand.

Supply conditions other than price, have a significant impact on the demand for air transport products. Whilst frequency of service, seat availability, departure and arrival times, number of en-route stops and other supply features influence the level of demand, as well as the distribution of that demand between competing airlines in the short term, it is the improvements in the overall speed and convenience of air transport that have had the most significant effect on demand in the long term.

The nature and growth of airline demand on any route can only be understood by reference to the economic and demographic characteristics of the market at either end of the route, as well as to the supply features of the air services provided. The peculiar circumstances affecting demand on a particular route such as the tourist attractiveness of a destination, the historical, cultural, ethic and even ideological ties between two countries, the impact of exchange rate fluctuations, as well as earlier or current population movements must be considered. These diverse factors will provide the explanation of growth and current level of demand on a particular route. Changes in any of these factors will have an impact on the growth of demand in the future. Ultimately, however, the demand for air travel, similar to most goods or services, seems to be most closely related to price and to the income levels of its consumers.

Although passengers represent the major portion of traffic carried by the world's airlines, freight and mail also constitute a significant amount of revenue earning traffic. For the airline industry as a whole, the carriage of freight is a significant factor, both in terms of the productive resources absorbed by it and the contribution made to overall revenues. For a specific airline, the relative attention given to passengers and freight is a matter of market opportunities and marketing policy. Although freight yields generally tend to be lower than passenger yields, some airlines are pursuing a conscious strategy to serve the needs of the air

freight market. The airline industry has a competitive edge over other modes of transport for the conveyance of freight in respect of high-value and time-sensitive freight over longer distances.

The airline product possesses some very distinct characteristics. Firstly, the product produced by an airline is of an intangible nature, namely an available passenger seat or cargo space between two cities. The relationship between the capacity offered by an airline and the actual passengers and freight carried is expressed as a percentage called load factor. As a result of the peculiar nature of airline costs and revenues, airline profitability is highly sensitive to fluctuations of the load factor. The load factor is important because the airline product is of a highly perishable nature, since once a flight has departed to its destination, any unoccupied seat or unutilised cargo space is lost as potential revenue. Also, the demand for airline services is highly sensitive to a vast array seasonal factors, as well as the business cycle. In particular, airline profitability tends to fluctuate widely during the different phases of the business cycle.

The majority of international airlines do not have an entirely free hand with regard to the demand they set out to satisfy. Their routes, as well as the density of demand on those routes, is largely determined by the interaction of geographical, political, economic and social factors which tend to be outside the control of an airline's management. The geographical location of an airline's home base, together with the level and extent of business and tourist interaction between the home country and other nations, largely determines the demand and growth potential of a specific airline. Also, in those instances where an airline is a country's only international airline, which is the case with most airlines, political pressure may be exerted to induce an airline to operate certain routes which it would otherwise tend to ignore.

2.9 KEY SUCCESS FACTORS OF THE AIRLINE INDUSTRY

Porter (1980,p3) states:

> 'The essence of formulating competitive strategy is relating a company to its environment. Although the relevant environment is very broad, encompassing social, as well as economic forces, the key aspects of the firm's environment is the industry or industries in which it competes. Industry structure has a strong influence in determining the competitive rules of the game as well as the strategies potentially available to the firm. Forces outside the industry are significant primarily in a relative sense; since outside forces usually affect all firms in the industry, the key is found in the differing abilities of firms to deal with them.'

Wheatcroft and Lipman (1986,p.194) assert that there can be no single formula for success in the airline industry. They do, however, identify a number of key requirements:

a. A well trained and well motivated workforce.
b. A close control of costs.
c. Price, product and capacity adaptability to meet changing competitive conditions.
d. Effective marketing arrangements and particularly CRS (computerised reservations system) access to all markets.
e. Full use of automating all activities, but particularly those in computerised yield management and inventory control.
f. Control over feeder services either directly or by agreement with commuter and regional operators.
g. Predominance at one or more hub airport with control of landing slots and gates.
h. Expansion of market opportunities through acquisitions, mergers or cooperative ventures where and when appropriate.

The environment in which the airline industry operates is currently in a state of flux. In particular, the move towards a deregulated market structure entails that airlines are confronted with the prospect of having to operate in an environment in which the rules of the game are fundamentally changing. Also, a major strategic reorientation awaits those airlines, which have hitherto operated within the ambit of the public sector, but will be privatised within the foreseeable future. Airlines will consequently have to assess their abilities to meet the challenges and opportunities of the newly emerging environment when formulating and implementing their strategic response.

2.10 SUMMARY

The environment in which the airline industry operates is becoming increasingly dynamic. This environment is influenced by a multitude of economic, social, political and technological issues, as well as changes in the competitive environment. However, there are many variables which affect industry performance and profitability over which airline management has relatively little control. In particular, many airlines are being challenged by competitors which often have a lower cost structure, and a more flexible approach to taking advantage of emerging or latent market opportunities than their more traditional rivals. Also, the management of several airlines are being confronted with the prospect of no longer managing their airlines as a public sector enterprise, but rather as a private sector business concern. Such managements have not only to reformulate the strategies they have hitherto pursued, but also must adapt to a new set of operating objectives. Deregulation and privatisation are the major issues

confronting the managements of several airlines for the rest of this decade. The theory of privatisation, the application of privatisation and the key success factors for privatisation are discussed in Chapters Three, Four and Five respectively, whilst a framework for airline privatisation is presented in Chapter Six. The practical experience of some airlines in respect of privatisation is discussed in Chapter Eight.

CHAPTER 3

THE THEORY AND CONCEPT OF PRIVATISATION

3.1 INTRODUCTION

The purpose of this chapter is to discuss and analyse theoretical issues with regard to the concept of privatisation. Although private ownership of productive resources represents a central tenet of the economic system in most countries outside the socialist world, state ownership of significant industries in so-called capitalist economies has been a well established practice for a considerable period of time. Privatisation constitutes a conscious effort to reduce the role of the public sector in the economy. Successful privatisation is, however, a complex phenomenon. This chapter focuses on some of these complexities.

Firstly, the background and origins of privatisation are discussed. In particular, privatisation became a public policy issue as a result of a general disillusionment with the performance of the public sector. Secondly, the objectives of a privatisation policy are identified. Thirdly, the rationale for privatisation is discussed, particularly from the point of view that unsatisfactory performance of the public sector emanates from the political dependence of public sector business enterprises. The benefits resulting from a privatisation programme are also listed.

Learned opinion, however, is not unanimous in its advocacy of privatisation. This chapter discusses some of the arguments in favour of state ownership of productive resources. Moreover, some aspects of the debate concerning market structure versus private ownership of productive resources as a remedy for the unsatisfactory performance of state-owned enterprises are discussed. The obstacles to implementation of a privatisation policy are also discussed.

Finally, the importance of the interests of the various stakeholders in the privatisation process are identified and analysed. In particular, privatisation is an intensely political process and successful privatisation must take cognisance of the roles, desires and actions of the various stakeholders.

2.2 BACKGROUND AND ORIGIN

State ownership of productive resources is not a recent phenomenon. Since earlier than the Roman era, governments established commercial entities to perform essential economic activities. The rapid expansion of the role and functions of the state into virtually every sphere of economic activity constitutes

one of the major institutional changes of this century. Many governments nationalised hitherto private businesses, either for ideological or economic reasons. In particular, in developing countries, state-owned enterprises were viewed as vehicles for rapid growth and economic development.

During the 1970s, however, the macro-economic environment in most countries changed dramatically. Latham-Koenig (1987) asserts:

> 'As pressure on government revenues grew, resources for financing these parastatals became scarcer. They were therefore regarded as a serious drain on limited public funds and their lack of clear managerial objectives, non-economic pricing policies and excessive political scrutiny attracted growing criticism.'

Increasing disenchantment with the performance of the state sector gradually set in, because the general public perceived, rightly or wrongly, that many state-owned enterprises failed to effectively and efficiently fulfil many of their functions. They also appeared to be unable to achieve even the basic objectives set by the political process and demanded by the electorate. Austin, Wortzel and Coburn (1986,p.52) state:

> 'With disturbing frequency and in vastly greater magnitudes, over the past decade state-owned enterprises have produced financial losses, have become net capital users, and have failed to accomplish the economic, social and political objectives for which they were created. Furthermore, the quality of their services has often been poor and charges of administrative corruption have abounded.'

Criticism against the public sector emphasised, inter alia, the return on capital employed compared to the private sector, the record on prices, productivity and manpower costs, the low level of customer satisfaction provided, and the escalating indebtedness.

Privatisation is now seen as a more rational approach to a broadly based policy which aims to revitalise economies of developed, as well as developing countries. Privatisation is rapidly becoming the dominant political issue in a number of countries and is radically transforming the economic and industrial structure of countries such as the United Kingdom. Privatisation represents political commitment to reducing the strength of the public sector and to place greater emphasis on free market forces. A systematic transfer of activities and resources from the public to the private sector has begun and privatisation now universally signifies a reduction in government involvement in the economy and a corresponding increase in the role of the private sector.

Pirie (1986,p.3) asserts:

> 'Part of the universal appeal of privatisation lies in the fact that it is not a policy but an approach. It is an approach which recognises that the regulation which the market imposes on any economic activity is superior to any regulation which men can devise and operate by law. It is an approach which also recognises that the market measures, and responds to, the choices and preferences of people more accurately than the political process. A programme performed in the private economy can be done more efficiently, more cheaply, and with greater satisfaction to its beneficiaries than its counterpart can achieve in the public sector.'

Privatisation, defined as the total or partial transfer of state assets to private ownership, is a development of global dimensions. According to De Jonquieres (1987,p.1):

> 'Rarely in history has an innovation in economic and financial policy caught on as quickly in as many countries as privatisation. Since the start of the 1980s, its popularity has spread to every continent. The idea has been seized on by countries ranging from the super-affluent to the dirt poor, ruled by governments of both right and left, operating under democracies and dictatorships. It has even found echoes in non-capitalist economies, including the Soviet Union, Eastern Europe and China.'

In the United Kingdom, where the Thatcher government has pioneered the concept of widespread privatisation, it has become a key element of economic strategy with the explicit aim of increasing business efficiency and encouraging popular capitalism, i.e. widespread share ownership. It is estimated that by the end of 1987, the size of the public sector in Britain will have been reduced by approximately forty percent in comparison to 1979 when the Conservative Party assumed power. Pirie (1986) alleges that Britain's experience of privatisation has encouraged several other governments to adopt a similar policy.

3.3 OBJECTIVES OF PRIVATISATION

Privatisation represents a fundamental shift in government policy towards managing the economy. Previously, in many countries, state control and ownership of the production infrastructure was regarded as the appropriate instrument for managing the economy. The trend towards privatising state-owned enterprises, together with the financing of new investment in public services from private sources evolved as a result of the combination of a number of factors such as:

a. A desire to reduce public sector borrowing requirements, thereby diminishing fiscal deficits, as well as the state's burden of servicing public sector loans.

b. A desire to reduce taxation.

c. The reduced availability of sovereign lending including export credits, especially to Third World borrowers.

d. Disenchantment with public sector administration.

e. Perceived benefits of privatisation.

Although the aims of privatisation programmes in various countries are similar, each country's government tends to place a different emphasis on the objectives of privatisation. These differences of approach emanate from the unique institutional arrangements in different countries. The nature and extent of the political mandate for pursuing a privatisation policy also tend to vary between countries. In the more affluent Western industrialised countries, an ideological commitment to the efficiency of private enterprise appears to have been the motivating factor, whereas in poorer countries privatisation has been the result of economic necessity.

The principal objectives of privatisation may be summarised as follows:

a. Better management.
b. Increased efficiency.
c. Extra government revenues.
d. Development of financial markets.
e. Wider share ownership.
f. Employee involvement.
g. Winning votes.
h. Depoliticising contentious issues in terms of allocation of scarce resources
i. Political prestige.

When business enterprises are relieved from financial and other constraints imposed by political authority, the quality of management is expected to improve because of the greater flexibility of operating in a market oriented environment. It is assumed that freedom from political interference will promote quicker decision-making, as well as the ability to streamline poorly-performing activities. When companies are directly accountable to private investors rather than to the often arbitrary and evolving criteria set by government officials, whose concern tends to be related more to meeting broad macro-economic objectives rather than the business enterprise's peculiar objectives, the business enterprise will tend to become more efficient and responsive to customer needs. When a firm is taken outside the public sector, monopolistic protection can be lifted more easily

and competition can consequently be stimulated. The improved efficiency of individual firms is also expected to lead to improved allocation of resources in the economy as a whole, thereby promoting prospects for general economic growth.

The proceeds from privatisation can be utilised to help finance tax cuts, retire public debt or obtain funds for other public projects. Privatisation can also provide fresh sources of capital for investment in infrastructure projects, especially in developing countries.

Popular capitalism can be promoted by encouraging individual investors to subscribe to privatisation issues. Jonn Moore (Korsten, 1986, p.6), the Financial Secretary to Britain's Treasury explains:

> 'Our aim is to build upon our property-owning democracy and to establish a people's capital market, to bring capitalism to the place of work, to the high street, and even to the home.'

Employee interest and commitment in their firms can be stimulated by encouraging them to become shareholders of their companies. Such a shareholding not only gives the employees a direct stake in their work-place, but also contributes in removing the distinction between owners and workers. By widening share ownership, some governments hope that their electorate's enthusiasm for embracing socialist parties in elections will diminish.

When the provision of certain services and activities are taken outside of the political arena, resources tend to be allocated on the basis of economic rather than political criteria. Particularly in respect of wage negotiations, public sector unions often elicit political support for their negotiating stance.

De Jonquieres (1987) asserts:

> 'Many governments also aspire to privatisation as a mark of prestige, conferring on their countries, a seal of political and economic stability and as a method of broadening and developing their financial markets.'

3.4 THE RATIONALE FOR PRIVATISATION

It is important to realise that being owned by a government is not all bad, nor is becoming part of the private sector all good. However, an essential difference between firms operating in the public sector and firms operating in the private sector results from the different goals being pursued by the respective business enterprises. Whereas private companies must respond to the marketplace in order to be able to expand on a profitable basis over time, public sector

companies tend to respond to a totally different set of signals, such as the need to satisfy all of the potential constituencies, even when the requirements of some of these interest groups may not make commercial sense. Governments have political sensitivities which tend to be quite different from those of an organisation driven by the profit motive.

Pirie (1986,p.10) states:

> 'Private business inhabits the economic world, but state business lies in the political world and is governed accordingly.'

In particular, state-owned enterprises do not behave like private sector businesses because the public sector is an integral part of the political process. Resources also tend to be more often than often not allocated on the basis of political pressure exerted by the respective political constituencies, rather than on the prospects of achieving profits. Political and economic objectives are not necessarily complementary and this fact would explain at least partly the lesser degree of efficiency in the public sector when compared to the private sector, and measured in respect of the rate of return on capital employed. Significantly, the state does not behave as a normal investor and in fact cannot be expected to do so. In particular, the state has interests other than profitability and rates of return to consider.

Lord King (Pirie,1985), the chairman of the now privatised British Airways asserts:

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

In particular, the priorities and time horisons of the public and the private sector tend to be entirely different.

Although governments may not necessarily interfere in the day-to-day management of a state-owned enterprise, the monitoring and control processes, which are required according to a politicised public sector financial framework for public sector companies, as well as restrictions imposed on the attracting of external financing, tend to result in greater bureaucratic involvement than experienced by private sector firms. At various times, governments have found the temptation to intervene in the pricing policies of public sector enterprises particularly difficult to

resist. This tends to have a perverse effect on the prices of the output of public sector firms, i.e. prices can rise substantially after a period of artificial price restraint. More specifically, government intervention with regard to pricing policy might seriously distort the true market position of a public sector firm.

The actions of nationalised concerns have been circumscribed by a variety of directives and controls which inter alia, include the following:

a. Restrictions on pay and prices.
b. The requirement to engage in foreign borrowing as part of a programme to manage the exchange rate.
c. The requirement to buy locally manufactured capital equipment.
d. Control over the timing and extent of capital expenditure.
e. The location of the companies' headquarters.
f. The structure of the companies' balance sheets.
g. Directives on the employment of labour.
h. Directives on operating some unprofitable services.

Traditional policies controlling public sector operations tend to operate at the macro level, attempting to secure solutions on the supply side, thereby seeking to alter the conditions under which public sector goods and services are produced. According to Pirie (1986), such macropolitical ideals are doomed to failure. Pirie (1986,p.vi) continues:

> 'The privatisation strategy, on the other hand, is a micropolitical approach which applies one of a number of techniques to each specific problem, making provision for the concerns of each interest group as it transfers activities from the public to the private sector. It is an approach which produces creative and innovative solutions to each problem, not a single solution on each case.'

It is argued that the policy of privatisation is derived from a recognition that the weaknesses of public supply are inherent. Pirie (1986,p.20) states:

> 'It assumes that any temporary grafting of private enterprise attributes onto the state sector will be temporary, and that the gains will be whittled away as the characteristics of the public sector economy reassert themselves. Such attempts to make the public sector more cost-effective and more responsive to demand are ones which will have to be continually remade, at great cost in political goodwill, and with no permanent success.'

Any improvement in the performance of public sector enterprises would thus seem to be of a transient nature.

The political control of business enterprises, operating within the public sector, stems from the use of public funds that is being made by these enterprises. Their borrowing, for example, is normally underwritten by the government, and is accordingly undistinguishable from other forms of public borrowing, with the result that, on occasion, the financing needs of individual state companies must be subordinated to macroeconomic requirements. Such financing constraints may have a serious impact on the companies' investment and expansion programmes. Yet, as long as these public sector enterprises operate within the public sector, public money is at stake, which means that public financial accountability through Parliament, as the guardian of public finances, must be preserved. Consequently, the strategy and objectives of the public sector business enterprises tend to be subjected to the political agenda of the government in power.

Parliamentary authority over a state company cannot be compared with the shareholders of a private sector business enterprise. Public ownership tends to be extremely diffuse and impersonal. Public ownership might thus not generate the urgency and incentive to effect an optimal utilisation of resources. Private ownership on the other hand, incurs a direct responsibility to private shareholders who demand that the best possible use of assets and resources is made. Although the view is often expressed that decisions made within the public sector represent the choices made by the public, these choices in fact express the priorities of legislators and bureaucrats.

Another consequence of public ownership is the conventional assumption that a government will not allow one of its businesses to be declared insolvent. This assumption means that a state-owned concern may be able to continue trading in spite of experiencing prolonged financial losses. Moore (1983,p.8) states:

> 'If the government stands behind the industries and is viewed as possessing a bottomless purse, it is no wonder that inefficiencies flourish and market responsiveness does not stand very high in the industry's scale of priorities.'

A weakness of public sector operations concerns their ability to effectively control costs. The private sector, in order to survive and be able to attract financial capital, must be alert to cost-cutting opportunities. The financial security of the public sector on the other hand, creates an immunity from cost controls. Although the budgets of public sector businesses are nominally under the control of governments, public sector costs are affected by a number of factors outside the control of government. In particular, wage demands in the public sector may tend to ignore the financial condition of the particular state-owned enterprise, and any disputes that may arise have the potential to become a political issue aimed at

embarrassing the government. The all-pervasive practice of cross subsidisation by public sector businesses also has the effect of raising the general cost structure of these businesses.

Saves (1982,p.20) adds:

> 'If a public official wants to increase the thrust of his agency so that it will be more effective, it is much easier, quicker, and more painless to do so if the agency is expanding. To fire incompetents, change inherited attitudes, turn around a misguided unit, or galvanise a tired one into action is a lot harder than getting more money, creating a new unit, staffing it with fresh people, and setting it off with enthusiasm in a promising new direction. In short, even the most selfless public servant can honestly say that he is able to serve the public better if he has a bigger budget.'

The relative absence of market responsiveness, and a marketing orientation within public sector firms, is responsible for the fact the public sector operations tending to become producer-oriented their activities being directed more towards meeting the interests of those engaged in production rather than those who receive the service. Sir George Jefferson (Moore, 1985), the chairman of the now privatised British Telecom adds:

> 'The commercial development of the business was centred on engineering concepts rather than market and commercial needs. The overall effect was quite clear. The customers certainly did not call the tune.'

In many instances of public sector manufacturing, the central purpose of the activity is shifted from the production of goods for consumers to the provision of jobs for workers, irrespective of the costs involved.

The unresponsive behaviour of public sector business enterprises is regarded as inherent to the nature of the state sector and is exemplified by a statement made by Drucker (1977):

> 'The most entrepreneurial, innovative people behave like the worst time-serving bureaucrats or power hungry politicians six months after they have taken over the management of the public service institution, particularly if it is a government agency. The forces that impede innovation in a public service institution are inherent in and integral to it and inseparable from it.'

The cultural orientation of the public sector differs fundamentally from the private sector. In the private sector, attributes such as risk-taking are generally valued, whereas the public sector responds to political pressures. Public sector officials tend to become rather adroit in managing the political process rather than emphasising innovation. Moore (1983,p.13) asserts:

'Great entrepreneurs would never flourish if they were faced with the constraints imposed on managers in nationalised industries. Nationalisation stifles flair and imagination and blunts business skills. And yet, these qualities are essential if new products are to be developed, new markets sought, and new jobs created.'

Pirie (1986,p.8) contends that in private businesses labour agreements are characterised by the flexible use of labour in terms of skills and time, whereas in the public sector restrictive work practices abound. Although unions and public sector management may be on opposite sides in labour negotiations, the demands of organised labour are more easily acceded to. In the private sector, the consumer is a tacit party to such agreements. If consumers do not accept higher costs reflected in higher prices, they can take their business elsewhere. In those instances in the public sector where monopolistic protection is afforded to state-owned business, the consumer is captive and has no option to turn to. The leverage of public sector unions, and consequently the tendency towards uneconomic working practices, is a consequence of the monopolistic market situation which normally characterises public sector operations.

Although the public sector aims to protect employment opportunities, nationalisation may in fact have destroyed jobs. Private sector firms which are faced with a secular decline in the demand for their products, must seek out new opportunities to replace lost business if they wish to survive at all. In contrast, the ability of public sector businesses to take advantage of new market conditions, is constrained. In the end, an abrupt and traumatic change may ensue. Success in highly competitive world markets, in which many major businesses operate, demands an ability to adjust to changing market conditions, technologies and products.

The ability of state-owned businesses to effectively meet their business objectives is severely constrained by the difficulty experienced in attracting financial capital. Many governments, because of either macroeconomic objectives or demands being made by other public expenditure commitments, are often loathe to invest new equity capital in their businesses. Political pressure tends to deny public operations the degree of capitalisation which they require. Moreover, the excessive reliance of these firms on debt capital has an impact on their risk profile because of the level of financing charges. The reliance on debt capital has led to the increasing indebtedness of public sector companies. The debt of a state-owned enterprise is, however, normally guaranteed by its national government.

The adverse public image of the public sector being chronically inefficient loss-makers, or consumer exploiting monopolies, seriously affects the ability of these businesses to strengthen their market position. The problems and failures

of poorly managed individual public sector business concerns have far-reaching consequences, tarnishing the reputation of other public sector enterprises, even although both groups of public sector enterprises are connected only public ownership.

Because of the dominant position of many state-owned firms in the economy, their actions also tend to permeate through the whole economy. If those public sector businesses which enjoy monopolistic protection, exploit their market position, and if they enterprises are run as bureaucracies rather than businesses, and if they do not respond to market opportunities, the effect is felt throughout the economy.

Attitudes towards the public sector of the economy are often affected by the way in which performance is evaluated. Whilst the production of goods and services in the private sector is evaluated in terms of normal commercial criteria such as profitability, efficiency and customer satisfaction, state activity is viewed as a public service which would require different standards of judgment. Public sector activities are often judged in opposition of what was intended. Moreover, any assessment of state-owned businesses is complicated by the fact that these businesses are normally required to pursue a multiplicity of objectives and are often subject to political interference in their day-to-day operations. State-owned businesses consequently escape scrutiny by professional financial analysts which tends to undermine financial discipline, control and internal accounting procedures. Comments on the performance of a particular public sector company in the media, more often than not tend to be politically motivated

The most important economic dimension of privatisation is perhaps represented by the fact that decision criteria in privatised business enterprises are shifted from the political to the economic arena.

3.5 THE BENEFITS OF PRIVATISATION

Certain benefits arise when a state-owned enterprise is brought within the fold of the private sector:

a. Privatisation produces transparency of decision-making. Privatisation forces decisions out into the open and allows people to see whether particular action has been taken for social or economic reasons. The extent of cross-subsidisation of activities may consequently be reduced.

b. When privatisation is accompanied by the establishment of a more competitive market structure, the privatised firm will tend to operate more efficiently in terms of its cost structure. The chances of better provision of services to consumers is enhanced by greater competition. Specifically, privatisation encourages innovation.

c. Life in the private sector means more freedom to manage and less intervention from politicians and civil servants.

d. Privatisation makes incentives more available for management and employees: for example they can have direct shareholding in the company they work for. Employee shareholding may be a very powerful motivating force, boosting the morale of workers and management alike.

e. Privatisation provides an opportunity for the investment community to buy shares in major enterprises.

f. Privatisation may turn tax consumers into tax producers. In particular, the tax base is broadened as privatised concerns become profitable and consequently become tax payers.

g. In some countries, unprofitable strike-riddled businesses have been converted into thriving profitable enterprises.

h. Privatisation may contribute towards depoliticising certain controversial social and economic issues. The government is under less pressure to intervene in the internal affairs of business enterprises.

i. In those instances where the yield of the sale of public sector firms has been utilised for development projects and social investment, less privileged communities have benefited.

j. Pay bargaining can be carried out much more responsibly and easily in companies removed from government interference. The conduct of industrial relations is taken outside the political arena. The government is no longer a direct participant, but rather an indirect observer. There is consequently less scope for militant trade unions to directly involve the government in wage or other industrial disputes.

k. The public image of the privatised firm is enhanced. As a listed company, the privatised business is more closely watched by the financial media, and the management of the privatised company is better able to build an appropriate relationship with the investment community.

l. The privatised firm has access to the equity capital market.

m. There is less scrutiny of an enterprise's specific investment plans and there are fewer political issues to be considered. Capital expenditure can be incurred as demanded by the company's strategy, rather than by the government's macroeconomic objectives.

n. Privatisation can attract additional capital to developing countries, thereby strengthening the balance of payments of these countries. An environment conducive to free trade and capital flow between countries would, however, seem to be a prerequisite before foreign investors would invest to any significant extent in privatised businesses in developing countries.

o. The desire to privatise a particular loss-making concern may be a very powerful incentive to achieve a financial turnaround, as is exemplified by the experience of British Airways.

p. The capital structure of a privatised firm can be geared more appropriately to the requirements of its industry. The debt-equity ratio of a privatised company would be more appropriate as it can rely on both equity and debt markets for capital requirements, rather than just on the debt markets, as most public sector firms are obliged to do.

q. Privatised firms tend to pursue the objective of enhancing shareholder wealth vigourously. Objectives tend to be clearly stated and understood. There is a reduced risk of management of a privatised firm being pulled between a variety of social, economic and political objectives which may be contradictory, as is often the case in many state-owned firms.

r. Private businesses tend to earn higher returns on the capital employed. Capital resource in any economy, however, tends to be a scarce commodity, which means that more efficient utilisation of capital resource would ensue from privatisation, thereby boosting the growth prospects of the economy as a whole.

s. Privatisation expands the size of the capital market. Privatisation creates an equity market where the shares of previously state-owned enterprises can be traded, rather than solely being a market for government bonds.

t. Privatisation provides cash to the government, which means that either the tax burden can be lowered or funds provided for other urgent public projects.

u. As the profitability of firms is expected to improve after privatisation, the market value of any remaining government shareholding would increase accordingly, which in some instances may even exceed the value of the firm before privatisation.

3.6 THE CASE FOR STATE OWNERSHIP

Herbert Morrison (Moore, 1983), in his book 'Socialisation of Transport' published in 1933 stated what he saw as the major theoretical benefits of nationalisation. These benefits inter alia, include the following:

a. The quality of service will improve and the prices charged will tend to decrease.
b. The industry itself will become more efficient.
c. The board of the nationalised concern and its officers will consider themselves as custodians of the public interest.

In many instances, state-owned enterprises were created as a pragmatic or ideological response to a host of specific economic needs or problems:

a. Promoting economic development.
b. Extracting revenue.
c. Rescuing failing enterprises.
d. Enhancing political and economic control.
e. Accomplishing social goals.
f. The phenomenon of natural monopolies.
g. An ideological commitment to public ownership.

Since the 1950s, many governments have created public sector companies with the specific aim of accelerating economic development, thereby contributing to the attainment of important economic, social and political objectives. These state-owned enterprises have been active in those industries where private investors were either unwilling or unable to invest because the risk-return relationships were considered unsatisfactory, or the capital requirements exceeded the available capital resources. Governments in many developing, as well as developed countries, have invested heavily in inter alia, the steel, mining and airline industries.

In many countries, foreign ownership of productive resources is a highly contentious political issue. By establishing a public sector enterprise, a few developing countries have nationalised some of these foreign controlled companies with the specific aim of obtaining a greater share of the revenue stream produced.

Many companies have been brought into the fold of the public sector as a result of rescue action taken by a government. The logic behind this is the economic burden of taking on a loss-making enterprise being outweighed by the benefit of saving jobs or ensuring essential supplies. Especially during times of recession, politicians are tempted to rescue ailing firms in order to protect employment.

It is argued that entrusting a few strategic services to private organisations might increase the political power of these organisations to such an extent that a general loss of independence for other private and public entities would ensue. In Africa and Asia in particular, state-owned enterprises have been created in order to establish economic and political control, as well as to wrest the control of trading activities from ethnic minorities. In these instances, public sector companies have been used as a means of counterbalancing the economic power of private business groups or political power blocks.

Public services are often utilised as a vehicle to advance other social objectives such as regional economic development. Public sector businesses might also be obliged to undertake certain activities for which the returns on private capital would be insufficient, but which are nevertheless considered to be essential in the public interest.

Conventional wisdom holds that monopolies are prone to take advantage of their customers. Consequently, only politicians and civil servants could be entrusted with monopoly power because they would exercise monopoly power with restraint. The protagonists of state ownership believe that when the management and workers in a public sector enterprise are placed in a position of trust and responsibility, the management and workers of the public sector firm would be so imbued with a sense of public good that their actions and aspirations would naturally reflect what is best for the country in general, and the company in particular. In some economic and political circles, a monopolistic market structure is also considered to be in the public interest, because competition is somehow considered wasteful and costly and to the detriment of consumers. This argument is based on the existence of a relatively small market, together with the limited availability of scarce resources.

For some ideologically committed individuals, the idea of seeking profit is held in utter contempt. The profit motive which drives private sector businesses is thus discouraged and replaced by a system whereby goods and services are being produced for the public good by businesses operating within the ambit of the public sector.

Although state-owned enterprises are often ridiculed for being inefficient, state companies can be efficient and profitable, and there are many cases throughout the world that prove this. The causes of poor performance in the inefficient public sector businesses need to be identified in order that corrective action can be instituted. Austin, et al. (1986) list some of these corrective actions:

a. Clarifying inter-governmental reporting structures, thereby emphasising both autonomy and accountability.

b. Clarifying and simplifying enterprise performance objectives with the purpose of reducing the incidence of conflicting and confusing objectives.

c. Depoliticising the appointment of senior public sector managers by instituting the chief executive officer be appointed by the state enterprise board rather than by the Ministry or Head of State.

d. Creating performance-based incentive reward systems, including the use of management bonuses and profit-sharing schemes.

e. Establishing improved procedures for appointing state enterprise boards, emphasising greater professionalism and longer continuity.

f. Establishing improved management information systems focused on key performance indicators.

g. Strengthening accounting and financial reporting practices including the use of annual outside audits for larger enterprises.

3.7 MARKET STRUCTURE VERSUS OWNERSHIP

Market structure and ownership of productive resources are two issues which dominate the public debate concerning economic policy and structure during the 1980s. Market structure refers to the extent to which competition between business enterprises should be promoted, whereas ownership concerns the question of privatisation as opposed to nationalisation.

Spier (1986) asserts:

> 'Deregulation is the 'sister' of privatisation. Often deregulation is a precondition for the process of privatisation to take place at all.'

Deregulation or liberalisation in these instances, involves the abolition of statutory controls which prevent private operators from competing with state enterprises. Also, the liberalisation of markets may force public sector companies into becoming more market oriented and efficient in terms of resource utilisation, thereby facilitating these firms' move towards the private sector. In many instances, the first step in the development of a trend towards private supply lies in demonstrating the viability of a private alternative. Public sector supply has been prevalent in a large number of industries, such as the airline industry, and informed opinion often questions the possibility of a valid private equivalent.

The argument that privatisation will encourage competition is dependent on the form in which the state-owned enterprise is privatised. If, during the process of privatisation, the number of competing firms is not increased, it will be difficult to imagine how privatisation would encourage competition. A private monopoly will simply be substituted for a public monopoly. There is no evidence that an unrestrained monopoly in the private sector would be less inclined to exploit its monopolistic market position than a monopoly in the public sector. The implication is that the privatisation of a public sector business, which has hitherto enjoyed monopolistic protection, requires the creation and development of a competitive environment. If it is not possible to establish effective competition, an appropriate regulatory regime should be developed, in order to ensure that the privatised company does not act to the contrary of public interest.

It is, however, a great fallacy to believe that all nationalised monopolies are in any sense natural monopolies. A natural monopoly exists where the long run average cost of production by the first producer in the field, steadily declines over the relevant range of output, thereby enabling the firm to exploit its market position. The counter argument states that the long run average cost curve is constantly changing due to technological change. Few so-called natural monopolies seem to be able to survive without legal restrictions on the operations of competitors. This fact appears to make the concept of natural monopoly little more than a theoretical nicety. The established competitive advantage of a public sector monopoly is, however, a reality and needs to be taken account of if a business enterprise is to be privatised.

Regulation of business activities is not without criticism. Firstly, regulation tends to spawn further regulation, which implies that the regulatory framework is likely to expand over time. Also, regulation by the state is a costly activity because regulation consumes resources from both the public and the private sector. Finally, politicians who formulate these regulations often lack any detailed knowledge of the industry for which the regulations are intended.

Deregulation and privatisation may in some instances be in conflict. The greater the extent of competition to which the firm, which is to be privatised, is subjected, the lower the profit prospects of the firm would be, thereby depressing its share price. The improved efficiencies that privatisation is supposed to bring about, may conceivably neutralise the impact of a more intense competitive environment. Deregulation, however, would tend to create greater uncertainty, thereby depressing share prices. Consequently, there is a risk that a government that wants to privatise a public sector company may preserve some monopoly privileges in order to boost the yield from the sale of the public sector business.

TABLE 7
PRIVATISATION AND THE IMPORTANCE OF MARKET STRUCTURE

	A.	B.	C.	D.	E.
Can the company go bankrupt?	No	No	Yes	No	Yes
Can the company be taken over?	No	No	Yes	No	Yes
Is there an incentive to meet consumers' needs	No	No	No	Yes	Yes
Is there an incentive to minimise costs?	No	No	Yes	No	Yes

Explanation: A = State monopoly
B = Private monopoly
C = Small private monopoly
D = State-owned company in competitive market
E = Privately owned company in competitive market

Source: Prowse, M., Why Ownership is not everything, Financial Times, April 24 1986

With regard to the allocation of resources, economists have identified two types of efficiency, namely productive and allocative efficiency. Productive efficiency considers the question of whether a company produces a given level and quality of output at minimum cost. In order to avoid being taken over, or facing bankruptcy, companies strive to produce at minimum cost. Ownership is consequently claimed to be the key to productive efficiency. Privatisation enhances productive efficiency whether or not the privatised firm operates in a monopolistic or competitive market environment. The demands of shareholders, in respect of the returns earned on their investment, dictate that privatised

companies organise their internal affairs as efficiently as possible. Allocative efficiency on the other hand is concerned with the ability of a business to respond to the needs of customers in respect of the price and quantity of goods produced. Customer satisfaction is enhanced by the nature and extent of competition in the market. Market structure is therefore the key to allocative efficiency.

Prowse (1986) asserts that a public sector firm in a competitive market has the incentive of meeting customers' needs, but not at minimum cost. Conversely a privately-owned monopoly has the incentive to minimise costs, but tends to ignore consumer needs in terms of the range and price of its output. The size of a company is crucial concerning productive efficiency considerations. In respect of a large privately-owned monopoly, there is no real prospect of either takeover or bankruptcy and hence no strong incentive to minimise costs. Private monopolies may also underperform compared to public monopolies with regard to allocative efficiency. According to Prowse (1986), private monopolists tend to strive more seriously to maximise profits, which in their case will not lead to the efficient pricing of goods. Limited gains with regard to efficiency can thus be expected from privatising a public monopoly without addressing the issue of market structure.

Prowse (1986) continues:

> 'Nationalisation and privatisation are both ideologies that emphasise the significance of ownership. Nobody would argue that ownership is irrelevant but there is cause for concern when this consideration starts to deflect attention from the more important economic issue of market structure.'

When a government decides to privatise a state-owned business which has enjoyed monopolistic market protection, that government needs to address the question of deregulation, as well as other competitive issues.

3.8 OBSTACLES TO PRIVATISATION

Privatisation is an intensely political process, which entails fundamental restructuring of the economic, social and political environment. These changes, however, engender opposition and resistance. Some obstacles to privatisation include:

a. There is genuine concern that a private monopoly will replace a public monopoly. However, public monopolies tend to enjoy almost guaranteed

finance and regulatory protection, whereas private monopolies must compete for financial resources, and they are exposed to, if not protected from, potential competition.

b. The economic structure in many countries is highly concentrated. There is concern that privatisation will strengthen this concentration if exiting conglomerates or business elites are allowed to obtain effective control of businesses which have hitherto operated within the ambit of the public sector.

c. The privatisation of state-owned enterprises entails that productive resources are transferred from the public to the private sector. Many groups within society which are committed to a socialist economy, are vehemently opposed to privatisation and have used industrial action and publicity campaigns in order to halt the privatisation process.

d. Governments have traditionally used their businesses to achieve certain policy objectives, such as pricing. There is, however, considerable reluctance in government circles to relinquish this control over the economy. On the other hand, private investors would be loathe to invest in companies which are effectively controlled by governments and which act as an instrument for government policy.

e. Cross-subsidisation of government services benefits some groups within the economy. Privatisation would normally bring about a desire to divest unprofitable activities, which would engender opposition from the groups so disadvantaged. A common charge against privatisation is that privatisation tends to result in service being rendered only to easy and profitable customers, while difficult and unprofitable customers are neglected.

f. It is not always easy to determine a fair market value of a public sector firm which is to be privatised. Invariably, this invokes criticism that public assets are being given away to certain privileged groups.

g. Public sector enterprises which governments are most keen on selling, are often those with the greatest losses because profitable state companies provide positive cash flow to governments. Private investors, however, would only be interested in purchasing loss-making concerns if the prices are extremely low, and indeed well below net asset value.

h. Although a government may be keen to privatise a particular state-owned enterprise, internal conditions such as entrenched working practices may require substantial organisational and financial restructuring before interest from the investment community can be enticed. Organisational and financial restructuring represents change which needs to be appropriately managed and which may be a very time consuming process.

i. Political commitment is an essential prerequisite for privatisation to occur. However, the realities of bureaucratic politics are such that government leaders have many economic and social programmes on their agendas, not all of which can be accomplished. They need to weigh the relative costs and benefits of alternative agenda items, and trade-offs need to be made. Privatisation may consequently not be a priority, particularly in those instances where the expenditure of political capital to force through a privatisation programme is unlikely to reap commensurate political rewards in return.

j. Privatisation changes the power structure within society. Public sector businesses often enhance the power of the Ministries which oversee these businesses. The transfer of these companies to the private sector is likely to be resisted by Ministry level policy makers. Public sector trade unions are also likely to resist privatisation because the power of unions is enhanced by the political involvement of government in the industrial relation mechanisms of public sector enterprises.

k. In many instances, the sheer size of some public sector companies may exceed the capital resources available to private buyers. In many developing countries, a sophisticated capital market does not exist. The capital market may consequently be unable to mobilise sufficient amounts of local private investment capital. A privatising government may accordingly be required to turn to foreign investors. This type of foreign investment may, however, be politically unacceptable.

l. In many countries, the general public has a very limited tradition of owning shares in companies. The reasons for individuals not investing in shares include:

- A lack of understanding of shares and how they work;
- No knowledge of how to purchase shares;
- An unwillingness to take on the risks associated with share ownership; and
- Legal restrictions on share ownership.

3.9 THE STAKEHOLDERS

Privatisation represents change. Change implies that certain individuals and groups benefit, whilst the change may be detrimental to the interests of other individuals and groups. If the privatisation initiative is to succeed, early identification of these beneficiaries and disadvantaged groups is crucial. A complete analysis needs to be made of the perceptions of the various interest groups which are affected by the privatisation process.

Austin, et al. (1986,pp.55-56) state:

> 'Because of their multiple objectives and broad sphere of activities, public enterprises typically enjoy the support of many groups with vested interests in continued government control. At the highest level there is the head of state, who may genuinely favour privatisation of state enterprises but whose awareness of the political risk and unfavourable publicity may make him hesitant to act. Government bureaucrats within supervising ministries resist privatisation or hinder its implementation because they fear privatisation will erode their influence and power. Similar resistance comes from SOE managers and employees who believe their jobs may be at stake if new owners attempts to rationalise employment. Finally, customers who sell to or buy from SOEs on relatively favourable terms are afraid they will be deprived of these benefits if privatisation occurs. They can exercise political pressure to maintain the status quo.'

According to Pirie (1986), the operations of the public sector need to be regarded as processes and examined thoroughly in order to track down the way in which their elements motivate individuals involved as producers or consumers, as tax-payers or beneficiaries. Policy creativity is required to ensure that the new reality will be willingly supported by enough of its participants to make the privatisation initiative a success, and to guarantee its permanence. Micropolitics is the art of generating conditions in which individuals are motivated on a voluntary basis, to prefer and embrace the alternative of private supply. Privatisation is most securely achieved when its progress is evolutionary, arising from free decisions.

Privatisation will fundamentally influence the future roles of government and consequently redefine the relationship between the public and private sectors. The interest of the government and government officials in the privatisation process is multi-faceted. Certain aspects are as follows:

a. Many governments pursue a privatisation policy for ideological reasons. These governments believe in the superior performance of the free market economy. Most governments, however, are faced with budgetary constraints, and would attempt to maximise the revenue that can be obtained from the sale of a public sector company.

b. Privatisation removes, or at least diminishes, the control of a government over the affairs of an enterprise. Often, a government may not wish to relinquish control, particularly if the government perceives the company to be of strategic interest to the rest of the economy.

c. The fact that many privatised businesses have been transformed from being tax consumers into tax producers is a major incentive for other governments to embrace privatisation. An increase in tax revenue is compounded by a decrease in subsidies.

d. The fact that nominally socialist governments such as the New Zealand labour government, have enthusiastically embraced privatisation indicates that privatisation is no longer ideologically based.

e. Privatisation provides funds which can be used by the government to retire public debt, thereby reducing the public interest burden. Alternatively, privatisation frees financial resources which can be used for social investment and other development projects.

Most enterprises are taken into the private sector by very much the same management which ran them in the public sector. Although in the United Kingdom privatisation was initially opposed by the senior management of some public sector companies, the general consensus soon changed in favour of privatisation. Steel and Heald (1984,p.17) allege:

> 'Suddenly, faced with an owner which can see nothing good in nationalised industries, the mood in certain industries seems to have swung decisively in favour of joining the private sector on the best possible terms. This changed outlook can partly be explained in terms of management simply watching the way in which the political wind was blowing.'

In some cases, where management actively opposed privatisation, the Thatcher government did not hesitate to replace the management.

The Thatcher government also imposed very restrictive financial controls on the public sector. The managements of public sector companies became visibly upset with the Treasury's enforcement of restrictive external financing requirements as they were at odds with corporate plans and investment requirements of the businesses. Steel and Heald (1984,p.17) continue:

> 'When they complained, they were told that such 'public sector constraints' were an inevitable consequence of their nationalised status and the only way to relax them would be to set the industries 'free in the market-place'. Making life unnecessarily unpleasant for the nationalised industries thus became a convenient spur to a change in management attitudes towards denationalisation.'

If a public sector company's senior management is supportive of the government's privatisation initiative, it certainly facilitates the privatisation process.

The management of a company which is to be privatised have inter alia the following concerns:

a. Privatisation offers the prospect of less interference by government officials in the operations of the privatised company. This independence from government interference tends to facilitate quicker decision making. Management needs to be less aware of political dimensions but more conscious of commercial implications of their actions.

b. It is highly likely that the remuneration packages of executives and other managers will improve after privatisation.

c. The objectives of privatised companies tend to be much clearer than they were when the companies were part of the public sector. The profit motive tends to be the central driving force rather than a combination of political, social and economic objectives.

d. The prospect of being able to participate in a share ownership scheme and other performance based reward structures, tends to be a powerful incentive for improving managerial performance.

Privatisation will only succeed if the advantages and benefits of a privatisation initiative are clearly understood and recognised by the employees of a firm which is to be privatised. Understanding necessitates an honest and clear communication campaign. Policy makers must also recognise that the potential social and economic dislocations accompanying privatisation are real and must be addressed. Privatisation almost always involves work force reductions in both blue collar and managerial ranks. Governments consequently need to make arrangements for retraining, job placement, and unemployment insurance. The major concern for public sector workers appears to be the issue of job security, as well as the uncertainties brought about by the privatisation process.

Thomas (1984,p.75) alleges:

> 'Public ownership may have bid up the terms and conditions of less skilled staff (like clerks and some manual workers) with poor bargaining power, and depressed the rewards which highly skilled workers (like managers and engineers) would expect in the private sector. In this precise sense public ownership has been an egalitarian force. How denationalisation will affect the staff of an enterprise will vary, depending not least on what, if any, productivity improvements result and on whether (as is likely) staff experience these productivity increases as fewer jobs, but higher pay.'

In order to boost morale and stimulate worker interest in the process of privatisation, the practice of share allocations being made on a preferential basis to employees is now generally accepted. This practice entails inter alia, an offer of free shares, an offer of shares given in proportion to shares purchased, and priority in the allotment process.

TABLE 8
EMPLOYEE PARTICIPATION IN UK GOVERNMENT SHARE SALE

COMPANY	DATE OF SALE	PERCENTAGE OF ELIGIBLE WORK FORCE PARTICIPATING
British Petroleum	Oct 79	43%
British Aerospace	Feb 81	74%
Cable and Wireless	Oct 81	99%
Amersham International	Feb 82	99%
National Freight Company	Feb 82	36%
Britoil	Nov 82	72%
Associated British Ports	Feb 83	90%
Enterprise Oil	Jun 84	71%
Jaguar	Jul 84	19%
British Telecom	Nov 84	96%
British Gas	Dec 86	99%
British Airways	Feb 87	90%

Source: Privatisation in the United Kingdom. Background Briefing, Her Majesty's Treasury, 1987

Privatisation in the United Kingdom has been slowed down by the argument from trade unions that privatisation would increase unemployment, as well as reduce standards of living and working conditions of public sector workers. The public sector trade unions have consequently been the group most vehemently opposed to the privatisation of public sector companies.

In the United Kingdom, unions, faced with the threat of denationalisation, pursued a strategy of attempting to win public opinion against the sale of public sector companies. In this regard union officials lobbied Members of Parliament, sent delegations to ministers, held press briefings and special conferences with members and other sympathetic groups, and produced vast amounts of publicity material against privatisation. The unions tried to build alliances against privatisation and elicited the support of consumer groups as well as top management of nationalised companies. The union's cause would receive excellent publicity if a public sector company's board openly stated that

denationalisation would damage the interests of an enterprise. The Thatcher government effectively closed this potential channel of union agitation by appointing supporters of the policy of privatisation when board vacancies arose. Few unions have used their strongest sanction, that is industrial action in an attempt to halt denationalisation.

Unions are, however, flexible and they have demonstrated their pragmatism by at times accepting privatisation as the lesser of two evils, when the other alternative was the complete closure of an enterprise or plant. The negotiating stance of the unions has included two objectives, namely that the public corporations should pass intact into the private sector and that guarantees should be provided that jobs and employment conditions of public sector workers would be unaffected. In a private sector environment, guarantees of this nature are of course unlikely, if not impossible.

Privatization has brought about a number of consequences for public sector unions:

a. Privatisation has significantly reduced the leverage of unions. In the United Kingdom, for example, industrial relations are increasingly conducted outside the political arena.

b. Privatisation has fostered militancy in some normally quiet unions.

c. Certain unions have adjusted their structures because corporations have been structurally reorganised as a result of privatisation.

d. Public sector unions have normally restricted their operations to the public sector. This self-denying ordinance cannot continue if public sector companies move towards the private sector.

Suppliers also have an interest in the privatisation of public sector companies. When tendering for contracts, domestic suppliers normally enjoy preference over foreign suppliers. This preferential treatment is likely to change after privatisation. Debt incurred by a state-owned enterprise is also generally guaranteed or underwritten by a government, which is not normally the case with private sector companies.

It would appear that consumer interest mainly concerns the provision of reasonably priced quality products and services. However, the reality is more complex. Behind the framework of statutory monopoly, extensive patterns of cross-subsidisation have emerged and consumers who currently benefit from the

practice of cross-subsidisation have sought to defend their interests. The notion that most consumers benefit from privatisation, is nowadays generally accepted, particularly if privatisation is accompanied by deregulation.

In countries such as France and the United Kingdom, privatisation has had a major effect on the distribution and pattern of share ownership. Privatisation has significantly contributed to the emergence of popular capitalism which is defined as the extension of ownership of wealth more widely in the economy. These new shareholders constitute a lobby which can be counted upon to oppose moves towards any subsequent renationalisation of a privatised concern. There are risks, however. De Jonquieres (1987,p.1) states:

> 'In democratic societies, at any rate, any serious failure by privatisation to deliver the positive economic results which the great mass of people have been encouraged to expect from it could lead rapidly to disenchantment and erosion of public support. That reaction could be compounded i. many small investors who have been persuaded to buy shares in privatised companies suffered losses as a result of a steep decline in equity markets.'

3.10 SUMMARY

Privatisation represents a fundamental shift in the economic practices and philosophies of governments in a number of countries. Privatisation signifies the individuality of the market economy rather than collectivism of the state economy. This transformation is a highly complex issue mainly because privatisation has an impact, either positively or negatively, upon the interests of all individuals and groups within society. Successful privatisation must take account of the political processes emanating from the actions of different interest groups which are affected by the privatisation initiative. Privatisation theory, however, states that a conscious effort should be made to spread the benefits resulting from privatisation as widely as possible. A most significant benefit of privatisation is the enhanced prospects for economic growth resulting from productive resources being transferred from the public to the private sector.

An understanding of and insight into the theoretical issues and considerations of privatisation is essential before the practicalities of privatisation can be considered. The application of privatisation is discussed in Chapter Four.

CHAPTER 4

THE APPLICATION OF PRIVATISATION

4.1 INTRODUCTION

The objective of this chapter is to discuss practical issues in respect of the implementation of the privatisation process. This chapter builds upon the theoretical issues of privatisation discussed in Chapter Three.

Although privatisation of different public sector enterprises tends to be unique, the implementation of a privatisation initiative is nevertheless a highly structured process. This chapter highlights some of the issues with regard to the implementation of a privatisation programme. Firstly, the stages of privatisation are listed. Some of the issues and activities identified during the different stages of the implementation of the privatisation process are discussed in the subsequent sections. The issues covered are the feasibility study, the legislative issues, the role of advisers, the preparations required for privatisation, the issues in respect f the valuation of a privatisation share issue, the privatisation methodologies, the question of partial privatisation, and the marketing of the privatisation process.

4.2 STAGES TO PRIVATISATION

Once a public sector company is identified as a possible candidate for privatisation, a number of logical steps are presented. These steps can be regarded as generic, although the exact procedure will of necessity be unique in each case where a state-owned business enterprise is privatised.

a. Stage one.

A feasibility study needs to be undertaken by the responsible government officials and the management of the identified business enterprise. External experts such as merchant bankers and management consultants normally assist in the feasibility study. The objective of this study is to ascertain whether the particular public sector company can sensibly be moved into the private sector. The feasibility study aims to initially highlight peculiar circumstances and problems that a particular privatisation may incur. It may touch on issues such as the prospective financial and organisational structure of the business which is investigated. In particular, various activities of a public sector conglomerate may not be equally suitable for privatisation. The

feasibility study may consequently assist in establishing an appropriate market definition for the strategic business units which are considered suitable for privatisation.

- A report on the prospects for privatisation is accordingly presented to the ministers. The feasibility study report discusses the options and prerequisites of a specific privatisation.

- A political decision is then taken to proceed in principle with the privatisation of the particular company. A choice is also expressed as to the methodology of the privatisation, such as a sale by means of floatation on the stock exchange.

- During stage one, political commitment to the privatisation of a particular state-owned enterprise is obtained and is publicly announced by the government.

b. <u>Stage two.</u>

- During stage two, the identified privatisation candidate is prepared for eventual privatisation. The management team may be strengthened. Private sector attitudes amongst management and staff are encouraged and new methodologies are introduced. The acculturation process may be complex and may be a rather time consuming exercise.

- The organisational structure of the business which is to be privatised, is adjusted. This process mainly entails two aspects, namely the appointment of an appropriately skilled management team, as well as effecting an appropriate market and business definition for the business. In particular, some strategic business units which do not conform to the chosen market and business definition of the firm may be hived off in a separate privatisation. However, if such a strategic business unit is not a suitable candidate for privatisation, then alternative arrangements must be made to keep the strategic business unit within the public sector.

- Conscious efforts are initiated in order to strengthen the balance sheet. Management efforts are directed to achieve a history of profitable performance.

- The government needs to prepare enabling legislation, as well as consider a regulatory regime that may be necessary. In some instances, time may be needed to foster the development of a deregulated environment.

- If necessary, the state-owned business is legally restructured as a company, thereby conforming to the legislation regulating normal private corporate entities.

- Advisers are appointed to assist and identify, as well as facilitate any organisational, financial or legal reorganisation exercise that may be necessary before privatisation can take place.

- During stage two, the first tangible steps are taken to bring about the transfer of the public sector company to the private sector. All interest groups are appropriately informed of the ensuing privatisation.

c. <u>Stage three.</u>

- The balance sheet is adjusted and authority is obtained to create and sell state assets if so required. Important financial ratios such as the debt-equity ratio, are brought into line with industry convention.

- A well-run public corporation with a commercially oriented management is created.

- The state-owned enterprise is now ready to be transferred into the private sector.

d. <u>Stage four.</u>

- A market slot in respect of the selection of appropriate shareholders and stock exchanges where the company is to be traded are chosen.

- A decision on the number of shares to be sold, as well as the price of the shares is taken. The question of whether the share issue is to be underwritten, as well as the timing of the privatisation particularly with reference to other issues, is addressed.

- The government needs to prepare enabling legislation, as well as consider a regulatory regime that may be necessary. In some instances, time may be needed to foster the development of a deregulated environment.

- If necessary, the state-owned business is legally restructured as a company, thereby conforming to the legislation regulating normal private corporate entities.

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- A decision on the number of shares to be sold, as well as the price of the shares is taken. The question of whether the share issue is to be underwritten, as well as the timing of the privatisation particularly with reference to other issues, is addressed.

- A pathfinder prospectus may be produced in order to test the market.

- A prospectus, outlining in careful detail the characteristics of the company, is to be produced.

- Public support is engendered through well-designed advertising and public relations campaigns.

- During stage four, the company is transferred to the private sector, even although the government may still retain some shareholding. Private sector attitudes and methodologies are, however, at this stage well entrenched in the privatised company.

4.3 THE FEASIBILITY STUDY

As a logical first step, it is essential to conduct a comprehensive feasibility study of the public sector enterprise in order to determine and evaluate its suitability as a candidate for privatisation. This study would entail a thorough examination of the business and would include a review of the following aspects:

a. The market which the enterprise serves, as well as the nature and intensity of the competitive environment needs to be analysed. This analysis may need to address questions such as whether deregulation needs to be promoted and whether provisions for consumer protection need to be established.

b. Financial results achieved, as well as future prospects need to be evaluated. The evaluation is crucial, because the investment community will only consider providing risk capital if reasonable prospects for adequate profits exist. Financial forecasts, as well as reported financial results achieved, must present a true and fair assessment of the financial condition of the enterprise.

c. The capital structure, and in particular the relationship between debt and equity, must be addressed. The industry's convention as to the debt-equity ratio must be ascertained in order that the financial risk profile of the business, if privatised, can be comparable to other industry participants. Potential sources of equity and debt capital must be be identified and evaluated as to sufficiency.

d. Prospective cash flow and working capital requirements need to be determined. The extent and ability of the business to generate funds internally is particularly important in this connection.

e. The taxation position of the public sector company must be considered. If privatisation would change the tax status of the enterprise, the impact of this change needs to be assessed.

f. The ability of the management team, as well as the suitability of the organisational structure, needs to be evaluated in order to determine whether changes are needed to enable the business enterprise to deal effectively with its future in the private sector.

g. The arrangements and charges to aspects such as pension schemes that may be required, must be clearly spelled out and the implications thereof highlighted.

h. The enabling legislation must be identified.

It is not to be expected that a public sector enterprise will satisfactorily meet all of the above criteria. The feasibility study will, however, provide information and guidance as to whether or not to proceed with privatisation; what areas of concern need to be resolved and corrected; the most suitable method of sale; the timescale which should be allowed; as well as enable an action plan to be compiled stating the responsibilities of those concerned. In particular, the milestones to be reached along the path to privatisation must be highlighted. Although the management team of the business enterprise under consideration needs to be involved in the feasibility study, individuals outside of the business must also be involved in order to provide expertise, as well as a different perspective and, importantly, provide credibility to the feasibility study. The feasibility study document is presented to the political authority, after which a decision in principle to proceed with privatisation is made.

4.4 LEGISLATION

Before privatisation can occur, the government must pass enabling legislation through Parliament. The legislation can either be of a general nature, authorising the government to privatise any business currently under its control, or specific, authorising the government to privatise a specific public sector company. In the former case, privatisation can generally proceed more rapidly as has been exemplified by the recent French privatisations, whilst in the latter case, the nature and characteristics of privatisation can be considered in more detail.

A particular privatisation initiative may need several pieces of legislation. Firstly, legislation may be necessary to unwind the public corporation and to create a limited company to which all property, rights and liabilities may be transferred. In addition, separate legislation may be required to give the government the power to sell the newly formed company. Legislation concerning a regulatory environment may also be required before privatisation can be seriously considered. Finally, aspects such as pension schemes may also need to be embodied in legislation. Depending upon the parliamentary procedures of individual countries, a considerable period of time may elapse between the drafting of the necessary 'white papers' or other documents of intent, through to the final enactment of the legislation by the appropriate legislative authority. In particular, if political consensus concerning the privatisation of a particular public sector company is absent, or if considerable opposition to privatisation from an ideological point of view exists, then the legislative process may be very time consuming.

4.5 THE ROLE OF ADVISERS

The privatisation of a state-owned enterprise can be a highly complex issue. Often, the expertise needed is not available within government departments or even within the public sector company itself. The process of bringing in private experts to handle aspects of the mechanics of privatisation is called the 'privatisation of privatisation'

After the government has publicly committed itself to privatise a particular public corporation, a number of advisers need to be appointed. In the majority of privatisations in the United Kingdom, the government and the firm which is to be privatised, have contracted different financial advisers (normally a merchant bank) and different solicitors. In the United Kingdom, a typical privatisation which entails flotation on the stock market, have required the following advisers to be appointed:

a. Financial advisers to the government.
b. Financial advisers to the company.
c. Solicitors to the Offer for Sale (acting on behalf of the government).
d. Solicitors to the company.
e. Solicitors to the underwriters.
f. Stockbrokers to the Offer for Sale (acting on behalf of the government).
g. Stockbrokers to the company.
h. Auditors and reporting accountants (normally a firm of
i. Chartered Accountants acting on behalf of the company).
j. Accounting advisers to the government (normally a firm of
k. Chartered Accountants).

l. Reporting specialist consultants (where, for example the business of the company is sufficiently specialised to warrant an independent professional report on a particular matter contained in the offer document).
m. Registrars and custodian bankers.
n. Advertising and public relations consultants.

Merchant bankers seem to be the professional advisers who merit the most attention for a number of reasons. Merchant bankers become crucially involved in the organisational process and advise on topics which may be highly controversial. Merchant bankers can provide guidance as to the ideal financial structure of the company after privatisation. Moreover, merchant bankers can provide advice on measures that need to be taken in order that the best possible price can be obtained on the stock market.

In the United Kingdom, the government and companies to be privatised, have found financial advisers particularly useful in respect of the following issues:

a. To conduct a strategic review of the organisation, which would include a comprehensive review of the present operational and financial position as well as the potential prospects after privatisation. In addition, the strategic review would address crucial organisational restructuring issues such as the strategic business unit structure of the business enterprise. The company's current management abilities would need to be considered.

b. Advice on the financial implications of introducing a regulatory regime, and in particular providing on the monitoring methods to be used by such a regulatory body.

c. To compile documentation required by the stock exchange.

d. To provide advice on the capital structure and and the available sources of finance.

e. To provide guidance on tax implications and the affects of taxation on the organisation after privatisation.

f. Employment issues, and in particular pension liabilities post-privatisation.

g. Appropriate accounting policies to be considered and adopted by the company post-privatisation.

h. The effectiveness of the accounting and management information systems and changes necessary to deal with the company's requirements after privatisation.

The role of legal advisers is to review the following matters to ensure that there are no issues which might ultimately jeopardise the privatisation:

a. The adequacy of insurance cover and its compliance with legal requirements in conjunction with the company's insurance brokers.

b. The nature of material contracts and agreements.

c. The details of material property title deeds to ensure that there are no defects of title or onerous conditions attached thereto.

d. All loan and lease documentation to ensure that there are no onerous conditions

e. All outstanding litigation.

In order to achieve maximum goodwill towards the company which is to be privatised, a communication strategy needs to be devised in conjunction with the company's advertising agents and public relations consultants. In particular, during the time of floatation, the company may wish to conduct an advertising campaign in order to stimulate interest in the company in general, and in its shares in particular. The communication strategy needs to take into account of the situational requirements of various interest groups and stakeholders.

The role of advisers is to provide guidance with regard to the wide array of actions needed to be taken when a public sector enterprise is prepared for privatisation. The ultimate objective is not only to achieve a maximum price during floatation but also to position the company strategically for its role in the private sector.

4.6 PREPARING FOR PRIVATISATION

After the decision has been made to privatise a public sector enterprise, a number of actions need to be taken to prepare the enterprise for its role in the private sector. Many aspects of the enterprise's organisation and operations are likely to require substantial change. Typical features which tend to require review inter alia, include the following:

a. Business and market definition.
b. The strategic business unit structure.
c. Corporate strategy and business plans.
d. Management objectives and structures
e. Financial control and reporting systems
f. Accounting policies.

g. Organisational structure.
h. Adequacy of marketing.
i. Management information systems.
j. Legal matters.
k. Personnel and training.
l. Pension arrangements.
m. Preparation of legislation and regulatory aspects.
n. Settlement of structural issues.

The first step in preparing a state-owned business for privatisation is to convert the enterprise into a company with shares. This process is called corporatisation. The new corporate entity is at this stage still wholly owned by the government, but is legally obliged to adhere to the provisions of relevant company legislation. At this stage the company must also be in a position to prepare financial statements as required by appropriate generally accepted accounting conventions.

The management of the company which is to be privatised, must conduct a strategic analysis and review of the company, particularly with a view to its strategic positioning after privatisation. The strategic review of the business needs to consider the market and business definition of the company after privatisation very carefully. This review would indicate the appropriate structure of strategic business units after privatisation. Management needs to evaluate the adequacy and appropriateness of the company's goals and objectives as required for success in the private sector. Any change in strategic direction, however, poses the question of whether the management team would be able to implement such a strategic reorientation. The availability of appropriate resources to effect such a change is an important issue which needs to be addressed. The internal political consequences of such a change must also be evaluated.

In preparing the enterprise for privatisation there may be a need to strengthen the management team and introduce private sector attitudes and methodologies. Significantly, the management restructuring exercise must be carried out at a reasonably early stage in order to allow a substantial period of time during which the strengthened team can familiarise, establish and prove itself in the eyes of the general public, the investment community and customers. The commitment of the management team to the privatisation initiative is considered to be essential. A board of directors must be appointed. At least some directors need to be drawn from the private sector for the sake of their commercial experience. The board of directors is charged with the responsibility of preparing the enterprise for privatisation and it would require the ambition to remain with the company for some considerable time thereafter. The board of directors must also be given clear strategic objectives, as well as challenging financial and performance targets.

In many countries, businesses in the public sector apply different accounting systems from private sector companies. Consequently, a review of all financial reporting and control systems needs to be undertaken to determine whether they are appropriate to a listed company, adequate to safeguard the company's assets, and whether they are capable of producing reliable and timely accounts, reliable management accounts and comprehensive budgets and reliable forecasts.

A review of all accounting policies and practices must be conducted as soon as possible after the decision to privatise has been taken. These policies and practices need to have been consistently applied over the five years immediately prior to the public offering, and must be appropriate for a listed company. It may be necessary to consider whether prior year figures need to be restated, and whether or not the information is available to make the necessary adjustments. If a listing on a foreign stock exchange is contemplated, adjustments may be required in order that the results are determined in accordance with the appropriate generally accepted accounting principles. A number of accounting policies and practices must be considered:

a. Timing of recognition of revenue and expenditure.
b. Basis of consolidation.
c. Foreign exchange accounting.
d. Amortisation and depreciation of tangible and intangible fixed assets.
e. Capitalisation expenditure such as research and development costs.
f. Accounting for leasing.
g. Treatment of extraordinary items.
h. Deferred taxation
i. Valuation of assets.

The public profile, or the perceived image of a public sector company, may not inspire the necessary enthusiasm from the investment community. Consequently, it may be necessary for the enterprise to conduct a thorough review of its public profile. The company must project its new public image to consumers as well as the investment community. On the one hand the company must address the market for its products and services, whilst on the other hand the company must take the market for its shares into account.

Because legal liabilities may significantly affect the value of a privatised concern, a review of all outstanding or pending litigation needs to be conducted with a view to:

a. Ensuring that these legal liabilities will not be prejudicial to the offer for sale.

b. Establishing whether a satisfactory settlement can be achieved prior to the offer for sale.

c. Determining what information needs to be disclosed in the prospectus on the assumption that the matter cannot be successfully resolved prior to its issuance.

The liabilities stemming from the public sector company's pension fund need to be carefully evaluated. In particular, the financial state of a public sector company's pension fund may seriously impair the prospects of privatisation. In some instances, the pension fund may need to be fundamentally restructured. Employees may consequently be offered alternative pension arrangements which they may accept or reject. The pension scheme arrangements in a privatised company must satisfy the following conditions:

a. The pension scheme must be fully funded, as determined by an actuarial valuation carried out as recently as possible.

b. The benefit structure of the scheme must be comparable to those of other companies in the private sector, and not unduly onerous, such as being inflation linked.

The government must consider the regulatory environment in which the newly privatised company will operate with the view to stimulating the necessary competition and ensuring consumer protection. Guide-lines on the establishment of a regulatory regime or the development of a deregulated environment must also be sufficiently clear to potential investors so that they can interpret the possible commercial impact on the company. A number of issues must be considered for the promotion of greater competition with the objective of promoting efficient operations and expanding consumer choice:

a. Tariff policy and price controls.
b. Licensing of new entrants.
c. Foreign ownership restrictions.
d. Contestability of markets.
e. Environmental constraints.

The relationship between the privatised company and the government needs to be addressed prior to privatisation. This relationship is inter alia, circumscribed by:

a. The percentage of shares retained by the government, i.e. the extent of ownership and equity control remaining with the government.

b. The existence of a 'golden share' which entails certain pre-emptive rights, but no profit participating rights.

c. The degree to which long term debt, either provided or guaranteed by the government, will remain after the floatation. It is generally not feasible for a government to remove guarantees in respect of existing debt.

The financial structure of many public sector companies may need to be adjusted before privatisation can take place. The gearing of the enterprise (debt-equity ratio) must conform with what is considered to be appropriate in a particular industry if the share issue is to be attractive to the investment community. An unacceptably high gearing ratio can be rectified by any of the following mechanisms:

a. New shares may be issued to the government for cash prior to the floatation.

b. The government may assume directly or indirectly part or all of the existing debt.

c. 'Treasury shares' may be offered by the company in exchange for cash.

d. The capital structure may be adjusted by 'off balance sheet' mechanisms such as operating lease arrangements and lease-back operations.

4.7 VALUATION

Selling an enterprise is an administratively complex task. The assessment of the value of the company being privatised is a particularly difficult task, especially in those countries which lack well developed and sophisticated equity markets. In countries such as the United Kingdom, the government has been willing to experiment and innovate in respect of privatisation issues in order to achieve a fair price for both the tax-payer and investors.

However, pricing a share issue is always a difficult matter of judgment, whether the company being floated is state- or privately-owned. The valuation is particularly complex if the company's shares have not been traded before, or when there are no directly comparable companies currently listed on the stock exchange. Furthermore, between the date of fixing the price of an issue and the first day of trading, conditions on the stock market may have changed considerably. Some privatisations involve very large companies relative to the size of the equity market. Although the market value of these shares may be regarded as a fair price, the valuation remains controversial.

The value of a company as an on-going concern is derived from its ability to earn profits in the future. This ability arises from managerial action. The value of a company, and consequently of a share, is thus directly related to the quality and excellence of a company's management. The net book value of assets as they appear in the balance sheet based on a company's historical cost, is of little relevance to the value of a company. In some circumstances, the net realisable value of assets may be an appropriate indication of the company's value. This type of valuation is appropriate when a company is in imminent danger of liquidation. In spite of the fact that a state enterprise may run at a loss for socio-economic reasons, this does not imply that these assets have no value. Although the value of an enterprise bears a relationship to its asset base, value is derived from the use being made of these assets.

In order to achieve maximum benefit for the state, an independent assessment of asset value should be undertaken at the time of privatisation. Griffiths (1985,p.2), asserts that an independent assessment of asset value should be a regulatory requirement for each transfer into the private sector. Even if a special price or arrangement is justified, a proper full valuation should also precede whatever agreement the price of a public asset is finally reached.

Pricing a share may be more of an art than [illegible]. Although it may hold considerable appeal to establish as high a pr[illegible] possible, especially if a secondary offering to existing shareholders is included, overpricing a share must be avoided. There is a high probability that an overpriced share issue may fall on the stock market. Investor confidence may consequently be destroyed, thereby accelerating a downward propensity in the share price. If a share is slightly underpriced, in order to allow for a modest price rise in the immediate aftermarket, public interest may be stimulated. Slightly underpricing of shares and offering preferences to key constituencies such as existing management, employees and customers may pay off handsomely in terms of boosting morale and strengthening the privatised concern's market position. Grossly underpricing a privatisation issue, however, may elicit considerable criticism and political opposition that may endanger a government's privatisation programme. Moreover, when a privatisation issue is grossly underpriced, the result is a smaller equity injection than could be achieved. A privatising government should obtain professional advice with regard to valuation of a privatisation share issue. Underwriters typically advise a company on an appropriate price to ensure an active aftermarket in the shares.

The pricing of privatisation issues has a number of peculiar characteristics which somewhat complicate the matter:

a. Often, a privatised concern enjoys a prominent public profile. If it can be shown that these companies have reasonable profit prospects, then considerable interest appears to be expressed by the investment community.

b. The perceived public image of a state-owned enterprise may significantly affect the market valuation of its shares when being privatised.

c. In those instances where the privatised company dominates its industry, there are no benchmark companies with which to compare its share valuation.

d. Many privatised companies tend to be large, which may create a perception of security thereby stimulating market demand and consequently market valuation.

e. The government can fundamentally influence the market value of a company which the government intends to privatise. Firstly, if a government establishes a highly competitive environment prior to privatisation, or intends to promote deregulation after privatisation, this type of market liberalisation would lower the privatised company's profit potential and would consequently depress the company's share price. The financial restructuring exercise whereby the gearing ratio is adjusted may also have an impact on the privatised company's market valuation.

4.8 PRIVATISATION METHODOLOGIES

The mechanics of privatisation tend to be very complex, mainly because the circumstances surrounding different public sector activities tend to be more or less of a unique nature. In practice, the shift of supply from the public to the private sector necessitates a battery of sophisticated techniques which take full account of the political and social problems of the public sector, as well as economic shortcomings.

Each instance of privatisation raises its own problems and this has led to the realisation that there is no one premier privatisation technique. The approach needs to be situational in the sense that each part of the public sector constitutes different problems and requires different sets of techniques. Although a large number of variants (Appendix 4) on the privatisation theme have been identified, four main privatisation methodologies exist. Firstly, denationalisation refers to the sale of a public sector asset or enterprise, either wholly or partly. Secondly, contracting represents the substitution of private contractors for in-house production. Thirdly, liberalisation means the removal of statutory prohibitions on

the private sector competing against the public sector. Liberalisation may also entail the encouragement of private sector supply, rather than from the public sector and could include activities abandoned by a public sector enterprise. Finally, charging involves the substitution of user charges for tax finance. These different methodologies may be applied in conjunction with each other in the case of a particular public sector activity.

TABLE 9
A TYPOLOGY FOR PRIVATISATION

	PUBLIC PRODUCTION	PRIVATE PRODUCTION
PUBLIC FINANCING	Public Sector	Contracting
PRIVATE FINANCING	Charging	Private Sector - Denationalisation - Liberalisation

Denationalisation concerns the sale of a state-owned enterprise to the public. Denationalisation represents the most significant form of privatisation in the sense that denationalisation involves a change in ownership of the productive resources within an economy. Denationalisation has typically taken one of the following forms:

a. Floatation of existing shares or new shares through one or more stock exchanges by means of an offer for sale, a tender, or a combination of both.
b. Private vendor placement of shares.
c. Sale to managers and or employees.
d. Disposal of residual shareholdings in private companies.

In the case of larger public sector businesses, the usual method of privatisation has been a public floatation on a stock exchange. In these instances, parliamentary authority must be obtained in most countries. This legislation normally provides for the creation of a new public limited company to take over the business operations of the public sector enterprise, which is called corporatisation. Initially the government holds all shares in the new company, but provision is made for the government to dispose of all or some of these shares at a public floatation. Meanwhile, the new company is prepared and restructured for a new role in the private sector.

Depending upon considerations such as the size of the equity market, the government may decide to dispose of its shareholding of large companies gradually. In the case of public sector conglomerates, a government may well decide to break up the conglomerate and privatise the constituent businesses separately. If the company fulfils a strategic role in the economy, the government may also insist on provisions that will preclude a take-over by another company, or specifically by foreign interests. In some instances, a small foreign shareholding may be desirable. In particular, foreign participation in privatisation may provide a desirable inflow of foreign capital for those countries which are burdened by an onerous foreign debt commitment. Special provisions in respect of shareholding may be made for specific interest groups such as management, employees, customers and financial institutions, in order to obtain greater commitment from these groups. The selection of specific shareholder groups may be significant with regard to the company's strategic position, marketing abilities and efficiency of production. It is important to recognise that the various public sector companies which are to be privatised, require the application of different and unique approaches. There are peculiar circumstances within each company, and specific needs of stakeholders in different companies.

Contracting involves the substitution of public sector supply with private sector supply because the private sector business can presumably produce more efficiently than the public sector entity. Successful change-over to contract services involves inviting competitive tenders from companies seeking the business. This method involves recognition that a government can still be responsible for guaranteeing a supply, even when that government does not produce the supply itself.

The advantages of contracting entail the following:

a. Contracting harnesses competitive forces and brings the pressure of the marketplace to bear on inefficient producers

b. Contracting permits better management, free of most distractions characteristic of overtly political organisations.

c. The costs and benefits of managerial decisions are felt more directly by the decision maker, whose own rewards are directly at stake.

d. Contracting permits a quicker response to new needs and facilitates experimentation in new programmes.

e. Contracting relieves a government of non-viable state activities.

f. Contracting limits the size of government involvement, at least in terms of the number of employees.

g. Contracting enables a government to take advantage of specialised skills lacking in its own workforce.

h. Contracting is a way of avoiding large capital outlay. Contracting spreads costs over time at a relatively constant and predictable level.

i. Contracting can reduce the dependence on a single supplier and consequently lessen the vulnerability to strikes.

The arguments against contracting involve the following:

a. Contracting implies higher costs because the contractors need to make a profit.

b. Contracting increases the scope for corruption.

c. There is a limited number of qualified contractors, which makes comparison of price and quality nigh impossible.

d. Managing and monitoring contractor performance is a costly exercise.

e. The marginal cost of expanding government service tends to be low.

f. Contracting limits the flexibility of government response to emergencies.

g. Contracting is demoralising to employees and deprives the government of skills which are needed in-house.

h. Contracting fosters an undesirable dependence on contractors and leaves the public vulnerable to the risk of bank uptcy of the contracting firm.

In many countries, contracting often represents a first experiment with privatisation because contracting allows a government to retain some control. Contracting can be regarded to be on the periphery of the trend towards privatisation as it does not involve a clean break with state control as offered by denationalisation. Contracting-out has been described (Ernst and Whinney, 1987) as the 'privatisation of management.' The management of a public sector enterprise need only control and evaluate the performance of the contractor in general, rather than manage the operation in its entirety.

A simple method of extending the reach of the private sector is to abolish the monopolistic protection which shelters the state's domination of some activities. This method provides an opportunity for private entrepreneurs to enter a particular industry without dismantling the public sector company. If a public sector company needs to compete for customers, it can be expected that it might seek out innovations and improvements and keep its prices competitive. Deregulation is thus one way of improving efficiency of this type of business and preparing it for eventual privatisation in the form of denationalisation.

Charging prices for public services is a form of partial privatisation. Just as the production of goods and services may be either in the public or the private sector, the finance of production may also be in either sector. Charging prices for public services involves taking finance into the private sector whilst leaving the production in the public sector.

4.9 PARTIAL PRIVATISATION

Although a government may wish to transfer a particular public sector business enterprise to the private sector, there is evidence that in many instances, a government may still retain a minority shareholding, or indeed a majority interest.

According to Steel (1984,p.102):

> 'Given the extent to which the hybrid had become the chosen method of denationalisation, the term 'residual shareholding' is itself significant for it scarcely carries any sense of deliberate choice or permanence. Ministers have argued that hybrid status is not a destination to be reached but only an intermediate station en route to full denationalisation. In support of this view, they point to the limits on the capital market's ability to absorb large flotations and the difficulties of fixing prices at which shares should be offered. Both these considerations are said to favour moving in stages rather than selling all the shares at once.'

A state corporation with no history of profitable operations might not command a very high price. By selling a percentage of a public sector company's shares, especially a controlling percentage, the state returns the public sector company to the private sector even while the government retains a significant holding. As the disciplines of the private sector assert their effect on the privatised company, it becomes more cost-effective and more profitable, the value of the state's interest increases, and the remaining shareholding can be sold at a higher price.

It would appear that an enterprises which is significant to the performance of the economy as a whole, is likely to take the form of mixed public-private ownership

at least for the foreseeable future. Many governments intend to retain at least a minority, if not majority shareholding, in those companies which they regard as being of strategic interest. Pickering (1984,p.56) states:

> 'In our political culture there may be a need to express the state's involvement in such industries through a shareholding, even when the government of the day espouses a free market ideology.'

The gradual approach to privatisation may also be regarded as a method to defuse opposition to privatisation. By gradually divesting tranches of shares the state's shareholding is eventually reduced to a minority interest. At this stage the management, employees and consumers have become accustomed to the company operating within the private sector, and private sector culture has become firmly established and secure. Gradual privatisation also enables a government to experiment with and gain experience in the concept of privatisation.

The view that the existence of private shareholders and consequent disciplines of the capital market will make it more difficult for a government to intervene in the affairs of a privatised company, thereby shielding such hybrid companies from political pressures, is regarded with some scepticism. Many companies with substantial government shareholding operate in areas where the government retains major responsibilities. It seems highly unlikely that a government will not attempt to influence major policy and strategic decisions taken by a privatised firm.

If a minister decides to intervene in the affairs of a privatised company, this intervention can be achieved by mobilising the government's shareholding. However, direct involvement in a privatised company's activities would be a last resort. The company's directors would be well aware of the latent power of a large block of voting shares. Steel (1984,p.109) states:

> 'One suspects that even now they are conscious of the fact that their largest shareholder is only sleeping not deceased and would consider it prudent to listen carefully to ministers' views.'

A government would also be in a strong position to influence board appointments On specific issues, ministers could resort to the practice of persuasion and arm-twisting which they have adopted on many occasions in the United Kingdom, as well as in other countries, in relation to public sector companies.

The potential role that a government would play in the affairs of a privatised company can be analysed by providing answers to the following hypothetical questions:

a. Would a government allow a major privatised company, in which it has retained a significant shareholding, to be declared insolvent?

b. Would the government allow a privatised firm to drastically curtail some unprofitable operations on the basis of the argument that cross-subsidisation is no longer feasible?

c. If, in order to preserve unprofitable operations, an explicit subsidy is granted, would a government not take a close interest in the manner in which it was calculated and spent?

d. Would the government be able to ignore an industrial dispute in a privatised concern which is strategic to the rest of the economy?

In a number of instances, a government's shareholding is largely superfluous because it also owns a 'Special Share' which can be invoked to outvote all other shares, albeit only in strictly defined circumstances, such as the prevention of a takeover attempt and the reduction of influence of foreign shareholders. A 'golden share' is of considerable significance because the threat of takeover is one of the mechanisms of capital market discipline.

4.10 MARKETING THE PRIVATISATION PROCESS

Similarly to the marketing of any product or service, the marketing of a privatisation issue must proceed along established marketing principles, taking into account aspects such as product design (for example ordinary or preference shares), pricing of shares, promoting the share issue, as well as establishing appropriate distribution channels. It is of particular importance for the success of a privatisation initiative, that an assessment of the needs and requirements of the targeted market segments is made. In the case of a privatisation issue, the targeted market segments consist principally of the stakeholders. It is crucial to the success of marketing a privatisation issue that a general consensus in respect of the desirability of the privatisation exists amongst the various stakeholders.

The process of privatisation is not only dependent upon the will of the government. There must be considerable creativity in policy innovation, each requiring new and sometimes intricate techniques tailored to the specific characteristics of a particular privatisation. In the United Kingdom, the success of the privatisation concept is exemplified by the fact that the number of individual shareholders more than trebled during the past eight years. Shareholders are now spread right across the different socio-economic groups. The enthusiasm of both institutional and private investors in providing funding in areas which have

traditionally been regarded as only capable of attracting state guaranteed finance, has also been a major feature of change in the British financial system. In South Africa, for example, financial institutions reacted enthusiastically with regard to the privatisation of SASOL.

A government has two main options when pricing an issue, namely fixing the price according to its assessment of the value of the enterprise, or by means of a tender. In the former case, all those who wish to buy at the stated price are sold shares scaled down in the event of an over-subscription, whilst in the latter case, the government announces a striking price and all those who have tendered above that price are sold shares at the striking price. It is thought that in the first case small investors are favoured, whilst in latter case financial institutions are favoured.

The objective of the marketing exercise is to create the correct image of the company in the market for investment funds. It also needs to be borne in mind that this marketing exercise would take up a tremendous amount of executive and management time. The marketing efforts in a privatisation issue are usually directed at the following audiences, namely the investment community (domestic and foreign financial institutions, larger and smaller private investors), the stockbrokers, opinion-forming individuals such as financial analysts, the financial and other media, as well as the management and employees of the firm which is to be privatised. In the United Kingdom special arrangements have been made to encourage the extension of share ownership, particularly employees, customers, small investors, and on occasion, foreign investors.

These special arrangements include inter alia, the following:

a. The widest possible marketing of shares, consistent with retaining proper protection for investors.

b. Marketing of shares by means of a corporate advertising campaign on television, as well as in the press.

c. Detailed press coverage explaining the privatisation and method of application for shares.

d. Detailed communication with journalists from the financial and popular press to ensure there would be fair coverage, and in the hope that newspapers would encourage people to apply.

e. A regional network of stockbrokers and other financial intermediaries has been developed in order that full information about privatisation issues can be widely and sensibly disseminated.

f. Opening a share information office, to handle enquiries on privatisation in general, as well as the share issue in particular.

g. 'Road shows' for investors that are hosted by the senior management of the company immediately prior to privatisation.

h. Using branch and outlet displays to promote the privatisation campaign.

i. Issuing a publication on how to buy and sell shares.

j. Issuing a 'pathfinder prospectus' in cases where full information about a company is not already in the market, as well as to provide a mechanism to gauge market interest in the company.

k. Introducing 'mini-prospectuses' and simplified application forms for shares.

l. Deliberately fixing the minimum amount of money required to make an application for shares as low as possible.

m. Allowing payment by instalment for shares.

n. Allowing investors more time in which to make their applications.

o. Giving a bonus distribution of shares (loyalty bonus) to those small shareholders who retain their shares for an extended period of time.

p. Holding a fees competition in order to determine the composition of the equity underwriting syndicate, thereby reducing the costs of the share issue.

q. Acting effectively against multiple applicants, namely investors completing more than one application form.

r. Issuing vouchers to individual shareholders for application against the purchase of the company's products or services.

s. Offering discounts to shareholders for the purchase of a company's products and services.

t. Weighing allotments in the event of oversubscription in favour of those investors applying for a low number of shares.

u. Offering free shares to employees and management, as well as preferential treatment in the allocation of shares.

Pickering (1984,p.55) expresses the view:

> 'The encouragement to employees and small investors to hold shares sits rather uneasily with the government's stated preference for the free market, since it involves administrative interference in the sale to produce a desired political result. In the case of free share offers for employees, there is also a conflict, albeit quite a small one, with the objective of achieving the best price for the tax-payer.'

Sometimes it may be necessary to market a limited number of shares overseas. This type of foreign placement is done in order to ensure that the issue as a whole will be successful, as well as to obtain additional benefits for the national economy. Firstly, in some instances a country's equity market may not be sufficiently capitalised to be able to successfully absorb the privatisation issue. Secondly, selling overseas may stimulate the demand for shares, thereby ensuring that a fair price is achieved. Moreover, in those instances where the company is operating in the international market, a foreign shareholding may actually strengthen its market position. Participation in overseas financial markets may also add value to a company's profile overseas, which in turn can lead to valuable export orders. However, a listing on a foreign stock market entails adherence to a larger number of regulations and may also bring about onerous reporting requirements.

The prospectus is a document of prime importance when the shares of a company are placed on the market. The prospectus discloses general information about the company which is to be privatised. Specific information on the company's sales, profit margins, competitive position, as well as its executive officers and directors is contained within the prospectus. The prospectus also contains information on how the company's management sees its future as a privatised concern, together with projections of earnings and capital requirements. It is carefully scrutinised by financial analysts and can significantly influence the demand for a company's shares.

The timing of a public offering is crucial to its success. There are certain constraints appertaining to the precise timing of an issue. It is now common practice for the issuance of a prospectus to be carried out in two steps. Firstly, a 'pathfinder prospectus' is issued which is complete, except that the price of the shares and other financial information are excluded. The 'pathfinder prospectus' is used to gauge investor interest and to assist in pricing of the shares. Approximately three weeks later the final prospectus is issued. However,

conditions on the stock market from the date of publication of the prospectus and the day the shares are finally listed could have changed fundamentally, and could significantly affect the success of the privatisation issue.

However, the success of a share issue can be 'guaranteed' by the involvement of an underwriter, or syndicate of underwriters in the case of larger issues. Commission paid to underwriters can thus be regarded as a form of insurance safeguarding a public sector company's entry into the private sector.

4.11 SUMMARY

Privatisation is a highly structured process and requires meticulous attention to detail. Before the privatisation of a specific public sector enterprise can be considered, a feasibility study must be conducted. Political commitment would only be forthcoming if the political authorities are satisfied that the specific public sector company can feasibly be privatised. Moreover, the political authorities need to pass the necessary legislation in order to make privatisation a reality.

The company which is to be privatised, normally would not possess the required skills and expertise to effect all the various aspects of the implementation of privatisation. Advisers, such as merchant bankers and management consultants, would play an extremely useful role in this regard. The involvement of advisers in the privatisation process is known as the 'privatisation of privatisation'. In particular, the restructuring of the business which is to be privatised, may elicit some very sensitive issues, which the internal interest groups could find difficult to deal with. The restructuring process involves legal, organisational and financial dimensions. Corporatisation is an essential step before privatisation can occur. The organisational issues in respect of the restructuring process concern aspects such as an appropriate strategic business unit structure, as well as the availability of an appropriately skilled management team. The financial restructuring process mainly involves the establishment of an appropriate capital structure for the privatised company.

Although a variety of privatisation methodologies can be identified, the floatation of a company on one or more stock exchanges is regarded as the essential form of privatisation. The floatation of a company on a stock exchange, however, entails many complexities, for example, the valuation and timing of the share issue. The valuation of a privatisation share issue is a particularly difficult exercise. Partial privatisation may in some instances be a tactic whereby the complexities of privatisation can, in the short to medium term, be dealt with effectively. Finally, the implementation of a privatisation initiative requires the conscious marketing of the privatisation process amongst internal, as well as external stakeholders.

Theoretical considerations, and practical issues with regard to privatisation, as discussed in Chapters Three and Four respectively, form the basis of key success factors for privatisation which are identified in Chapter Five.

CHAPTER 5

KEY SUCCESS FACTORS FOR PRIVATISATION

Moving public sector companies into the private sector is a complex process. Knowledge and understanding of the characteristics of successful privatisation are therefore crucial. Specialised skills, as well as an innovative approach to the peculiar problems and challenges presented by the privatisation process, are required. New techniques have been developed to ensure that vital national and public interests could be reconciled with private ownership. The key success factors in privatisation, which are listed in this chapter, have been developed from the theoretical and practical issues with regard to privatisation, which have been discussed in Chapters Three and Four respectively. Key success factors for privatisation are numerous and include the following:

a. The government must have no further interest in owning the enterprise concerned. Political commitment is crucial to privatisation. The government must also be convinced that public policy will be better served by private supply. A government must take particular care that its privatisation policies are not frustrated by government bureaucracy. The government must also be convinced of the underlying strength and vitality of the private economy.

b. It is essential to ensure that privatisation does not result in the erosion of essential services, which would result in political support evaporating rapidly. If unprofitable activities merit support, subsidies should be direct, contractual and specifically targeted.

c. The company must be attractive to the investment community. The prospects for profits should be real and reasonable, remaining so for at least the short to medium term.

d. The privatised company should not be burdened with large amounts of debt or contingent liabilities (such as a deficit on its pension fund or any unresolved litigation claims or proceedings). In particular, the debt-equity ratio should be comparable to what is regarded to be the industry norm.

e. The enterprise should be ready and willing to enter the private sector. An appropriate financial structure, management team and other facilities should be organised before privatisation. The organisational culture must also be appropriate to a private sector environment.

f. The privatisation process will make significant demands on management's time. Management must be prepared for such demands and responsibilities, and be capable of dealing with them. The strength of the management team will be closely scrutinised by underwriters and investors alike. The quality and excellence of management have a significant impact on the share price the a company being floated.

g. The government should consider the regulatory environment in which the privatised company will operate as early as possible. The regulatory guide-lines must be clear, yet sufficiently comprehensive to enable potential investors to interpret the possible commercial impact on the company.

h. Privatisation can only succeed if there is close cooperation between the authorities and the private sector in all of its ramifications.

i. The sale of an enterprise must be acceptable to the public. The public would normally demand that the enterprise is sold at a 'fair' price. It must be kept in mind that the value ascribed by an investor to a business enterprise would generally be determined by reference to the entity's prospects for profits. The capacity of a privatised firm to pay dividends, presently as well as in the future, rather than the net asset value of the business, tends to be the basis for valuing an on-going concern. The profits of the enterprise should therefore be able to support a value of at least equal to its net assets, otherwise the government will be accused of disposing public assets at less than their value.

j. The Government needs to be convinced that privatisation will not conflict with its economic policy or damage local interests, for example. through the closure or relocation of plant or through massive redundancies.

k. Government policies must not be encroached upon through privatisation, for example. a potential investor might be a foreigner or might be a competitor. Concerns like this would need to be identified, and a plan for their resolution prepared.

l. The interests and concerns of all stakeholders must be understood and satisfied. Employees may be concerned about job security, as well as maintenance of pension arrangements. Customers and suppliers may be concerned that the enterprise may use its monopoly position to exploit them. In the United Kingdom, experience has shown that the most successful privatisations have been those where all of the major interest groups have benefited to a greater or lesser extent.

m. The public should be satisfied that the sale of the enterprise is fair and equitable. A widespread public issue without restrictions is the most favoured route. Sale to a single buyer is more risky as it exposes the government to criticism of favouratism and underpricing. It is extremely important to avoid creating the notion that the shares are being given away to a few people.

n. The stock market should be buoyant, but not overheated. Unstable conditions would tend to limit interest emanating from risk averse first-time investors. In the United Kingdom, the concept of privatisation was boosted by the longest running bull market. The slump on the world's stock exchanges since October 1987 may result in privatisation plans of some governments being postponed either temporarily or indefinitely.

o. In order to stimulate investor interest in privatisation, it is desirable that the share price be slightly underpriced. This gives small investors, as well as employee shareholders, an immediate tangible benefit in respect of the privatisation initiative.

p. It is crucial that the value of the firm which is to be privatised, is determined as accurately as possible.

q. Policy makers must resist the temptation to view privatisation as the panacea for all of their economic problems. This view can only lead to disappointment if privatisation does not produce the desired result. Privatisation will not resolve all of the problems surrounding public enterprises, but experience has revealed that privatisation is both desirable and feasible in many instances.

r. The privatisation solution must be tailored to the unique political, social and economic conditions that exist in different countries. The unique characteristics existing within the industry, as well as the peculiarities of the firm itself must also be taken into account fully. In other words, privatisation requires a situational solution.

s. It is essential that the opponents of the privatisation initiative be identified as early as possible. Specific steps can then be taken to break down the resistance from such groups as government officials, management, employees, unions, and consumers.

t. It is essential that the best possible professional advice is obtained. Credence should be given to 'privatising the privatisation process.'

u. It may be necessary to design creative and innovative financial products, especially in those equity markets which lack sufficient capitalisation. The nature of the shares offered must correspond to the needs of the potential investors and the privatised company alike.

v. An appropriate communication strategy needs to be devised in order to inform all stakeholders of the nature, process, timing and consequences of privatisation.

w. The first attempts at privatisation should be taken with those public sector companies which already operate on the periphery of the private sector. Success would give the government confidence to attempt the more difficult cases. The privatisation programme should also be adequately spaced to allow the equity market to absorb successive privatisations.

x. When a particular private sector company has been identified as a candidate for privatisation, the momentum achieved must be retained. A realistic timetable must be prepared and progress towards privatisation must be continually monitored.

y. The privatisation process must be carefully planned, and the appropriate administrative apparatus must be put in action in order to carry out the privatisation. According to Austin, et al. (1986,p.56), the following issues must be addressed in the planning effort.

- Over what period of time will the divestment program be conducted? Most countries have grossly underestimated the length of time it takes to complete the sale of even one company.

- If for financial or other reasons the companies cannot be sold all at once, in which order should they be sold? Should the biggest losers be sold first, in order to save money, or should the most profitable (and easiest to sell) be offered first?

- How much of the equity in each public sector company should be offered for sale? The government may retain some equity if it feels the need to maintain a degree of control over the divested enterprise through partial equity ownership.

- What form of decision-making and approval process should be followed in carrying out the divestment program? Experience shows that once the administration of a divestment process becomes politicised, the speed and smoothness of flow of the process can be seriously impaired. The more carefully the

process is spelled out at the outset, the less chance there will be of political interference, subjective interpretation and changing the 'rules of the game' along the way.

- Who will manage the process once the privatisation process is established? Failure to provide the divestment process with a strong and credible administrative entity has been a serious flaw in many privatisation efforts. Because divestment calls for sophisticated financial, legal, public relations, managerial, and negotiating skills, the privatisation process cannot be entrusted to a weak and under-funded bureaucracy for its execution. A recommended approach is to create a temporary 'privatisation commission' of recognised, non-political professionals and technicians representing both the public and private sectors.

- How will the divestment effort be financed? The initial costs of mounting a successful privatisation programme can be significant. The costs include legal fees, title searches, management consulting and investment advisory services, and most important, the enormous investment that must be made (in some cases) to get a company's balance sheet into saleable condition.

Successful privatisation requires meticulous attention to detail. Although the privatisation process needs to be highly structured, the implementation process must be very innovative and creative. In particular, the motivations of the various stakeholders must be understood, and appropriate strategies devised. Privatisation represents a strategic reorientation for a privatised company, and significantly affects the strategic positioning of a privatised company. Privatisation is, however, a unique experience and requires a tailor-made approach.

The theoretical and practical issues in respect of privatisation, as well as the key success factors of privatisation, which have been discussed in Chapters Three, Four and Five respectively, together with the characteristics of the airline industry, which has been discussed in Chapter Two, form the basis of a hypothesised framework for privatisation in the airline industry. The hypothesised framework for airline privatisation is discussed in Chapter Six. The practical experience of some privatised airlines with regard to the suggested framework for airline privatisation, is described and analysed in Chapter Eight.

CHAPTER 6

AIRLINE PRIVATISATION : A FRAMEWORK

6.1 INTRODUCTION

The objective of this chapter is tc present a framework for airline privatisation. This framework is based upon the analysis of the characteristics of the airline industry, as well as the theory and application of privatisation as described in Chapters Two to Five. The purpose of this framework for airline privatisation is to identify and describe the scope for and implications of the strategies and general characteristics appertaining to privatisation in the airline industry.

Although airline privatisation is a rather complex issue, twenty-five propositions which endeavour to explain some major issues with regard to the scope and implications of airline privatisation, were derived from the analysis of the strategic an operational characteristics of the airline industry, as well as from the evaluation of the theoretical and practical implications of privatisation. These propositions formed the basis of the structured interviews which were conducted with key individuals from a number of airlines which had recently been either fully or partly privatised.

6.2 A FRAMEWORK FOR AIRLINE PRIVATISATION

The concept of airline privatisation is a relatively novel one, which surfaced in 1979, when British Airways was first suggested as a candidate for privatisation. A number of airlines, such as Malaysian Airline System, Singapore International Airlines, Alitalia, Cathay Pacific Airways, as well British Airways have since been floated on one or more stock exchanges. Also, some airlines which were already partly privatised such as KLM, Japan Air Lines and Lufthansa, succeeded in raising fresh equity, thereby reducing the extent of state ownership. In the cases of British Airways and Japan Air Lines, the British and Japanese governments completely divested their shareholder interest in their respective national airlines. Several governments have recently publicly expressed their interest in privatising their national airlines, and an inexhaustive list includes airlines such as as Air France, Air Canada, Air New Zealand, Alia Royal Jordanian Airlines, Australian Airlines, Qantas, South African Airways, Mexicana, Pakistan International Airways and Aerolineas Argentines.

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The rationale for postulating and devising a framework for privatisation as applicable to the airline industry, is based upon the premise that there are certain unique situational characteristics appertaining to privatisation in different industries. However, the situational framework for privatisation also suggests that the unique institutional features, and the peculiar political and economic considerations within each country, as well the specific conditions within each airline all influence the privatisation process. The situational framework is based upon the notion that privatisation is a micropolitical approach, taking the interests of the various stakeholders into consideration. In particular, the situational framework requires the formulation of a unique strategy for privatisation in different airlines.

It is postulated that there are a multitude of different reasons and objectives for privatisation in the airline industry. Firstly, the airline industry has massive capital requirements. State-owned airlines do not have access to the world's equity markets, and consequently must rely on debt finance. Such a reliance on debt finance tends to affect the financial risk profile of a particular airline detrimentally. The economic, social and political environment in which the airline industry operates is also in a state of flux. Secondly, the trend towards deregulation of the airline industry would appear to make state-ownership of one of the competing airlines undesirable because that particular airline would not be subject to the disciplines of the capital market, whereas the other private airlines would if their strategic effectiveness and operational efficiency were to prove unsatisfactory. Thirdly, the theory of privatisation suggests that greater efficiency would be derived from privatisation. Privatisation might consequently result in an improvement of the marginal profit performance of the airline industry. Moreover, the general wisdom of the concept that airlines should operate within the ambit of the public sector might be questioned as the airline industry operates on the periphery of the private sector. Finally airline privatisation may be part of a general policy of privatising state-owned businesses.

It is thought that as a result of privatisation, the extent of political involvement in the affairs of an airline would diminish, but not entirely disappear. Firstly, airlines which operate international routes are still dependent upon their national governments to negotiate air traffic rights on their behalf. Secondly, as many governments view their airlines as strategic national resources, it is thought to be unlikely that a government would immediately divest the total share-holding that it holds in its national airline. Thirdly, airlines have a significant impact on the general economy and governments might be unwilling to relinquish direct control over the air transport sector of the economy. In particular, in most countries, commercial airliners need to be imported, which would have an impact upon the country's balance of payments. Moreover, many privatised airlines would tend to enjoy a dominant market position, thereby necessitating a regulatory framework in

order to protect consumer interests. Finally, the level of air fares is an extremely emotional political issue and it appears to be unlikely that a government would relinquish total control over the pricing policies of its privatised airlines.

The public image of a privatised airline is expected to improve after privatisation. When an airline is privatised, it is thought that its profit prospects ought to improve. The airline would also be able to pursue commercially oriented, rather than politically oriented policies and objectives. It would thus be seen to be operating as an independent business concern rather than as a branch of the government. The fact that a privatised airline is listed on the stock exchange would tend to enhance an airline's public image. In particular, there would be relatively few political considerations when the performance of a privatised airline is analysed. An airline's actual financial performance would tend to be the basis for scrutiny by financial and other investment analysts.

The objectives pursued by an airline's management are perceived to be far clearer after privatisation than before. In particular, it is thought that the management of a privatised airline would consciously pursue profitability as its prime objective. If, however, an airline's management pursued any non-economic objectives, it would be likely to be with the airline's overall strategic positioning in mind, rather than the government's social and political aims.

When a government decides to privatise an airline which hitherto has enjoyed monopolistic market protection, it would need to address the issue of establishing an appropriate regulatory framework. It would appear that establishing a private monopoly would be politically unacceptable. There would seem to be some conflict between privatisation and deregulation in the sense that deregulation would depress the profit prospects of an airline, thereby reducing the price that a government could obtain when floating the airline. There is genuine concern about privatising a public monopoly as a private monopoly. It is also plausible that some time would elapse before credible competition could emerge, and this might result in the privatisation process being delayed.

A government must be politically committed in order to privatise its national airline. Accordingly, a government must be willing to withstand political agitation from trade unions and socialist opposition against privatisation. It would, however, seem that from what is currently occurring in countries such as New Zealand, privatisation is no longer ideologically based. When analysing the reasons for privatisation in different countries, especially in third world countries, fiscal constraints seem to be the motivating force for embracing a policy of privatisation. The realisation by a government and its electorate that a loss-making airline, or any other state-owned enterprise for that matter, can no

longer be maintained by government finance and subsidies would seem to be a powerful incentive for the development of a national political consensus in favour of privatisation.

It is a fairly complex issue to determine the market value of an airline that is to be privatised. The value that private investors attach to a company is based upon its profit earning potential. Many airlines, however, have a history of marginal profitability and normal valuation techniques would consequently suggest a market value substantially less than its net asset value. Selling an enterprise at such a low price would patently be unacceptable politically. In most countries, the airline to be privatised would be the first airline listed on the stock exchange. There would consequently be no benchmark airline to assist in the valuation of the airline which is to be privatised. Another complication for airline valuation would appear to be the widely differing depreciation policies pursued by airlines in different countries.

Theory states that airline share price movements can be related to the cycle of economic activity. In particular, as a result of the high degree of operating leverage of airlines, airline profitability is highly sensitive to changes in the demand for airline services. It is consequently expected that airline share prices might be more volatile than the overall stock market index. Investors, however, tend to regard volatile shares as being risky. Investors in privatised airlines might consequently require a relatively higher rate of return on their investments than obtainable from other more stable sectors of the economy.

Many governments regard their national airlines as strategic national resources. Governments thus tend to place restrictions on foreign shareholding. These restrictions, however, also result in the prevention of the emergence of a truly global airline. Many bilateral air service agreements also stipulate provisions such as 'substantial ownership and effective control'. An international airline that ignores restrictions concerning the extent of foreign ownership would run the risk of international route licenses being revoked. There also exists a mechanism, called a 'golden share', whereby a government can resume control over an airline if foreign interests obtained a controlling interest in a privatised airline.

It is expected that airlines would tend to pay particular attention in selecting an appropriate group of shareholders. Firstly, airlines have very large capital requirements and this would indicate the necessity of involving financial institutions. Secondly, in spite of the appearance of a high degree of capital intensity, airline operations are highly labour intensive. In order to succeed in the market place, airlines must be highly service oriented and there would be the requirement of allocating a substantial amount of shares to employees. Thirdly, marketing considerations may indicate the necessity for allocating some shares to commercially important customers.

Airline privatisation is expected to proceed gradually, meaning that the state will only incrementally divest of its interest in the national airline. Firstly, the market capitalisation value might exceed the capital resources available on the national equity market. Secondly, gradualism would represent a cautious approach towards privatisation and it would therefore be easier to reverse the process if proven unsuccessful, than if the airline were fully privatised initially. Gradualism would also enable the airline to adapt its cultural orientation far more smoothly to private sector practices, than if it were plunged suddenly into the private sector. Finally, many governments regard their national airlines as strategic national resources, and would consequently be loathe to lose complete control over significant operational and strategic decisions that an airline's management may wish to make.

It is postulated that the time period required to privatise an airline varies among airlines and is influenced by the peculiar circumstances within an airline. It must be kept in mind that, although airlines operate on the periphery of the private sector, governments vary in their approach to and philosophy on allowing their national airlines to pursue private sector business practices. The extent of restructuring and preparation required for privatisation is thus expected to vary between airlines.

Privatisation in the airline industry requires substantial restructuring. This restructuring exercise is of a three-dimensional nature, namely legal, organisational and financial. Legal restructuring would entail the corporatisation of the airline. The airline would be registered as a public company according to the company legislation applicable in a specific country. As state-owned airlines already operate rather closely to the private sector, many airlines are already structured as corporate entities. Corporatisation would, however, be a prerequisite for privatisation to take place.

The organisational restructuring of an airline might be rather extensive, depending upon the peculiar circumstances within a specific airline. Firstly, an airline's management may not have the appropriate management in order to take the airline into the private sector. Privatisation can only succeed if the company's management is positively inclined towards privatisation. Secondly, an airline's productivity record might preclude it from operating as a privately-owned concern. In order to rectify and improve the airline's productivity performance, significant adjustments in working methods and employee numbers might be necessary. Guaranteed job security would also be normally unacceptable within the private sector. Finally, the organisation restructuring process may necessitate the creation of an appropriate group of strategic business units. This organisational restructuring process might be rather complicated and time-consuming. In particular, the politics of the privatisation process would have to be carefully managed.

The financial restructuring exercise would mainly entail adjusting the debt-equity relationship in accordance with the norm of the private sector airline industry. The financial risk profile of an airline tends to be a critical determinant of the willingness of investors to invest risk-capital in an airline. The extent of debt finance would also influence the amount of equity that could be raised, as well as the market capitalisation value of the airline. It would also be necessary to evaluate the extent of contingent financial liabilities such as the airline's pension scheme, as this might affect investor opinion of the airline's future profit prospects and financial health.

Airline privatisation needs to be marketed amongst the various stakeholders which have an interest in the well-being of the industry. The purpose of a marketing exercise would be to create and project the desired image of the airline internally, as well as externally. This type of public relations exercise is regarded to be essential in order to maximise investor interest, and consequently maximise the market value of the privatised firm. The purpose of an internal marketing exercise would be to elicit support and enthusiasm for privatisation amongst management and employees. In particular, privatisation would require cultural reorientation.

It is postulated that the relationship between a government and its national airline would change fundamentally once the airline has moved into the private sector. Firstly, the airline's top management would no longer be appointed by the government but would rather owe their continued tenure to their ability to satisfy and achieve shareholder objectives. Secondly, the government might be tempted to make the tax environment less favourable because they no longer own the privatised airline. Thirdly, long term debt incurred by a privatised airline would probably no longer be guaranteed by its national government. Some airlines, particularly from Third World countries, might however find it very difficult to obtain finance for aircraft acquisitions, and would therefore still require some form of government support. Finally, the government might no longer be supportive with regard to a regulatory environment. In particular, the government might want to grant an operating licence to a competing airline.

Privatisation is a rather complex issue and it is considered to be unlikely that an airline would have the required expertise to handle the complete privatisation process on its own. It is consequently expected that advisers would play a significant role in the privatisation process, This phenomenon is known as 'the privatisation of privatisation.' In particular, merchant bankers and underwriters would play a significant role in determining the market value of the privatised airline; accounting advisers would assist in developing an accounting system geared towards the needs of the private sector; and marketing consultants would assist in devising a communications strategy and programme directed at the internal and the external stakeholders.

The various privatisation methodologies, namely floatation, contracting, liberalisation and charging, are expected to be applicable to a greater or lesser extent in respect of the airline industry. Privatisation, for the purpose of this research study is taken to mean floatation on a stock exchange. It is expected that an airline would normally be floated on its national stock market, but because of the international nature of airline operations, a case for multiple listings would be appropriate. With regard to other privatisation methodologies such as contracting, it is inoustry practice that airlines contract services such as handling and catering to other organisations when these services are required outside the airline's home base. In a number of countries, some private airlines have also been licensed to operate in competition with the state-owned airline. These moves towards deregulation can also be regarded as initial steps towards fully privatising the state-owned airline.

Although a privatised airline would, for all intents and purposes, operate within the ambit of the private sector, it would be regarded to be unlikely that a government would allow its prime national airline to be declared insolvent. Experience in the United States as well as the United Kingdom, however, indicates that Braniff Airlines and Laker Airways were allowed to become bankrupt by their respective governments. These airlines carried only a relatively small proportion of total traffic in their countries, whereas the privatised national airlines generally carried a dominant share of the total market. Theoretical considerations of privatisation postulate that an absence of the risk of bankruptcy would result in an airline not operating as efficiently as it otherwise would.

Effective privatisation requires that the practice of cross-subsidisation be discontinued because operating unprofitable services would dampen overall profitability. It is consequently postulated that an airline in the process of privatisation, would probably terminate unprofitable services and close non-performing sales offices thereby reducing overall costs as well as improving overall profitability. It is to be expected that privatised airlines would be more sensitive to opportunities that could represent cost reductions. The theory of privatisation also postulates that privatised airlines would generally operate more efficiently than their state-owned counterparts.

6.3 SUMMARY

A framework for airline privatisation suggests a number of peculiar aspects which can be summarised as follows:

a. Airline privatisation is situational and this framework for privatisation also suggests that the unique institutional features and peculiar political and economic considerations within each country, as well the specific conditions within each airline, all influence the privatisation process.

b. Governments are motivated by a multitude of reasons and objectives to privatise their national airlines.

c. The ability of privatised airlines to obtain equity capital which can be used to finance aircraft acquisitions is a major incentive for airline privatisation.

d. It is thought that the extent of political involvement in the affairs of an airline would diminish, but not entirely disappear, after privatisation.

e. The public image of a privatised airline would improve after privatisation.

f. The objectives pursued by an airline's management are perceived to be much clearer after privatisation than before.

g. When a government wants to privatise its national airline, it also needs to consider the regulatory environment in which the privatised airline will operate.

h. The government must be politically committed to privatise its national airline.

i. It is postulated that the relationship between a government and its national airline would change fundamentally once the airline moved into the private sector.

j. In spite of the fact that they would be operating within the private sector, privatised airlines do not face the risk of bankruptcy.

k. The essential methodology of airline privatisation entails a listing on one or more stock exchanges.

l. It is a fairly complex issue in order to determine the market value of an airline that is to be privatised.

m. The share prices of privatised airlines are thought to be more volatile than the overall stock market indices on the stock exchanges where these airlines are listed.

n. Governments would tend to place restrictions on the extent of foreign shareholding in privatised airlines.

o. It is expected that airlines would tend to pay particular attention in selecting an appropriate group of shareholders.

p. Substantial employee share ownership is assumed to be highly desirable when an airline is privatised.

q. Airline privatisation is expected to proceed gradually and the state will only incrementally divest of its interest in the national airline.

r. It is postulated that the time period required to privatise an airline varies between various airlines, and is influenced by the peculiar circumstances within an airline.

s. Privatisation in the airline industry requires substantial restructuring. This restructuring exercise is of a three-dimensional nature, namely legal, organisational and financial.

t. Before an airline can be privatised, it must be incorporated according to the specific country's company legislation.

u. An airline may need to be organisationally restructured in terms of employees and management before privatisation can proceed.

v. The financial restructuring exercise mainly entails adjusting the debt-equity relationship in accordance with the norms of the private sector airline industry.

w. Privatised airlines would become more efficient and profitable than they were when they still operated in the public sector.

x. Airlines would require the assistance of advisers to provide guidance with regard to the various aspects and processes of privatisation.

y. Airline privatisation needs to be marketed amongst the various stakeholders which have an interest in the well-being of the industry.

The above propositions concern some of the major issues in respect of privatisation in the airline industry.

These propositions have consequently formed the basis of the research that has been conducted into the practical experience of major international airlines such as British Airways, KLM, Lufthansa, Singapore International Airlines and Japan Air Lines with regard to the privatisation phenomenon. The research findings are discussed in detail in Chapter Eight.

CHAPTER 7

RESEARCH METHODOLOGY AND APPROACH TO THE STUDY

The objective of this research report is to identify general guide-lines in respect of privatisation in the airline industry. The research aims to establish a generalised framework for airline privatisation from these guide-lines. An investigation into airline privatisation must take account of strategic and operational characteristics of the airline industry, as well as theoretical and practical considerations with regard to the phenomenon of privatisation.

A set of propositions for airline privatisation has been developed from perspectives gained from the strategic evaluation of the characteristics of the airline industry, which have been discussed in Chapter Two, as well as the theoretical and practical considerations of privatisation and the key success factors for privatisation, as discussed in Chapters Three, Four and Five respectively. A hypothesised framework for airline privatisation has been presented in Chapter Six. This framework forms the background against which the phenomenon of airline privatisation has been researched. It must be emphasised that there exists no authoritative reference work dealing purely with the phenomenon of airline privatisation.

Although various methodologies of privatisation can be identified in the airline industry, the main thrust of this research report concerns the phenomenon of airline shares being floated on one or more stock exchanges where they were previously owned by a government or a government agency. This research report is consequently concerned with those instances where either a fully or partly state-owned airline has been either fully or partly privatised.

The phenomenon of airline privatisation appears to have gained momentum recently. Several governments have expressed an interest in privatising their national airlines. However, the practical experience in respect of privatisation within the airline industry is at the present moment still rather limited. Although, for the purpose of this research report, it was endeavoured to select a broadly based sample of privatised airlines in order to be able to identify and evaluate the general principles of airline privatisation, the choice of research objects was rather limited. The airlines which were chosen, consist of British Airways, KLM Royal Dutch Airlines, Lufthansa German Airlines, Singapore International Airlines and Japan Air Lines.

The sample of airlines chosen for investigation represents the major approaches to privatisation in the airline industry:

a. British Airways was privatised from full state ownership to full private ownership.

b. In the cases of Lufthansa and Singapore International Airlines, the extent of the state's majority shareholding was reduced.
c. In the case of KLM the state's majority shareholding was reduced to a minority shareholding.
d. In the case of Japan Air Lines the Japanese government sold its remaining minority shareholding.

Harrigan (1983,p.400) notes that, 'Representative sampling can reduce the need to interview entire universes. For example, in-depth interviews with key competitors can provide data describing how the other competitors managed similar strategic challenges.'

The set of propositions, as described in Chapter Six, was tested and evaluated from information obtained from structured interviews which were conducted with key individuals from the chosen sample of privatised airlines. These structured interviews formed the basis of the research methodology. The questions which guided the structured interviews are attached as Appendix Five. The link between the various propositions and the questions posed to the different airlines is indicated in Table Ten which is attached to this chapter.

A complication of the research methodology pursued emanates from the fact that circumstances and philosophies within the different airlines that constituted the chosen sample, are considerably different. This difference of perspective between the various airlines influenced the course and nature of the interviews.

The main limitations of the research methodology pursued, are the following:
a. The nature of the research methodology, as well as the relatively small sample size of airlines being investigated, brings about the risk of the research results being biased by subjective opinions being expressed by the interviewees.
b. The lack of generality of some of the research, mainly with regard to the impossibility of applying rigourous statistical validation techniques.
c. The various research results may not necessarily be applicable to a particular airline because institutional arrangements in different countries may be vastly different.
d. Privatisation is a unique event for a particular airline. An experiment in respect of the privatisation of a particular airline can therefore not be replicated.

In order to reduce the risk of subjective analysis, the information and views obtained from the structured interviews were supplemented by reports from airline industry journals. The annual reports and prospectuses of the different privatised airlines were also thoroughly scanned in order to enhance the understanding and insight into the practicalities of the experience in respect of

privatisation by the different airlines. Harrigan (1983,p402) continues, 'Strategy research needs many sources of information to reconstruct firms' business strategies and comprehend their strategy choices.'

The approach of the research methodology has consequently been more of a qualitative, rather than a quantitative nature. The qualitative nature of the research emanates from the fact that the experience of the sample of airlines in respect of privatisation was analysed from viewpoints expressed by the key individuals who were interviewed. The qualitative analysis dealt with the following issues:

- The unique factors appertaining to privatisation in each airline.
- The motivations of privatisation from both the government's and the airline's perspective.
- The role of the government in the airline after privatisation.
- The issues in respect of the flotation of the airline, such as the valuation of the shares, the composition of shareholders, and the timing of the flotation.
- The preparations needed for privatisation (legal, financial and organisational).
- The extent to which advisers were utilised in the privatisation process.
- The marketing issues of the privatisation process.

Certain quantitative analyses were, however, conducted such as those estimating the beta values of some airlines, calculating returns on investment, debt-equity ratios, and productivity performances. The beta values of the respective airlines were calculated in order to determine the volatility of the shares of the different privatised airlines. The returns on investment and productivity performances were calculated in order to determine the efficiency and profitability changes in the different airlines as a result of privatisation. The debt-equity ratios were calculated in order to determine the extent of financial restructuring as a result of privatisation. The purpose of this type of quantitative analysis has been to illustrate a principle that emerged from the qualitative research rather, than establish a principle as such.

According to Harrigan (1983,p.399), 'the major advantages of fine-grained studies can include meticulous attention to detail, relevance to business practice and access to multiple viewpoints.' The rationale behind choosing a fine-grained research methodology has been:

a. The chosen research methodology made it possible to probe into key issues with regard to airline privatisation.
b. The detailed perspectives of the finer nuances of the privatisation process could be analysed.
c. The fine-grained research methodology requires meticulous attention to detail. Privatisation is a highly complex phenomenon.
d. The relevance to business practice could be easily established.

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d. The relevance to business practice could be easily established.

e. The fine-grained research methodology allowed access and analysis of multiple viewpoints. Privatisation is dealt with differently in different airlines.

To summarise the information gathered from the structured interviews, the annual reports and prospectuses of the different airlines, as well as reports from airline trade journals were collated. This information was analysed, evaluated and interpreted, particularly in respect of the set of propositions from the hypothesised framework for airline privatisation which has been discussed in Chapter Six. The research findings are discussed in detail in Chapter Eight, and the conclusions reached and recommendations proposed are listed in Chapter Nine.

TABLE 10

LINK BETWEEN PROPOSITIONS STATED (CHAPTER 6) AND QUESTIONS POSED TO KEY INDIVIDUALS OF AIRLINES THAT HAVE RECENTLY BEEN PRIVATISED

PROPOSITIONS	QUESTIONS
Airline privatisation is situational.	Please describe the background and origin of privatisation in your airline. What is your definition of airline privatisation?
Governments are motivated by a multitude of reasons and objectives to privatise their national airlines.	Why did your government decide to privatise your airline?
The ability of privatised airlines to obtain equity capital which can be used to finance aircraft acquisitions is a major incentive for airline privatisation.	Did the management of your airline favour privatisation? Why? What are the major benefits of privatisation for your airline? What are the major disadvantages of privatisation for your airline?
It is thought that the extent of political involvement in the affairs of an airline would diminish, but not entirely disappear, after privatisation.	What role does your national government play in the affairs of your company? Did the role of the government change after privatisation? Does your government possess any special mechanisms such as a 'golden share' with regard to your airline? Does your government still own any shares in your airline? If so, why?
The public image of a privatised airline would improve after privatisation.	Did the public image of your airline change after privatisation?
The objectives pursued by an airline's management are perceived to be much clearer after privatisation than before.	What are the major objectives of your airline's management? Did these objectives change after privatisation?
When a government wants to privatise its national airline, it also needs to consider the regulatory environment in which the privatised airline will operate.	Did the regulatory environment change after privatisation? How?
The government must be politically committed to privatise its national airline.	What are the national political considerations in respect of privatisation in your country? To what extent is your national government committed to privatisation as a national economic policy? What is the risk of renationalisation?

TABLE 10 (CONTINUED)
LINK BETWEEN PROPOSITIONS STATED (CHAPTER 6) AND QUESTIONS POSED TO KEY INDIVIDUALS OF AIRLINES THAT HAVE RECENTLY BEEN PRIVATISED

PROPOSITIONS	QUESTIONS
It is postulated that the relationship between a government and its national airline would change fundamentally after the airline moved into the private sector.	What role does your national government play in the affairs of your company? Did the role of the government change after privatisation? What is the nature of the relationship between your airline's management and government officials?
In spite of the fact that they would be operating within the private sector, privatised airlines do not face the risk of bankruptcy.	How credible is the risk of bankruptcy for your airline? Would your national government allow it?
The essential methodology of airline privatisation entails a listing on one or more stock exchanges.	What is your definition of airline privatisation? On which stock exchanges are your airline's shares listed?
It is a fairly complex issue in order to determine the market value of an airline that is to be privatised.	How did you determine the value of your airline's shares at the most recent share issue?
The share prices of privatised airlines are thought to be more volatile than the overall stock market indices on the stock exchanges where these airlines are listed.	How volatile are your airline's shares in comparison to other shares listed on your national stock exchange?
Governments would tend to place restrictions on the extent of foreign shareholding in privatised airlines.	Why did your airline's management decide to list your airline's shares on a foreign stock market? What restrictions, if any, do you place on foreign shareholding in your airline?
It is expected that airlines would tend to pay particular attention in selecting an appropriate group of shareholders.	Does your management pursue any specific policies in order to attract specific groups of investors as shareholders in your airline?
Substantial employee share ownership is assumed to be highly desirable when an airline is privatised.	To what extent do employees own shares in your airline? How important is the concept of employee share ownership for your airline's management?
Airline privatisation is expected to proceed gradually and the state will only incrementally divest of its interest in the national airline.	Does your government still own any shares in your airline? If so, why?
It is postulated that the time period required to privatise an airline varies between various airlines, is influenced by the peculiar circumstances within an airline.	Were there any factors that resulted in the privatisation of your airline being delayed?

TABLE 10 (CONTINUED)
LINK BETWEEN PROPOSITIONS STATED (CHAPTER 6) AND QUESTIONS POSED TO KEY INDIVIDUALS OF AIRLINES THAT HAVE RECENTLY BEEN PRIVATISED

PROPOSITIONS	QUESTIONS
Privatisation in the airline industry requires substantial restructuring. This restructuring exercise is of a three-dimensional nature, namely legal, organisational and financial.	What kind of restructuring was required before your airline could be privatised?
Before an airline can be privatised, it must be incorporated according to the specific country's company legislation.	Were there any legal complications concerning the privatisation of your airline?
An airline may need to be organisationally restructured in terms of employees and management before privatisation can proceed.	Did any employees or management lose their jobs as a result of privatisation? Do your management and employees enjoy security of tenure? Did the culture of your organisation change as a result of privatisation?
The financial restructuring exercise mainly entails adjusting the debt-equity relationship in accordance with the norms of the private sector airline industry.	What is the policy of your airline in respect of its capital structure? Did your pension scheme arrangements present any problems with regard to privatisation?
Privatised airlines would become more efficient and profitable than they were when they still operated in the public sector.	Did the effectiveness and efficiency of your airline improve as a result of privatisation?
Airlines would require the assistance of advisers to provide guidance with regard to the various aspects and processes of privatisation.	What role did advisers play in the privatisation process?
Airline privatisation needs to be marketed amongst the various stakeholders which have an interest in the well-being of the industry.	Who are the major interest groups with regard to privatisation in your country, and also in your airline? Did you market privatisation internally in your organisation? How? Did you market privatisation externally? How?

CHAPTER 8

AIRLINE PRIVATISATION : THE PRACTICAL EXPERIENCE

8.1 INTRODUCTION

This chapter discusses the results that emerged from the research study. The findings reported are in response to the propositions which emanated from the hypothesised framework for airline privatisation which is described in Chapter Six.

It needs to be emphasised that although some general conclusions may be reached from the research results, the research findings primarily concern those airlines which were investigated. The relevance of the research results discussed in this chapter therefore needs to be considered together with the unique factors and considerations present in the particular airline which is considered to be a candidate for privatisation.

The propositions for airline privatisation which were identified in Chapter Six, are discussed below in eight general categories. These categories are the following:

a. The applicability of a situational framework.
b. The motivations for privatisation.
c. The role of government in a privatised airline.
d. Floatation issues.
e. Partial privatisation.
f. Preparing for privatisation.
g. The role of advisers.
h. Marketing the privatisation process.

The relationship between the set of propositions identified in Chapter Six and the categories which are discussed in this chapter is indicated in Table Eleven.

8.2 THE APPLICABILITY OF A SITUATIONAL FRAMEWORK

The research findings confirm that a situational framework is an appropriate approach for airline privatisation. Conditions and circumstances within different airlines which were investigated differed widely, and this necessitated a unique approach to privatisation. In particular, it needs to be kept in mind that privatisation is a micropolitical approach. Successful privatisation consequently needs to take into consideration the psychology of the different interest groups very carefully. Motivations, and actions, and indeed the composition of these

TABLE 11

RELATIONSHIP BETWEEN THE CATEGORIES OF DISCUSSION IN RESPECT OF THE PRACTICAL EXPERIENCE OF AIRLINE PRIVATISATION (CHAPTER 8) AND THE HYPOTHESISED PROPOSITIONS FOR AIRLINE PRIVATISATION (CHAPTER 3)

CATEGORIES OF DISCUSSION	PROPOSITIONS FOR AIRLINE PRIVATISATION
The applicability of a situational framework.	Airline privatisation is situational and this framework for privatisation also suggests that the unique institutional features and peculiar political and economic considerations within each country, as well the specific conditions within each airline all, influence the privatisation process.
The motivations for privatisation.	Governments are motivated by a multitude of reasons and objectives to privatise their national airlines. The ability of privatised airlines to obtain equity capital which can be used to finance aircraft acquisitions is a major incentive for airline privatisation.
The role of a government in a privatised airline.	It is thought that the extent of political involvement in the affairs of an airline would diminish, but not entirely disappear, after privatisation. The public image of a privatised airline would improve after privatisation. The objectives pursued by an airline's management are perceived to be much clearer after privatisation than before. When a government wants to privatise its national airline, it also needs to consider the regulatory environment in which the privatised airline will operate. The government must be politically committed to privatise its national airline. It is postulated that the relationship between a government and its national airline would change fundamentally once the airline moved into the private sector. In spite of the fact that they would be operating within the private sector, privatised airlines do not face the risk of bankruptcy.
Flotation issues.	The essential methodology of airline privatisation entails a listing on one or more stock exchanges. It is a fairly complex issue in order to determine the market value of an airline that is to be privatised. The share prices of privatised airlines are thought to be more volatile than the overall stock market indices on the stock exchanges where these airlines are listed.

TABLE 11 (CONTINUED)
RELATIONSHIP BETWEEN THE CATEGORIES OF DISCUSSION IN RESPECT OF THE PRACTICAL EXPERIENCE OF AIRLINE PRIVATISATION (CHAPTER 8) AND THE HYPOTHESISED PROPOSITIONS FOR AIRLINE PRIVATISATION (CHAPTER 6)

CATEGORIES OF DISCUSSION	PROPOSITIONS FOR AIRLINE PRIVATISATION
Flotation issues (continued)	Governments would tend to place restrictions on the extent of foreign shareholding in privatised airlines. It is expected that airlines would tend to pay particular attention in selecting an appropriate group of shareholders. Substantial employee share ownership is assumed to be highly desirable when an airline is privatised.
Partial Privatisation.	Airline privatisation is expected to proceed gradually and the state will only incrementally divest of its interest in the national airline.
Preparing for privatisation.	It is postulated that the time period required to privatise an airline varies between various airlines, and is influenced by the peculiar circumstances within an airline. Privatisation in the airline industry requires substantial restructuring. This restructuring exercise is of a three-dimensional nature, namely legal, organisational and financial. Before an airline can be privatised, it must be incorporated according to the specific country's company legislation. An airline may need to be organisationally restructured in terms of employees and management before privatisation can proceed. The financial restructuring exercise mainly entails adjusting the debt-equity relationship in accordance with the norms of the private sector airline industry. Privatised airlines would become more efficient and profitable than they were when they still operated in the public sector.
The role of advisers.	Airlines would require the assistance of advisers to provide guidance with regard to the various aspects and processes of privatisation.
Marketing the privatisation process.	Airline privatisation needs to be marketed amongst the various stakeholders which have an interest in the well-being of the industry.

interest groups are different to a certain extent for all airlines, because different airlines operate within different institutional, economic, social and political environments.

The privatisation of British Airways was a highly political issue, mainly because the concept of privatisation is ideologically based in the United Kingdom. The opposition Labour Party, as well several trade unions, have been doing their utmost, albeit without success, to disrupt and slow down the privatisation process in general. In fact, the Labour Party threatened to renationalise British Airways in the event of the Labour Party becoming the government of the United Kingdom at a future date. When British Airways was first suggested as a candidate for privatisation in 1979, the airline's financial position was also very precarious. British Airways was considered to be heavily over-manned as well, which was a result of the merger between British Overseas Airways Corporation and British European Airways, which had led to the formation of British Airways. The privatisation of British Airways was characterised by a massive restructuring process, whereby British Airways was restored as a serious competitor within the international airline industry. The privatisation of British Airways was also delayed on several occasions as a result of threatened litigation in the United States emanating from the collapse of Laker Airways.

KLM has, since 1957, been partly privatised. The Dutch government held a majority shareholding in KLM until a recent share issue in 1986 altered its shareholding by reducing it to thirty-nine percent of the voting shares. It is understood that KLM has been managed as a private sector company for a relatively long period of time. Private sector attitudes seem to be well entrenched and consequently, relatively little restructuring was required at the time of the latest share issue. The Dutch Labour Party, as well as a few airline trade unions, however, expressed their concern at the Dutch government's shareholding dropping below fifty per cent. This concern was, however, countered by the Dutch government by introducing a mechanism whereby it could resume control in the event of KLM experiencing problems with regard to its air traffic rights. The Dutch government generally did not interfere in the management of the airline, although it did pursue policies very favourable to KLM such as a relatively liberal air transport policy, as well as providing the airline with an excellent infrastructural facility at Schipol airport.

Lufthansa has also operated for a relatively long period of time as a partly privatised airline. When it was suggested in 1985 that the extent of the German government's shareholding be reduced, opposition was elicited from Mr Franz-Joseph Strauss who happened to a board member of Lufthansa, as well as chairman of Airbus Industrie. His opposition to any further privatisation of Lufthansa was based upon the notion that Lufthansa's aircraft acquisition policies would become less favourable to Airbus Industrie. However, Mr Strauss later

relented and the government shareholding was reduced by means of a rights issue which the German government did accept. The German government still retains a majority shareholding and it appears that Lufthansa's operating policies are still somewhat influenced by dicta from the German government. The German airline trade unions also appear to be opposed to any further reduction in the state's shareholding.

Singapore International Airlines was privatised in early 1986. The shareholding of the Singaporean government, however, was progressively reduced from the mid-1970s as a result of shares being issued at net tangible asset value to employees. Employees consequently own a substantial shareholding in Singapore International Airlines. The Singaporean government still retains a majority shareholding, and in order to protect Singapore Airlines' nationality status, it is expected to remain so at least for the foreseeable future. Singapore Airlines also has a substantial foreign shareholding although it is not listed on any foreign stock exchange. Even prior to privatisation, Singapore Airlines had an excellent public image. Privatisation consequently required no financial or organisational restructuring and this could be regarded as tantamount to an exercise whereby an efficient and effective private sector company is to be listed on a stock exchange.

Although the Japanese government has held a minority shareholding in Japan Air Lines for a considerable period of time, the management of the airline was significantly constrained by legal provisions contained in the Japan Air Lines Law. As a result of changing philosophy with regard to airline competition in Japan, the Japanese government decided to fully divest its interest in Japan Air Lines. Japan Air Lines would consequently face competition from rival Japanese airlines on international routes, and would be allowed to compete domestically. An aircraft belonging to Japan Air Lines suffered an air crash a few days after the announcement to privatise Japan Air Lines fully. The airline's management was consequently severely chastised for inefficiency by inter alia the Japanese Prime Minister. A new top management was appointed which resulted in restructuring. As a result of the Japan Air Lines Law been amended, Japan Air Lines have since been fully privatised.

The practical experience of privatisation by a number of airlines confirms that airline privatisation is situational. A situational framework for privatisation suggests that the unique institutional features and peculiar political, economic, social and legal considerations within each country, as well as specific conditions within each airline, all influence the nature and characteristics of the privatisation process.

8.3 THE MOTIVATIONS FOR PRIVATISATION

Governments appear to be keen to privatise their national airlines for a number of reasons.

Firstly, though governments generally consider their national airlines to be strategic national resources, they have come to realise that the airline industry essentially belongs in the private sector. Policy considerations can be adequately fulfilled by establishing an appropriate regulatory framework which would govern the operations of the airline industry. The British and Japanese governments in particular, and to a lesser extent the Dutch government, are ideologically committed to establish and nurture a private sector airline industry. The Singaporean and German governments seem to be in favour of a private sector airline industry, but appear to be approaching the privatisation process somewhat more cautiously.

Secondly, some governments may be keen to privatise their airlines in order to obtain additional revenue, thus reducing the level of taxation. This appears to be a major consideration in the case of British privatisation generally, although it does not appear to have been so with regard to the privatisation of British Airways. In the case of Japanese privatisations, revenue maximisation does not appear to be a consideration at all. Thirdly, the governments of the United Kingdom and Japan hoped that the privatisation of their respective national airlines would result in them being able to operate more efficiently and consequently more profitably. Fourthly, the Dutch, British and German governments would appear to view privatisation of their national airlines as an essential step in order to enable their respective national airlines to compete effectively in a liberalised European air transport environment after 1992. Finally, the Singaporean government appears to be motivated by the realisation that Singapore Airlines is a highly respected international airline and that it would be able to compete more effectively internationally without full government ownership.

Governments are consequently motivated by a multitude of reasons and objectives for privatising their national airlines.

Airlines are also motivated by a diverse set of reasons for preferring to operate within the private sector. When airlines operate within the public sector, their ability to obtain equity capital is severely constrained. Governments do not appear to be very willing to provide their national airlines with equity capital. In order to compete effectively in the international environment, and to a lesser extent in the domestic environment, airlines continually need to acquire aircraft which are better suited to a dynamic environment. When an airline is not able to obtain equity capital, it needs to rely on debt capital which is financially risky in the

sense that it incurs fixed financing charges. Airlines such as Singapore Airlines and KLM do not particularly need equity finance, because they have accumulated very large reserves of current assets. Lufthansa, British Airways and Japan Air Lines are, however, not is such a fortunate position because their current liabilities exceed their current assets.

TABLE 12
CURRENT ASSETS AND CURRENT LIABILITIES 1986 US DOLLARS (MILLIONS)

AIRLINE	CURRENT ASSETS	CURRENT LIABILITIES
British Airways	1256	1843
Japan Air Lines	1664	2092
KLM	1752	900
Lufthansa	1098	1706
Singapore Airlines	1725	820

Source: Airline Annual Reports

In general, the ability of privatised airlines to obtain equity capital which can be used to finance aircraft acquisitions, might be a major incentive for an airline's management to be positively inclined towards privatisation. Some airlines may, however, not need this type of finance in the short term.

8.4 THE ROLE OF GOVERNMENT IN A PRIVATISED AIRLINE

Although a government may have divested its shareholding in its national airline, it does not mean that it will have no further interest in its national airline. Although British Airways was operating independently, it still needed government support to assist it in its take-over of British Caledonian Airways, and to thwart the attempt by Scandinavian Airlines System to take over British Caledonian Airways. In Japan, in spite of the the Japanese government holding a minority interest in Japan Air Lines, the airline's management still had to present its business plans to the government for formal approval. However, since the Japanese government has now fully privatised Japan Air Lines, the airline nowadays pursues a far more independent course of action. KLM, Lufthansa and Singapore Airlines pursue business strategies relatively independently from governmen. interference, but still need to have formal approval from their respective national governments for aircraft acquisitions. International air traffic rights must also be negotiated by national governments on behalf of their privatised airlines.

It is thus confirmed that the extent of political involvement in the affairs of an airline would diminish after privatisation. However, the role of the government would not entirely disappear. The privatised airline's management consequently still need to maintain good relations with its national government.

Government enterprises are often criticised for being inefficient and ineffective in respect of their business operations. State-owned airlines face similar criticism, which has a negative impact on the airlines' public image. Airlines which are owned by their national governments are criticised for the sake of political, rather than economic and commercial reasons. British Airways, KLM and Lufthansa feel that their public image has improved with privatisation, and KLM and Lufthansa feel that their public image will continue to improve if the state sells off further tranches of shares. Singapore Airlines has stated that by operating in the private sector its financial performance is being continuously scrutinised by financial and other investment analysts. Such financial scrutiny induces the airline to perform well. However, as a result of Singapore Airlines' service orientation, they have always had an excellent public image. In the cases of British Airways and Japan Air Lines, the airlines' management were obliged to rebuild public credibility as part of the process of preparing for privatisation. The public image of each airline was enhanced by this conscious action.

As a general rule, it can be stated that the public image of a privatised airline would improve after privatisation. If, however, the airline already had an excellent public image, its transition into the private sector would be smoothed.

State-owned airlines are generally required to pursue political, as well as commercial objectives. Sir Colin Marshall (1985,p.58), chief executive of British Airways, states that:

> 'If a business is to be profitable, everybody concerned with it must have a clear understanding of what they are there to achieve. If the management understands clearly the policy it is expected to follow, the resources it can call on and the results it is expected to produce, and if it is then given the freedom to get on with the job as it thinks best, then the company can devote itself quite single-mindedly to profitability through commercial success.'

Prior to privatisation British Airways pursued objectives such as:

- To link the nations in the British Commonwealth.
- To further the interests of British foreign policy.
- To provide employment for as many of the workforce as possible.
- To buy British goods, especially British manufactured aircraft.
- To show the flag.

Although the Japanese, German, Dutch and Singaporean governments did and still do on occasion influence management decisions, their respective airlines' managements have been able to pursue the profit motive to a far greater extent than British Airways. This may explain the very poor financial performance of British Airways before it was considered as a candidate for privatisation. Different airlines all deem that their managements are able to pursue the profit motive far more purposefully than before they were privatised.

The objectives pursued by an airline's management are consequently perceived to be much clearer after privatisation than before. In particular, the profit motive seems to be the main driving force for management decision and action.

State-owned airlines normally enjoy monopolistic market protection. It is generally considered to be politically untenable to privatise a public monopoly into a private monopoly. It is consequently necessary to consider the regulatory environment in which airlines operate.

During the process of preparing for privatisation, the British government endeavoured to strengthen British Caledonian Airways at the expense of British Airways. British Airways was inter alia, required to relinquish its very profitable Saudi-Arabian routes in exchange for British Caledonian Airways' not-so-profitable South American routes. The United Kingdom government also licensed British Midland Airways to operate between London and Glasgow, London and Edinburgh and London and Belfast, which was in direct competition with British Airways. British Airways has recently, however, been successful in launching a take-over of British Caledonian Airways. The acquisition was approved on the basis of British Airways' desire to compete on a global scale with the emerging American mega-airlines. In spite of these developments, the United Kingdom government remains committed to a competitive airline environment. British Airways would consequently run the risk of competition being allowed on some of its very lucrative routes if it were to pursue predatory policies against other [illegible] British airlines.

The rationale for fully privatising Japan Air Lines was in fact a desire by the Japanese government to deregulate its airline industry. Toa Domestic Airlines and All Nippon Airways were allowed to compete with Japan Air Lines on some international routes, and Japan Air Lines was granted a licence to operate a few domestic routes. The Japanese government realised that Japan Air Lines could not compete effectively if it were constrained by the now defunct Japan Air Lines Law.

In the cases of KLM and Singapore Airlines, the regulatory environment did not change as a result of privatisation. The Dutch and Singaporean governments still favour a liberalised air transport environment, mainly because their respective national airlines owe some of their success to their ability to carry fifth freedom air traffic via Amsterdam and Singapore respectively. The regulatory environment in which Lufthansa operates has also not changed, mainly because the German government still retains a majority shareholding in Lufthansa.

When a government wants to privatise its national airline, it will normally consider altering the regulatory environment of its airline industry. Any moves towards deregulation seem to take into consideration the present competitive advantages of the airline that is to be privatised. A government is fully aware that full-scale deregulation may depress an airline's profitability, thereby reducing the price that could be obtained for the airline.

The government is a very significant stakeholder in the privatisation process. The British government is ideologically committed to the principle of reducing the role of the state in the economy. The opposition Labour Party has, however, threatened to renationalise British Airways at a future date. This threat is, however, regarded by British Airways' management to lack substance, as a future Labour government would have more pressing priorities than bringing the airline back into the public sector. There does not seem to be any fundamental opposition to the privatisation of Japan Air Lines and Singapore Airlines. In the cases of KLM and Lufthansa a number of public sector trade unions and the socialist opposition have expressed their concern about further privatisation.

Political commitment of a government is an essential prerequisite for privatisation to occur. An airline's management will also tend only to express themselves publicly in favour of privatisation, if they are aware that their government holds similar views. The nature and extent of governmental commitment to privatisation tends to depend upon the peculiar political and institutional considerations within a particular country.

The risk of bankruptcy or the risk of being taken over by a more effective or efficient airline is a discipline exerted by the capital market. Although it is theoretically possible that a privatised national airline may become insolvent, it has been conceded by all the airlines interviewed that it would be unlikely that their respective national governments would allow this to happen. The British, Dutch and Japanese governments have also introduced mechanisms which would prevent their respective national airlines from being taken over by other airlines, or by foreign interests.

In spite of operating within the private sector, privatised airlines do not face the risk of bankruptcy and this consequently seems to be only of theoretical interest to a major privatised national airline.

When a government privatises its national airline, it redefines its role in respect of its national airline. In particular, a government's role as shareholder is altered by the process of privatisation. In the cases of British Airways and Japan Air Lines the respective governments have fully divested their shareholding interest in their national airlines. Both governments have consequently made the decision to withdraw from the airline business, except with regard to their role in a regulatory capacity. In the cases of KLM, Lufthansa and Singapore Airlines, the Dutch, German and Singaporean governments have accepted a reduced role in their airline industries. These governments, however, have never played a substantial role as shareholders in their respective national airlines. Significantly, it is politically unacceptable for a government to display any signs of favouritism towards a privatised airline within the domestic environment, although it may justifiably favour its privatised national airline in competition with foreign airlines.

The assumption that the relationship between a government and its national airline would fundamentally change after the airline has moved into the private sector is partly confirmed. A government still retains a responsibility to its privatised national airline within the international environment.

8.5 FLOTATION ISSUES

Although airlines may contract with outside suppliers to provide a multitude of services such as catering, passenger handling and even the provision of a reservation system, these actions are only regarded to be on the periphery of privatisation. The floatation, together with the listing of an airline's shares on a stock exchange, is regarded as the essential mechanism for privatising a state-owned airline.

British Airways, KLM, Japan Air Lines, Lufthansa and Singapore International Airlines are listed on one or more major stock exchanges. It would appear that a listing on a major international stock exchange is regarded as an enhancement of the public image of the privatised airline. All of the above airlines also operate internationally, and it is thought that an international listing would enhance the respective airlines' ability to obtain, inter alia, debt capital from international capital markets in order to finance aircraft acquisitions. Moreover, an international listing is thought to strengthen the privatised airline's market and strategic position in the country where it obtained a listing on the stock exchange. An international listing of an airline's shares may tend to enhance the tradeability of the shares, which may facilitate the privatisation of the airline.

TABLE 13
STOCK EXCHANGES WHERE AIRLINES ARE LISTED

AIRLINE	STOCK EXCHANGE
British Airways	London New York
Japan Air Lines	Tokyo
KLM	Amsterdam Dusseldorf Frankfurt New York
Lufthansa	Dusseldorf Frankfurt
Singapore Airlines	Singapore

A listing on a foreign stock market is however, not essential in order to have foreign shareholders. British Airways placed some shares with institutions in Japan and Switzerland without actually obtaining a listing on the Tokyo and Zurich stock exchanges. Similarly, Singapore Airlines has allocated twenty-five per cent of its shares to foreign shareholders without actually being traded on any foreign stock market. It also needs to be kept in mind that a foreign listing results in additional reporting requirements, which may be rather onerous. For example, British Airways and KLM are required to restate their financial statements in order to comply with United States GAAP (Generally Accepted Accounting Principles).

The various airlines which were investigated agreed that a listing on one or more international stock exchanges is the essential methodology for privatising a major international airline. When an airline's shares are traded on a stock exchange, the airline is normally required to comply with an extensive set of regulations which have been devised in order to protect investors in publicly traded companies.

The price at which an airline's shares are to be brought to the stock market can be fairly difficult to determine. In the case of British Airways, the opening price of the shares was not certain until the very last moment. The British government were obliged to take care that the opening price of British Airways' shares was a fair assessment of the shares' inherent market value. If the price were too high, the listing would fail because investors would lack interest in purchasing overvalued shares. If the price were too low, the British government would be criticised that it was giving away state-assets. For this reason, the United Kingdom government employed the services of merchant bankers and stock-

brokers amongst others, in order to ensure that a fair price was determined. The British government also made use of the services of underwriters in order to ensure that all shares would be taken at a guaranteed market price.

Lufthansa, KLM and Japan Air Lines have been traded for a number of years. The market value of these shares have consequently been well established. The current market price of the respective airline's shares could therefore be used in order to determine the price of any further offerings of shares. Singapore Airlines faced a similar problem to British Airways when it was first listed in 1986. The price of the Singapore Airlines' shares which were offered in 1987 could be related to a market price that is now well established.

The privatisation of an airline can be delayed by events on the world's stock exchanges. The final privatisation of Japan Air Lines was postponed for a few weeks in order that normality return to the Japanese stock market after the slump on the world's stock markets in October 1987. Indeed, the privatisation of Air France was postponed indefinitely as a result of the stock market slump.

The difficulty in determining a market value for the shares of an airline that is to be privatised stems from a number of reasons:

a. There is usually no benchmark airline with which the price of shares of the privatised airline can be compared.
b. Different international airlines pursue very different accounting policies. In particular, depreciation policies differ vastly amongst various airlines. This phenomenon makes financial comparison between international airlines tremendously difficult.
c. The market value of an airline is not only influenced by its net tangible assets, but also by intangible assets such as route licences.
d. The airline industry's financial position is highly sensitive to the course of the business cycle, as well as to events on the international oil and currency markets.

The research findings confirm that it is a fairly complex exercise to determine the market value of an airline that is to be privatised.

The notion that share prices of privatised airlines are more volatile than overall stock market indices of stock exchanges where they are listed, has been partly confirmed by the research conducted. If the standard deviation of the weekly percentage change of a share's price is indicative of share price volatility, then the share prices of British Airways, Lufthansa, KLM, Japan Air Lines and Swissair are more volatile than share prices generally on their national stock exchanges. According to this definition of share price volatility, the share prices of Cathay Pacific Airways and Singapore Airlines are less volatile than share prices

generally on the Hong Kong and Singapore stock exchanges respectively. The standard deviation of the weekly percentage change of a share's price is indicative of the range in which an airline's share price could fluctuate.

TABLE 14
VOLATILITY OF SHARE PRICES
(STANDARD DEVIATION OF WEEKLY PERCENTAGE CHANGE)

AIRLINE	AIRLINE SHARES	STOCK EX-CHANGE INDEX
British Airways	9.82	4.21
Cathay Pacific	5.07	5.20
Japan Air Lines	6.83	3.40
KLM	5.71	3.41
Lufthansa	5.60	3.89
Singapore Airlines	4.67	4.78
Swissair	5.60	3.07

TABLE 15
BETA ESTIMATES OF AIRLINE SHARES

AIRLINE	BETA	STD ERROR	T-VALUE	R-SQUA-RE	OBSERVAT-IONS
British Airways	1.8186	0.2081	8.74	0.59	57
Cathay Pacific	0.5983	0.0791	7.56	0.38	96
Japan Air Lines	0.5050	0.2106	2.40	0.05	114
KLM	1.2311	0.1099	11.20	0.53	114
Lufthansa	0.8847	0.1093	10.59	0.51	114
Swissair	1.2440	0.1273	9.77	0.46	114

Another measure of a share's price volatility is the estimate of a share's beta value. The beta value estimates the extent to which a share price will fluctuate in response to fluctuations of the overall stock market index. The estimated value of British Airways' beta is relatively high, which indicates that when share prices on the London stock exchange fluctuated, the price of British Airways' shares would fluctuate even more widely. The share prices of KLM and Swissair also appear to fluctuate more widely on their respective national stock markets than share prices generally. The beta values of shares of Singapore Airlines, Cathay Pacific Airways and Lufthansa are all less than one, which would indicate a lesser degree of volatility on their respective national stock exchanges than share prices generally.

Research findings indicate that movements in the share price indices of various stock exchanges statistically explain between thirty-seven and fifty-nine per cent of share price fluctuations of privatised airlines. In the case of Japan Air Lines, there appears to be no statistical relationship between fluctuations of share prices generally on the Tokyo stock exchange and the share price of Japan Air Lines.

Governments tend to regard their national airlines as strategic national resources. However, major national airlines generally operate extensive international route networks. The international exposure of these airlines may necessitate some foreign shareholding in order to enhance the market and strategic positioning of the airlines within the international environment. The emergence of a truly global airline also presupposes a multinational shareholding.

The British and Singaporean governments have specifically restricted the extent of foreign shareholding to twenty-five percent of all voting shares in British Airways and Singapore Airlines respectively. The Japanese government restricts foreign shareholding to one third of all voting shares in Japan Air Lines. In cases of British Airways and Japan Air Lines, their managements may refuse to register any further foreign shareholders once the respective thresholds are reached. There are no specific provisions restricting foreign shareholding in KLM and Lufthansa, mainly because the shares of both airlines are bearer shares. These airlines consequently do not know the identity or nationality of all of their shareholders. The Dutch government may, however, resume control of KLM if the airline were to be heading towards being controlled by foreign interests. The German government still retains a controlling interest in Lufthansa, which makes the question of restricting foreign shareholding largely theoretical.

A mechanism also exists whereby a government can control the affairs of its privatised national airline in the event of foreign interests gaining control of a privatised airline, or in the event of foreign interests launching a take-over attempt of a privatised airline. This mechanism is known as a 'golden share'.

The research findings confirm that an essential feature of airline privatisation would be governments tending to place restrictions on the extent of foreign shareholding in privatised airlines.

It would appear that airlines do pay limited consideration in selecting an appropriate group of shareholders. Airlines appear to consider an appropriate group of shareholders to consist of financial institutions, employees, important customers, the general public and foreign shareholders. British Airways, in particular, allocated large tranches of shares to financial institutions, employees and foreign shareholders. Japan Air Lines, Lufthansa, KLM and Singapore Airlines have been traded on a stock exchange for a considerable period of time. These airlines were legally obliged to make a rights issue to their existing shareholders

during their most recent privatisation. Only Japan Air Lines have a scheme that enables shareholders to obtain discounted air travel facilities. Other airlines appear to be opposed to schemes like this, mainly because it would be tax-inefficient for their shareholders in their respective countries.

An airline can only consciously select the composition of its shareholders at the time of initial privatisation. Any further reductions of the state's shareholding must take the existing shareholders into consideration by means of a rights issue. The characteristics of an airline's choice of shareholder composition would appear to be dependent upon the peculiar nature of a particular country's equity market. In those instances where foreign shareholding is deemed to be important, institutional shareholding appears to be most appropriate.

Although an airline may design its share structure according to the peculiar requirements of a target group of investors at the time of initial privatisation, the airline's management is only able to marginally influence the composition of shareholders after privatisation. The eventual group of shareholders that may emerge may be an inadvertent result of airline's dividend policies, inter alia.

Employee share ownership appears to be very important for privatised airlines. In particular, British Airways and Singapore Airlines have allocated substantial numbers of shares to their employees. Lufthansa and KLM both profess to be in favour of some employee share ownership, but neither airline has instituted any particular scheme to encourage employee share ownership. KLM and Lufthansa also lack a mechanism to gauge the extent of employee share ownership because their shares are bearer shares. Although the employees of Japan Air Lines own approximately one percent of the airline's shares, it was not considered politically feasible to allocate additional shares to employees at the most recent privatisation of Japan Air Lines.

Airline management appears to consider employee share ownership as highly desirable when an airline is initially privatised. Political considerations make it necessary, however, to limit the extent of employee share ownership.

8.6 PARTIAL PRIVATISATION

The general experience of privatisation in the airline industry indicates that governments tend to prefer to incrementally divesting their shareholding in their national airlines.

The United Kingdom government privatised British Airways fully at the beginning of 1987. They retained a very small number of shares which will be allocated as a loyalty bonus to a few shareholders that retain their shares until 1990. The Japanese government recently withdrew from the airline business when Japan Air Lines became a fully privatised airline. The Japanese government progressively reduced its shareholding in Japan Air Lines over an extended period of time. It would appear that the German, Dutch and Singaporean governments are pursuing a similar strategy to the Japanese government.

The rationale for partial privatisation was given by various airlines as:

a. Airlines are considered to be strategic national resources.
b. The respective governments wish to demonstrate their allegiance to their national airlines by a limited shareholding.
c. A government shareholding confirms the nationality status of a privatised airline.
d. Partial government ownership means that the particular government will still guarantee the privatised airline's debt commitments.
e. Partial privatisation is a cautious approach and a government will be able to evaluate the progression of the privatised airline into the private sector more carefully.
f. A country's stock market may not be sufficiently capitalised to provide the amount of equity capital required for full privatisation of a national airline.

The research results therefore confirm that airline privatisation would normally proceed gradually. Governments will tend to incrementally divest their interest in their national airlines.

8.7 PREPARING FOR PRIVATISATION

An essential feature of the process of airline privatisation is the nature and extent of restructuring required to prepare an airline for privatisation. Research conclusively found that the extent of the restructuring exercise depends upon the extent to which private sector attitudes have already been entrenched in a particular airline. The restructuring exercise also entails a clearer definition of the purpose the business of a particular airline, as well identifying appropriate strategic business units.

When British Airways was first put forward as a candidate for privatisation, the airline would not have been able to operate effectively in the private sector. Firstly, the airline was tremendously over-manned. Airline staffing was therefore reduced from fifty-eight thousand to nearly thirty-six thousand employees. Secondly, the extent to which British Airways relied on debt finance, as well as the amount of accumulated losses, meant that the airline could be considered to

be technically bankrupt. Profits generated since 1983, however, have resuscitated the capital structure of British Airways to a more acceptable level. Thirdly, the business strategy of British Airways was fundamentally revised. Fourthly, the airline's profitability was also improved by discontinuing the operation of a number of unprofitable routes, as well as by closing non-performing sales offices.

Fifthly, management systems were introduced, whereby management performance could be measured more appropriately. Sixthly, British Airways management found it necessary to introduce a profit sharing scheme amongst employees in order to entrench profit performance as a business motivation and objective. Pension scheme arrangements had be changed in order that they presented a less onerous future liability for a privatised British Airways. Finally, British Airways had to be incorporated as a publicly limited company before privatisation could occur. British Airways could only be privatised after an extensive restructuring exercise had been performed.

TABLE 16
BRITISH AIRWAYS' FINANCIAL INFORMATION

FINANCIAL YEAR	PROFIT BEFORE TAXATION (MILLION UK POUND)	SHAREHOLDERS' EQUITY (MILLION UK POUND)	DEBT-EQUITY RATIO
1983/84	185	128	6.66
1984/85	191	286	2.07
1985/86	195	480	0.71
1986/87	162	605	0.45

Source: British Airways' Annual Report and Accounts 1986-87

The process of privatising KLM, Lufthansa and Singapore Airlines was less traumatic The reason privatisation in these airlines proceeded with less upheaval can be ascribed to the fact that all three airlines were only partly privatised at their most recent share issue. Both Lufthansa and KLM have also operated as companies with some private shareholding for a period of time, whereas Singapore Airlines had some employee shareholding since the mid-seventies. However, in the case of Japan Air Lines, more fundamental restructuring occurred

when the airline was prepared for full privatisation. In particular, the management structure, as well as the organisational structure, was revamped to prepare Japan Air Lines for full privatisation.

TABLE 17
KLM FINANCIAL INFORMATION

FINANCIAL YEAR	PROFIT BEFORE TAXATION (MILLION DUTCH GUILDERS)	SHAREHOLDERS' EQUITY (MILLION DUTCH GUILDERS)	DEBT-EQUITY RATIO
1983/84	79	1492	1.51
1984/85	279	1784	1.64
1985/86	312	2617	1.15
1986/87	300	2918	1.26

Source: KLM Annual Report 1986-87

TABLE 18
SINGAPORE AIRLINES' FINANCIAL INFORMATION

FINANCIAL YEAR	PROFIT BEFORE TAXATION (MILLION SINGAPORE DOLLARS)	SHAREHOLDERS' EQUITY (MILLION SINGAPORE DOLLARS)	DEBT-EQUITY RATIO
1983/84	127	1452	2.01
1984/85	221	1626	2.03
1985/86	312	2268	1.53
1986/87	492	2667	1.17

Source: Singapore Airlines' Annual Report and Accounts 1986-87

The time required to prepare an airline for privatisation appears to depend upon the nature and extent of the restructuring exercise. It took almost eight years for British Airways to enter the private sector after it was first put forward as a

candidate for privatisation. However, threatened litigation in the United States in respect of the collapse of Laker Airways contributed to the extensive delay of the privatisation of British Airways. The privatisation of Lufthansa, KLM, Singapore Airlines and Japan Air Lines proceeded with far less delay, mainly because the privatisation of these airlines did not occur in one full action.

The research conducted consequently confirmed that:

a. The time period required to privatise an airline varies between airlines and is influenced by peculiar circumstances within an airline.

b. Privatisation in the airline industry may require substantial restructuring. This restructuring exercise is of a three-dimensional nature, namely legal, organisational and financial. The extent of restructuring depends crucially upon the profitability history of the airline, as well as the extent to which the airline has been allowed by its national government to operate as a quasi-private sector company.

c. Before an airline can be privatised, it must be incorporated according to the specific country's company legislation.

d. An airline may need to be organisationally restructured in terms of employees and management before privatisation can proceed. The objective of this exercise would be to entrench private sector attitudes and culture amongst both management and employees.

e. The financial restructuring exercise executed when an airline is being privatised mainly entails adjusting the debt-equity relationship. The debt-equity ratio can be fundamentally improved only by operating profitably for a number of years.

f. The restructuring exercise has resulted in privatised airlines being more efficient and profitable than they were when still operating in the public sector.

8.6 THE ROLE OF ADVISERS

All of the airlines which were analysed subscribed to a greater or lesser extent to the principle of 'privatising the privatisation process.' British Airways in particular, made extensive use of advisers in their privatisation initiative. These advisers played a substantial role in the organisational and financial restructuring process, as well as the marketing of the privatisation amongst the internal and external interest groups. British Airways' management also made use of underwriters and

merchant banks in order to assist it in valuing the shares appropriately. Moreover, advisers assisted British Airways' management to reposition the airline strategically, as well as improve the public image of the airline thereby strengthening the airline's market position.

KLM, Lufthansa, Singapore Airlines and Japan Air Lines made less extensive use of the services of advisers than British Airways. The reason for this can be ascribed to the fact that these airlines required lesser restructuring. However, the managements of KLM, Lufthansa, Singapore Airlines and Japan Air Lines did make extensive use of advisers in order to to assist them in the valuation of the airlines' shares, as well as the marketing of their airlines' shares. In particular, these airlines made use of overseas investment banks to market their shares to foreign financial institutions.

The research confirms that airlines would normally require the assistance of advisers to provide guidance with regard to the various aspects and processes of privatisation. The extent and nature of support from advisers and consultants, however, differs between various airlines.

8.9 MARKETING THE PRIVATISATION PROCESS

The nature and extent of marketing the privatisation process amongst internal and external interest groups differs quite substantially between airlines. British Airways marketed the privatisation process extensively, whereas other airlines pursued a more low-key approach.

British Airways, as part of its restructuring process, launched a massive communication programme amongst its employees and management. The purpose of this programme was to make the organisational climate more conducive to private sector attitudes. The communication programme also aimed to explain the nature and objectives of the privatisation process. The external marketing exercise aimed to promote the public image of British Airways amongst investors as well as customers. British Airways endeavoured to project a highly efficient and profitable public image, as well as one of being responsive to the needs and requirements of its customers.

The marketing exercise conducted by other airlines was of a less extensive nature. This low-key approach can be ascribed to a number of factors:

a. Privatisation enjoys a lesser degree of public attention in other countries.

b. These airlines already had private shareholders and were legally obliged to offer shares to their existing shareholders.

c. These airline generally enjoyed a good public image in their respective countries, and consequently required a lesser degree of market exposure.

d. The internal stakeholders of these airlines already accepted, to a lesser or greater extent, the need to operate in the private sector.

The research confirms that airline privatisation needs to be marketed amongst the various stakeholders which have an interest in the well-being of the airline being privatised. The nature and extent of the marketing exercise is dependent upon the peculiar circumstances within a particular airline.

8.10 SUMMARY

The research that was conducted in respect of British Airways, KLM, Lufthansa, Singapore International Airlines and Japan Air Lines confirms the applicability of a situational framework for privatisation in the airline industry. Privatisation is a unique experience and differs between various airlines. Privatisation in a particular airline is dependent upon the peculiar circumstances within that airline. The extent of restructuring and organisational change in a particular privatisation initiative is dependent upon the extent to which private sector attitudes and cultures are entrenched in that particular airline. Although privatisation is unique, there are general principles that need to be kept in mind when an airline is being considered as a candidate for privatisation.

The conclusions and recommendations emanating from the research that was conducted amongst British Airways, KLM, Lufthansa, Singapore International Airlines and Japan Air Lines are discussed in Chapter Nine. It will endeavour to provide some general guide-lines for other airlines which may be considered by their governments as candidates for privatisation.

CHAPTER 9

RECOMMENDATIONS AND CONCLUSIONS

9.1 CONCLUSIONS DRAWN FROM THE FINDINGS OF THE RESEARCH

The following conclusions can be drawn from the findings and observations that have emerged from the research study:

a. Airline privatisation is a unique experience. The situational framework is consequently an appropriate approach for privatisation in the airline industry. The applicability of a situational framework stems from the fact that the external environmental conditions, as well as the internal circumstances, differ widely from airline to airline. Moreover, the situational approach in respect of airline privatisation, recognises the fact that the desires and motivations of a particular airline's stakeholders are unique. The consequence of the validity of the situational framework for airline privatisation is the implementation strategy for privatisation that must take cognisance of peculiar circumstances within an airline.

b. Different governments pursue a privatisation policy for different reasons. The characteristics of a particular privatisation initiative are crucially influenced by the motivations and objectives of the privatising government.

c. The ability of privatised airlines to obtain equity capital which can be used to finance aircraft acquisitions is a powerful incentive to an airline's management to favour privatisation. Strategic considerations necessitate the maximisation of the value of the equity injection through privatisation.

d. The extent of political involvement in the affairs of an airline is reduced as a result of privatisation. However, the role of the government does not entirely disappear. The privatised airline's management consequently needs to maintain good relations with its national government. In particular, an airline's management needs to be able to call on its national government for support when the airline's interests are threatened by a foreign competitor.

e. The public image of a privatised airline improves as a result of privatisation. In particular, privatised airlines are evaluated on the basis of their financial performance rather than the basis of being a branch the government.

f. In privatised airlines, management objectives are influenced by political considerations to a limited extent. Although a privatised airline's management cannot deny the existence of the political environment, political considerations are no longer the crucial determinant of strategic direction. A privatised airline's management can pursue economic objectives without political objectives exerting undue influence, which tends to be the case prior to privatisation. The pursuit of the profit motive appears to be the driving force for management action and direction in a privatised airline.

g. Airline privatisation cannot be considered without the issue of airline deregulation being addressed. Public opinion will generally not tolerate the privatisation of a public monopoly to a private monopoly. The characteristics of the regulatory environment that are to be established, are dependent upon the peculiar market considerations in a particular country.

h. Political commitment to a private sector airline industry is an essential prerequisite for airline privatisation.

i. A government will not allow its privatised national airline to become insolvent. A privatised national airline is therefore [illegible] fully subject to the disciplines of the capital market.

j. The nature of the relationship between the management of a privatised airline and the government does not appear to alter significantly after privatisation, except with regard to the pursuit of political objectives by the airline's management. However, top management of a partly privatised airline may still be appointed by the government, whereas in a fully privatised airline, private investors would appoint the top management team. The top management of a privatised airline has a strategic responsibility to maintain good relations with government officials because a privatised airline continues to need its national government to negotiate international air traffic rights on the airline's behalf.

k. The floatation of an airline's shares on one or more stock exchanges is generally accepted as the essential form of airline privatisation. Denationalisation is the only effective privatisation mechanism whereby the political influence on airline management decision-making can be reduced.

l. The establishment of an airline's market capitalisation value for the purpose of privatisation is a fairly complex exercise, particularly when an airline's shares are being listed for the first time. It is of strategic interest to a privatised airline that the equity injection resulting from privatisation,

is maximised. Airline management generally elicit advice from underwriters and merchant banks in order to assist in determining the share price of the privatisation issue.

m. The share price of a privatised airline is not necessarily more volatile than the stock market index of its national stock exchange. This has important consequences for the cost of equity capital for a privatised airline.

n. Governments consider their privatised national airlines to be strategic national resources. Although a limited foreign shareholding is regarded as highly desirable for a privatised airline, few, if any governments, will allow their privatised national airline to be controlled by foreign interests. The imposition of restrictions on foreign shareholding effectively prevents the emergence of a truly global airline.

o. When an airline is privatised, the composition of shareholders is carefully considered. An airline's shares are normally distributed amongst employees, financial institutions and the general public. There is only limited evidence that privatised airlines entice their customers to become shareholders.

p. Employee share ownership is a very important consideration for an airline which is being privatised.

r. The time that is taken to privatise an airline is dependent upon the peculiar circumstances within the airline. There is no general guide-line as to the time required to transfer an airline from the public to the private sector.

s. Airline privatisation requires legal, organisational and financial restructuring. The extent of the restructuring exercise is dependent upon the extent to which private sector attitudes and culture have already been entrenched within the specific airline.

t. Incorporation as a publicly limited company is a prerequisite for airline privatisation. Most state-owned airlines are, however, already incorporated.

u. The organisational restructuring exercise for an airline which is being privatised, mainly entails the identification of appropriate strategic business units, as well as the employment of a competent management team.

v. When an airline is prepared for privatisation, the debt-equity ratio of the airline being privatised is adjusted in accordance with the norms of the private sector airline industry. In particular, profits generated during this period are utilised to strengthen the airline's equity base. Any equity received as a result of privatisation would also improve the airline's gearing ratio.

w. Privatised airlines generally operate more efficiently and profitably than prior to privatisation.

x. During the process of a privatisation, the managements of airlines are being privatised, make extensive use of the services of advisers, such as merchant bankers, management consultant and public relations consultants. Airline management adheres to the concept 'privatising the privatisation process.'

y. The privatisation process is marketed amongst the internal, as well as the external stakeholders of the airline being privatised. In particular, commitment and acceptance of an ensuing privatisation are essential prerequisites for airline privatisation. The objective of the external marketing exercise is to engender enthusiasm from the investment community. The marketing of the privatisation of a particular airline is an opportunity to improve the public image of the airline.

9.2 RECOMMENDATIONS

The most important recommendation emanating from this research study is that when an airline is considered for privatisation, the privatisation process needs to be structured according to the peculiar circumstances within the particular airline. The privatisation process must consequently be carefully planned and managed. In particular, a project team consisting of airline managers, as well as external experts, must be appointed to actively drive the implementation of the privatisation process. It is recommended that the implementation strategy for a privatisation initiative includes inter alia, the following actions:

a. The extent of the government's commitment to privatising its national airline must be determined. Without governmental commitment there can be no privatisation. The objective and purpose of the privatisation initiative needs to be clearly spelled out. The legislative aspects must also be identified and the necessary legislation passed through Parliament.

b. The airline's management must decide on the airline's desired strategic positioning and direction in order that investors are able to estimate the profit potential of the privatised airline. The mission, business objectives and strategies need to be determined and communicated to the appropriate interest groups. The competitive issues which will affect the privatised airline must also be addressed.

c. The organisational structure of the privatised airline must be decided upon. This entails inter alia, the determination and definition of the airline's strategic business units.

d. An appropriate strategy needs be devised, whereby the most significant stakeholders of the airline can be persuaded to actively support the privatisation initiative. The privatisation of an airline needs to be actively marketed amongst the key stakeholders. These key stakeholders include the airline's management and employees, but most significantly, the airline's customers as well. These key stakeholders need to be convinced of the benefits that will ensue from privatisation.

e. The role of the government in its privatised national airline must be determined before privatisation, and not thereafter. Investors need to know how the government will influence decision-making within the privatised airline.

f. Conscious actions should be taken in order to ensure that the share price of the privatisation share issue is maximised. In particular, a marketing programme in respect of the share issue needs to be launched. The marketing of the airline's shares must be targeted to specific groups of investors.

g. If necessary, the airline must be incorporated according to the specific country's company legislation. Privatisation cannot take place, unless an appropriate corporate structure is created.

h. A competent management team that can operate according to private sector management methodologies must be appointed. In particular, the management team must be committed to the pursuit of the profit motive as the major corporate objective. The existence of a history of profitable operations is a prerequisite for privatisation.

i. Expert advice must be obtained in order that the airline's management, as well as the government, can be guided through the intrecacies of the privatisation process.

k. Specific targets and deadlines need to be established for the privatisation initiative to be implemented.

9.3 FURTHER RESEARCH SUGGESTED BY THE STUDY

The following research is suggested by the research study:

a. The objective of this research report is to establish a framework for airline privatisation. The various considerations with regard to the privatisation process, however, need to be researched and investigated in greater detail. These considerations include inter alia, the following:

- The objectives of privatization.
- The merits of privatisation with specific reference to the airline industry.
- The strategic considerations in respect of privatisation in the airline industry.
- The role of advisers in the privatisation process.
- Preparing for privatisation in the airline industry.
- The role of stakeholders in the privatisation process.
- Privatisation methodologies.
- Valuation considerations with regard to privatisation.
- Marketing the privatisation process.

b. South African Airways has been suggested by the South African government as a possible prospect for privatisation within the foreseeable future. The implications and considerations with regard to the privatisation of South Africa's national airline need to be investigated and researched.

9.4 A FINAL THOUGHT

Although privatisation is a highly structured process, the implementation of privatisation must be creative and innovative. In particular, the privatisation process presents many challenges and opportunities. However, privatisation brings about change, and change needs to be managed. Privatisation is a major strategic decision in the life of an airline. Privatisation results in a major strategic repositioning of an airline which is being privatised.

A number of airlines will move from the public sector to the private sector within the foreseeable future. The strategic characteristics of the airline industry will change fundamentally as a result. To summarise, a new era has dawned for world's airline industry.

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APPENDIX 1

FREEDOMS OF THE AIR

NEGOTIATED IN BILATERAL AIR SERVICES AGREEMENTS

FIRST FREEDOM
The right to fly over another country without landing.

SECOND FREEDOM
The right to make a landing for technical reasons (Eg refuelling) in another country without picking up/setting down revenue traffic.

THIRD FREEDOM
The right to carry revenue traffic from your own country (A) to the country (B) of your treaty partner.

FOURTH FREEDOM
The right to carry traffic from country (B) back to your own country (A).

FIFTH FREEDOM
The right of an airline from country (A) to carry revenue traffic between country (B) and another country (C).

SUPPLEMENTARY RIGHTS

SIXTH 'FREEDOM'
The use by an airline of country (A) of two sets of third and fourth freedom traffic between two other countries but using its base at (A) as a transit point. Sixth freedom rights are not formally recognized in air services agreements, though several confidential memoranda of understanding make implicit reference to them them, especially when dealing with capacity issues.

CABOTAGE RIGHTS
The right of an airline of country (A) to carry revenue between two points in country (B). Cabotage rights are very rarely granted.

Source: Doganis, R., Flying Off Course (The Economics of International Airlines), George Allen & Unwin, London, 1985.

APPENDIX 2

AVIATION OBJECTIVES OF EUROPEAN GOVERNMENTS

ON BEHALF OF THE CONSUMERS

a. Reasonableness of tariffs:
   - range of market oriented products.
   - no need to pay for unwanted product features.
   - cost related fares.
b. Simple, comprehensive tariff structure.
c. Convenient interline arrangements.

ON BEHALF OF AIRLINES

a. Economic viability of airlines.
b. Improvements in airline efficiency.
c. Maximisation of market opportunities for their airlines.

ON BEHALF OF OTHER PARTS OF THE AIR TRANSPORT SYSTEM

Avoidance of capacity problems (Eg airport congestion, air traffic delays)

ON BEHALF OF OTHER ASPECTS OF OTHER PUBLIC INTEREST

a. Maintenance of services to smaller communities.
b. Protection of tax payers against airline subsidies.
c. Avoidance of excess airline profits.
d. Benefits for the tourist industries.
e. National economic, prestige and cultural objectives.
f. Environmental protection (Eg noise).
g. Efficient use of resources (Eg energy).
h. A balance between air and surface transport.
i. Maintenance of safety standards.

Source: Wheatcroft, S. and Lipman, G., Air Transport in a Competitive European Environment (Problems, Prospects and Strategies), The Economist Intelligence Unit, London, 1986.

APPENDIX 3

CONTENTS OF THE PROSPECTUS

SUMMARY OF FINANCIAL INFORMATION

a. Brief details of the trading record and, if appropriate the financial forecast.
b. Information on earnings, dividends and asset value per share.
c. Statistics related to market capitalisation.
d. Statement of indebtedness at a recent date.

DIRECTORS AND ADVISERS

- Names and addresses of directors and advisers.

THE BUSINESS

a. History of the company's development.
b. Description of the company's activities.
c. Description of the company's products and markets.
d. Information on significant customers and suppliers.

DIRECTORS, MANAGEMENT AND STAFF

a. Details of directors and senior management.
b. Summary of other employees.

TRADING RECORD AND FORECAST DIVIDEND

a. Summary of last five years' trading and the forecast.
b. Brief discussion on the trading with an explanation of the unusual factors.
c. Indication of the future dividend policy.

REASONS FOR AND USE OF PROCEEDS OF THE SHARE ISSUE

a. Disclosure of the amount of cash being raised.
b. Purpose for which the cash will be used.
c. Statement by the directors that there is adequate working capital.

PROSPECTS

- Directors' opinion on the immediate prospects of the company.

ACCOUNTANTS' SHORT FORM REPORT

- Financial information which includes a summary of accounting policies, profit and loss accounts and sources and application of funds for the previous five years and the latest balance sheet.

PROFIT FORECAST

a. Bases and assumptions underlying the forecast (if included)
b. Copies of letters relating to the profit forecast from the sponsors and the reporting accountants.

STATUTORY AND GENERAL INFORMATION

a. Details of share capital.
b. Summary of articles of association.
c. Information concerning any employee share schemes.
d. List of subsidiaries and associated companies.
e. Details of premises.
f. Directors' interest in share capital.
g. Any material contracts not into the ordinary course of business.
h. Summary of the underwriting, offer for sale or placing agreement.
i. Other statutory and stock exchange disclosures including details of litigation.
j. List of documents available for inspection.

APPENDIX 4

PRIVATISATION TECHNIQUES

a. Selling the whole.
b. Selling complete parts of the whole.
c. Selling a proportion of the whole operation.
d. Selling to the workforce.
e. Giving to the public.
f. Giving to the workforce.
g. Charging for the service.
h. Contracting out the service to private business.
i. Diluting the public sector.
j. Buying out existing interest groups.
k. Setting up counter groups.
l. Deregulation via voluntary associations.
m. Encouraging alternative institutions.
n. Making small-scale trials.
o. Repealing monopolies to let competition grow.
p. Encouraging exit from state provision
q. Using vouchers.
r. Curbing state powers.
q. Divestment
s. Applying liquidation procedures.
t. Withdrawal from the activity.
u. The right to private substitution.

Source: Pirie, M., Privatisation (in Theory and Practice), Adam Smith Institute, London, 1985.

APPENDIX 5

QUESTIONS POSED TO KEY INDIVIDUALS OF AIRLINES THAT HAVE RECENTLY BEEN PRIVATISED

1. Please describe the background and origin of privatisation in your airline.
2. What is your definition of airline privatisation?
3. Why did your government decide to privatise your airline?
4. Did the management of your airline favour privatisation? Why?
5. What are the major benefits of privatisation for your airline?
6. What are the major disadvantages of privatisation for your airline?
7. What role does your national government play in the affairs of your company? Did the role of the government change after privatisation?
8. Does your government possess any special mechanisms such as a 'golden share' with regard to your airline?
9. Does your government still own any shares in your airline? If so, why?
10. Did the public image of your airline change after privatisation?
11. What are the major objectives of your airline's management? Did these objectives change after privatisation?
12. Did the regulatory environment change after privatisation? How?
13. What are the national political considerations in respect of privatisation in your country?
14. To what extent is your national government committed to privatisation as a national economic policy?
15. What is the risk of renationalisation?
16. What is the nature of the relationship between your airline's management and government officials?
17. How credible is the risk of bankruptcy for your airline? Would your national government allow it?
18. On which stock exchanges are your airline's shares listed?
19. How did you determine the value of your airline's shares at the most recent share issue?
20. How volatile are your airline's shares in comparison to other shares listed on your national stock exchange?
21. Why did your airline's management decide to list your airline's shares on a foreign stock market?
22. What restrictions, if any, do you place on foreign shareholding in your airline?
23. Does your management pursue any specific policies in order to attract specific groups of investors as shareholders in your airline?
24. To what extent do employees own shares in your airline? How important is the concept of employee share ownership for your airline's management?

25. Were there any factors that resulted in the privatisation of your airline being delayed?

26. What kind of restructuring was required before your airline could be privatised?

27. Were there any legal complications concerning the privatisation of your airline?

28. Did any employees or management lose their jobs as a result of privatisation? Do your management and employees enjoy security of tenure?

29 Did the culture of your organisation change as a result of privatisation?

30. What is the policy of your airline in respect of its capital structure?

31. Did your pension scheme arrangements present any problems with regard to privatisation?

32. Did the effectiveness and efficiency of your airline improve as a result of privatisation?

33. What role did advisers play in the privatisation process?

34. Who are the major interest groups with regard to privatisation in your country, and also in your airline?

35. Did you market privatisation internally in your organisation? How?

36. Did you market privatisation externally? How?

APPENDIX 5

SHARE PRICE FIGURES

a. LONDON STOCK EXCHANGE : SHARE PRICE INDEX

b. BRITISH AIRWAYS : SHARE PRICE

c. HONG KONG STOCK EXCHANGE : SHARE PRICE INDEX

d. CATHAY PACIFIC AIRWAYS : SHARE PRICE

e. TOKYO STOCK EXCHANGE : SHARE PRICE INDEX

f. JAPAN AIR LINES : SHARE PRICE

g. AMSTERDAM STOCK EXCHANGE : SHARE PRICE INDEX

h. KLM : SHARE PRICE

i. FRANKFURT STOCK EXCHANGE : SHARE PRICE INDEX

j. LUFTHANSA : SHARE PRICE

k. SINGAPORE STOCK EXCHANGE : SHARE PRICE INDEX

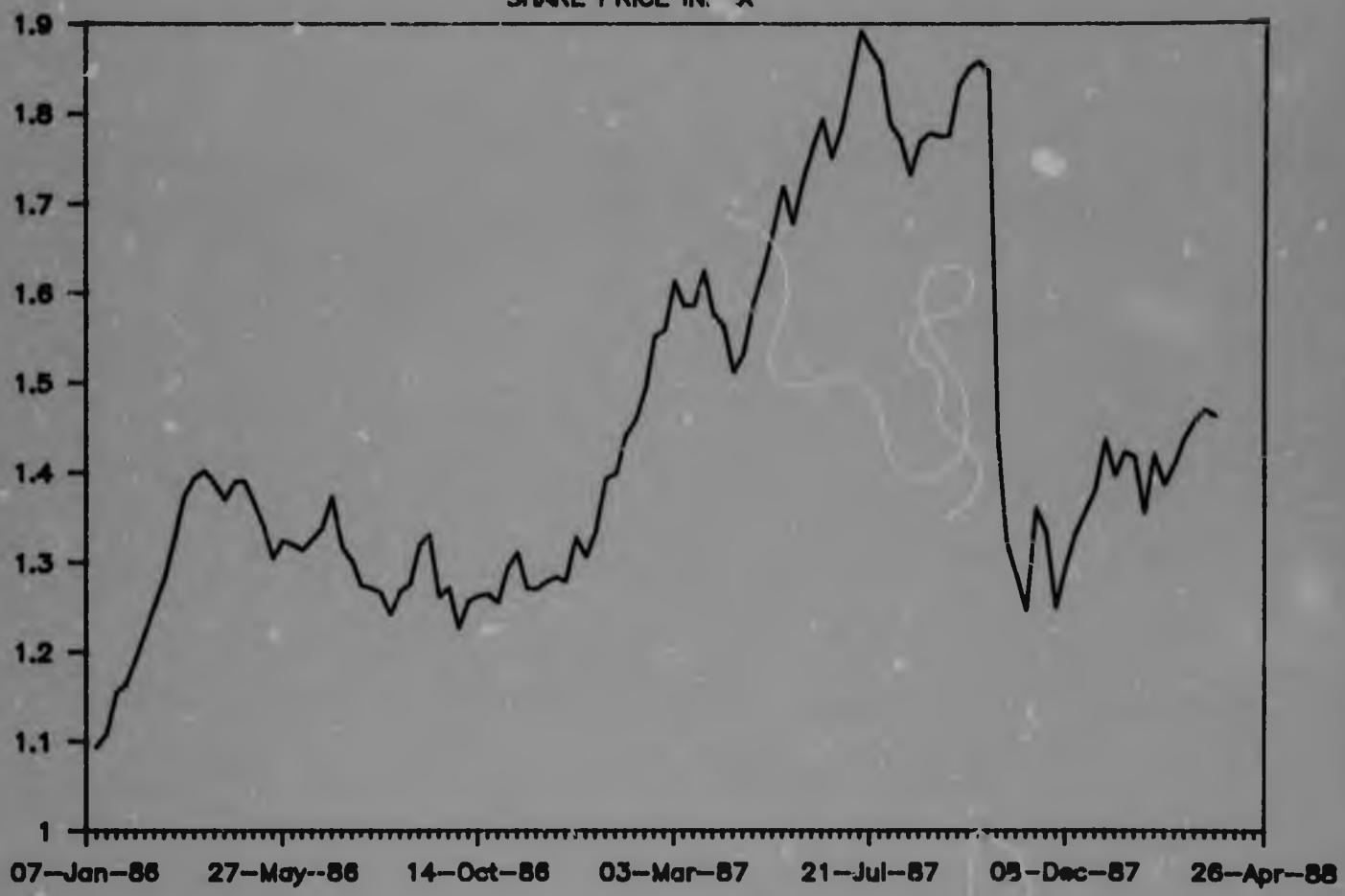
l. SINGAPORE INTERNATIONAL AIRLINES : SHARE PRICE

m. ZURICH STOCK EXCHANGE : SHARE PRICE INDEX

n. SWISSAIR : SHARE PRICE

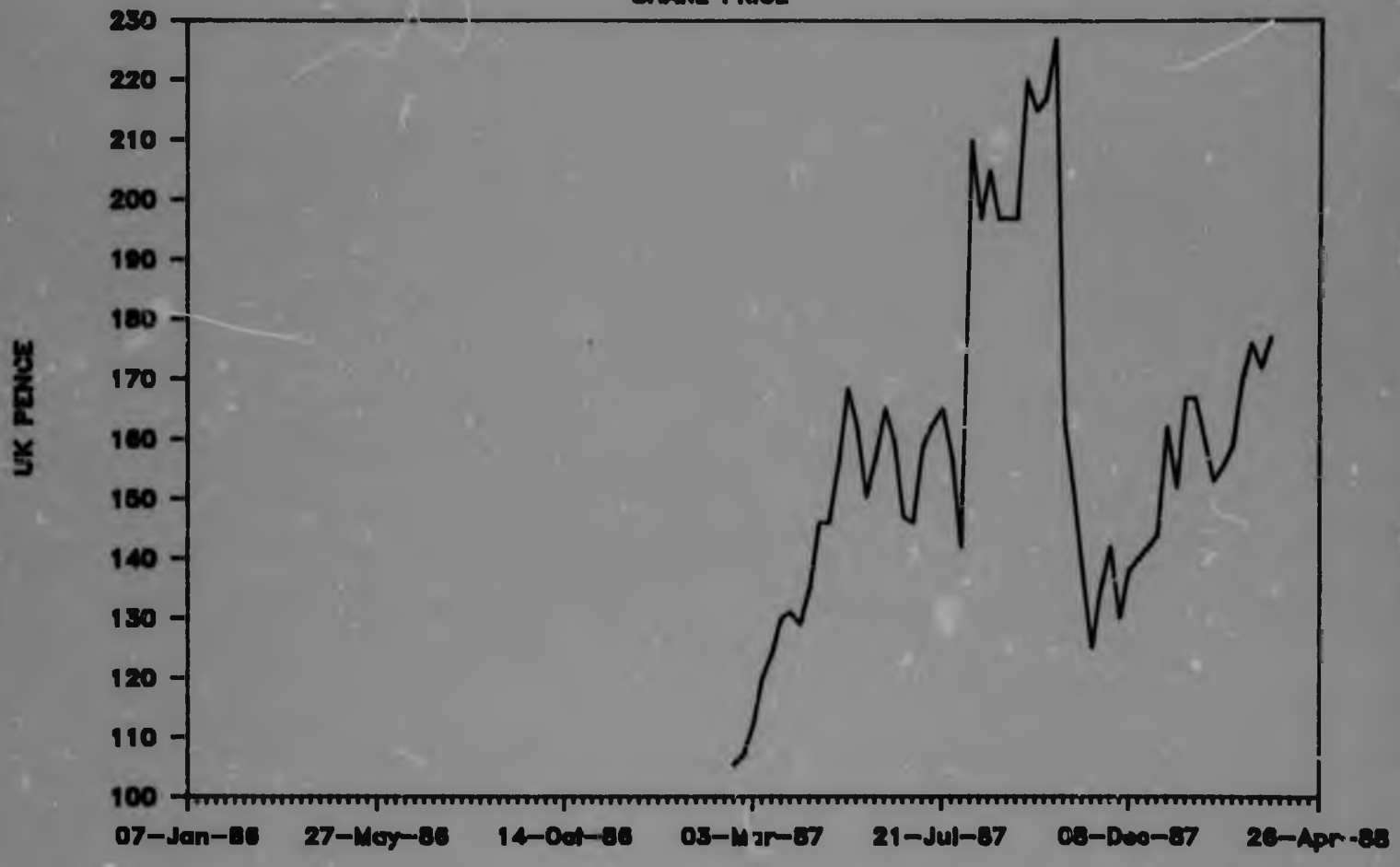
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SHARE PRICE INDEX

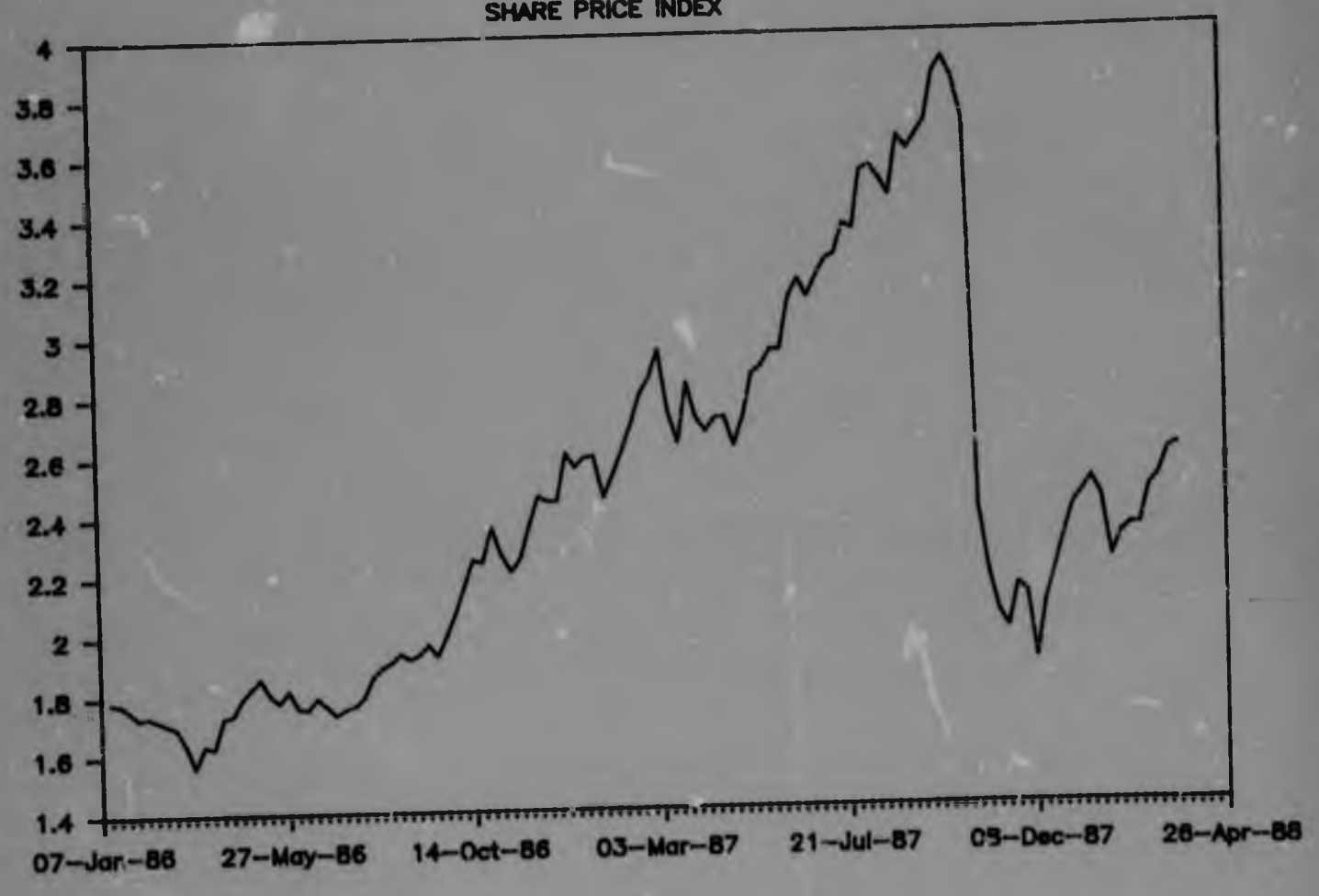


BRITISH AIRWAYS

SHARE PRICE

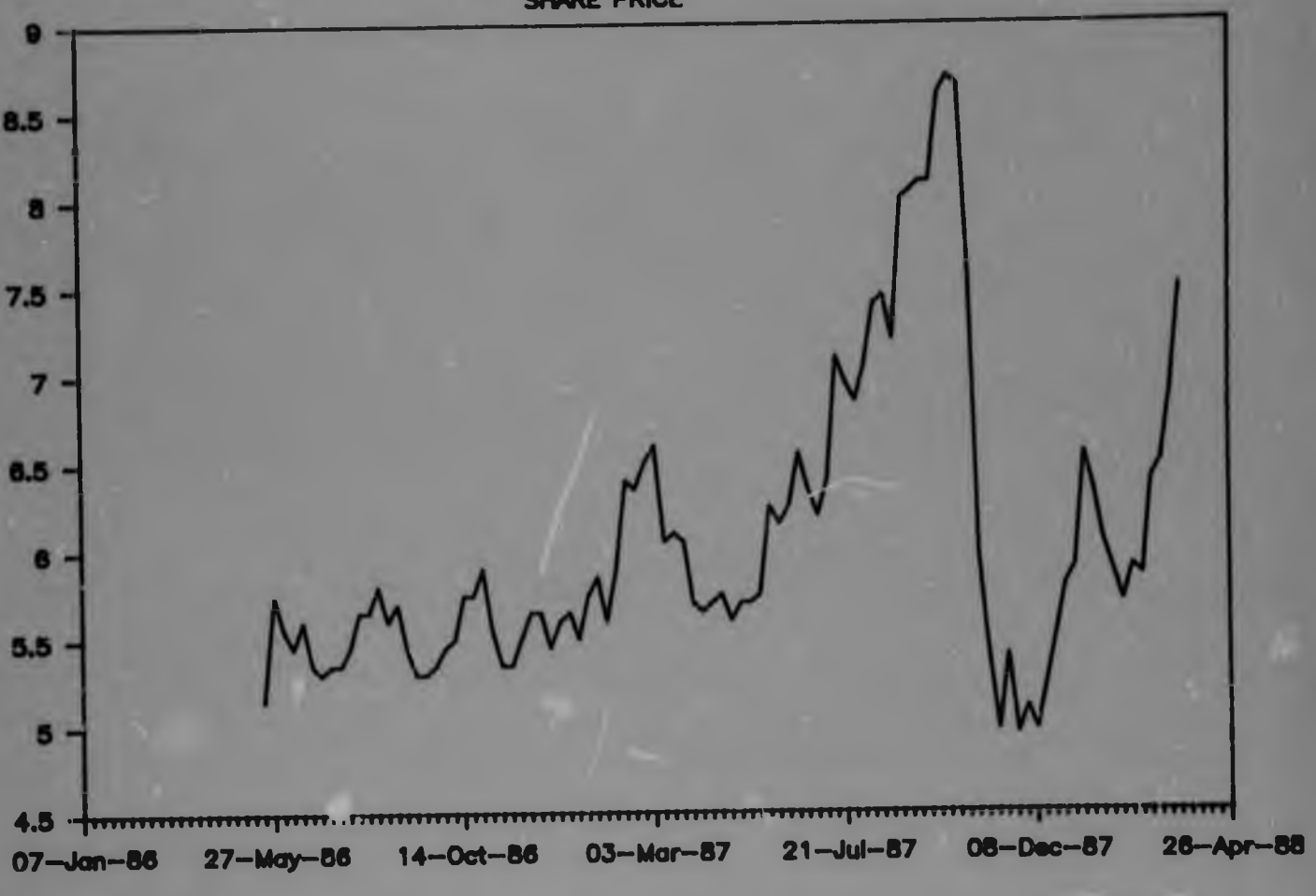


HONG KONG STOCK EXCHANGE

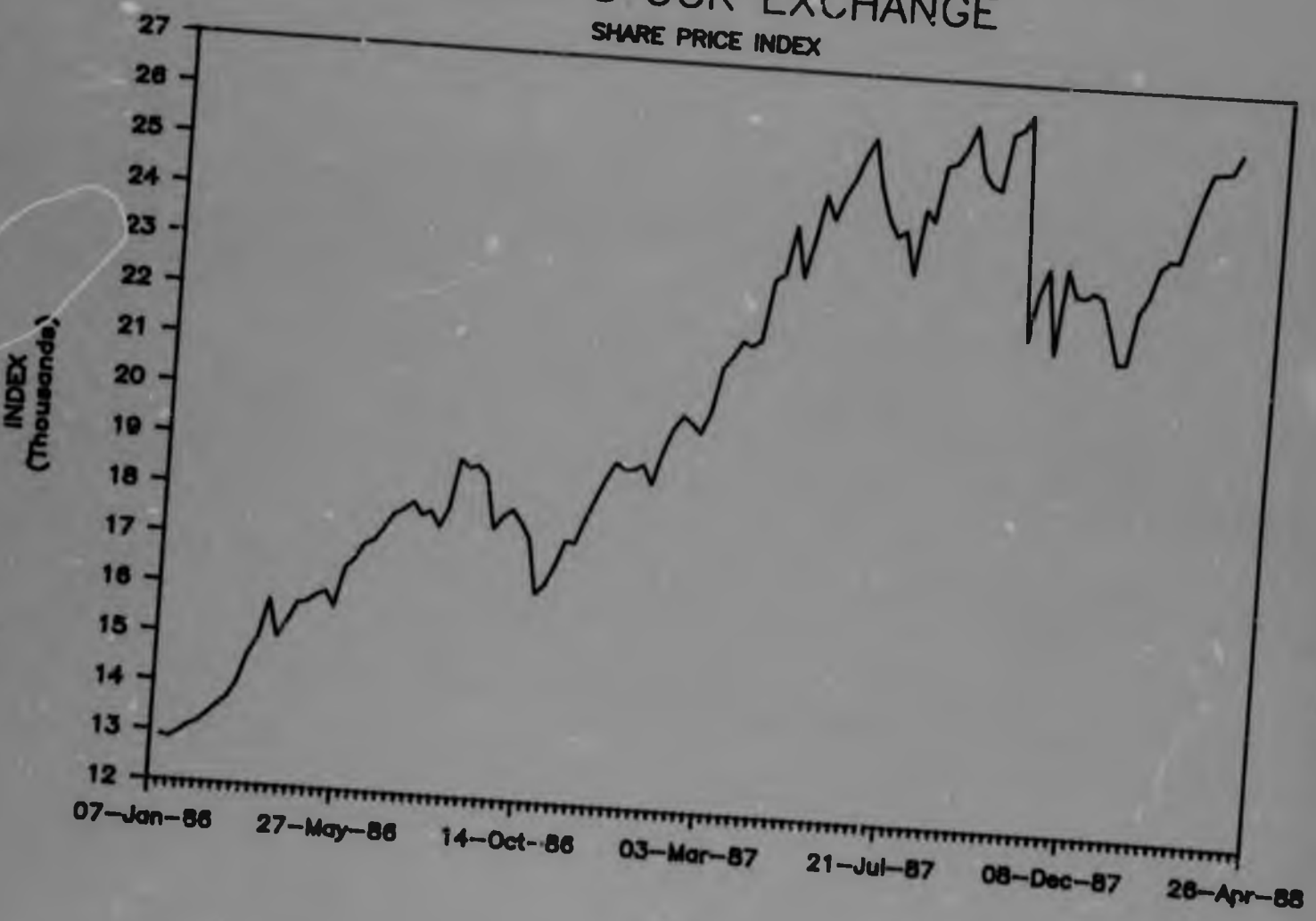


CATHAY PACIFIC AIRWAYS

SHARE PRICE

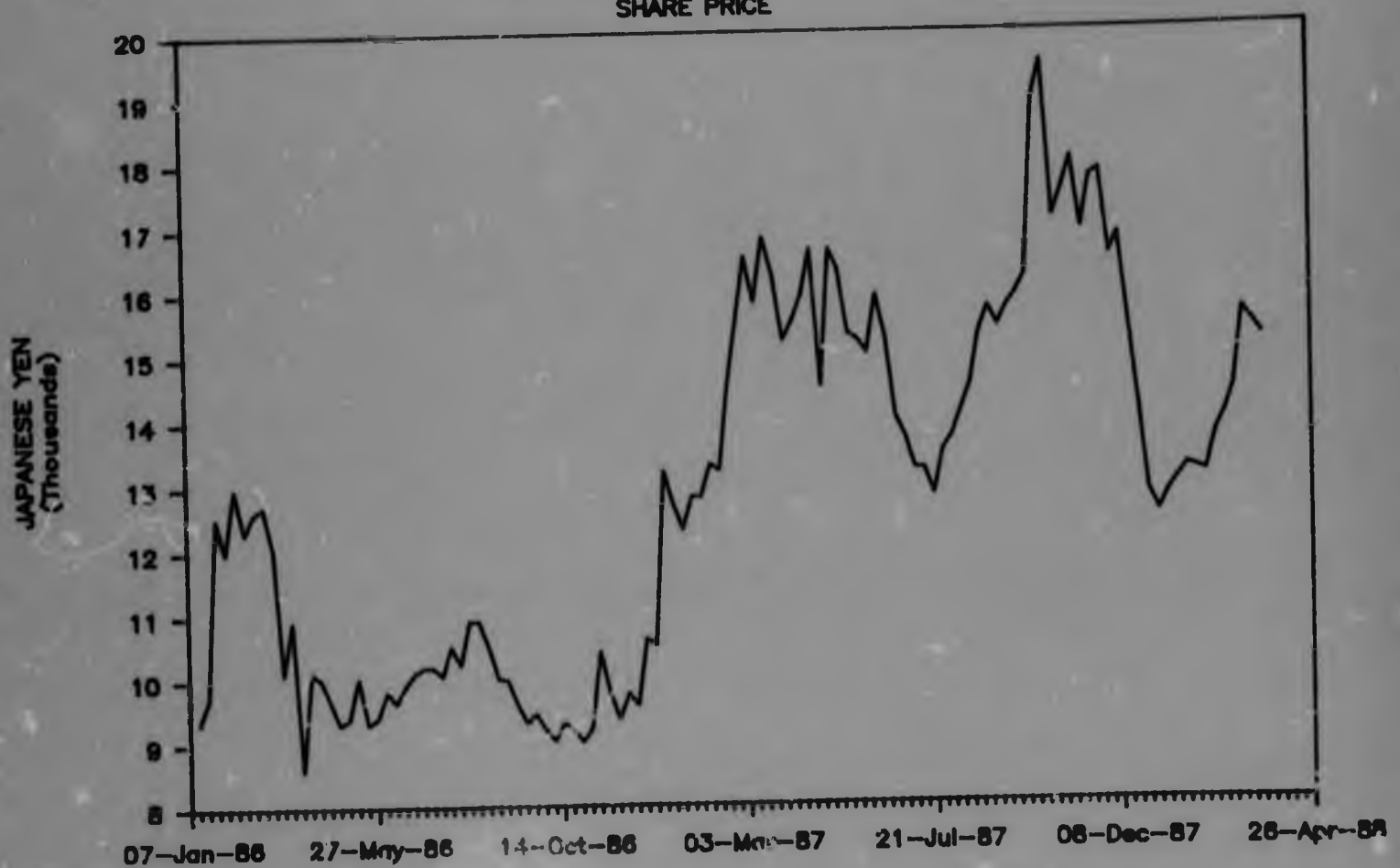


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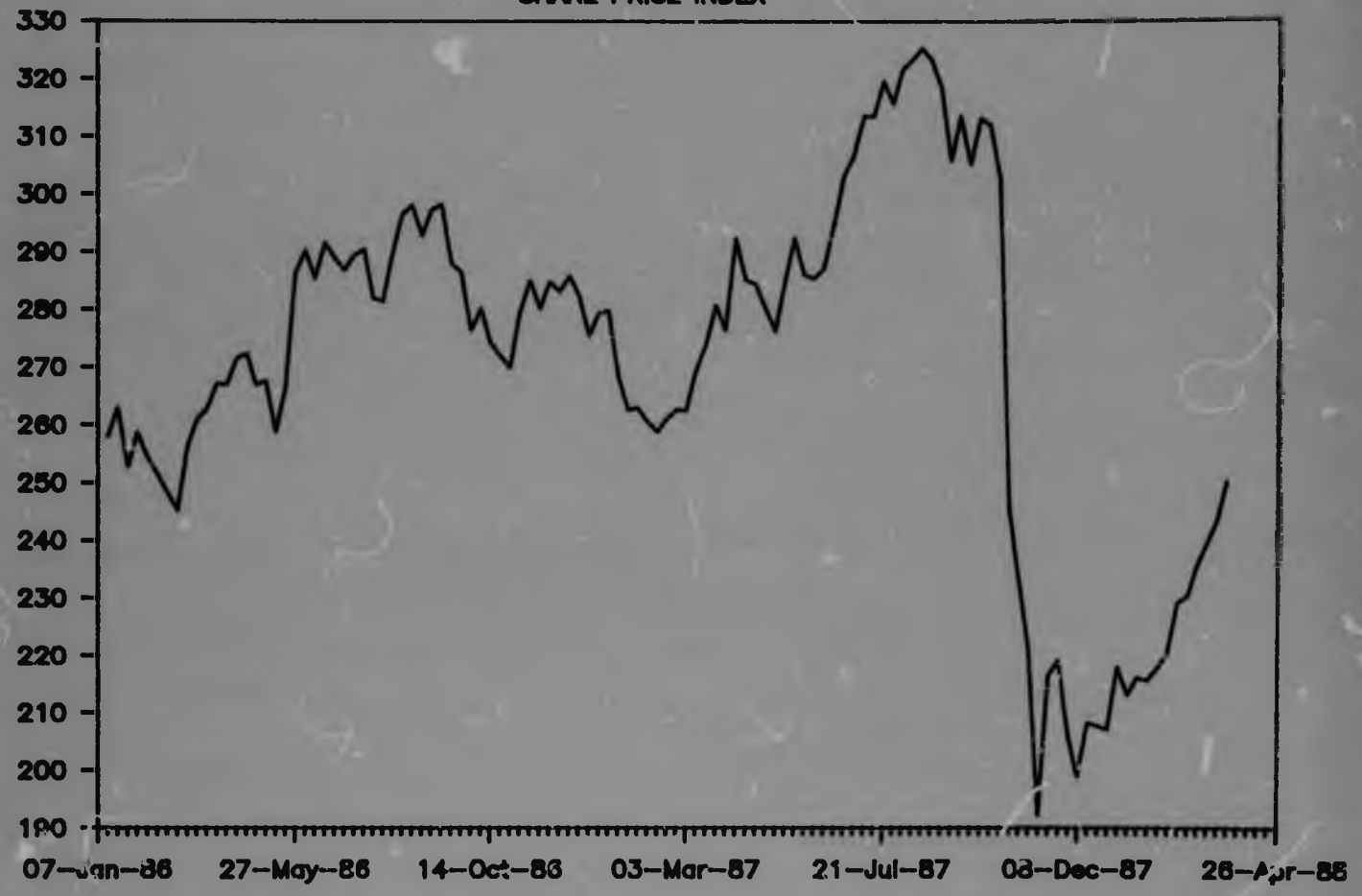


JAPAN AIR LINES

SHARE PRICE

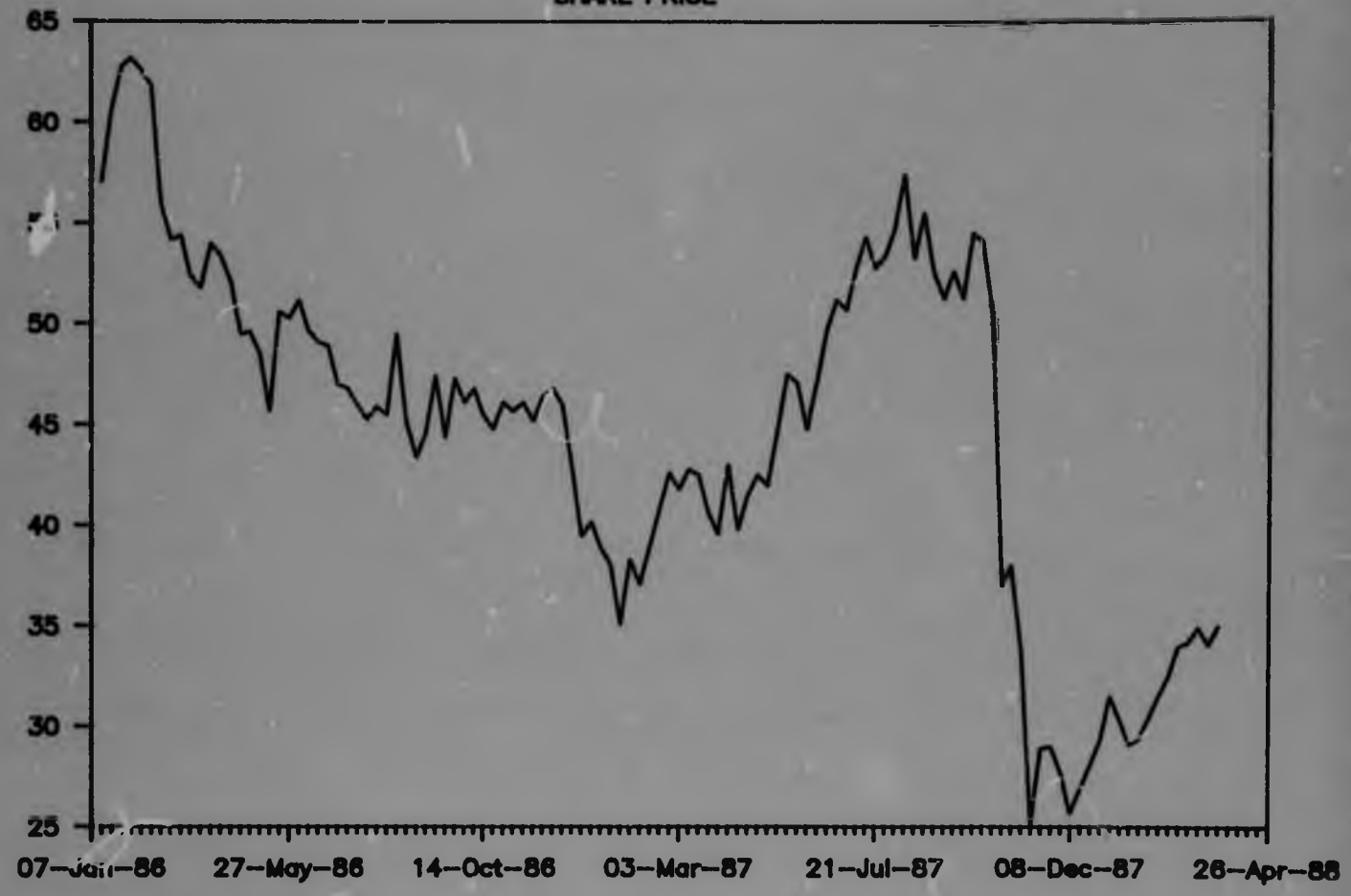


AMSTERDAM STOCK EXCHANGE

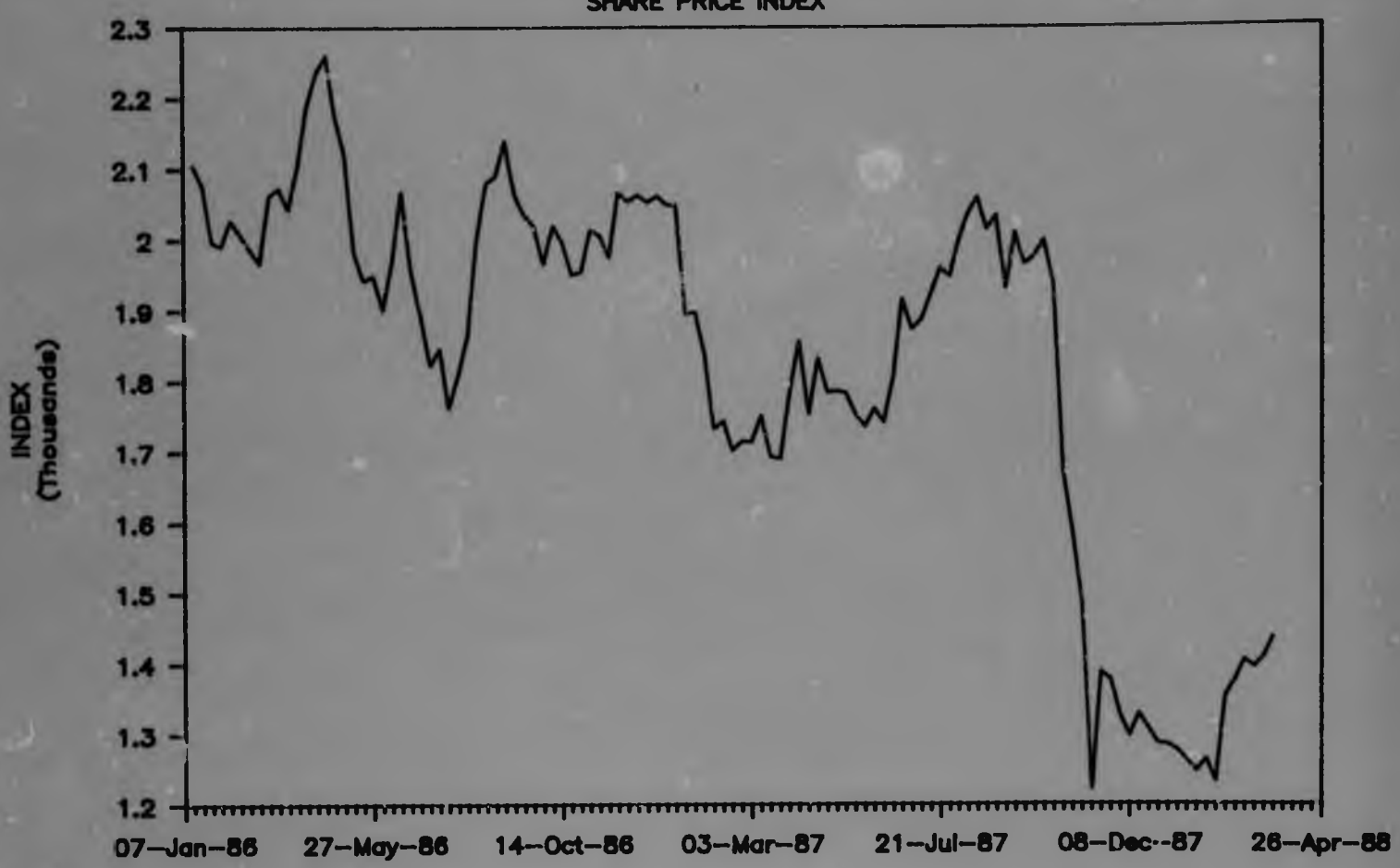


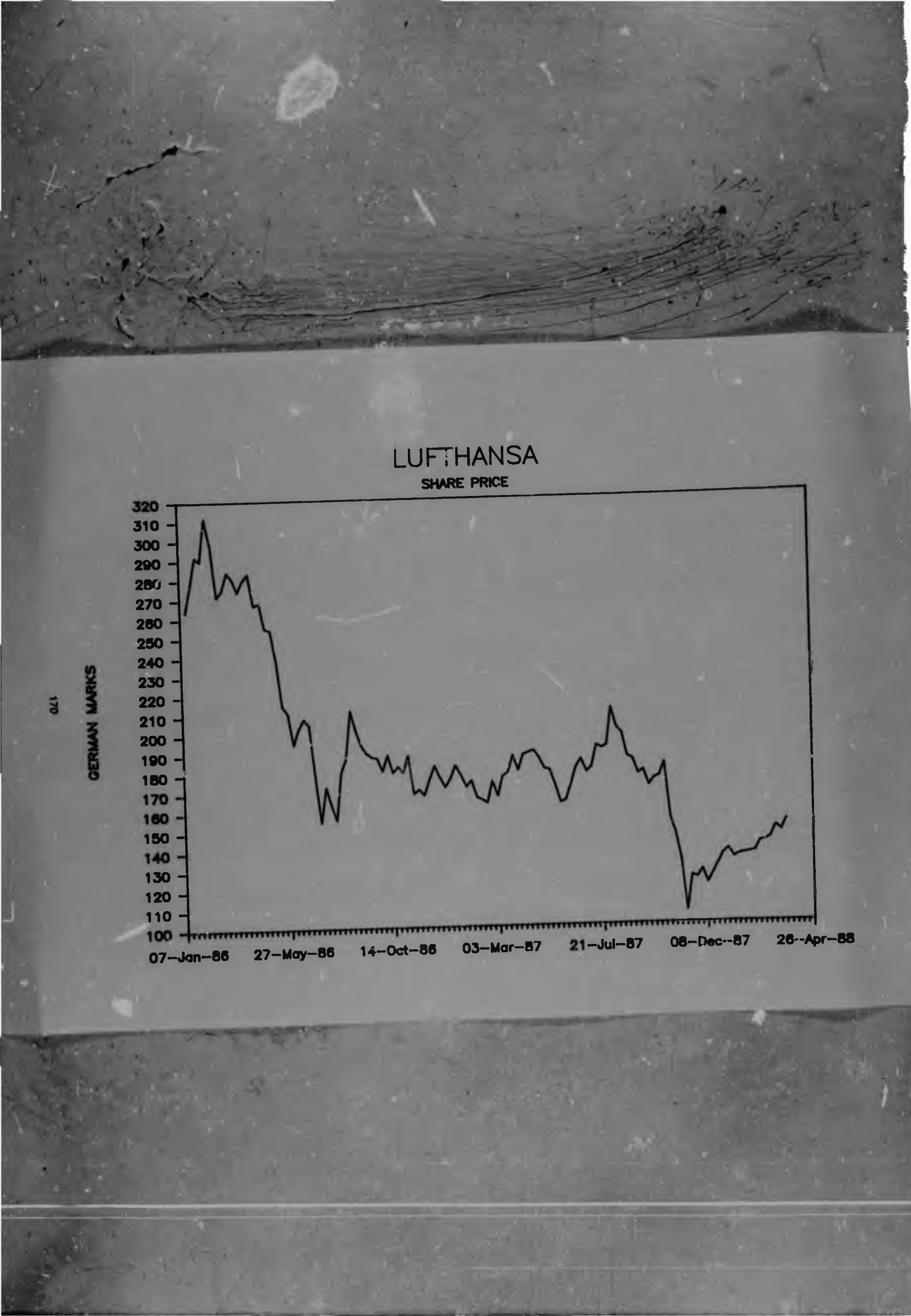
KLM

SHARE PRICE



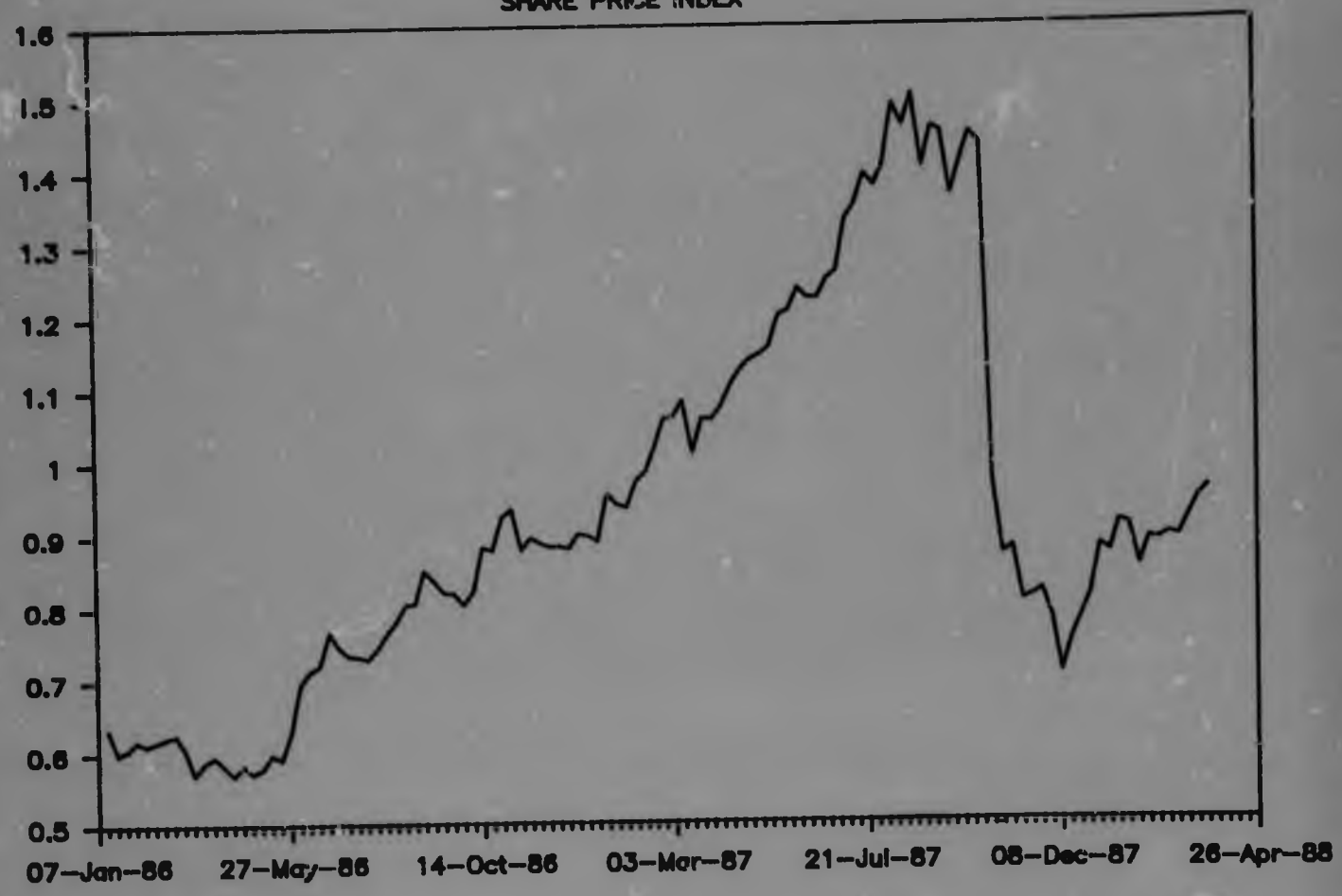
FRANKFURT STOCK EXCHANGE



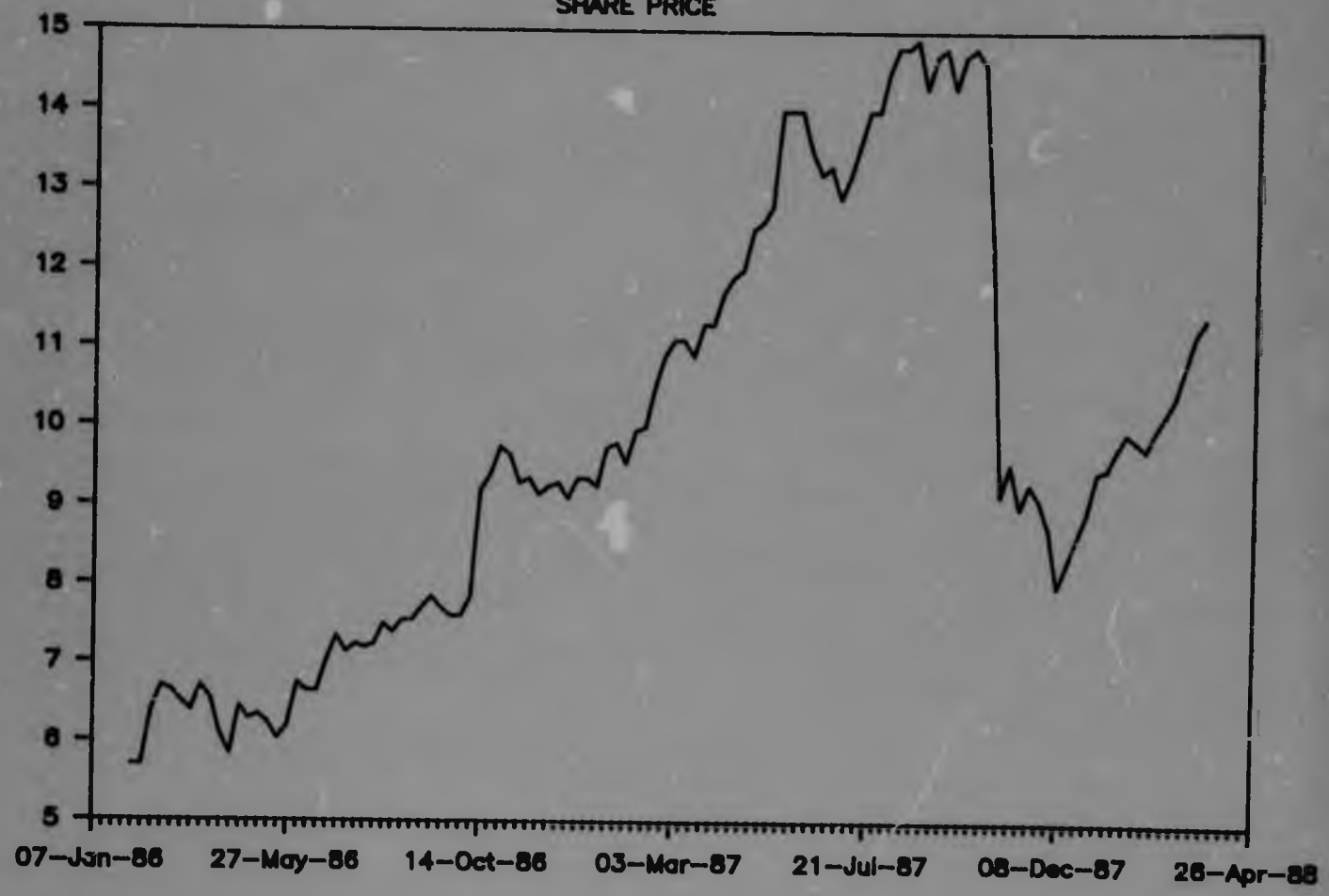

LUFTHANSA
SHARE PRICE
GERMAN MARKS
320
310
300
290
280
270
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210
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190
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170
160
150
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130
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110
100
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27-May-86
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03-Mar-87
21-Jul-87
08-Dec-87
26-Apr-88

SINGAPORE STOCK EXCHANGE

SHARE PRICE INDEX

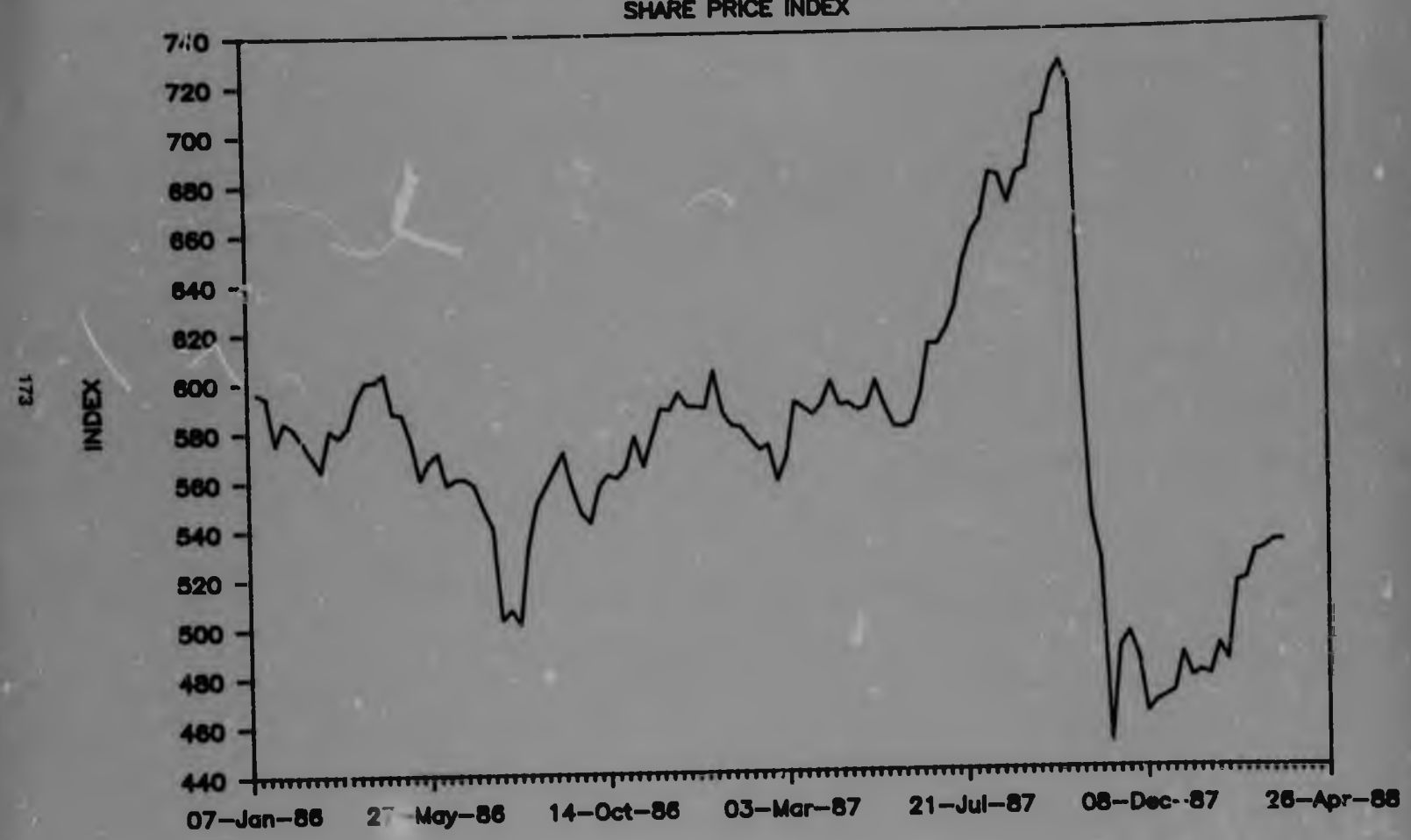


SINGAPORE INTERNATIONAL AIRLINES



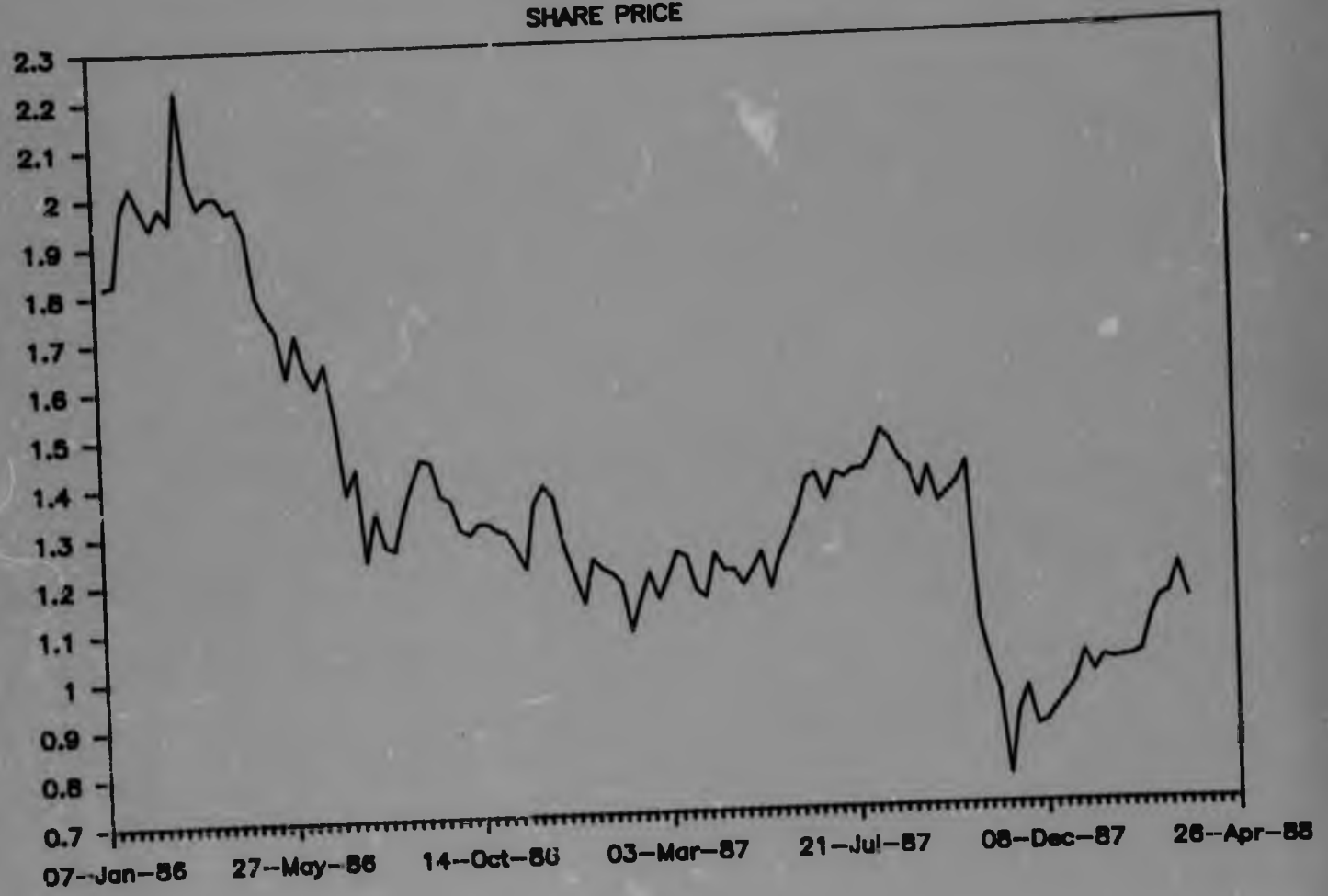
ZURICH STOCK EXCHANGE

SHARE PRICE INDEX



SWISSAIR

SHARE PRICE



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