OLIVER WYMAN

CREATING A SUSTAINABLE PRIVATIZATION PROGRAM

REALIZING SAUDI ARABIA'S VISION FOR THE FUTURE

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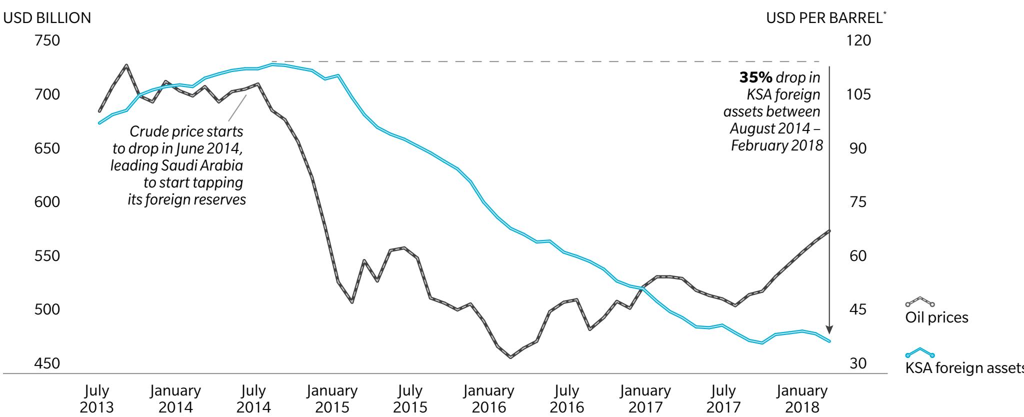
I. INTRODUCTION

The collapse of oil prices in 2014-2015 slashed Saudi Arabia's key source of revenue, which has historically made up some 75 percent to nearly 90 percent of the Kingdom's income[1]. This led in turn to huge deficits, forcing the government to draw down its foreign reserves and issue bonds.

Exhibit 1: Budget deficits in KSA are depleting foreign reserves

KSA GOVERNMENT FOREIGN ASSETS VS. OIL PRICE



*USD per barrel refers to generic 1st 'CO' Future

Source: SAMA, Bloomberg, Oliver Wyman Analysis

But while oil prices have since rebounded, the causes behind the collapse – rising global supply, and a growing movement toward renewable energy sources, remain. Fiscal deficits in Saudi Arabia are rapidly depleting foreign reserves. At the same time, many state-owned enterprises (SOEs) remain bloated and unprofitable, relying on government support and reducing competition in the Kingdom.

It is crucial that Saudi Arabia act now to diversify its economy and increase revenues. One option is to privatize SOEs.

The government has already announced plans to privatise some SOEs, the most famous being the privatization of the Saudi Arabian American Oil company (Saudi Aramco), the value of which is estimated to be US$ 2.0 trillion[2]. Saudi Arabia intends to sell less than a 5 percent stake in Aramco. In addition to contributing to the Public Investment Fund (PIF) stake sale in Aramco and its subsequent IPO (expected to be the world's biggest IPO), the initiative would provide much-needed depth and breadth to the Saudi Stock Exchange (Tadawul). Most importantly, the privatization would provide necessary capital for the development of strategic sectors and establishing national corporations.

1 Saudi Arabian Monetary Authority (SAMA). (2008 – 2016). Forty Fourth – Fifty Second Annual Report. Retrieved from http://www.sama.gov.sa/en-us/economicreports/pages/annualreport.aspx?paged=true&p_sortbehavior=0&p_samasortorder=2.00000000000000&p_id=6&pagefirstrow=91&&view=%7B0bf8da9d-5cf3-4408-95cc-240396b022f3%7D

2 Aramco value to top $2 trillion, less than 5 percent to be sold,... (2016, April 25). Retrieved from https://www.reuters.com/article/us-saudi-plan-aramco/aramco-value-to-top-2-trillion-less-than-5-percent-to-be-sold-says-prince-idUSKCN0XM16M

Privatization is a critical aspect of Vision 2030, Saudi Arabia's reform agenda, as well as its National Transformation Policy (NTP) 2020. The program is a response to both medium- and long-term challenges faced by the Kingdom: a rapidly growing population, with high youth unemployment and a reliance on government spending.

Privatization can accomplish much good if executed well. But if done incorrectly, it carries a risk: It can leave behind a legacy of trouble that can impact the economy and society and linger over a country for decades. Indeed, there are multiple examples of poorly managed privatization efforts that have hurt, rather than helped nations.

For privatization to succeed, it needs to be done right and done well. Here are four key points to consider:

Exhibit 2: The four key success criteria along the privatization journey

1 **Right assets**

- Clear criteria aid in the selection and prioritization of assets /services (filter and prioritization)
- Such criteria will ensure making strategic decisions based on objectives and requirements

2 **Right model**

- Privatization can take varying models with differing levels of private sector involvement. Hence the appropriate model must be chosen
- Economic, fiscal and social objectives of the government should be specified and matched with an appropriate privatization model

3 **Regulatory framework**

- Regulations protect the public sector from adverse effects after privatization, particularly for monopolies
- The technical committee should be governed by clear set of objectives and regulations that dictate its performance

4 **Governance structure**

- Appropriate governance structure should be put in place to manage the privatization process and enhance communication channels between stakeholders

II. SUSTAINABLE PRIVATIZATION

Privatization has the potential to play an integral part in Saudi Arabia's diversification and reform strategy. When executed properly, privatising state-owned enterprises can bring clear benefits to the economy, driving growth and employment and improving the fiscal balance.

The Gulf Cooperation Council (GCC) is no stranger to privatization. Yet despite its potential, privatization in the GCC has been littered with stalled efforts and, in some cases, outright failure[3]. Before undertaking the process, it's necessary to think carefully and seriously about the steps one needs to take – otherwise the privatization program could end up failing.

For privatization to succeed – for it to be done right and done well – there are multiple points to be considered. We see four key criteria along the privatization journey that are needed to drive the government to action.

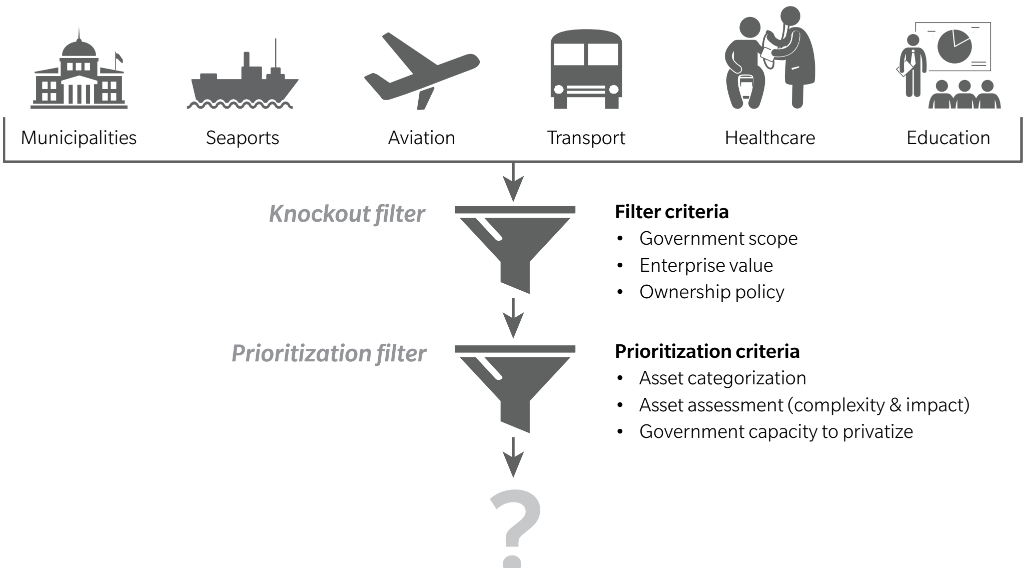
RIGHT ASSETS

Clear criteria must be defined to prioritize target assets and services that are based on government objectives. Filtering for norms and standards help in selecting and prioritizing assets/services. Some of the basic criteria include: enterprise value; ownership policy; government scope; asset categorization and assessment; how complex privatization is likely to be; and what impact will it have economically and socially.

After assets are filtered, they should be ranked by the extent to which they are most suited for privatization, and separated based on whether privatization should be done in the short term, medium term, or long-term. The assets should then be further categorized based on the privatization model best suited to achieve the government's objective.

3 See Oliver Wyman's 2017 report, "Creating a Sustainable Privatization Program in the GCC".
http://www.oliverwyman.com/our-expertise/insights/2016/oct/creating-a-sustainable-privatisation-program-in-the-gcc.html

Exhibit 3: Clear criteria should be defined to prioritize target assets and services based on government objectives



RIGHT MODEL

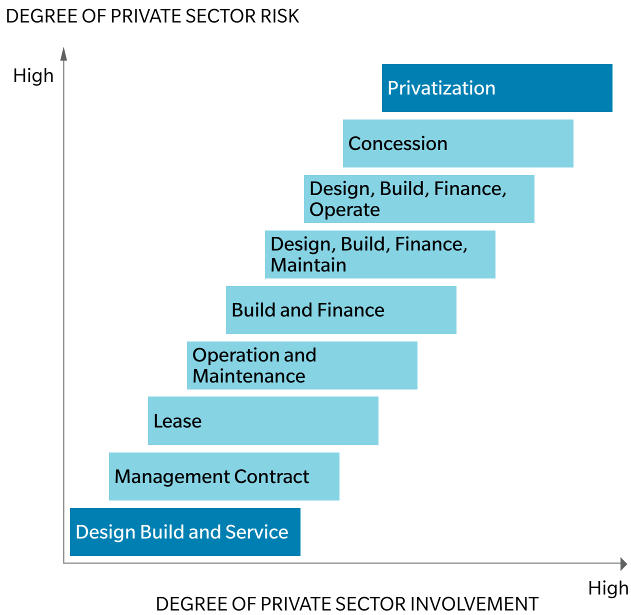
Privatization can take on varying models with differing levels of private sector involvement. It's not the case of one-size-fits-all: the specific contours of the model will vary depending on the economic, fiscal, and social objectives of the government. The focus of the government may range from raising money to enhancing its finances to improving the level of services to raising the overall its overall competitiveness in the global economy.

Exhibit 4: Success requires matching government objectives with the appropriate model

PRIVATIZATION OBJECTIVES

FOCUS	IMPLICATION
Government fiscal position	Improve government fiscal position through collecting concessions revenues and reduce operating expenditures/subsidies
Service delivery (social)	Enhance quality of service delivery to citizens through private sector driven innovation, transfer of know-how and enhanced operational efficiency
Economic competitiveness	Enhance economic competiveness through increasing private sector involvement, deepening capital markets and developing labour markets

POTENTIAL OPTIONS FOR PRIVATE SECTOR INVOLVEMENT



Successful privatization programs require the model to match well with the specific government objective. For example, if the primary government objective is to enhance efficiency in an industry (and not raise revenues), this can often be achieved through a management contract whereby a group of private sector players bid for the right to exclusively manage services for a period of time. The competitive and time bound nature of such arrangements often result in industry players finding creative ways to reduce costs without compromising services. Management contracts are common for services in which privacy or security are not compromised by outsourcing to a private sector player. Examples include managing the cleaning of schools and hospitals. In this case, the government retains ownership of the asset, and cost savings and efficiencies are realized through outsourcing to the private sector.

By contrast, if the goal of the government is to raise public revenues and achieve efficiencies, opening up the asset to the competitive forces of the private sector through an IPO may be the best course of action. While this arrangement is more complicated and results in the government losing control of the day to day administration of the asset, it is an effective way to raise revenues in the short term and enhance the competitiveness of the asset.

CASE STUDY: SPAIN, THE CASE OF A POOR MODEL

In 2010, Spain launched an airport privatization program aimed at generating revenues for the government, which was beset by fiscal crisis. Introduced during the depths of the European debt crisis, Spain adopted a new airport management model, including the concession of its two biggest airports in Madrid and Barcelona. In addition to the elevated risk presented by the ongoing debt crisis, the complexity of the asset and model brought down the valuation of the concession, which in turn led to disagreement and a lack of alignment on the model, resulting in opposition from the various stakeholders.

In 2011, the government scrapped the outsourcing effort. In the case of Spain, the absence of a clear model for privatising the airports, a lack of alignment of the stakeholders, and a model that failed to maximize the valuation of the airports contributed to the failure.

REGULATORY FRAMEWORK

Many of the assets under consideration for privatization usually involve industries that have operated as monopolies. Clear regulations from a capable watchdog are critical for privatization to succeed. The characteristics of a successful regulatory framework include: alignment on clearly defined objectives; an experienced, resourceful, and competent staff; a high level of transparency and accountability; and the power to run day-to-day operations.

The government must put into place a series of cross-sector regulations applicable to all industries, including: antitrust, health and safety, environmental protection, and intellectual property rights. In addition, the government must implement sector-specific regulations overseeing those areas in which the public interest is involved, a monopoly exists, and regulation is highly complex.

Exhibit 5: Clear regulations from a capable regulator are critical for privatization success

REGULATORY FRAMEWORK

FRAMEWORK	DESCRIPTION
Horizontal Regulation	• Cross sector regulations that apply to all industries equally, including: – Antitrust – Health and Safety – Environment Protection – Intellectual Property
Sector Regulation	• Sector specific regulation to oversee activities where: – Public interest is involved – An element of monopoly is likely to persist (hence, involve the right stakeholders to ensure fair playing ground) – Regulation is highly complex and specific

KEY CHARACTERISTICS OF A SUCCESSFUL REGULATOR

- Alignment on clearly defined objectives
- Well-resourced and competent staff
- Empowered to run day-to-day operations
- High levels of transparency and accountability

Source: Research Paper – Privatization in the 21st Century: recent Experiences of OECD Countries (OECD); Oliver Wyman Analysis

GOVERNANCE STRUCTURE

Appropriate governance structures are needed to manage the process of privatization and maintain and enhance communication between the various stakeholders. The government must define clear guidelines and procedures for the selection of private investors.

A common practice, with clear benefits, involves the development of framework legislation (such as prioritisation of assets, bidding processes, ways of selecting finalists, etc.). Doing so improves the transparency, consistency and effectiveness of the process, generating greater confidence in potential investors. As such, adopting framework legislation can increase the number and quality of prospective investors.

CASE STUDY: ARGENTINA, A FAILURE OF OVERSIGHT

Argentina is a glaring case in which privatization failed in large part because of the absence of supervisory and regulatory oversight of onetime monopoly industries. For half a decade, beginning in 1989, Argentina privatized 90 percent of all state-owned enterprises, including YPF, the giant energy company. The privatization program came in response to weak investment, poor quality of services, and operational inefficiencies. Sole authority for privatizing rested with the president of Argentina, resulting in opacity. And the main type of privatization was the franchise model.

Privatization in Argentina was fast and comprehensive, and at first was popular with the public. Privatising initially achieved the fiscal goal of eliminating state subsidies and lifting tax revenues; it also attracted investment in infrastructure and improved public services. Most importantly, it sent a strong signal to international investors that the government was committed to restructuring the economy. However, the economy's performance soon returned once again to a lackluster state. Meanwhile, the privatization effort had resulted in a concentrated ownership and poor consumer protection, and in the face of public outcry, prices of services had to be renegotiated.

Eventually, many of the privatized entities had to be renationalized in the face of their failure to deliver services to constituents and customers. It was a case in which the government failed to retain control and oversight via regulation and the necessary legislation and supervision to support the vast privatization effort was not in place.

The lesson to be drawn from Argentina: governments need to retain control by establishing contracts that ensure responsiveness from the new owners to provide good service to constituents; the design stage needs to include supportive legislative measures; and transparent processes are in the public's best interest.

The government should also create a central body to drive the private investment program. This governance model carries two major benefits. First, the central authority is able to coordinate private-sector participation efforts across all sectors. Second, privatizations are highly complex processes, involving many phases steps, which often require specific expertise in finance, law, governance and human resources. Such steps would need to be conducted by specialized firms. Considering privatizations can take many years, it is crucial to have a central authority to oversee and co-ordinate the work of the specialized firms and various government agencies.

III. SAUDI ARABIA: CHOOSING A HIGH-IMPACT PRIVATIZATION PROGRAM

Saudi Arabia plans to raise $200 billion in the next decade by privatizing a wide range of SOEs across multiple industries and sectors. The biggest privatization, of course, is the sale of a 5 percent stake in Aramco through an IPO, with shares to be listed on Tadawul and at least one foreign exchange. The plan for floating a small piece of the oil giant heads a list of other privatization schemes being floated or already underway. Others include the Saudi Grains Organisation, where there is a plan to create four separate corporate entities for domestic and international sale; the airline Saudia is planning a $500 million sale of its medical services business as part of its drive to focus on its core business; Saudi Aramco plans to reduce its stake in Sadara, a joint venture with Dow Chemical, cutting it from 65 percent to 35 percent; and the government-operated postal system, Saudi Post is expected to be sold privately[4].

Exhibit 6: Major privatization plans currently considered/underway (sample – not exhaustive)

Saudi Aramco	• Planned 5% sale through IPO • Shares to be listed on Tadawul & at least one foreign exchange	**Saudi Electricity Company (SEC)**	• Plans to split into separate companies for sale either to citizens through IPOs or local/international firms
Saudi Grains Organization	• Plan to divide milling operations into four specially formed corporate entities for domestic and/or international sale	**SAFF Soccer Clubs**	• Sale of up to 5 soccer teams in Saudi professional league
Saudia	• Has begun sale of medical services business in Jeddah, valued at roughly $500 million	**King Faisal Hospital**	• Privatization stage reportedly advanced & expected to provide framework for future health care sales (Ministry of Health considering privatization of 55 primary healthcare centers in Riyadh)
Minstry of Education	• To privatize construction and management of school buildings	**Saudi Post**	• Expected private sale • Sale type & amount undisclosed
SWCC	• To be transformed into joint-stock holding company & work with investment partners for eventual IPO	**Sadara**	• Saudi Aramco to cut stake in Sadara joint venture from 65% to 35%

Source: Reuters (2017); Oliver Wyman analysis

4 Saudi Aramco to dilute stake in Sadara Chemicals via IPO: exec. (2017, May 3). Retrieved from https://www.reuters.com/article/us-sadara-aramco-ipo-idUSKBN17Z0LA; Factbox: Saudi Arabia's privatization plans (2017, December 1) Retrieved from https://www.reuters.com/article/us-saudi-privatisation/factbox-saudi-arabias-privatization-plans-idUSKBN1DV45V

To govern the privatization process, the Kingdom has created the National Center for Privatization & PPP (NCP) and Supervisory Committees. The role of the NCP is to drive the process of privatization, assist and enable government agencies, and hold each accountable for formulating regulations, establishing privatization blueprints, and implementing processes for asset sales. Specifically, according to the privatization program of the Saudi Arabia Vision 2030 realization program, the NCP will:

> "work on developing or proposing frameworks that will enable and manage privatizations. NCP will also ensure that the designing, preparations and implementation are carried out in accordance with the approved governance frameworks. It will ensure the level of efficiency of the system and ensure maximizing the benefit of the system of expertise in privatization."[5]

The role of the Supervisory Committees – composed of relevant agencies with the NCP and the Ministry of Finance as permanent members – is to provide a technical, financial, legal, and regulatory framework for privatizations and public-private partnerships (PPPs) and to identify and leverage global best practices of target entities.

A privatization program that is carefully implemented can bring benefits to the government and economy, producing stronger growth, higher employment, and a better fiscal balance. Shifting assets to the private sector reduces government costs by removing inefficient and unprofitable companies from a state's balance sheet. Privatization can also provide governments with the opportunity to inject money into the treasury in the short term and help make corporate tax initiatives more profitable in the longer term.

The gains extend well beyond a balanced budget. They can result in greater overall effectiveness in policy planning and execution, allowing functions to be performed with greater transparency and efficiency. In fact, effective government is a core determinant of successful economic development and private sector empowerment – especially in Saudi Arabia, where government plays a central role in the economy.

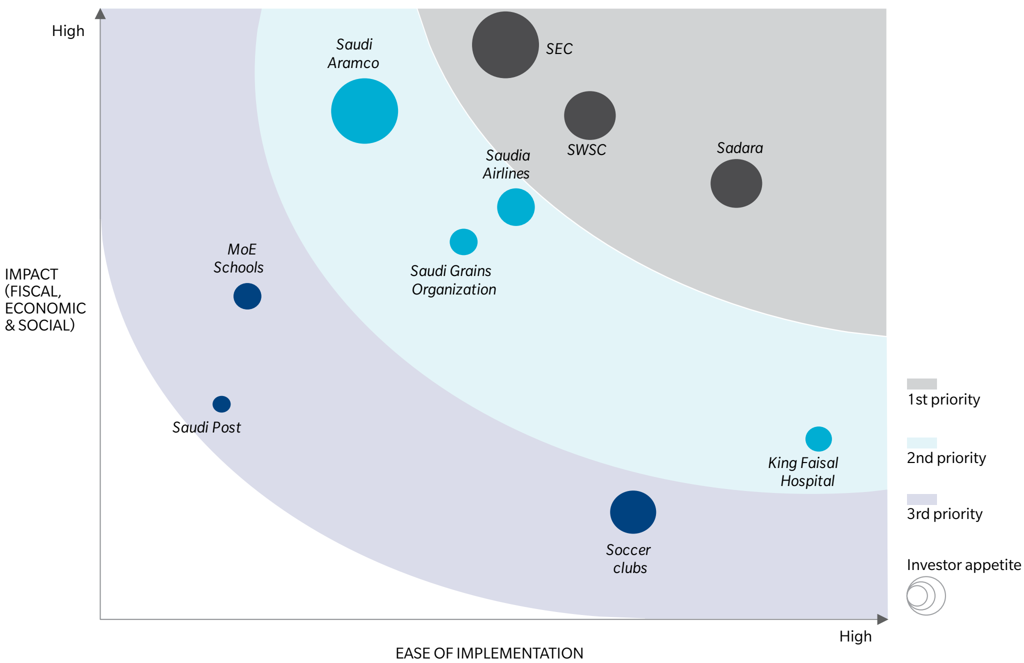
Oliver Wyman research suggests that there is investor appetite for many assets currently under consideration for privatization by the Kingdom. Moreover, overall there is a high correlation between firms for which there is high market appetite and firms that, if privatized, would have a high fiscal, economic and/or social impact on the country.

Moving forward, the Kingdom should focus on assets with high investor appetitive that are also seen to have a high impact and relatively high ease of implementation. Perceived high impact by the market is important because it suggests these assets can become high priority items for the government, particularly given its 2030 Vision aspirations. Likewise, market perception of a high ease of implementation is important as it suggests investors believe the government will be able to follow through on the privatization initiative.

5 Privatization Program (Delivery Plan 2020). A Saudi Vision 2030 Realization Program. (2018)

Exhibit 7: Market perception of the Kingdom's proposed assets for privatization

MARKET PERCEPTION



Source: Oliver Wyman analysis

Results from an anonymous survey conducted by leading market players including bankers, investors, public officials, accountants, industry players and researchers/academics

The market analysis suggests that the top candidates for privatization are Saudi Electricity Company (SEC), the Saline Water Conversion Corporation (SWCC), and Sadara. Each of these assets have relatively high investor appetite, and are anticipated to provide high impact (economic, fiscal and social). Moreover, the market sees them as having a high ease of implementation compared to the other assets under consideration. This combination of high investor appetite and perceived high impact and ease of implementation should place these assets among the primary candidates of SOEs to be considered for privatization.

Unsurprisingly, the investor appetite for Saudi Aramco is the highest, and it is among the assets that is perceived to have the largest economic impact. The market, however, appears to have some reservations as to the ease of implementation of what could potentially become the world's largest company by market capitalization. The lower relative ease of implementation is due to the perceived secrecy around the cost structure of the firm, its willingness to divulge information on the size of its oil reserves, and the relationship that a privatized Saudi Aramco would have with the government in terms of tax obligations. Enhancing transparency on these issues would likely increase the perceived ease of privatizing the entity.

IV. UNDERSTANDING THE RISKS

Privatization is not without risk, particularly in a region where change is both an object of desire and of fear. We have set forward four criteria that are critical to a successful privatizing program, but within each of those steps are multiple smaller measures and challenges that must be met along the way. Each one represents risk.

Exhibit 8: Risks that can render a privatization process ineffective

Political will	• Limited political support to take difficult, often unpopular, decisions (e.g. tariff reforms) and publically champion the reforms leading to lack of interest from private sector
Commercial viability	• Assets are not commercially attractive, either due to legacy costs (e.g. over staffing) or due to business model restrictions (e.g. no clear revenue stream), leading to lack of traction from the private sector
Anti-competitive process	• Privatization process is not transparent (e.g. no clear bid factors), nor designed to increase competition (e.g. through optimal lot sizes), leading to inefficient awards and subsequently poor service delivery
Property rights	• Sufficient safeguards are not built in for private sector against the risk of expropriation, which results in lower valuation from the private sector (i.e. risk is priced in by private sector) and later increased likelihood of privatization failure (e.g. failed privatization of electricity distribution company in Albania)
Regulatory lag	• Regulatory capacity is not upgraded to manage new contracts, leading to either over or under regulation of privatized entities • Particularly challenging for regulated monopolies requiring strong regulated oversight

These risks can be managed by putting certain restrictions on the assets prior to the privatization launch: freezing budgets and restricting major capital expenditures; halting new net hires; no major changes in management, organization, and remuneration policy; putting a halt on internal and external long-term agreements; no major sector restructuring and regulatory changes/law changes and no major asset restructuring; and no ministerial communication related to privatization.

Exhibit 9: Restrictions on assets that can help manage privatization risks

RESTRICTION		DESCRIPTION
1	**Budget**	• No changes in budget • No major capital expenditures
2	**Hiring**	• No above net-hiring
3	**Organizational structure**	• No major changes in organisation and remuneration policy • No major changes in management
4	**Long-term contracts**	• No internal and external long-term agreements (approval for >2 years)
5	**Restructuring**	• No major sector restructuring and regulatory changes/ law changes • No major asset restructuring
6	**Ministerial communication**	• No communication related to privatization

Source: Oliver Wyman analysis

V. WHAT'S AT STAKE FOR SAUDI ARABIA?

While often viewed purely in fiscal terms, privatization provides important economic and social benefits. Economic benefits include introducing market competition, attracting local or foreign investment, extending technological and management know-how, and developing capital markets. Social benefits include improving services and creating greater efficiencies, as well as involving citizens in the ownership of the economy through the distribution of shares.

The fiscal, economic and social climate is ripe for privatization. Recent fiscal deficits and a slowdown in economic growth have increased support for privatization among government actors. Similarly, on the social side, the Vision 2030 has received broad support from the public – which seems enthusiastic to modernize its economy and society. One pillar of this modernization should be the privatization of select state-owned enterprises.

To obtain the maximum benefit from privatization, the Kingdom must make sure that the levers for value creation are clearly understood and the correct assets chosen. Clear criteria and gauges need to be defined and put in place so as to filter, prioritize, and rank target assets and services in terms of the government's objectives and requirements. Those initial filters may be defined by the scope of the government's role and ownership, the value of the enterprise, and ownership. The prioritization criteria may include categorization of assets, assessing assets in terms of complexity and importance, the ability of the government too privatize the specific assets.

Additionally, setting up and establishing a privatization program takes time–and planning. Results don't happen overnight. For privatization to succeed, Saudi Arabia must first focus on assets for which there is appetite from the market. The market analysis provided in this paper offer insights into what those assets may be. Even after the sectors and assets have been identified, it is best to break them down further into those which are short-, medium, and long-term privatization projects.

The longer-term nature of such programs may discourages governments from embarking upon privatization. Despite this, and the other challenges highlighted, when done correctly, privatization should be seen as an important tool to enhance the fiscal, economic and social situation in Saudi Arabia.

ABOUT OLIVER WYMAN

Oliver Wyman is a global leader in management consulting that combines deep industry knowledge with specialized expertise in strategy, operations, risk management, and organization transformation.

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