

Confessions of a Privatizer: The Privatization of CSL Ltd*

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THE wholly government-owned Commonwealth Serum Laboratories (CSL) was sold in 1994 for nearly \$300 million. I was responsible for CSL at the time the government took the decision to sell.¹ In their book, *Privatisation: Sell Off or Sell Out?*, Bob and Betty Walker gave the 'Wooden Spoon Award' for Australia's worst privatization to CSL Ltd.²

Was the Commonwealth wrong to sell CSL, or was the sale the realization of a public asset and a chance for an Australian manufacturer to develop and contribute to the national economy as never before?

Walker and Walker, and Hamilton and Quiggin,³ regarded the sale of CSL as consisting of only one form of risk: the risk that the taxpayer would receive insufficient return on its investment. They did not consider the risks involved in the continued ownership of CSL by the Commonwealth. Their focus was zero-sum: a gain to the purchaser must mean a loss to the seller.

They did not consider the dynamics of the situation. CSL was not an institution, it was a company. Among other things, it operated in the highly competitive pharmaceutical industry. It had to invest in research and development, it had to seek alliances with other companies in order to develop sophisticated drugs. It had to be alert to competition. CSL produced vaccines and sera for treating a variety of illnesses, including diphtheria, tetanus, cholera, plague, pertussis (whooping cough), smallpox and influenza. Any of these products could conceivably,

at some point, have been manufactured by a competitor for a lower price. The Commonwealth was also a purchaser of most of the products. It would have been entitled to seek the best price. As both producer and buyer, the conflict for the Commonwealth was obvious.

CSL's largest single manufacturing activity was (and is) blood fractionation. Plasma is sourced from blood donors to the Australian Red Cross Blood Transfusion Services and the Commonwealth had a clear

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public health obligation in this part of the business. While it was unlikely that the Commonwealth would source its fractionation elsewhere, or that a competitor was going to arise, there may have been advantages in splitting the company, separating fractionation from vaccines and sera. Other divisions, such as Biosciences

and Veterinary, could similarly have had a life of their own, or indeed may have been better placed in another institution such as CSIRO.

A whole range of options, from total sale, to partial sale, to dismemberment of the company were all seriously considered over a number of years. CSL was not a body to be nursed, it was an array of productive assets to be maximized.

The decision to sell CSL whole may or may not have been the best one. Who knows what further options would have proved even better? What we do know, however, is this. CSL paid \$4 million income tax in 1994; in 2000, it paid \$27 million. CSL employed just over 1,300 people in 1994; in 2000, it employed over 1,400 people in Australia, and a number overseas. In 1993, sales revenue was around \$170 million and assets were \$230 million. In 2000, sales revenue was over \$500 million and assets were nearly \$1 billion. The question the critics of the sale must answer is: would CSL have made such a contribution to Australia had it remained in Commonwealth hands?

DID THE COMMONWEALTH RECEIVE AN ADEQUATE RETURN?

Returning to the critics' narrow focus, the most difficult part of identifying the losses and gains of a sale is estimating the 'sale' or 'retention' value of an asset. This estimate is considerably influenced by the view taken on whether there is a differential cost of capital faced by government and the private sector. The

critics argue⁴ that the cost of capital is always higher to the private sector than to government. The argument follows, that the only way a government can induce a buyer in the private sector is to sell the asset at less than it is worth. This is nonsense. As Hathaway suggests, 'the mere fact of government (as opposed to private) ownership does not alter the value of an asset'.⁵ The cost-of-capital argument is based on the observation that the government sector need not pay company tax, and that the government sector can borrow at lower rates than the private sector. These observations are correct, but it does not follow that the government cost of capital is lower than the private sector cost. Ultimately, the case for the privatization of government enterprises does not turn on the cost of capital for government business enterprises. It is based entirely on the efficiency gains it makes possible.

The study of the privatization of CSL by Hamilton and Quiggin (relied on by the Walkers) made the false assumptions of the kind Hathaway describes. When the authors applied their measure to the CSL sale, in the first instance they concluded that the sale price was right!⁶ Indeed, the Australian National Audit Office (ANAO) audited the sale of CSL and concluded that the Commonwealth's return on the sale of CSL was acceptable given the modest size of the initial after-market share premium and that it approached reported shareholder funds.⁷

THE NEW PLANT AND THE NEW AGREEMENT

To sustain their criticism that the Commonwealth sold CSL too cheaply, however, Hamilton and Quiggin relied on two other elements of the sale—the new fractionation plant at Broadmeadows and the 1993–2004 Plasma Fractionation Agreement (PFA).⁸ The CSL acquired a new blood fractionation facility, substantially funded by the Commonwealth, which was to gen-

erate higher future profits. The sale of blood-products was controlled by a contract with the Commonwealth, which, before sale, substantially increased the price for product, thus underwriting future profits. The critics' argument is that the Commonwealth will be paying out \$45 million per year more for the life of the

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ten-year agreement than it would have, had CSL remained in Commonwealth ownership.⁹ Is this accusation sustained by the facts?

The profitability of CSL did and does, to some extent, depend on its PFA contract with the Commonwealth. Commonwealth payments to CSL before the PFA were a non-commercial pricing arrangement. They did not include any allowance for capital upgrades to enable continuing manufacture of blood products. Presently, the payments are a commercial arrangement, and as such represent a real return to CSL. Such a return meant a considerable increase in the price of the products.

Akin to the differential cost-of-capital argument, Hamilton and Quiggin argued that the real cost of producing blood products could be less in the hands of a government-owned CSL. In fact, with the same efficiency of operation, the cost would be the same. The things that varied were the reassignment of risk

between the Commonwealth and the CSL, an agreement to share any future gains in productivity over the lifetime of the agreement, and for the first time, the government and the CSL would have to negotiate a real price.

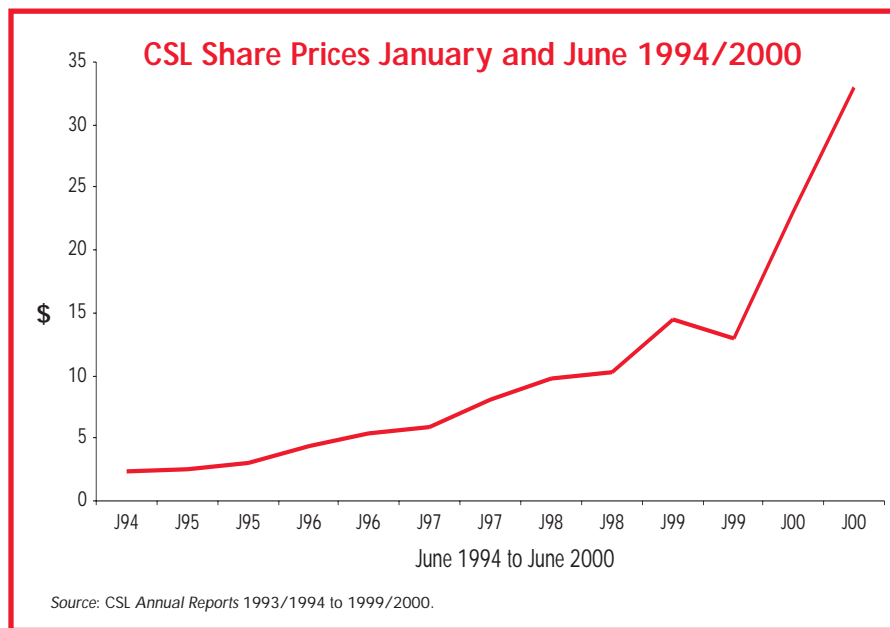
Because there is a single buyer and a single seller in blood fractionation in Australia, risk can only be assessed through negotiation and review. That does not mean that risk is not apparent, or that it should be set at zero. Fortunately, the PFA incorporated adjustments for efficiency gains, which were to be split 50:50 between the Commonwealth and the CSL, and there was an agreement to review pricing arrangements during the course of the contract.¹⁰

A major impact on the review of pricing was a disagreement about the depreciation of the Broadmeadows facility. The ANAO argued: 'Some \$35 million, which CSL had received in respect of depreciation on its assets was added back into the total asset base value'.¹¹ The Department of Health countered that 'projections indicate that \$219 million will be recovered over the period of the contract compared to \$221 million [of the target amount]. This means there has been no double-counting'.¹²

The disagreement on the rate of depreciation for the Broadmeadows plant does not suggest the dogmatic conclusions of Hamilton and Quiggin and the Walkers on the price received by the Commonwealth for the sale of CSL. Moreover, the agreement to share any variation in the adjustment to the price of blood product considerably reduces the magnitude of any supposed loss, especially as the matter is to be renegotiated in 2004.

HAS THE NATION LOST AN ASSET OR HAS IT GAINED ONE?

The price of CSL shares has soared in the years since the float. The critics argue that any improvement in the share price implies a loss to the taxpayer. They include profits five ►



years after privatization as belonging to the Commonwealth, assuming CSL would have generated those profits in government ownership. The only way that could happen was for the government to have captured the improvement in value by having purchased CSL shares at its sale!

What specific activities led to the extraordinary rise in value of CSL shares? Since the float in 1994, other than the Managing Director, almost every single other management role in the organization has changed. CSL's acquisitions of JRH Biosciences USA in 1994 and Biocor Animal Health USA in 1998 have made some difference, although the acquisition of ZLB Switzerland in September 2000 was, in the opinion of a senior CSL executive,¹³ seen by the share market as adding considerable value.

Further, the market has seen CSL's R&D activities as adding value to the company, specifically its collaboration with Merck on an HPV vaccine (human papilloma virus) as well as its collaboration with AstraZeneca (Sweden) on the development of a therapeutic pylori vaccine. Another jump in the share price occurred in 1999 when CSL entered into collaboration with the American Red Cross for the development of a fibrin bandage. Overall, the new

investments in R&D and in purchases, and the new 10-year blood fractionation agreement with the Commonwealth appear to account for the confidence that shareholders have in CSL.

CONCLUSION

The criticism that CSL was Australia's worst privatization is based on the view that government assets should only pass into private hands if the taxpayer receives a return equal to that which would be received by a private operator, when that operator had promoted a more efficient use of capital. A government which was unwilling and unable to run CSL as a private company could not expect to recoup a present value from assets that were improved after they were sold. Of course, the basis for much of that improvement rested in the preparation of CSL for sale, in particular the new fractionation plant and the corporatization process. It may also be true that the Commonwealth could have struck a better bargain with CSL on the price of plasma products and the assignment of depreciation at the Broadmeadows plant.

Nevertheless, the Commonwealth was able to realize an asset in such a way that the nation has continued to benefit from the growth of

CSL through taxation, employment, capital accumulation, foreign acquisitions, exports, and investment in new technology. The future of CSL may be subject to much greater risk as it breaks into new markets and confronts greater competition¹⁴—the sort of risk and competition that a government-owned operation could not handle, indeed, would not dare handle.

NOTES

- * The full version of this paper is available at the IPA website: www.ipa.org.au
- 1 As Parliamentary Secretary to the Minister for Health, Housing and Community Services.
- 2 Walker B. and B. Walker, 2000. *Privatisation: Sell Off or Sell Out?* Sydney: ABC Books, 224.
- 3 Hamilton, C. and J. Quiggin, 1995. *The Privatisation of CSL*. The Australia Institute, Discussion Paper Number 5.
- 4 Walker and Walker, 2000, Chs 4, 5 and Appendix to ch 5. Quiggin, J. 1997. 'The Equity Premium and the Government Cost of Capital: A Response to Neville Hathaway'. *Agenda* 4(4): 475–488.
- 5 Hathaway, N. 1997. 'The Equity Premium and the Government Cost of Capital: A Rejoinder'. *Agenda* 4(4): 486. Also, Hathaway, N. 1997. 'Privatisation and the Government Cost of Capital'. *Agenda* 4(2): 155.
- 6 Hamilton and Quiggin, 1995, 4.
- 7 Australian National Audit Office, 1995. *The Sale of CSL*. The Auditor General. Audit Report No. 14. 1995–96. AGPS, Canberra, 5.
- 8 Hamilton and Quiggin, 1995, 4.
- 9 Hamilton and Quiggin, 1995, 6.
- 10 The average minimum price in the PFA was around 65 per cent of world prices for fractionated plasma products. Department of Finance. ANAO, 1995, 43.
- 11 ANAO, 2000. *Commonwealth Management and Regulation of Plasma Fractionation*. Audit Report No. 24. 1999–2000 Performance Audit, 59.
- 12 ANAO, 2000, 61.
- 13 Personal correspondence with author, April 2001.
- 14 Macquarie Research Equities, February 2001. *CSL*, 8.

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