

# **PUBLIC POLICY TOWARDS STATE ASSETS\***

## **A Submission to the Review Group of State Assets and Liabilities**

by

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### **1. Introduction**

We are pleased to be able to respond to the call for submissions to the Review Group of State Assets and Liabilities (“the Group”) recently established by the Minister of Finance “to examine and provide advice on the proper stewardship of state assets and on opportunities for better use of those assets.”<sup>1</sup> While the exigencies of the current financial and budgetary crisis have given rise to the creation of the Group, the issues raised are of fundamental importance to the health of the economy in the longer term, given the nature of state-owned assets to the Irish economy, particularly in the non-traded sector. The commercial state-owned firms control the major airports, urban and, to a lesser extent, inter-urban bus travel, ports, railways, electricity generation, transmission, and distribution, gas distribution and supply, postal services, TV and radio broadcasting, forestry and solid fuel production. In terms of intangible assets, the State creates and is responsible for allocating radio spectrum for broadcasting and telecommunications, mineral, hydrocarbon and other licences, and carbon dioxide emission permits.<sup>2</sup> Furthermore, the State and organisations close to the State provide a wide range of services, some of which primarily serve private interests. The brand and expertise of such bodies should be seen as intangible assets too.

The terms of reference for the Group are as follows:

- To consider the potential for asset disposals in the public sector, including commercial state bodies, in view of the indebtedness of the State.
- To draw up a list of possible asset disposals.

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<sup>1</sup> Taken from Department of Finance website: <http://www.finance.gov.ie/viewdoc.asp?DocID=6396>. Accessed 29 July 2010.

<sup>2</sup> An interim list of assets to be reviewed by the Group includes 28 commercial state bodies and three classes or types of intangible assets. For details see source in previous footnote. Aer Lingus is not listed, but it is obviously a state-owned asset whose value could be quickly realised. In other jurisdictions, such as England, water utilities are privately-owned commercial firms, but publicly regulated. Hence there is an argument for inclusion of both Aer Lingus and water utilities in the assets reviewed by the Group.

- To assess how the use and disposition of such assets can best help restore growth and contribute to national investment priorities.
- To review where appropriate, relevant investment and financing plans, commercial practices and regulatory requirements affecting the use of such assets in the national interest.

There is a clear preference for asset sales as a method of helping to resolve the indebtedness of the State. However, in considering asset sales the terms of reference suggest, quite properly, that wider considerations need to be taken into account. Drawing up a list of potential assets disposals implies setting criteria as to which assets should be sold. Furthermore, the terms of reference suggest that the asset sales should not only assist in resolving indebtedness, but also “help restore growth and contribute to national investment policies.” Finally, the terms of reference list a series of factors that may need to be taken into account when considering the use to which these assets are put. In sum, the terms of reference can be read as the maximisation of income from asset sales subject to a series of important wider public policy constraints.

The purpose of this paper is not to present a rank order of which assets should be sold. Rather the purpose is discuss the considerations of what factors should be taken into account in deciding which assets should be sold, the regulatory and other mechanisms that might be introduced to complement such asset sales, and some of the difficulties that are likely to be experienced in conducting assets sales. Tangible assets are discussed in Section 2, before attention turns to intangible assets in Section 3. A conclusion completes the submission (Section 4).

## **2. Tangible Assets: Commercial State-Owned Firms.**

### ***Introduction***

Selling State assets is nothing new in Ireland. The importance of state-owned firms has declined, both in absolute and relative terms, since the early 1990s, due to a combination of privatisation and the growth in the economy.<sup>3</sup> In the early 1980s state-owned firms employed 91,000 persons, accounting for 8 per cent of total employment in the economy; by 2008 employment declined to 41,000 persons in state-owned firms accounting for 2 per cent of total employment in the economy.<sup>4</sup> The

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<sup>3</sup> For discussion see, for example, Palcic and Reeves (2004).

<sup>4</sup> Based on Barrington (1985, p. 289) and Forfas (2010, p. 3). The latter source contains an extensive discussion on the importance of state-owned firms to the economy.

State exited ownership involvement in banking,<sup>5</sup> telecommunications, steel, shipping and sugar refining. Nevertheless, what remains, as noted above, is state involvement in important sectors of the economy, some of which are competitive, others oligopolistic or monopolistic.

In considering which state-owned firms might be appropriately privatised, it is important to first examine the rationale for public ownership. If there are no strong or compelling reasons for public ownership, then the state-owned firm could be disposed of through privatisation. However, that is only a necessary, not a sufficient condition for privatisation. Attention has to be paid to the way in which the state-owned firm is privatised, especially when it has market power, to ensure that complementary policies are introduced so that the firm is subject to appropriate checks and balances. Even if these conditions are met there may be further barriers to successful privatisation which also need to be considered.

### ***Why Government Ownership?***

In considering whether or not a state-owned firm should be transferred to the private sector an important set of issues revolve around why the state-owned firm is in the public as opposed to the private sector. Thus the following questions need to be addressed:

- What purpose or rationale was there for the creation of the state-owned firm?
- Is that purpose or objective still relevant in 2010?
- Will the transfer of the firm to the private sector damage the attainment of the objectives of public ownership?
- Are there better or more effective methods or instruments that could be used to attain those objectives?

Many state-owned firms were created many decades ago such as the ESB in 1927, Bord na Mona in 1946, or CIE in 1950 (Barrington, 1985, Appendix 1, pp. 308-311). Furthermore, in some instances, since the state-owned firm was created it has increased the range of activities in which it is involved. For example, while Bord na Mona was initially concerned with peat mining, it entered commercial and domestic waste management in 2007 with the acquisition of AES, which increased Bord na Mona's revenue by 20 per cent from activities in the State.<sup>6</sup>

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<sup>5</sup> Until that is the financial crisis resulted in the State taking ownership in whole or in part in several banks.

<sup>6</sup> For details see Competition Authority (2007).

The rationale as to why these activities were and are conducted within the public sector may no longer be relevant or valid and/or there may be better ways of attaining the objective. This may reflect technological change (e.g., the market has expanded so much that there is room for many suppliers and thus the monopoly rationale for the state-owned firm is no longer valid); institutional reform (e.g., public private partnerships may be a much more appropriate and efficient procurement method than direct provision through state ownership); and, changes in ideology (e.g., a move away from a belief in protectionism, autarky and a distrust of the private sector towards reliance on a liberal open trading system and the efficacy of markets).<sup>7</sup>

Of course, this discussion assumes that the rationale(s) for public ownership is carefully specified in publicly available documents and, where there is more than one rationale, no conflicts occur. It also assumes that when a state-owned firm diversifies its activities – such as Bord na Mona in the above example – a similar exercise is conducted. Finally, it assumes that there is no disparity between the publicly-stated rationale and the underlying or ‘real’ rationale. In the case of Bord na Mona while the stated rationale for intervention is security of supply,<sup>8</sup> arguable job creation is as, if not more, important motivation.<sup>9</sup> It is not at all obvious that these conditions will always be met. Hence discovering why an activity is in the public realm is likely to be neither easy nor straightforward.

To some degree, however, this may not be an insuperable problem. In determining whether there is a valid rationale it is suggested that market failure framework be used. After all what is being compared are the merits of the public and the private sector. The framework is well developed and has been suggested by other commentators such as Forfas (2010, pp. 21-22) in the current debate over the role of state-owned firms. Nevertheless, there may be differences between the stated rationale for public ownership and those consistent with the market failure framework. The stated reasons reflect political decisions, where arguably concerns about re-election are uppermost, while the market failure approach is more about what politicians *should* do in order to maximise societal welfare (Gorecki, 2009).

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<sup>7</sup> This change in view is consistent with the record in Ireland. See Barrett (2004) for a discussion on this point.

<sup>8</sup> This rationale is discussed further below.

<sup>9</sup> Indeed, Honohan (1997, p. 105) comments that peat-based electricity generation “can best be rationalised as an income redistribution measure.” Peat mining is of course an essential input into such generation.

The market failure framework suggests that following rationales for government intervention:<sup>10</sup>

- Monopoly, combined with high barriers to entry, so that the firm has market power which can be used to raise prices above costs. Prices are too high with the result that consumers are worst off, either because they cannot purchase the product at the competitive level (due to a budget constraint) or they purchase the product but at too high a price;
- Externalities, prices are meant to reflect costs, but not all costs may be included in the price, such as the polluting activities of a factory or the noise imposed by an aircraft or highway vehicles on nearby residents; the water or air may be 'free' to the firm whereas it should be priced, with the result that there will be too much pollution and noise and water resources will be overexploited;
- Imperfect or asymmetric information, in that the seller or provider of a service or product possess knowledge not available to the buyer and that can be used to distort the buyers choice. Information can be provided to rectify the asymmetry;
- Public goods; that is, goods that are non-rivalrous and non-excludable. Non-rivalry means that consumption of the good by one individual does not reduce availability of the good for consumption by others; and non-excludability that no one can be effectively excluded from using the good. Examples often cited include security of supply (e.g. energy), clean air, free-to-air television, defence and lighthouses.<sup>11</sup> Because the private sector will under provide such goods, because of the difficult of recouping the cost of provision, government could, for example, subsidise the activity or provide directly or under contract.

These rationales, of course, only provide grounds for government intervention. They do not specify *how* the government should intervene. There is an extensive literature on the choice of instrument - public enterprise or tax or the creation of a property right or regulation or incorporation within a government department or a subsidy.<sup>12</sup>

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<sup>10</sup> For a discussion of this framework, in the context of EU Structural Funds, see Honohan (1997, pp. 75-92).

<sup>11</sup> However, it is not at all clear that lighthouses fall into this category. For a discussion, which refers to the experience of Great Britain and Ireland see Coase (1974).

<sup>12</sup> See for example, Trebilcock et al (1982) and Gorecki (2009).

Broadly speaking the result of the exercise examining why a firm is part of the public sector should result in state-owned firms being divided into three broad categories:

- *those state-owned firms for which the stated rationale, whether or not it accords with the market failure framework set out above, is no longer relevant and valid and hence consideration can be given for privatisation.* For example, Bord na Mona's peat mining for use in electricity generation may have been justified on grounds of security of supply, given Ireland's reliance in imported fuels.<sup>13</sup> However, this rationale may no longer be tenable, because of concerns about the environment – carbon dioxide emissions from peat are very high; and competitiveness – peat is high cost typically necessitating an annual surcharge on all electricity consumer (e.g. €78 million in 2010/11); while security of supply concerns are being addressed by other policy instruments – interconnection with Great Britain and the development of off-shore gas resources;<sup>14</sup>
- *those state-owned firms for which the objectives, whether or not it accords with the market failure framework, can be met by more efficiently and effectively through the use of alternative policy instruments.* For example, while urban bus services might have been run as a state-owned firm in order to assure supply and avoid inefficiencies/congestion with multiple providers on the same route, a better, more cost effective and flexible method of provision could be for a public authority to design the network of routes required but use competitive tendering to determine which firm would provide the service for a particular route. Under this model the state-owned enterprise could compete for the right to supply the service, but would be competing against other suppliers. Such a tendering system has been used to determine, for example, which firm should operate the LUAS in Dublin;<sup>15</sup> and,

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<sup>13</sup> This interpretation is consistent with DCMNR (2007), EC (2001), and ESB (2005).

<sup>14</sup> For a discussion on these points see Tuohy et al (2009) and CER (2010). If a peat fired generating station's notified entitled costs are greater than its revenues then a surcharge – the Public Service Obligation – is levied; if its costs are less than its revenues, the difference is returned to the PSO fund. Typically it appears that monies are not returned.

<sup>15</sup> Another example might be ports, most of which are in public ownership. This is justified by reference to the fact that they are “essential pieces of national infrastructure and as such have a strategic role in facilitating both national and regional economic development” (Department of Transport, 2010, p. 7) and the need to “ensure that ... wider socio-economic interests are protected” (*ibid*, p. 9). However, arguably the same applies to Eircom and airlines, both of which are largely, if

- *those state-owned firms for which the objectives are best met through public ownership.* The electricity and gas transmission and distribution networks are natural monopoly and there are arguably grounds for these remaining in public ownership.

The remainder of the discussion below discusses the factors that need to be taken into account in considering the first two options.<sup>16</sup>

Of course, it should be noted that it is possible that a large state-owned firm that is diversified and/or vertically integrated may as a result of this exercise be split up, with some parts remaining in the public sector and others in the private sector. It might be argued that the ESB, for example, was established as a public firm because of the need to control a monopoly supplier of electricity and in order to ensure rural electrification which might not otherwise be provided. However, electricity generation is rapidly becoming more competitive with entry of new generators and interconnection with other markets, with only transmission and distribution as a natural monopoly. Furthermore, the creation of the independent regulator, the Commission for Energy Regulation, addresses the problem of controlling the monopoly power that remains in the incumbent ESB. Indeed, a separate entity, EirGrid, controls and operates and will soon, unless government policy changes, own the transmission system, separate from ESB. Hence arguably, ESB generation activities could be privatised while the natural monopoly could remain within the public sector.

### ***Structurally Competitive vs Oligopolies/Monopolies***

The owner of a firm, whether in the public or private sector, monitors its performance and sets its goals and objectives, such as maximising profits or a profits break even target. Of course, in the private sector where the ownership of the firm may be widely held, management may play a larger role in setting policy, subject, of

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not entirely, in private hands. Furthermore in the 1990s (Industrial Policy Review Group, 1992, pp. 45-46) and in the 2000s (Competition Authority, 2003, p. 3) concerns were expressed about the lack of competitiveness of Irish ports, which retarded rather than promoted economic development. As a result some attention is required as to why ports cannot be privatised, particularly the larger ones, and why these development and socio-economic interests – whatever they might be – cannot be safeguarded through other means.

<sup>16</sup> A thorough review of state-owned firms would consider governance and other issues related to the third category. For a discussion of these issues see Forfas (2010).

course, to the market for corporate control.<sup>17</sup> Irrespective of whether or not the firm is part of the private or public sector, competitors will also impose constraints on the firm's behaviour, the strength of which depends on market characteristics. If the market has many competitors, with low barriers to entry, then any one firm is likely to have little market power. Its competitors place constraints on its pricing and other dimensions of business behaviour. At the other extreme, if the firm is a monopoly in a market with high barriers to entry, then the firm will have market power, potentially at least, to charge prices above costs and generate excess profits which can be used for various purposes. In the latter case, with the state as owner, can in theory at least, constrain the pricing behaviour of the firm while if the firm were in the private sector it is much more likely to raise price above competitive levels.

This is, of course, very much a stylised picture of reality. In some structurally competitive markets such as inter-urban bus transport it is arguable that the market has not been competitive as they could be precisely because barriers to entry have been raised by restrictive licensing by government to protect the incumbent state-owned firm from competition.<sup>18</sup> A recent example was the behaviour of the Minister of Transport with respect to licensing decisions biased in favour of Dublin Bus at the expense of a private bus operator, the Swords Express.<sup>19</sup> Further in some of these markets the State is able to provide large levels of funding for firms that in part at least are involved in competition. CIE, for example, received a subsidy of €316 million in 2009, equivalent to 43 per cent of its revenue (CIE, 2010, p. 8).<sup>20</sup> The bus subsidy runs for 5 years and was not put out to tender.<sup>21</sup>

Equally, a firm – irrespective of whether or not it is publicly or privately owned - with market power may use some of that power to earn supra normal profits,

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<sup>17</sup> Mergers and acquisitions; the argument is that if firms become inefficient and/or do not maximise profits then another firm will acquire them and remove the inefficiency and maximise profits. For a discussion of the market for corporate control see Manne (1965).

<sup>18</sup> Of course, this point should not be overstated as there are a litany of examples of the state supplying restrictive regulation to protect private firms. For a discussion see Gorecki (2009, 2010) and OECD (2001).

<sup>19</sup> For details see High Court, *Digital Messenger Limited Trading As Swords Express and Minister for Transport and Dublin Bus* [2010] IEHC 311, delivered on 30 July 2010. This judgment may be accessed <http://www.courts.ie/Judgments.nsf/bce24a8184816f1580256ef30048ca50/8f959bc0e75602c88025778b003de28d?OpenDocument>. Accessed 7 September 2010.

<sup>20</sup> The subsidy consists of a Public Service Obligation and Rail Safety Grant. The PSO was agreed with the bus services of CIE for five years, for rail for 10 years dating from December 2009.

<sup>21</sup> Another example is what Barrett (2006) refers to as the regulatory capture by the formerly 100% publicly-owned Aer Lingus of its parent department that over many decades refused to allow new entrants to compete with the national flag carrier until Ryanair was allowed to operate in 1986.



some of which may be dissipated in various forms of activity. When privately owned it might be used for corporate expenses and perks; in the public sector to keep open factories in a Minister's constituency in the 1980s<sup>22</sup> or to diversify into activities that may be politically popular but make little or no commercial or perhaps even environmental sense (e.g., the promotion of electric cars by the ESB) or to allow monopoly rents to be captured in the form of higher labour costs (e.g. ESB).<sup>23</sup>

Nevertheless, the above characterisation does contain sufficient traction to provide some guidance as to the considerations that might be entertained when a state-owned firm is sold into the private sector. Essentially there should be complementary policies designed to ensure that the formerly state-owned firm should not be able to exercise market power and that as far as possible market forces should be used to allocate resources and set prices. This prevents the privatisation process from being nothing more than a transfer of a firm with market power from the public to the private sector. Such an approach has the advantage that it is consistent with the terms of reference for the Group which refer to helping restore growth and regulatory requirements. In order to ensure that resources are allocated as much as possible consistent with market forces the following options and considerations are recommended.

Break-up state-owned firms into monopoly and competitive parts where feasible.

If there are substantial economies of scope or vertical complementarities such an approach may be unduly costly. However, where this is not the case - arguably in the case of ESB discussed above - then such separation should be seriously considered. The competitive parts can be privatised and market forces will be sufficient to monitor performance while the monopoly element can be regulated. By engaging in this separation it makes the role of the regulator much easier since it precludes the monopolist from diverting profits into the competitive parts of the business or using the security of the regulated asset to engage in risky activities in other sectors of the economy. As noted above the ESB would be an instance where such restructuring could take place prior to privatisation. Another possible example would be the introduction of terminal competition at Dublin Airport, whereby each of the two terminals could be privatised but sold to different owners, or alternatively the

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<sup>22</sup> On this see Sweeney (1960, p. 101).

<sup>23</sup> On the latter point see Deloitte (2005, p. 10, p. 48, p. 224) and Diffney et al (2009, p. 481). The former source finds that labour costs in ESB are between 20 and 30 % above comparable UK generators.

terminals could be retained in public ownership but operating the terminals could be franchised out through a tendering process.<sup>24</sup>

Remove unnecessary entry and other restrictions used to protect the incumbent state-owned firm.

To the extent that entry and other regulations are used to protect a state-owned firm from competition, as arguably is the case in urban and to a lesser extent inter-urban bus services, then these restrictions should be abolished as part and parcel of any transfer of assets to the private sector. Of course, abolition of such restrictions should be part of any sensible policy to improve the efficiency of the economy, irrespective of the ownership issue. While some steps have been made in this direction on foot of the OECD (2001) report on this issue and a series of reports on the professions by the Competition Authority,<sup>25</sup> much remains to be done as discussed elsewhere in this paper in specific instances.

Competition *for* the market rather than competition *in* the market.

In some instances the problems created by a monopoly situation, based on economies of scale, scope and/or density can be resolved by instituting competition *for* the market through a tendering procedure, rather than the creation of a regulatory agency to supervise competition in the market. A good example of competition for the market is household waste collection, where the evidence suggests that contracting out the right to collect such waste secures the lowest price, compared to a situation of an unregulated state-owned monopolist (Competition Authority, 2002). Recent government policy announcements are moving towards tendering for waste collection (DoEHLG, 2010, pp. 13-14). Franchising bus routes is another example. In 2002 the Minister for Transport announced that 25% of the bus routes in Dublin would be franchised from 2004 with the implication of more to follow (Department of Transport, 2002, pp. 5-6). However, despite compelling arguments<sup>26</sup> for such a move, by 2010 there were no franchised routes.

Regulation as a last resort.

Where none of the above measures to introduce competition are likely to be successful and the firm has market power then the firm should be subject to

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<sup>24</sup> Serious consideration was given to establishing a second terminal at Dublin Airport to compete with existing facilities (Panel, 2003), but this did not go ahead. On terminal competition see CAA (2005) which had previously been sceptical concerning airport terminal competition and CC (2009) which considers terminal competition in the context of BAA plc.

<sup>25</sup> Full details may be found on the Competition Authority's website: [www.tca.ie](http://www.tca.ie).

<sup>26</sup> See, for example, Massey (2006).

regulation. There are many examples of regulatory structures in Ireland to select from in coming to a view as to which is the most appropriate model to follow. Indeed, in most cases the state-owned firm is already subject to regulation such as ESB and Bord Gais by the Commission of Energy Regulation, which begs the obvious question that if the original motivation for public ownership was to control the monopoly problem, why is both state ownership and regulation necessary? Given the necessity of independent regulation under EU Directives and Regulations relating, to for example, telecommunications, gas and electricity, it is clear that public ownership is the weaker constraint.<sup>27</sup>

#### Resolution or Step-in Rights.

Large firms with potential market power are difficult to regulate for a whole host of reasons from asymmetric information to the ability to funnel resources from regulated to unregulated activities. One difficulty is that the regulated firm may decide to incur considerable debt and ask the regulator for a rate increase and/or may be in financial or other difficulties and request a rate increase to fund this costly error. Since many regulated firms with market power provide important services essential to the every day functioning of the economy, if these firms were to become bankrupt or unexpectedly stop supplying services – even for a short time - then this could have substantial adverse effects on the economy. Thus the regulated firm is in a strong bargaining position when it asks the regulator for a price increase, implicitly threatening bankruptcy and discontinuity of service if it is not granted.

In order to level the regulatory playing field when the state-owned firm is privatised one option would be to allow the regulator to step in, run the firm and dispose of the assets as the regulator saw fit, if the regulated entity failed to meet the conditions set out in its license.<sup>28</sup> Of course, the regulator would not be required to run the regulated firm itself; it could appoint a trustee. A suitable model may be the Financial Regulator which recently appointed a trustee to run Quinn Insurance where there were concerns about the financial viability of the firm.

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<sup>27</sup> On electricity see, for example, Article 35 of Directive 2009/72/EC concerning common rules for the internal market in electricity, of 13 July 2009.

<sup>28</sup> The license might for example set out a programme of investment that is expected and as well as the regulatory regime that will be imposed in the regulated entity. If the regulated entity is unable to meet the investment programme because it has incurred too much debt then step in rights might be invoked. Of course, holders of debt would be aware of this possible problem and thus this acts as a disincentive for the regulated entity to market such debt.

One of the implications of the above approach to privatising any state assets is that the price will be lower than it otherwise would be. Monopolies, even publicly owned, tend to be worth more than if divided into a series of smaller firms required to compete with each other. However, the terms of reference for the Group envisage other factors being taken into account and hence the above considerations are relevant.

### ***Barriers to Reform: Compensating the Losers?***

No matter how thorough the analyses of whether a state-owned firm should remain in public ownership some will argue against the sale of assets to the private sector. The sale might be characterised as needlessly selling off the family silver, either because the price is too low with the current depressed state of the economy or on principle. Alternatively those that manage and work for state-owned firms may argue against the sale of such firms, because they may currently benefit from the present arrangements. However, unlike the first group, those employed in state-owned firms have the power to resist the transfer of state assets to the private sector through strikes and other action. Attempts to franchise out bus routes in Dublin in 2002 were abandoned after the bus unions objected while the Irish Congress of Trade Unions stated, together with reforms of CIE, franchising would threaten the survival of social partnership (Massey, 2006, p.1). These groups are likely to make change difficult. They are concentrated and well organised, while the beneficiaries of change – society at large through a more efficient allocation of resources and a more competitive economy – are dispersed and much less effective at organising. Furthermore the State has created institutional mechanisms – Employee Share Ownership Plans (“ESOP”) which also make privatisation more difficult.

### **Rent collection.**

Firms with durable market power are able to charge a price above the competitive level without attracting entry to compete away that price/cost margin, where the margin includes a normal rate of return. Indeed, that is the definition of market power. Frequently the rent – the difference between the competitive and the monopoly return - is captured in part by labour through higher wages and/or inefficient work and other practices. In the case of ESB its labour costs would appear to be substantially above those of electricity systems where there is more competition, while there is also evidence of over manning (Deloitte, 2005; Diffney et al, 2009). Transferring these functions to the private sector while at the same time introducing mechanisms such as

those suggested above to facilitate greater competition means that these rents will be competed away.<sup>29</sup> Under these conditions employees and management, which is also likely to be sharing in these rents, will strongly resist a simultaneously switch in ownership and competitive conditions. Furthermore, Ministers who are able to influence the behaviour of the state-owned firms as a method for implementing their policy preferences – particularly in depressed times – may be reluctant to support privatisation.

#### Employee Share Ownership Plans (ESOPs).

While rent collecting by labour and others is nothing unusual in advanced countries when it comes to state-owned enterprises the creation of Employee Share Ownership Plans or ESOPs are by all accounts unique to Ireland. ESOPs are owned by the employees of the state-owned firm. The ESOP is awarded shares in the state-owned firm either free or at a substantial discount.<sup>30</sup> In some instances the ESOP is created when the state-owned firm is privatised, where the shares held by the ESOP typically account for just under 15% of the company (Palcic & Reeves, 2004, Table 11, p. 20), or while it is still in state ownership, where the ESOP's ownership is 5% or less.<sup>31</sup> The sums transferred, for selected privatisations up to 2002, are considerable: from €83,161 per ESOP member in the case of Eircom to €27,522 per ESOP member in the case of ACC Bank (*ibid.*, Table 11, p. 20). At least three issues arise with respect to the privatisation of state owned firms and ESOPs.

First, it is not entirely clear what the rationale for this transfer of wealth from society at large to a select group of individuals who happen to be lucky enough to work for the state-owned firm. It appears to consist of two parts: first, in return for work place changes and increased flexibility (*ibid.*, p. 20);<sup>32</sup> and second, a bribe not to attempt to block privatisation. It is not at all clear how close is the relationship

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<sup>29</sup> Of course, introducing market mechanisms to increase competition is likely to reduce if not eliminate rents irrespective of ownership; however, that does not necessarily prevent the return to capital be captured by labour, which would be much less likely under private compared to public ownership.

<sup>30</sup> For the ESOPs involved in privatised state-owned firms, 5% of the shares were given free in exchange for changes in work practices and voluntary redundancies, with the remaining 9.9% was purchased by the ESOP at a discounted price. Palcic & Reeves (2004, p. 20).

<sup>31</sup> The percentage of the capital stock distributed is less for those state-owned firms which are still in public ownership. In 2008 the ESOP for Bord Gais was incorporated and by 2009 accounted for 3.29% of its capital stock. This was given in return for “transformational savings” (Bord Gais, 2010, p. 7). In contrast the ESOP for ESB own 5% of the capital stock of the state-owned company. The ESOP was part of the Cost and Competitiveness Review agreed between the Government, ESB management and the ESB group of unions in 1996. Legislation creating the ESOP was passed in 2001 enabling the roll out of the ESOP. For further details see: <http://www.esbesop.ie/index.html>. Accessed 7 September 2010.

<sup>32</sup> See also previous footnote.

between the value of the shares awarded free to the ESOP and the value of the increased flexibility, since in all the ESOPs analysed by Palcic and Reeves (*ibid.*, p.20) bar one, 5% of shares of the privatised firm are allocated for this purpose. The same percentage was awarded in the case of the ESB ESOP although the percentage was a little lower for the Bord Gais ESOP (3.29%). Recall that the employees of the state-owned firm are likely to be already collecting a wage premium and/or have restrictive practices so it not clear that these awards are appropriate.

Second, ESOPs lead to a reduction in the return for the exchequer when the firm is sold. This is in two parts: the awarding of free and discounted shares; and subsequently favourable tax treatment of the ESOP when the newly privatised firm acquired by another firm.<sup>33</sup> Third, ESOPs have a considerable influence over the running of the newly privatised firm as well as existing state-owned firms. The ESOPs incentives may not always be aligned with management in terms of improving efficiency and competitiveness.

Thus the Group will need to carefully consider whether the continued transfer of public assets together with future constraints on management are merited in any future privatisation. In our view it is difficult to justify such a transfer of assets, especially in the midst of a recession with public expenditure subject to extreme pressures. Any transfers to ESOPs in exchange for flexibility should reflect the value of these concessions, determined by an independent source, taking into account any wage premium already present. There should be no bribes for the switch of assets from the public to the private sector.

### **3. Intangible Assets: Property Rights**

#### ***Introduction***

Intangible assets such as radio spectrum licences, mobile phone licences, oil drilling permits, wind turbine permits<sup>34</sup> and carbon dioxide emission permits are likely to be valuable property rights. So are brand recognition and know-how. This reflects their scarcity value. Demand exceeds supply, which is limited for

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<sup>33</sup> This has been the record with respect to Eircom.

<sup>34</sup> Wind is a common property resource that is the property of the people of Ireland. It is a scarce resource since some sites are better than others and, as such, is likely to command a positive price, particularly in view of the assumption by electricity consumers of the downside risk in the price of wind-generated electricity through the REFIT programme which, in 2010/11, cost consumers €29 million (CER, 2010, p. 18). In addition, there is a possibility that wind generated electricity may be exported from Ireland to Great Britain with the rents from wind accruing to the owners of the right to generate wind power, not consumers or taxpayers in Ireland.

technological, public policy, geological, economic or social reasons. The issue thus becomes how to allocate these scarce resources. Three options are considered: auctions; beauty contests; and, free allocation. The discussion suggests that auctions, suitably designed, are the most appropriate solution for allocating intangible assets.

### *Auctions*

Typically scarce resources, whether it is an Auguste Renoir or a Jack Yeats painting or the right to drill for oil and gas in the North Sea, are sold to the highest bidder. This reflects their scarcity value. Any price less than this implies a transfer from the seller to the buyer, in the case of publicly owned property rights, from the State to the oil exploration firm or the radio station operator or the mobile phone operator. The UK Government, for example, auctions carbon allowances under the EU ETS to the highest bidder, because it “is consistent with providing value for money to the taxpayer, subject to the process being transparent, resilient and secure” (DEFRA, 2007).<sup>35</sup> Perhaps the most famous example of an auction by a government was the UK auction of 3G telecom licences, which raised Stg£22.5 billion or 2.5% of UK GNP or enough to build 400 hospitals. Germany was also successful in raising substantial sums in its 3G auction (Binmore & Klemperer, 2002).

Designing an auction requires careful attention to the way it is structured such that the desired outcome is reached. The 3G auction referred to above employed a team of experts to design the auction with considerable success. Other countries were less successful in their design. Nevertheless, there is substantial expertise and experience to draw on with respect to the theory (e.g., Klemperer, 2004) and practice (e.g. Matthes & Neuhoff, 2007 on carbon permit auctions). It should be noted that in designing auctions, as with the discussion above on state-owned firms, attention needs to be paid to competition issues. For example, if a market is dominated by a small number of players then there might be a case for reserving one slot for a new entrant; this also has the advantage that it might make it more difficult for the existing players to game the auction.

Recently the Commission for Communications Regulation (“ComReg”) issued a consultation paper on the allocation of 900 and 1800 MHz spectrum in which different types of auctions are proposed (ComReg, 2009). The final outcome is however, dependent on the consultation process. In any event this is in contrast to the

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<sup>35</sup> Note that Ireland has irreversibly foregone the right to auction emission permits.

beauty parade combined with administrative fee option selected with respect to the allocation of 3G licenses earlier in the decade and discussed below.

### ***Beauty Contests or Parades***<sup>36</sup>

Scarce rights can be allocated on the basis of what is sometimes referred to as a beauty parade. This is akin to a form of barter. Some non-price criteria are set out for the awarding of the property right possibly combined with a minimum payment. The criteria might include some things thought worthy from a public policy point of view or at least the preferences of the body awarding the property right. However, these need to be weighed and each contestant needs to be evaluated, a potentially time consuming and opaque process that can easily lead to charges of favouritism and corruption. Furthermore beauty contests, when combined with an administrative fee, are likely to result in considerable forgone revenue compared to an auction. Five of the seven EU countries that auctioned 3G licences earned more, after adjusting for population size, than the €249 million administrative fee that Ireland earned as part of its beauty parade.<sup>37</sup> The amount earned depended on auction design (UK vs. Netherlands) and the timing in relation to the internet stock bubble (UK & Germany vs. Switzerland & Belgium).

### ***Free Allocation***

The third alternative is simply to give the asset away free. While this is perhaps unusual, there are nevertheless some instances of this. For example, under the EU ETS Member States can elect to auction off 10% of the allowances. Ireland chose not to, with the result that the forgone revenue in 2008 would have been €36 million (Gorecki et al, 2009, p. 25).<sup>38</sup> It is not obvious why valuable assets should be given away free. To the extent that there are some implicit criteria for allocating these property rights then they fall into the same category as beauty contests.

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<sup>36</sup> See Binmore & Klemperer (2002, pp. C76-C77) and NAO (2001, p. 44).

<sup>37</sup> ComReg awarded three 3G licenses in 2002 with a present value of €175 million. The nominal value was €279.3 million. In 2005 a fourth licence was issued, bringing the total raised to €249 million in present value terms or €393.6 million in nominal terms. (Based on various ComReg press releases (e.g. Director of Telecommunications Regulation (2002)), *Annual Reports* and discussions). In the UK the 3G licences yielded about €670 per head, Germany €80, Italy €220, Netherlands €180, Austria €90, Belgium €50, and Switzerland €30 (NAO, 2001, Figure7, p. 19, which refers to licences issued up to March 2001). Ireland's population in 2002 was 3.9 million, with revenue per head of €64, higher than Belgium but lower than Austria.

<sup>38</sup> In 2010, emissions regulated by the EU ETS amount to about 15 million tonnes of carbon dioxide; the current spot price is €14/tCO<sub>2</sub>.



### *Intangible Assets and Tangible Assets*

In some instances, government agencies and quasi-governmental organisations have build up a considerable amount of know-how and substantial brand recognition in delivering a range of services to (parts of) the public. Incorporation of such agencies and organisations would instantly improve the government's balance sheet.<sup>39</sup> It would also open the door to a discussion which services are primarily in the public interest – and should therefore be financed from the public purse and perhaps provided by a state-owned company – and which serve primarily private interests – and therefore should recover a share of their costs through fees, be mutualised, or privatised. Examples include the sales promotion activities of Bord Bia and Failte Ireland; and the consulting services of and SEAI and Teagasc.

#### **4. Conclusions**

The debate over the treatment of certain tangible and intangible assets turns into much more than an exercise in ranking these assets by commercial viability and value. It is clear that the presumption should be that intangible assets of the type listed in terms of reference for the Group should be auctioned off to the highest bidder, but using a carefully designed auction which needs to take into account the competitive situation amongst the bidders not only to prevent collusion and gaming, but also to encourage entry and competition. In contrast, in the case of tangible assets – commercial semi-state firms – the debate is around whether these firms should be the public sector and whether the objectives can be better met by alternative arrangements. In privatising these state-owned firms careful attention needs to be paid to ensure that markets are well organised and competitive. This may necessitate for example breaking up a vertically integrated firm into its competitive and monopoly parts. To a considerable degree the debate over privatisation reflects issues related to the regulatory reform agenda. But in both cases what is on offer is a more efficient and competitive economy if reform is conducted sensibly and is not derailed by vested interests as has been the case, on occasion, in the past.

4 October 2010.

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<sup>39</sup> Note that this may not reduce borrowing costs if potential lenders deduct the now-explicit assets from the implicit assets.

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