TASC

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The Strategic Role of State Assets

– *Reframing the Privatisation Debate*

Table of Contents

Preface

TASC is an independent, progressive think-tank dedicated to promoting equality, democracy and sustainability in Ireland through evidence-based policy recommendations.

TASC's previous work in corporate governance includes *Outsourcing Government*, *Mapping the Golden Circle* and *Public Appointments: Options for Reform*. Our interests in corporate governance and economics come together in relation to State ownership of companies as well as in relation to the State's vital role in comprehensively regulating the economy so that it serves the public interest. It was therefore natural for TASC to look at the topic of privatisation and examine the evidence regarding the possible consequences of privatisation for the public interest.

In 2011, TASC prepared a response to the recommendations and analysis in the Report of the Review Group on State Assets and Liabilities in partnership with the Irish Congress of Trade Unions. This report is a development and elaboration of that response, and represents TASC's views rather than necessarily those of Congress.

Regulation, the public interest and economic strategy

There is a legitimate debate to be had about how to strengthen the performance of state assets and enterprises, and about whether there is evidence that moving to private ownership would improve their performance and serve the wider public interest. However, regardless of whether one favours privatisation or state ownership, the weight of evidence indicates that regulation is far more significant in determining the effect on the public interest from a given enterprise or sector than its ownership. Conversely, the evidence does not show a benefit to the public interest in changing from state to private ownership separately from the effect of changed regulation which often accompanies privatisation. In other words, regulation rather than changing ownership is the key to achieving outcomes in line with the public interest.

Inevitably, an evidence-based approach may suggest that policies for state assets and enterprises in one sector of the economy should be different from what is appropriate in another sector. For example, state ownership of retail businesses is qualitatively different from state ownership of utilities. The conclusions reached in this report are based on an analysis of the available evidence in relation to the theory and experience of privatisation of state assets.

The report includes a survey of the theoretical and empirical literature relating to privatisation (see Appendix) and also describes case studies of privatisation in Ireland and elsewhere. The cases of Telecom Éireann (Eircom) and Irish Steel suggest that privatisation has cost the State and the wider economy far more than the short-term benefit realised from their sale.

A crucial aim of this report is to change the understanding of three key concepts related to the issue of state assets and their potential privatisation. These concepts are regulation, strategy and the public interest.

The evidence examined in this report shows that regulation is paramount to achieving optimal outcomes from State-owned enterprises and private companies in any given sector of the economy. But what is meant by regulation is far more than 'light touch' regulation. Regulation implies a comprehensive analysis of a given sector/market of the economy, within which issues of public interest have been clearly identified. Working on the basis of this information, regulation implies that strict rules and other incentives are put in place to ensure not only the optimal functioning of the sector, but also the protection of the public interest. Regulation also requires an independent and sufficiently resourced regulator to fully enforce the rules.

One way of explaining what is meant by the public interest is by using the 'triple bottom line' method of full accounting for public sector bodies. The method, ratified by the UN, involves appraising the effects on the wider economy, society and the natural environment of activity in any given sector. In economics, these effects (often negative, sometimes positive) are called 'externalities' and are typically poorly or not at all measured in standard cost-benefit analyses. Examples include the costs of pollution to local health, the social consequences when sections of society cannot afford basic goods and services (such as heating), and the benefit to the wider economy of good quality employment in otherwise deprived areas of the country. Triple bottom line accounting belongs to a growing body of similar methods that calculate the real costs and benefits deriving from economic activity.

Regulation for the benefit of the wider public interest is an essential component of economic strategy. Regulation can be used to require State-owned enterprises and/or private companies to address societal and environmental problems, such as regionally concentrated unemployment, fuel poverty or greenhouse gas emissions. While it is more obvious that a profit-maximising private enterprise may not take account of these wider issues, it is not automatic that a State-owned enterprise will do so either, in the absence of strong, strategically-focused regulation.

The current Irish context

Having identified the theoretical potential of regulation to protect the public interest, when guided by wider strategic considerations, it is important to place this perspective in the context of Ireland's current economic crisis and financial constraints.

The State is currently struggling to balance a large deficit (gap between revenue and spending), and has accumulated a huge national debt which may be unsustainable. In order to borrow money at a relatively affordable rate, the State has signed an agreement with the IMF and European institutions, which stipulate a strict timetable for repayment of these loans. It has been made clear in various public statements that the 'troika' of the IMF, European Commission and ECB have only insisted on a timetable for repayment, not the means of achieving it. Therefore, whether or not state assets are sold is solely the responsibility of the current Government.

The recommendation by the Review Group appointed by the previous administration that €5 billion be sought from the sale of state assets suggests a very narrow viewpoint. €5 billion would pay off less than two and a half per cent of the national debt and make practically no difference to annual interest payments, yet the wider costs to the economy, society and the environment could be multiples of that benefit.

Conversely, part of the solution to Ireland's economic and debt crises must be productive investment in areas of the economy that will lead to sustainable growth and jobs. The regulation of the economy can ensure that investment continues and, where necessary, is enhanced in areas of long-term strategic importance, such as harnessing Ireland's wind and wave resources to achieve energy security.

The position of the current administration in relation to state assets is unclear. Indications of policy vary from commitments in the Programme for Government to more recent actions. The purpose of the recently established NewERA company as a 'shareholding' body under the auspices of the NTMA is also unclear. The establishment of a 'holding company' for all State-owned enterprises would be the most radical transformation of industrial policy since the 1960s, yet it is not clear that this would be guided by a strategy based on the public interest. The strategy of the National Asset Management Agency (NAMA) as a holder of state assets is also highly opaque. There is a need for more transparency and a clear articulation of policy from the Government in relation to the issue of state assets and how the Government intends to use them to protect the public interest.

Nat O'Connor

Director, TASC

Key recommendations

Decisions regarding the future of state assets and State-owned enterprises have a potentially major impact on the public interest in relation to the economy, society and the environment. Decisions about the ownership of state assets, such as to privatise or part-privatise, can be difficult to reverse. As such, it is vital that there is a coherent, transparent and evidence-based national policy on state ownership of assets in general, as well as policies on specific sectors.

In this context, four key findings and recommendations have emerged from TASC's analysis of the evidence in relation to state assets.

1. **Regulation is paramount to improving the public benefit from the operation of State-owned enterprises and private companies in the economy.**

   We recommend that an in-depth analysis of each sector (market) in the economy should be carried out before any decisions are made on the disposal of state assets. Such in-depth analysis should include:

   - a full assessment of the public interest (in terms of the wider economy, society and environment) in that sector;
   - a full assessment of the criteria used to identify what role the State should play in any particular sector;
   - a full analysis of the corporate governance, competition and regulatory consequences of any privatisation or partial privatisation, and the possible effects on the governance of any holding company, as well as on the wider economy, society and environment;
   - A full analysis of rules and other incentives required to achieve public interest goals in the sector, as well as the resources required by the industry regulator to ensure the enforcement of regulation.

2. **The corporate governance of State-owned enterprises requires reform.**

   - We endorse the recommendation of the Review Group on State Assets and Liabilities that responsibility for regulatory oversight and the semi-state shareholder function should not reside within the same Government Department.
   - We recommend that regulatory oversight should be the responsibility of the Department of Jobs, Enterprise and Innovation.
   - We recommend that control of the regulators' receipts and expenditures should reside with the Department of Finance, and that this budget should be allocated annually as part of voted expenditure under this Department. Regulators must have sufficient independence and resources to be capable of fully enforcing regulation.
   - We recommend that appointments to the NewERA holding company, and other state boards, should be made on an independent, transparent basis. TASC's more detailed recommendations in relation to independent public appointments are available on our website: TASC (July 2011) *Public Appointments: Options for Reform*.

3. **The balance of evidence does not support a number of claims made about selling state assets, such as the potential for proceeds to be used to paying down the national debt or the asserted superior performance of privatised enterprises.**

    - We recommend a detailed cost-benefit analysis be conducted to weigh the benefit of selling state assets to raise revenue against the short and long-term costs to the economy, society and the environment.
    - We recommend that no decision be made on the disposal of state assets until the regulation of that sector of the economy has been reformed (as outlined above) and the effects of the reformed regulation are known.
    - We recommend that an in-depth analysis of the regulation of each sector of the economy takes place at an appropriate interval after the reform of that regulation. Such in-depth analysis should include:
        - a full assessment of the public interest (in terms of the wider economy, society and environment) in that sector;
        - a full analysis of whether regulation in that sector is sufficient to protect the public interest (in terms of the wider economy, society and environment);
        - a full analysis of what (if any) benefit to the public interest would result from privatisation or partial privatisation in addition to the benefits achieved through reformed regulation.

4. **The balance of evidence does not support a number of recommendations made by the Review Group on State Assets and Liabilities in relation to the public interest benefits of privatisation.**

    TASC recommends, in view of binding European targets, energy security considerations and the need to develop renewable energy, that the Government reject Review Group recommendations 19 and 26 (on scaling down targets for wind penetration and grid development).

    TASC does not support the recommendation to privatise either the ESB or Bord Gáis. The only economic rationale for privatising them would be to raise revenue and, given the current economic climate, there is a real possibility of only securing ‘fire sale’ prices from their sale.

    TASC recommends retaining a share in Aer Lingus in State ownership.

    TASC does not support the recommendation to privatise Dublin Bus.

    TASC does not support the recommendation to privatise Dublin Port.

    TASC recommends retaining Coillte and Bord na Móna in State ownership at this juncture due to the significant public interest in preserving employment, among other issues. Both companies employ large numbers of people in rural areas and the effect on employment could be devastating in the event of privatisation.

1 Macroeconomic context

1.1 Ireland is experiencing a recession unprecedented in the history of the State. The rate of unemployment increased dramatically from four per cent in 2007 to 13 per cent in January 2010. The unemployment rate now stands at over 14 per cent (European Commission, 2011; CSO, 2012).[2] The long-term unemployment rate has increased from 2.2 per cent in the first quarter of 2009 to 8.4 per cent in the third quarter of 2011. The unemployment figures understate the full adjustment as there has been a net outmigration of people of working age. The number of people employed has declined from 2,113,900 (CSO, 2011b)[3] in the second quarter of 2008 to just 1,805,500 in the third quarter of 2011 (CSO, 2011c)[4].

1.2 Economic output measured in terms of GDP fell 17 per cent in nominal terms from its pre-crisis peak. This collapse in output caused a drop in tax revenues by one third. This drop in Government revenue coupled with a surge in public spending from higher levels of unemployment and rising interest repayments, quickly generated unsustainable double digit fiscal deficits. The response by the Government to the economic crisis was to pursue a policy of fiscal consolidation in an attempt to close the fiscal deficit and reduce borrowing requirements. Consolidation measures totalling €24.6 billion have been passed through budgetary adjustments since July 2008. This adjustment is over fifteen per cent of 2011 GDP. The general government balance is estimated to be in deficit to the tune of €15.7 billion for 2011 (DOF, 2011) and €13.7 billion for 2012 (DOF, 2011c[5]) Ireland is committed to almost €10 billion of further austerity measures under the terms of the loan facility deal negotiated in November 2010 with the troika of the European Union (EU), the European Central Bank (ECB) and the International Monetary Fund (IMF). Ireland.

1.3 The large and persistent deficits have impaired Ireland's debt sustainability. These deficits, combined with the socialisation of approximately €70 billion (44 per cent of GDP) of private banking debt, have created a dynamic whereby Ireland's solvency is now tenuous.

Table 1.1
Estimated Cost of the Bank Bailout

	Existing	Future	Total
Anglo	29.3bn	0bn	29.3bn
Allied	7.2bn	13.3bn	20.5bn
INBS	5.4bn	0bn	5.4bn
ILP	0bn.	4bn	4bn
EBS	875bn	1.5bn	2.375bn
BOI	3.5bn	5.2bn	8.7bn
Total	46.275bn	24bn	70.275bn

Source: Department of Finance

[2] CSO, (2011a) http://www.cso.ie/en/media/csoie/releasespublications/documents/latestheadlinefigures/lreg_dec2011.pdf

[3] CSO, (2011b) http://www.cso.ie/statistics/empandunempilo.htm

[4]CSO,(2011c) http://www.cso.ie/en/media/csoie/releasespublications/documents/labourmarket/2011/qnhs_q32011.pdf

[5] DOF (2011c) http://budget.gov.ie/budgets/2012/Documents/Economic%20and%20Fiscal%20Outlook.pdf

1.4 As a result of this socialisation of debt, the European Commission and the IMF (2011) have both forecast that Ireland's debt-to-GDP ratio will exceed 120 per cent by 2013. The European Commission estimates a gross debt of €210 billion by 2015, by which time annual debt interest repayments will exceed the State's entire annual education budget. The NTMA forecasts the general government debt will peak at 119 per cent of GDP in 2013[6].

1.5 A variety of factors will inhibit a short- to medium-term recovery being established in Ireland's domestic economy. These factors include the large public and private debt overhang, the low level of liquidity available to the private sector, the continued uncertainty surrounding the evolution of the European debt crisis, and the exceptional size of the Government's programme of fiscal consolidation. Fiscal consolidation by Ireland's major trade partners, for example the United Kingdom, will inhibit the growth of net exports.

1.6 The cost of Irish Government ten-year bonds stood at over seven and a half per cent in January 2012 and, without a substantial positive external shock, Ireland will be unable to access the markets at sustainable rates of borrowing in 2013. Ireland is then likely to enter the European Stability Mechanism for an extended period barring further developments in the debt crisis.[7]

1.7 It was in this fiscal context that the Government commissioned a review to examine the extent to which sales (disposals) of state assets could provide an alternative source of revenue and reduce the level of debt and consequently the level of debt interest repayments. As the Review Group concludes, there is no immediate need to engage in a 'fire sale' of state assets as the country need not return to the markets before 2013 (McCarthy et al., 2011) and the short-term, one-off gain of selling off any asset must be balanced against the potential cost of long-run damage to the economy's competitiveness and the loss of strategic control over an area of economic development. The report identifies that €5 billion could potentially be raised through the sale of state assets. This amount is less than 2.5 per cent of the Government's estimated debt in 2015 of over €200 billion and will not qualitatively alter the sustainability of Ireland's debt dynamics.

[6] NTMA (2012) http://www.ntma.ie/GovernmentDebt/GeneralGovernmentDebtForecasts.php
[7] See McDonnell (2011) for a wider discussion.

2 The role of State Enterprises in a progressive model of development: considerations

The Triple Bottom Line

2.1 A well-run economy must provide for innovation and job creation by viable businesses, while also ensuring that public goals are met in relation to the *'triple bottom line'* of effects on the wider economy, the natural environment and society as a whole. The triple bottom line is the dominant approach to public sector full cost accounting, ratified by the United Nations.

2.2 Similar attempts to widen the scope of what is included in economic calculations can be seen in the work by Fitoussi, Sen and Stiglitz on the French *Commission on the Measurement of Economic Performance and Social Progress*.[8]

2.3 There is no one-size-fits-all solution that applies equally to all sectors of the economy, and all goods and services. The characteristics of each sector, and of particular goods and services, need to be examined in detail before deciding what mixture of private and State activity will most likely result in the optimum outcome for the economy, the environment and society as a whole.

2.4 Ireland's economy contains a mixture of private enterprises (for-profit and not-for-profit) and State-owned enterprises. Activity in every market is also shaped by the prevailing institutions or 'rules of the game'; that is legislation, regulation, standards, taxation system, culture, and diverse other constraints and incentives. The State is the primary source of these constraints and incentives. Below we examine some of the factors governing the appropriate role of SOEs in different markets, as well as the impacts of private and state ownership on different elements of the 'triple bottom line'.

Economic considerations

Market structure

2.5 The appropriate role of public enterprises in a given market depends on a number of factors. Of particular importance is the most economically efficient market structure for supply of the good or service, for example whether the most efficient structure is monopolistic or competitive, and whether the most efficient structure is likely to generate market failure. Traditional market failure occurs where there is an inadequate level of competition in the market (Brown and Jackson, 1986; Miles, Myles and Preston, 2003; Lane, 2008) leading to 'allocative inefficiency'[9]. This occurs in situations where there is a dominant market player, and is commonplace in markets for natural monopolies, which may include water, electricity or other network infrastructures.

2.6 In some cases, an analysis of the determinants of supply and demand in the market will show that it is possible to rectify the market failure through the application of regulatory measures, for example, ordering and enforcing the breakup of a monopolist or dominant market player. In certain other cases, regulation will be insufficient to rectify the market

[8] http://www.stiglitz-sen-fitoussi.fr/en/index.htm

[9] Allocative efficiency occurs where there is an optimal distribution of goods and services and where prices correspond with the firm's long-run marginal cost of supply.

failure and in these particular cases it may be necessary for the state to provide the good itself. For example, certain markets are characterised by economies of scale[10] (Silvestre, 1987) or positive network externalities (Liebowitz and Margolis, 1995), and these market characteristics can make competition very difficult to achieve or of sub-optimal efficiency. In these cases, state provision of the good or service may be appropriate. [11]

Natural monopolies

2.7 Early theories behind natural monopolies originated with Antoine Cournot, Jules Dupuit and John Stuart Mill in the mid-nineteenth century. They suggested that there were some industries and services where a monopoly was likely to form as a matter of course, or where competition would be destructive. Such industries or services could be identified by the presence of decreasing costs or increasing returns to scale (Baumol, 1977). These 'natural monopolies' may be defined as an industry or service in which multi-firm production or provision of services is more costly than production or provision by a single entity. Natural monopolies are characterised by network infrastructure, very large fixed costs, and economies of scope and scale through low or zero marginal cost[12]. They are, almost by definition, immune to competition. Posner (1969) defined natural monopolies in this way: "If the entire demand within a relevant market can be satisfied at lowest cost by one firm rather than two or more, the market is a natural monopoly".

2.8 One justification for allowing a monopoly to persist is that competition cannot effectively work in that market and that a single provider of the service may be the most efficient market structure. A natural monopoly does not refer to the actual number of sellers in the market but to the relationship between demand and the technology of supply. As technology changes, a market may cease to be, or indeed may evolve into, a natural monopoly.

2.9 There are likely to be market failure concerns associated with any natural monopoly, and these market failures may have important social and economic costs. If there are sufficiently high barriers to a new firm entering the market, the monopolist can restrict the supply of output to raise price above the marginal cost of production, and although sales will fall, the monopolist's profits will rise. This leads to an economically inefficient level of consumption and production causing a deadweight loss in the welfare of society. The monopolist's super-normal profits impose competitiveness costs on the rest of the economy thereby stunting growth.

[10] Economies of scale refer to the presence of efficiency gains (reductions in unit cost) in a production process as the usage level of inputs increases. If substantial economies of scale are present then the most efficient market structure may be one containing just a single supplier.

[11] H.J. Chang developed a transaction cost theory of state intervention. He argued that by intervening in the market and by establishing the rules of the game, the state may reduce the allocative inefficiency and improve the functioning of the market. Through this framework, state intervention can be measured as transaction costs and the real question is thus, 'whether the state can achieve the same allocative efficiency at a lower cost than the market . . . and not whether state intervention is costly *per se'* (Chang, 1994, quoted in Andreosso, B. and Jacobson, D., *Industrial Economics and Organization: A European Perspective*, (2005)

[12] The marginal cost is the cost of producing one more unit of output.

Natural monopolies: advantages and disadvantages of public ownership

2.10 There are advantages and disadvantages to public institutions running natural monopolies. On the positive side, public institutions can justify running at a loss because of the side benefits generated by the service[13]. These 'community benefits', known as 'positive externalities', are arguably the fundamental justification for public enterprise.

2.11 Simply put, the public enterprise can make investments that take into account the benefits to wider society and the economy (for example investments in the provision of rural broadband) which a private enterprise, operating on a purely commercial basis, might not otherwise make.

2.12 Public institutions can also provide a stabilising counter-cyclical mechanism by generating guaranteed employment during recessions. Public enterprises have been used successfully in Ireland and internationally as vehicles for the promotion of long-term economic, social and environmental development goals.

2.13 On the negative side, unless adequately monitored, public monopolies can suffer from soft budget constraints (Kornai, Maskin and Roland, 2002) and an unwillingness and failure to minimise their cost bases. This can lead to technical inefficiency.[14] In addition, public institutions can be exploited for political advantage; for example, cheaper electricity prices in advance of an election can be used to bribe an electorate. Strict, transparent and independent regulation is essential to prevent such abuses.

Enterprise performance: ownership and competition

2.14 Many comparative studies concerning the impact of ownership on performance have been criticised by scholars. According to Palcic and Reeves (2011), this criticism is based primarily on the failure to control for determinants of performance such as regulatory environment, size, market structure and incentive structure. They conclude from their review of the literature that *"the empirical evidence on the comparative performance of public and private sector enterprises fails to provide a clear-cut consensus regarding the superiority of either form of ownership"*.

2.15 On the other hand the literature does indicate that the degree of market competition is an important explanatory variable in firm performance, Competition, rather than ownership, appears to be key to determining outcomes. According to Palcic and Reeves the empirical evidence suggests: *"there is no economic case for privatising firms with market power. Where market power occurs, accompanying measures of liberalisation and regulation are necessary"*. There is a tension in the case of natural monopolies because liberalisation can reduce allocative efficiency due to the loss of economies of scale.

[13] An example of a side benefit would be the benefits of increased social inclusion generated by the provision of transport links to loss-making areas of low population density.

[14] Technical efficiency occurs when the firm is maximising output for a given level of resources.

Regulation

2.16 The regulatory framework and its enforcement sets the 'rules of the game' by which the economic actors must operate. These rules are present in some form in all markets. Appropriate regulation will not only consider economic efficiency (allocative and technical), but will also consider broader issues of equity, distribution, environment, security of supply and service, social cohesion, human rights, and a variety of other strategic economic development concerns. There may be tensions and trade-offs between these goals and this makes an appropriate regulatory regime complex to design. Changing economic context and evolving technological possibilities make appropriate regulation a constantly moving target.

2.17 Inefficiencies caused by the exploitation of a monopoly position can be ameliorated or eliminated by implementing appropriate regulatory mechanisms – at least in principle. The regulator must endeavour to minimise the cost to the rest of the economy by ensuring the monopolist cannot earn more than the normal rate of profit, and by ensuring the monopolist is operating to minimise its own internal costs. The economic goal of regulation is to simulate the conditions of competition for the enterprises to remedy the inefficiencies of monopoly. Regulation itself imposes costs (for example, administration costs for the Government and compliance costs for the firm) and these costs must be balanced against the gains from regulation. The regulator must also endeavour to avoid setting prices so low that it eliminates the commercial case for future investment.

2.18 Regulation is often not an effective means of exercising authority and can lead to the phenomenon of *'as bad as the law allows'*.

2.19 In recent years, Ireland has been characterised by failures of regulation in a number of sectors, for example in telecommunications and in financial services. Eircom's court battles with the telecommunications regulator ComReg - which arose from Eircom's resistance to opening up segments of its network to competition - illustrate the difficulties involved when regulating private monopolies. The rational decision of the private regulated firm will be to obstruct the regulator through whatever means possible (for example legal challenges), if the benefits of doing so outweigh the costs. If it is cheaper not to obey regulators (including the paying of fines) then the regulated firm will simply choose not to obey regulators.

2.20 The difficulties associated with regulation are compounded by the information asymmetries between monopolist and regulator, and by the dangers of regulatory capture or co-option. Regulatory capture has been a pervasive phenomenon internationally and regulatory failure/capture is accepted as one of the primary causal factors of the on-going recession in Ireland and elsewhere. To avoid these risks, there is a need for clear distance between regulator and operator.

2.21 Transparency can help minimise the risk of regulatory capture. For example regulators could be obliged to explain and justify all of their major decisions to the Oireachtas, and to release all of the non-commercially sensitive information pertinent to their regulatory decisions. Consumers' interests should play a direct representative role in regulatory oversight. To ensure effective representation of consumer interests, the regulatory process should include quasi-judicial procedures and should be presented in an adversarial context with evidence presented by both sides and with a public advocate representing the collective interest of consumers. Full transparency is paramount and there should be nothing a monopolist or utility operator can hide from the public, as these are businesses of clear public interest.

2.22 The recommendation of the Review Group that responsibility for regulatory oversight and the semi-state shareholder function should not reside within the same Government Department is sound and should be acted upon.

2.23 The shareholder function should be separated from the regulatory function. Regulatory oversight should be the responsibility of the Department of Enterprise. Control of the regulators' receipts and expenditures should reside with the Department of Finance and this budget should be allocated annually as part of voted expenditure.

Environmental considerations

Sustainable development

2.24 Sustainability is not just a necessity in a world at the point of peak oil production, with dwindling resources; sustainability offers an opportunity to refocus human ingenuity on new areas, to provide green jobs, while also placing the focus on reorganising the economy to raise everyone's quality of life.

2.25 Sustainable development can mean different things to different people, but a commonly used definition identified by the Brundtland report (1987) and used by the European Council is *"that the needs of the present generation should be met without compromising the ability of future generations to meet their own needs."*[15] While notions such as strong or weak sustainability may occupy researchers, policy makers, and environmentalists, most proponents recognise that equality, poverty reduction, social and cultural cohesion and democracy are both aims and prerequisites for sustainable development. They also recognise that economic and social development is dependent on *"a healthy and functioning environment"*.[16]

2.26 Sustainable development is about safeguarding the earth's capacity to support life in all its diversity and is based on the principles of democracy, gender equality, solidarity, the rule of law and respect for fundamental rights, including freedom and equal opportunities for all. It aims at the continuous improvement of the quality of life and well-being on Earth for present and future generations. To that end it promotes a dynamic economy with full employment and a high level of education, health protection, social and territorial cohesion and environmental protection in a peaceful and secure world, respecting cultural diversity.[17]

2.27 Some aspects of environmental protection are already contained in separate pieces of environmental legislation, especially at the European level. Policy aims such as social and

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[15] Council of the European Union, *Review of the EU Sustainable Development Strategy (EU SDS): Renewed Strategy*, Brussels, 26 June 2006

[16] Comhar the Sustainable Development Council, (SDC). Comhar, (SDC), has developed a list of principles for sustainable development, for use in policy development. http://www.comharsdc.ie/sustainable_development/index.aspx, accessed 22 June 2011

[17] Council of the European Union, *Review of the EU Sustainable Development Strategy (EU SDS): Renewed Strategy*, Brussels, 26 June 2006

cultural inclusion and democracy are generally thought to reside in other policy sectors. However, as will be discussed in the section below, a progressive economy must ensure that environmental and social costs are internalised.

2.28 Thus, the challenge for the State and SOEs is not only to operate with the frameworks provided by our environmental obligations and the principles of sustainable development, but also to understand and see the opportunities for growth that such development and innovation can bring. There is a role, in particular, for state enterprise in the development and roll-out of new technologies. Investment in key areas, such as renewable energy and energy efficiency, can bring dividends for the state and the economy, not only in terms of decreased carbon emissions, but also in increased employment and lower energy bills.[18] State investment can be crucial to the development of new technologies and SOEs can have a key role in this. An example of this critical role is the ESB's involvement in the roll-out and design of electric car charging infrastructure.

2.29 SOEs also have a key role in stimulating the economy beyond their own immediate sector. Public procurement, in particular, can have a positive impact on national and local economies. It can be a key source of business for Irish firms, and moves towards green public procurement will provide a market and an incentive for Irish companies developing green technology and services. More and more countries are seeing the development of the green economy not just as a means to reduce greenhouse gas (GHG) emissions,[19] but as an essential and significant area of economic growth. Ireland must continue to invest both in research and development and in the manufacturing of green technology, or risk falling behind.

Environmental obligations (national/international)

2.30 Ireland's environmental obligations find expression in both domestic and international legislation. These obligations can range from controls on the use of nitrates to a ban on the sale and distribution of bituminous coal within certain urban areas. They can be tackled through the use of standards, subsidies or taxation. A common method of fulfilling Ireland's obligations on environmental pollution and farming, for example, is through the use of subsidies. The Rural Environment Protection Scheme (REPS), which provides payments to farmers to incentivise farming in more environmentally friendly ways, is an example of this. Companies requiring a licence to operate from the Environmental Protection Agency (EPA), will find environmental standards contained in their licence conditions. The carbon levy is Ireland's most recent environmental tax and is designed to provide a price signal for carbon in the economy, with the aim of changing behaviour over time.

2.31 Environmental obligations most often emanate from the EU and find expression in domestic legislation and actions. Unfortunately, Ireland has a bad record in this area and many environmental directives remain unimplemented.

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[18] See *Jobs, Growth and Reduced Energy Costs: Greenprint for a National Energy Efficiency Retrofit Programme*, IIEA (2009) for a discussion on the economic and employment dividends investment in retrofitting can bring.

[19] Carbon dioxide (CO2), Methane (CH4), Nitrous oxide (N2O), Hydrofluorocarbons (HFCs), Perfluorocarbons (PFCs) and Sulphur hexafluoride (SF6). Emissions from all of these gasses are usually counted in CO2 equivalent units.

2.32 In terms of economic development, the most significant environmental obligations are those relating to GHG emissions and renewable energy. Ireland is a signatory to the Kyoto Protocol, which sought to stabilise GHG emissions from industrialised countries up to 2012. The intergovernmental conference on climate change in Durban 2012 agreed to extend the Kyoto Protocol to 2015 to allow for a successor treaty to be negotiated. This new agreement will include all countries and should be operational by 2020. EU targets dictate the level of carbon reduction expected of Ireland. Under current EU targets, Ireland must reduce emissions by 20 per cent by 2020. However, international climate change policy will continue to evolve over the coming decade.

2.33 Meeting the 20 per cent target by 2020 will be challenging for Ireland as a significant amount of our emissions emanate from agriculture (27 per cent). In 2009 the transport and energy sector accounted for 21 per cent each. Waste accounted for two per cent, residential for 12 per cent and industry and commerce accounted for 14.8 per cent of emissions. The target is divided between those outside of the emissions trading scheme (mainly transport, agriculture, waste and buildings) and inside of the scheme (power generation and large industry).

2.34 Ireland is also bound by Directive 2009/28/EC to ensure that 16 per cent of gross final energy use comes from renewable sources by 2020. This includes a mandatory ten per cent in the transport area. While the 16 per cent and ten per cent targets are mandatory, Ireland is free to pursue various policy options in the achievement of these targets. A requirement of the Directive is the production of National Renewable Energy Action Plan (NREAP), which sets out Government strategy in relation to the targets. Ireland's NREAP commits to 40 per cent share of renewable in electricity use by 2020. It is also committed to a 20 per cent improvement in energy efficiency by 2020.

2.35 Thus, economic development must take place within the context of challenging and evolving environmental obligations. The role that currently SOE-dominated sectors, like energy and forestry, may be required to play in meeting these obligations must be considered.

Social considerations

Equality

2.36 Combating social exclusion and tackling inequality should be important policy goals for all governments. It has been established that more equal societies are healthier and suffer from fewer social problems.[20] The common assumption that inequality is the engine of growth can be easily refuted by examining the performance of more equal societies. Countries such as Sweden, Finland and Denmark are commonly at the top of the competitiveness index (2nd, 7th and 9th place respectively). Thus, greater equality does not come at the expense of economic development. Moreover, it has been argued that increasing inequality has greatly contributed to the current economic and financial crisis.[21]

[20] Wilkinson, R. and K. Pickett (2009) *The Spirit Level: Why More Equal Societies Almost Always Do Better*

[21] http://www.nytimes.com/2010/08/22/weekinreview/22story.html accessed 17 January 2012

2.37 Tackling inequality requires a 'whole of Government' approach. Discussion on social inclusion should permeate all levels of policy making. Economic development is particularly pertinent to equality and social inclusion, as is ensuring a high level of public services. Where public services are poor, those on lower incomes suffer more. Access to energy and public transport at an affordable price are prerequisites for social inclusion, and SOEs have an important role in providing these.

Employment and redistribution effects

2.38 Empirical evidence concerning the effects of privatisation on labour is ambiguous: it does not automatically result in major changes in employment (Haskel and Sysmanski, 1993) or wage levels (Martin and Parker, 1997). Brown Earle and Telgedy (2010) studied the impact of privatisation on employment and wages in post-transition East European manufacturing firms. Their results suggest broadly neutral job impacts with no significant job losses and do not imply large wage cuts from either domestic or foreign privatisation. However, Megginson and Netter (2001) point out that employment in privatised firms usually falls although, again, there are some studies which have shown the opposite. They also acknowledge that there is little empirical evidence on how privatisation affects consumers.

2.39 There is, however, stronger evidence of negative redistribution effects from privatisation. Florio (2004) studied the welfare impact of the United Kingdom privatisations between 1979 and 1997 and estimated that the wealthiest fifth of the population were net beneficiaries, and the least wealthy fifth of the population were net losers from privatisation. Job losses and greater job insecurity were identified as reasons for the losses incurred by the net losers. Birdsall and Nellis (2003) find that many privatisation programs have worsened the distribution of assets and income, at least in the short run.

Leisure and amenity benefits

2.40 To some extent, the focus on peak oil, energy efficiency and climate change has overshadowed another important concern of sustainable development, that is the retention and development of amenity resources. Amenity benefits are more difficult to quantify. They can be tangible (e.g. parks and playgrounds) or intangible (e.g. visual aspect), and their value can vary between cultures and societies, but they are increasingly seen as important components of quality of life. They are also important to the tourism industry, a key target for economic growth in Ireland.

2.41 In addition, they are relevant to the equality debate, as many lower income families live in areas where the local environment is degraded and amenities (tangible and intangible) are in short supply. Ireland's SOEs are some of the largest landowners in the country and, as such, they have a large part to play in the retention and development of amenities that benefit the entire population, regardless of income.

3 Privatisation Experience in Ireland and Internationally

Reasons for privatisation

3.1 While the experience of the UK with privatisation has been widely studied, the dearth of country-based studies outside of the UK is problematic. The political and economic context in which the UK operated its privatisation polices differs from those of other countries.

3.2 Although the economic and political context was different in the UK compared to other industrialised economies, the aims of the privatisation policies in the UK were also different. It has been argued that in the UK, the push for privatisation was mainly political, driven by ideology, decreasing efficiency in publically-owned firms and the desire to weaken the power of the trade unions in these strategic industries. Vickers and Yarrow (1988:157) summarised these objectives as follows:

- Improvement in enterprise efficiency;
- Reduction of the Public Sector Borrowing Requirement (PSBR);
- Reduction of government involvement in enterprise decision-making;
- Easing problems of public sector pay determination;
- Widening share ownership and encouraging employee share ownership; and
- Gaining political advantage.

3.3 However, this analysis has been disputed by Foster (1994), who argues that the role of politics and ideology in the UK was secondary to the need to reduce public expenditure and realise short-term gains, and the belief that private ownership was more efficient. In this, he challenges the Chicagoan and Virginian schools of public choice theory which provide a rationale for privatisation and an explanation for its development.

3.4 In many Southern European countries in the 1990s, on the other hand, privatisation policies were pursued as part of the preparations to participate in a monetary union. In order to meet the Maastricht criteria for EMU entry, they needed to raise revenues to pay down national debt.

Effects of privatisation

3.5 The privatisation of utility companies is usually complicated by the need to develop a regulatory environment and an effective competition policy regime in which the newly privatised companies can operate. A strong regulatory system, especially where natural monopolies have previously dominated, is seen as a crucial component of the success or failure of privatisation to improve performance and increase welfare.

3.6 The wider economic effects of privatisation, including its distributional impacts and the welfare of stakeholders, employers and consumers, have also been studied, but to a much lesser degree than the question of efficiency. Palcic and Reeves (2011) argue that although this is a critical question for policymakers, methodological challenges in measuring overall social welfare effects make it a more difficult area of study.

3.7 In his 2004 work on privatisation policies in the United Kingdom, Massimo Florio uses a social cost benefit analysis to examine the welfare effects of these policies. As he points out, standard macroeconomic theory asserts that privatisation should, through indirect effect, increase output and employment. However, based on his study of the UK, Florio contends that the evidence for this is ambiguous.

3.8 In his examination of UK firms which were privatised from 1979 to 1996, Florio (2004) found that while there was a 60 per cent decrease in employment in these firms, seven-eighths of this downsizing happened while the firms were in public ownership. He found that where there were drastic changes in the level of employment in these firms, this was a result of exogenous factors such as changes in regulations, demand conditions or market structures. While it is worth noting that changes in regulations and market structures can often take place in preparation for privatisation, Florio found that privatisation *per se* did not cause a break in employment trends.

3.9 With regard to wages, evidence from eleven companies showed that average wages in the post-privatised companies remained above the averages wages in British manufacturing. This may be due to a number of factors, including the high level of union membership in many privatised companies and the fact that workers with below-average wages disproportionally lost their jobs following reorganisation of privatised companies. The position of less skilled workers as a group worsened following divestiture; many lost their jobs and those that remained enjoyed less protection from trade unions and more uncertainty about their future.

3.10 Management on the other hand is generally seen to have benefitted from privatisation. A study of 215 board members of UK utilities showed a nominal increase in remuneration of around 600 per cent following privatisation in 1996. While this can be seen as an extremely generous increase, Florio argues that the pre-privatisation salary was found to be below market rewards. Overall, the average increase in management salaries in one year post-privatisation was found to be 78 per cent. This does not include stock option schemes, which will undoubtedly have increased the gains made by management by an even greater percentage.

3.11 With regard to prices, Florio found that the price changes in privatised industries depended on a number of factors, including competition, regulation, technical progress and demand trends. He found it was not possible to determine how much privatisation or ownership change *per se* may have contributed to observed price trends, as it would require a natural experiment[22] where public and private companies were observed and other factors were controlled for. Florio also points to the inconclusive results from European analysis on the question (Florio, 2004).

3.12 An EU-funded research project, *Privatisation of Public Services and the Impact on Quality, Employment and Productivity (PIQUE)*, examined the impact of privatisation and liberalisation of public services in five different European countries, Austria, Belgium, Germany, Sweden and the United Kingdom. Case studies across six different sectors found that following liberalisation and privatisation, the main company objective, i.e. the reduction of production costs, was achieved primarily at the cost of workers, mainly

[22] "Natural experiments or quasi-natural experiments in economics are serendipitous situations in which persons are assigned randomly to a treatment (or multiple treatments) and a control group, and outcomes are analysed for the purposes of putting a hypothesis to a severe test; they are also serendipitous situations where assignment to treatment 'approximates' randomized design or a well-controlled experiment." *The New Palgrave Dictionary of Economics Online*, http://www.dictionaryofeconomics.com/article?id=pde2008_N000142, 20 December 2011

through the worsening of working conditions (PIQUE, 2009:36). In sectors where it was possible to increase productivity through new and labour saving technology (e.g. in the postal services), the consequences for the quality of services from the cut in labour was mixed. However, where the quality of the services depended on a certain level of labour input (e.g. bus driving or patient care), the project found that service quality suffered as a result of privatisation and liberalisation.

3.13 The privatisation and liberalisation of the electricity sector in the UK *"did not automatically result in a sustainable competitive market structure. Out of the 70 British companies in the supply segment, only six have a market share of more than 5% while three of the supply almost 65% of the electricity consumed in the UK."* (PIQUE, 2009:71) The authors argue that one cannot assume that increased liberalisation will lead to increased employment across the wider economy, *"as it is difficult to prove that more competition in one sector can lead to positive employments in other sectors"*. (PIQUE, 2009:71)

3.14 *"We could not find evidence suggesting that marketisation itself has driven any significant long-term upward shifts in the levels of added value produced in the target sectors.*[23] *Instead, it appears that the drivers of increased added value primarily arise by changes in technologies and the rate of growth (and demand level) in the overall economy. Yet if liberalisation and privatisation had a significant impact on productivity, the more efficient resource allocations mainly stem from job reductions . . . This means that generalised statements about the potential impacts of liberalisation on productivity should be strongly qualified not only in relation to the different effects that might arise from variations in country characteristics but also in as far as any real productivity changes can be disentangled from simple cuts in employee numbers and/or technological change."* (PIQUE, 2009:72)

3.15 The PIQUE project concurs with many other authors in its findings that *"positive effects and better performance . . . were mostly the result of superior regulation rather than of competition or private corporate initiative. . . Liberalisation and privatisation of public services have largely negative effects on employment and working conditions and varied effects on productivity and service quality."* (PIQUE, 2009:98)

The Irish experience

3.16 The development of SOEs in Ireland dates back to the 1920s, with the establishment of the Shannon electrification scheme and the ESB. The then Minister for Industry and Commerce, Patrick McGilligan, initially hoped that private operators would run the scheme, but eventually came to the conclusion that electricity generation and supply were too important to be left to the private sector.

3.17 Public enterprise subsequently became an important tool in economic development. In the 1930s, a number of companies were established in the drive towards self-sufficiency in industry, agriculture and investment. These included the Irish Sugar Company, the Industrial Credit Company (also known as the Industrial Credit Corporation, or ICC), the Agricultural Credit Company, Ceimici Teo and Aer Lingus. Aer Rianta took over the management of Dublin Airport in 1937. The use of SOEs in the economic policy and

[23] Electricity, postal services, local public transport and health services/hospitals

development of the state continued during and following the Second World War (Forfás, 2010).

3.18 In the period 1958-1972, as part of Ireland's drive to become a more export-orientated economy, a number of state agencies were created with the intention of attracting and servicing private capital. By the 1980s, there were approximately 100 State-owned bodies, 23 of which were engaged in commercial activity while the rest were engaged in administration, regulation or development of industry. The creation of these bodies was usually on an *ad hoc* basis, designed to address the significant lack of industry, private capital and enterprise in the State.

3.19 Unlike other European countries, most notably the UK, Ireland did not embark on a privatisation programme until 1991. During the fiscal crisis of the 1980s, the poor commercial performance of many of Ireland's SOEs became a concern. While privatisation might arguably have seemed an attractive option for raising much-needed revenue, it was not utilised by the Government, which sought instead to increase the commercial viability of the SOEs. This led to an increased business focus in the companies concerned (Sweeney, 1990). The policy of commercialisation rather than privatisation was an element of the 1987 Programme for National Recovery negotiated with the social partners. The entrance into Government of the pro-privatisation Progressive Democrats led to a change in policy in the early 1990s. The 1991 social partnership agreement included agreed principles on *"private involvement in the shape of joint ventures and the sale of shares"* (Palcic and Reeves, 2011).[24]

3.20 To date, there have been ten privatisations of SOEs yielding proceeds of over €8.36 billion.

Table 4.1

Company	Year of Sale	Proceeds (€M)
Greencore (Irish Sugar)	1991	211
Irish Life	1991	602
B and I Line	1992	11
Irish Steel	1996	0
Telecom Éireann	1999	6,400
ICC	2001	322
TSB	2001	408
Irish National Petroleum Corporation	2001	20
ACC	2002	155
Aer Lingus	2006	241
Total		**8,369**

(Palcic and Reeves, 2011)

[24] While Palcic and Reeves (2011) provide the most comprehensive discussion on privatisation in Ireland to date, see also Sweeney, (2004) and Forfás (2010)

As a relative latecomer to privatisation, Ireland's experience is somewhat different from that of the UK and other countries in terms of timing, rationale for sales and details of divestitures. It has been argued that privatisation in Ireland owes more to pragmatism and a *"peculiar mix of forces that are unique to the Irish case"* (Palcic and Reeves, 2011:52).

3.21 The first two privatisations, Irish Sugar and Irish Life in 1991, were by initial public offering. Palcic and Reeves (2011:62) argue that: *"While this wider institutional context certainly paved the way for the introduction of privatisation policies, the key factor in the case of the first two sales was the ability of top management in both companies to successfully pursue their pro-privatisation agendas".*

3.22 In the case of both Irish Sugar and Irish Life, the impetus to privatise came from within the management of the company. Paul Sweeney points to the fact that management made great gains from the privatisation process. Every time a transaction is made, top management are generally awarded a percentage of the overall deal, leading to massive rewards for management every time a company changes ownership. Thus, it can be the case that senior management gain better remuneration from transactions rather than from improving performance (Sweeney 2006).

3.23 The motivations for privatising poorly performing companies such as Irish Steel and British and Irish Line were not ideological but pragmatic. The requirement for continued capital injections and the criteria for membership of the single European currency meant that it was more difficult for the state to continue supporting these companies.

3.24 Telecom Éireann was the only utility to be privatised while transport companies, apart from Aer Lingus, remain in state ownership. This is in contrast to the UK, where all utilities and transport companies were privatised. Those companies that remain in state ownership are either natural monopolies or have massive market power. Some (such as the ESB and Bus Éireann) are operating in liberalised or partly liberalised markets. The electricity market was partly liberalised in 2001 and fully liberalised in 2007. However, new players were slow to enter the market, with the result that the electricity market is arguably still not fully competitive.

3.25 The privatisation of Telecom Éireann has been the most controversial and criticised privatisation in Ireland to date. The manner of privatisation and the loss of state control over the telecoms infrastructural development at a time when it was becoming more important to the economy and society has been criticised by many and will be discussed below. The 'Telecom Éireann effect' may also have put a damper on the zeal for privatisation. As many small and first-time investors lost money in the deal, there remains a sense of public scepticism about privatisation as a means of increasing the shareholding class, and a feeling that privatisation is risky.

3.26 According to Sweeney (2004), this scepticism was also to be found within the Government at the time and probably contributed towards a more restrained approach towards privatisation, reflected in the decision to partially privatise Aer Lingus.

Case studies

Telecom Éireann/ Eircom

The pre-privatisation era

3.27 Up until the mid-1980s the Irish telecommunication service was run directly by the State, first by the Department of Posts and Telegraphs and then by An Bord Telecom. The performance of the telecommunications network was very poor prior to the 1980s. The Dargan Report (1979) found that over sixty years of underinvestment had led to a third-class service that was unable to cope with demand, was not fit for use, and was perhaps the worst in Western Europe (Burnham, 2003). There were waiting lists of over a year to receive a phone line, and poor quality service for those lucky enough to have one.

3.28 There was a change in telecommunications policy following the damning criticism in the Dargan Report and following sustained lobbying by business consumers and by the Industrial Development Authority (IDA). This led to a large-scale programme of investment starting in the early 1980s. The investment, coupled with the transfer of control of the telephone network from the Department of Post and Telegraphs to a newly created State Owned Enterprise (Telecom Éireann), was to lead to an increasingly modernised telephone system.

3.29 Telecom Éireann embarked upon a major upgrade of the Irish telecommunications infrastructure during the 1980s as well as an aggressive marketing campaign to sell services to residential and business customers (Burnham, 2003). Services improved rapidly and by 1987 the old analogue systems had been replaced by state-of-the-art digital technology at switching stations throughout the country. In 1988, Telecom Éireann achieved its first year of profitable operations, and by the end of the decade the organisation was considered a leader among European telecommunication service providers (Burnham, 2003). Pentzaropoulos and Giokas (2002) undertook a comparison of the main European public telecommunications organizations (PTOs) in terms of their operational efficiency and found Telecom Éireann to be fully efficient. Daßler, Parker and Saal (2002) considered the comparative performance of the major European telecommunications operators between 1978 and 1998 and found that productivity in Ireland surpassed that of every other country over the period.

Post-privatisation and the broadband failure

3.30 The process of privatising Telecom Éireann began in 1996 and culminated when Eircom[25] was floated on the stock exchange on July 8, 1999. Eircom was the largest commercial company operating in Ireland at the time of privatisation. It was investing heavily in its network and was free of debt. Despite international best practice of managing privatisations, the government decided not to retain a golden share[26] when it privatised Eircom. The Eircom privatisation occurred at the beginning of the broadband era. A positive relationship between broadband Internet and economic growth has been widely identified in the theoretical literature[27]. Eircom was successfully taken over via Leveraged

[25] The rebranded Telecom Éireann.

[26] A golden share grants certain veto rights over decisions in relation to changes in company ownership.

[27] Broadband internet reduces the costs associated with learning and is a facilitator of knowledge acquisition and diffusion. Rooney, Hearn and Ninan, (2005); Acemoglu (2009) and Aghion and Howitt,(2009) all argue

Buy Outs (LBOs) by the Valentia consortium in 2001, and by Babcock and Brown in 2006. These LBOs saddled the company with massive levels of debt which subsequently impaired the company's ability to invest in necessary upgrades to its network[28].

3.33 The economic literature supports the argument that there is a positive relationship between broadband market development, investments in broadband and economic growth. See for example Crandall and Jackson (2001); Ferguson (2002); Pociask (2002); Kelley (2003); Ford and Koutsky (2005); Gillett, Lehr, Osorio and Lerbu (2006) and Czernich, Falck, Kretschmer and Woessmann (2011)[29]. Czernich et al (2011) find that a ten percentage-point increase in broadband penetration raises annual per-capita growth by 0.9-1.5 percentage points.

3.34 Faulhaber and Hogendorn (2001) show that the structure of the broadband market depends on population density and that below a certain population density the ideal market will be a natural monopoly. As population density increases, so too will the number of firms in the market. Competition is asymmetric, with dense areas having more options than sparsely populated areas.

3.35 This has implications for broadband coverage and for price. Ireland has a much lower population density (62 persons per square kilometre) than the OECD average of 109 persons per square kilometre, and Ireland's broadband market is therefore much more likely to exhibit natural monopoly characteristics than the broadband market of the average OECD country. This will have constrained the ability of would-be competitors to challenge Eircom's dominance of the Digital Subscriber Line (DSL) broadband market. Broadband diffusion in Ireland has lagged behind that of the OECD as a whole, with broadband take-off not beginning in earnest until 2004 (see Figure 1). The period between 2002 and 2004 was effectively wasted and Ireland fell behind other OECD countries.

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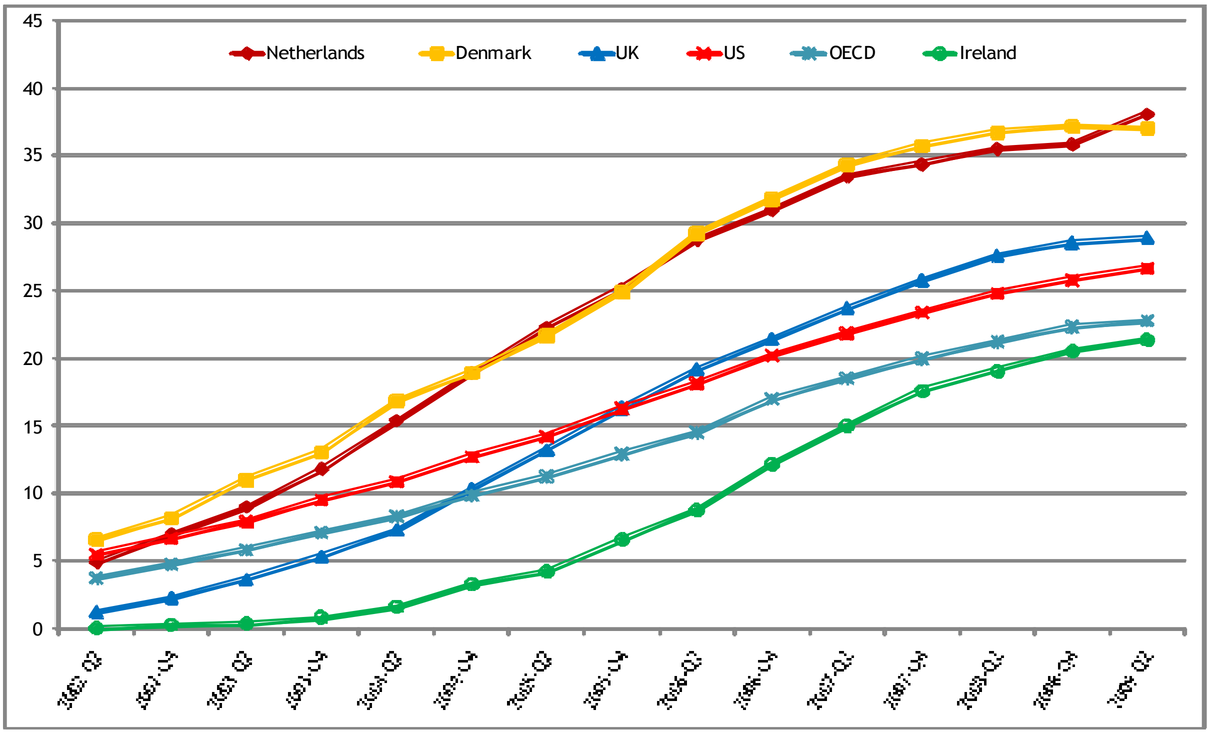
that the rate of knowledge acquisition in an economy plays an important role in the long term growth rate of that economy.

[28] The company displayed an excessive emphasis on short-term profit maximizing at the expense of long-term viability. This is perhaps best exemplified by the sell-off of Eircell in 2001. Palcic and Reeves find that capital expenditure between 2002 and 2004 was not even sufficient to replenish its asset depreciation.

[29] http://www.cesifo.de/pls/guestci/download/CESifo%20Working%20Papers%202009/CESifo%20Working%20Papers%20December%202009/cesifo1_wp2861.pdf

Figure 2

Broadband Subscribers per 100 inhabitants, 2002-2009



Source: Forfás (January 2010), derived from OECD statistics

Figure 2 shows the rates for fixed broadband subscriptions by platform in Western Europe in 2010 (OECD, 2011). There are a couple of key points to be made. First, the subscription rate in Ireland is below average, as indeed it has been throughout the broadband era. Second, the dominant platform for broadband in every country is DSL. At least 55 per cent of total broadband subscriptions in each country are DSL subscriptions. Ireland has the third lowest DSL subscription rate of the eighteen countries.

Table 4.2: Fixed (wired) broadband subscriptions per 100 inhabitants in the EU15 and Norway, Iceland and Switzerland (June 2010)

Rank	Country	DSL	All Other Platforms	Total	Total subscriptions
1	Netherlands	22.0	15.7	37.8	6 245 000
2	Denmark	22.3	15.1	37.3	2 062 000
3	Switzerland	25.9	11.2	37.1	2 894 830
4	Norway	20.2	14.1	34.2	1 653 837
5	Luxembourg	28.0	6.1	34.1	169 757
6	Iceland	30.5	2.8	33.3	106 258
7	Sweden	17.5	14.3	31.8	2 966 384
8	France	29.7	1.7	31.4	20 257 000
9	Germany	27.9	3.5	31.3	25 599 360
10	United Kingdom	24.1	6.4	30.5	18 827 700
11	Belgium	16.7	13.3	30.0	3 237 052
12	Finland	21.8	4.6	26.4	1 407 500
13	Austria	15.9	7.1	23.0	1 921 445
14	Spain	18.0	4.2	22.2	10 261 933
15	Italy	20.9	0.5	21.3	12 849 074
16	**Ireland**	**16.3**	**4.0**	**20.3**	**907 859**
17	Portugal	10.5	8.3	18.9	2 013 528
18	Greece	18.7	0.0	18.7	2 107 000

Source: OECD (June 2011)

3.36 The telecommunications regulator Comreg sought to force Eircom, as owner and operator of the natural monopoly, to unbundle the local loops of its network. Local Loop Unbundling (LLU) is a process for providing other operators with access to the network. Such access would have enabled other operators to offer their services directly to consumers. Eircom resisted this process (Irish Independent, 2011) and Comreg subsequently became locked in a series of legal and regulatory battles over local loop unbundling and a number of related issues. The Chairman of Comreg and an assistant secretary at the Department of Communications both claimed that Eircom was resisting competition and advances in technology for its own benefit (Irish Independent, 2011).

3.37 Private monopolies have little incentive to innovate as they face no competition and no threat to profits. The dogged resistance of the private monopoly Eircom to competition and to advances in technology is a rational response, was entirely predictable, and should have been readily anticipated by government. This is because increased competition and technological changes are both threats to the market share of the dominant market player.

3.38 The state lost control over a key utility at a time when the telecoms sector became extraordinarily important. Investment levels in telecommunications have fallen since privatisation and Ireland still has below average broadband service provision in all four of the major indicators of broadband performance: coverage, speed, penetration and cost.

3.39 Eircom now has debt levels approaching €4 billion, a legacy of the 'leveraged buy outs' by the Valentia Consortium in 2001, and Babcock and Brown in 2006. Incredibly, a utility provider endowed with a dominant market position at the time of privatisation in 1999 now faces an uncertain future and an imminent default on its debt covenants just 12 years later.

3.40 The Irish state has re-entered the broadband market on a number of occasions to ameliorate perceived market failures that have arisen since the transfer to full private ownership. These include the Metropolitan Area Network (MANS) programme to reduce barriers to entry for new operators in regional towns, the County and Group Broadband Scheme (CGBS) to subsidise provision of broadband in rural areas and small towns, and the National Broadband Scheme (NBS) to address digital divide issues in un-serviced rural areas.

Irish Steel

3.38 In 1946, Irish Steel went into receivership and was nationalised by the state. A Government ban on the export of scrap metal provided it with cheap resources, and successful operations in the 1950s and 1960s saw it expand until it employed over 1,200 workers by 1971. With the entrance of Ireland into the EEC in 1973, increased competition and outdated plant equipment, coupled with the general downturn in the European steel industry following the oil crisis, saw declining performance.

3.39 The company went through a restructuring project, replacing some of the outdated plant equipment, which it completed in 1981 at a cost of €108.58 million. The severe financial difficulties faced by the company continued throughout the 1980s, and by 1995 the company had made a profit in only three years out of twenty.

3.40 The poor performance of Irish Steel over this period has been attributed to many factors, including a costly overhead structure and uncompetitive labour costs (Palcic and Reeves, 2011). The European steel industry underwent a period of large-scale restructuring following a downturn in the industry in the late 1980s and early 1990s. The industry suffered falling prices and rising raw material prices in the 1980s, and as a small player in the European market Irish Steel suffered badly.

3.41 By June 1994, Irish Steel had accumulated losses of €176.5 million and an annual net loss of €26.25 million. Between 1980 and 1993, Irish Steel received €234.9 million in state funding. Poor financial performance and a high level of indebtedness led the board of Irish Steel to recommend privatisation to the Government. In April 1996, the Government sold Irish Steel to ISPAT International, one of the world's largest steel companies with a reputation for buying ailing steel companies and 'turning them around'.

3.42 The company was sold for a nominal one punt (£1), with a debt write-off of €21.5 million, payment to the new owner of approximately €21.7 million and a guarantee for a future investment. The new owners took on €25 million of debt and agreed to invest a further €30 million over five years. Palcic and Reeves (2011) have argued that this may have been the best deal that the Government could have negotiated at the time, in the attempt to save the company from liquidation and guarantee its survival for the next five years, with employment at a minimum of 300 jobs.

3.43 Palcic and Reeves argue that, although the company underwent rationalisation measures in 1994, the performance indicators did not improve after privatisation. While labour productivity slightly improved, operating losses continued and the returns on sales and assets remained negative.

3.44 New pollution controls to be imposed by the EPA would have cost the company significant amounts in clean-up bills. The company refused a union deal and announced the closure of the plant in 2001 with the loss of all 400 jobs.

3.45 The state was left with an estimated €30 million clean-up bill for the site. Since the closure of the site the estimated clean-up has risen, with reports that €50 million was spent on the site between 2007 and 2010. Employees were paid the minimum statutory payments and there were accusations of 'asset stripping' as the company sold a parcel of land and retained the proceeds. The continuing environmental damage caused to the site and concerns about public health have still not been adequately addressed. In 2004, the State lost a case in the High Court to require the liquidator to pay the estimated €30 million clean-up costs. Since 2007, environmental damage has cost the State a reported €50 million.

3.46 Irish Steel was privatised to secure the future of the company and its employees. As a continuing loss maker, without continuous support from the state the company would have collapsed years earlier. Its position as supplier of steel to the Irish market had become less important and, unlike a utility company, its importance to the economy was waning and non-strategic.

3.47 Privatisation was meant to provide Irish Steel with future private investment and stable employment. In fact, it did anything but. In prioritising the survival of the company, the State was left with large on-going environmental and financial costs. The jobs were lost and employees left with inferior redundancy payments.

4 To privatise or not to privatise: SOEs today

Energy companies

4.1 Below we examine the recommendations made by the Review Group against the background of the principles laid out in section 3, the international experience of privatisation in the energy industry, and the international and national policy context. In particular, we examine the recommendations in the context of ensuring energy security and achieving Ireland's national and international targets on renewable energy.

Policy context

4.2 Current Government energy policy is articulated in a number of documents, in particular, the 2007 White Paper '*Delivering a sustainable energy future for Ireland – The Energy Policy Framework 2007-2020'*, as well as the Programme for Government and the National Renewable Energy Action Plan (NREAP). The Programme for Government 2011-2016, commits to the transfer of transmission assets from the ESB to Eirgrid, followed by the creation of a new 'Smart Grid' company which would have full ownership and control of Ireland's electricity and gas networks. It also commits to the creation of a new state company called BioEnergy Ireland which will comprise Coillte and Bord na Mona.

4.3 The underlying strategic goals as set out in the White Paper in the three key areas of competitiveness, energy security and sustainability are as follows:

Competitiveness

- Delivering competition and consumer choice in the energy market;
- Delivering the All-Island Energy Market Framework;
- Ensuring that the regulatory framework meets the evolving energy policy challenges;
- Ensuring a sustainable future for Semi-State Energy Enterprises;
- Ensuring affordable energy for everyone;
- Creating jobs, growth and innovation in the energy sector.

Energy security

- Ensuring that electricity supply consistently meets demand;
- Ensuring the physical security and reliability of gas supplies to Ireland;
- Enhancing the diversity of fuels used for power generation;
- Delivering electricity and gas to homes and businesses over efficient, reliable and secure networks;
- Creating a stable attractive environment for hydrocarbon exploration and production;
- Being prepared for energy supply disruptions.

Sustainability

- Addressing climate change by reducing energy related greenhouse gas emissions;
- Accelerating the growth of renewable energy sources;
- Promoting the sustainable use of energy in transport;
- Delivering an integrated approach to the sustainable development and use of bio-energy resources;
- Maximising Energy Efficiency and energy savings across the economy;
- Accelerating Energy Research Development and Innovation Programmes in support of sustainable energy goals.

Renewable energy and grid development targets

Review Group recommendations	
19	Carbon emission targets should be pursued on a least-cost basis and current targets for wind penetration in power generation should be revised downwards in the context of the adequacy of existing capacity, the diminished prospects for demand growth and the altered outlook for gas supplies and prices.
26	The Review Group recommends that EirGrid's Grid 25 targets be re-considered in the light of demand developments and our recommendations regarding reduced wind penetration

4.4 Proposals to abandon targets for the renewable sources in electricity generation and the strengthening capacity of the Grid have their basis in the argument that wind generation is uneconomic and will lead to increased prices (Review Group, 2011; ESRI, 2011). The current and projected decrease in energy demand due to the economic downturn is taken as a rationale by the Review Group for the abandonment of these targets. The argument that wind will be a costly element of electricity generation is based on the prediction that gas prices will remain lower than wind and relatively stable over the coming number of years (Review Group, 2011). Electricity generation in Ireland is heavily dependent on gas. In 2009, gas comprised 57 per cent of Ireland's electricity generation mix. Wind stood at a mere 5.3 per cent of the electricity mix. In the short term, energy prices are due to rise and volatile geopolitics continues to bring uncertainty in future energy prices.[30]

4.5 For 2011, the Sustainable Energy Authority of Ireland (SEAI) made the following forecast (SEAI, 2011):

- The wind generation expected in 2011 will reduce Ireland's wholesale market cost of electricity by around €74 million.
- This reduction in the wholesale market cost of electricity is approximately equivalent to the sum of Public Service Obligation (PSO) costs, estimated as €50 million, and the increased constraint costs incurred, due to wind in 2011.

[30] http://www.bbc.co.uk/news/business-16728942 (accessed 26 January 2012)

- The total cost of generation is the sum of the wholesale cost of electricity, the PSO cost of wind and the dispatch constraint costs. The total cost does not increase with the inclusion of the 2011 wind capacity.

4.6 Some commentators are heralding a 'golden age of gas'. The Review Group, Dieter Helm and the ESRI argue that gas will be more readily available due to technological improvements and relatively cheaper than other fossil fuels due to increases in reserves and a lower environmental cost (Helm, 2003; Review Group, 2011; ESRI, 2011).

4.7 Technological changes are expected to mean that gas will be easier to transport and store, making a more integrated global market, or regional markets, possible. However, while energy experts are predicting a greater supply of gas, they are also predicting greater demand. Much of this will be due to the growth in demand in Asia and Russia, and the increased environmental cost of coal and oil. At the same time, the European increase in output will occur in Russia and other former Soviet republics. Output in OECD Europe is expected to continue on a downward trend. This leaves Western Europe, including Ireland, increasingly dependent on imported (especially Russian) gas. Gas import reliance will increase in Europe and different pricing mechanisms will coexist. In the short to medium term, the extent of competition from Europe and Asia for Pacific and Atlantic LNG will influence how far prices in these regions converge. (IEA, 2011:44)

4.8 A significant proportion of the predicted 'golden age of gas' is based on the forecast increase in exploitation of unconventional gas supplies, especially shale gas. In North America, it is estimated that unconventional gas (mostly shale gas) will increase from less than half of gas production in the region to nearly two thirds of gas production by 2035 (IEA, 2011). Poland in considered to have the best potential for shale gas in Europe and activities are underway in Germany, Spain, Ukraine and the UK. France on the other hand, has issued a moratorium on drilling due to concerns over water pollution. Despite this anticipated potential, significant production of shale gas is not expected in this region before 2020. (IEA, 2011) Given the environmental concerns surrounding shale gas, the IEA estimates that shale gas produced to proper environmental standards will still have a higher "well-to-burner" emissions rate than conventional gas. Life cycle emissions of shale gas production are higher than conventional gas and concerns about the release of methane during production exacerbate those concerns. However, the IEA argues that total emissions will be only slightly higher and water and climate impacts *"can be mitigated using existing techniques"*.[31] However, this optimism for the future supply of shale gas is far from uncontested. Environmental concerns in the US, and concerns that companies are overstating their shale gas reserves, have leaked into the press;[32] while the publication of documents and emails leaked from the EPA have thrown some cold water on the claims that shale gas will herald a bright new energy future. A recent study by scientists in Cornell University found that the climate impact of shale gas could be worse than that of coal due to the leakage of methane from gas wells.[33]

4.9 Ireland's electricity is currently generated by the following: 17.6 per cent coal, 11.8 per cent peat, 57 per cent gas, 4.4 per cent oil, 1.6 per cent hydro and 5.3 per cent wind (SEAI,

[31] International Energy Agency *Are we entering a golden age for gas: World Energy Outlook 2011 Special Report*, OECD/IEA 2011

[32] Urbina, Ian, 'Insiders Sound an Alarm Amid a Natural Gas Rush' *New York Times*, 25 June 2011

[33] http://www.bbc.co.uk/news/science-environment-13053040 (Accessed 30 September 2011)

2010).[34] Thus Ireland's electricity mix is already dominated by gas. A more diverse basket of fuel inputs would leave the Irish economy less vulnerable to fluctuations in gas prices. Moves to remove supports from wind generation would lead to a higher dependence on gas and magnify this vulnerability.

4.10 Carbon pricing also affects the economic rationale for increased wind penetration. If the price of carbon remains low, then wind becomes relatively more uneconomical. The UK Committee on Climate Change forecasts a carbon price of around €30/tCO_2e by 2020 if GHG emissions targets remain at 20 per cent or €55/tCO_2e by 2020 if targets rise to 30 per cent.[35]

4.11 The current economic downturn has led to a decrease in energy demand,[36] which may lead to a reduction in energy demand in 2020. In the event of such a reduction in demand the quantity of renewable energy required to meet the 2020 targets will also be reduced. However, the SEAI point to the export possibilities of electricity generation by 2020: *Overall, the amount of electricity generated is expected to grow by 29 per cent over the period, which is far in excess of the growth in domestic demand forecast. The much greater role of exports in the forecast accounts for this difference between actual electricity generated and domestic electricity consumption. Exports account for 15 per cent of all generation in 2020. Exports are driven by an increase in the interconnection capacity in 2016 combined with the expansion of renewable electricity generation* (SEAI, 2010).

4.12 As pointed out by the recent ESRI report on energy policy in Ireland (ESRI, 2011), if current EU and UK policies on renewable energy continue there will be an increased demand for offshore wind generation. However, the report argues that any while there may be potential for Irish energy producers to profit in the future from UK supports for offshore wind, this export should not burden the Irish electricity grid or be funded by Irish taxpayers or consumers through subsidy or tax. (ESRI, 2011) The Minister for Communications, Energy and Natural Resources, Pat Rabbitte TD, recently stated that he was confident that Ireland could reach the target of 40 percent level of renewable energy consumption by 2020 through onshore wind projects (Dáil Debates, 18 January 2012).

4.13 However, regardless of the gas versus wind debate, Ireland is still obliged to meet its international obligations on emission and renewable energy. The IEA World Energy Outlook, while heralding a 'golden age of gas', states that: *When burned, natural gas emits less CO_2 and local pollutants than other fossil fuels; but it compares less favourably in this respect with nuclear power and renewable energy. Much therefore depends on the particular changes in the use of other fuels. Though gas is the most benign fossil fuel in terms of CO_2 emissions, in the GAS Scenario these emissions are only slightly lower than in the New Policies Scenario, at about 35Gt. This emissions trajectory is consistent with stabilising the atmospheric concentration of greenhouse gases at around 650ppm, resulting in an average global temperature rise of over 3.5°C. To limit the increase in global temperature to 2°C would require much improved energy efficiency, a greater shift to low-*

[34] Also includes electricity imports at 1.4% and gas oil at 0.2%

[35] Committee on Climate Change, *The Fourth Carbon Budget: Reducing emissions through the 2020s* (December 2010)

http://downloads.theccc.org.uk.s3.amazonaws.com/4th%20Budget/CCC-4th-Budget-Book_with-hypers.pdf

[36] (most of the decrease in demand has been due to the recession but some of it is due to increased energy efficiency (p.3) SEAI

carbon energy sources and wide application of new technologies, including plants fitted with CCS[37]*. It follows that an increased share of natural gas in the global energy mix is not enough, on its own with today's technology, to avert serious climate change, though natural gas has an important role to play in complementing low-carbon energy solutions by providing the flexibility needed to support a growing renewables component in power generation (IEA, 2011:43).*

4.14 Ireland, as part of the EU block, has an interest in ensuring that the best possible successor to the Kyoto Protocol is negotiated. For Ireland to concede it is dropping its targets for renewable energy would cause profound difficulties for the EU, both in its internal and external negotiations. It would also send a signal to other countries that Ireland is not prepared to take the actions necessary to help avert catastrophic climate change.

4.15 Therefore, in light of binding European targets, energy security and the need to develop renewable energy, recommendations 19 and 26 on targets for wind penetration and Grid development should be rejected.

Electricity Supply Board

	Review Group Recommendations on the ESB
21	The transmission grid, including the high-voltage system in Northern Ireland, should be transferred to EirGrid and retained in public ownership as a regulated monopoly. The transfer prices for these assets should reflect their regulated asset valuations. The Review Group notes that unbundling is not an end in itself but a policy designed to increase competition and efficiency in the industry.
22	All hydro units should be transferred to EirGrid and should be operated by them as regulated assets.
23	The ESB should be required to dispose of further generating capacity in Ireland, the units to be sold to be selected by the CER. This should happen regardless of any ESB ownership decision. No acquirer should be permitted to bid for capacity which would bring its Irish market presence above approximately 2,000MW. There should be no regulatory inhibition to generators owning supply businesses, subject to competition law
24	The ESB's energy supply business, electricity distribution business, generation assets (after some divestment), international investment, and consulting and engineering businesses should be sold as a single entity.
25	Should the ESB be retained in state ownership, the Group recommends that, in order to assist in deleveraging the state balance sheet, all of its overseas interests should be disposed of and there be no further expansion outside the island of Ireland.

4.16 The Review Group's proposal for the sale of ESB's energy supply business, electricity distribution business, and generation assets, raises a number of concerns. Evidence is not presented for how this proposal would improve performance. The proposal to sell off the supply, distribution business and generation assets as a single entity would transfer a

[37] Carbon Capture and Storage

natural monopoly from public to private hands with all of the attendant risks that represents. Thus, it will merely change ownership rather than increasing competition in the market. However, as discussed in Section 3, change of ownership without a change in market structure does not necessarily lead to improved performance (Bachiller 2009).

4.17 The rationale for privatising the energy companies was stated as follows:

Gas and electricity networks businesses are normally seen as natural monopolies, but competition is both possible and desirable in power generation and supply. However, the pattern which has emerged of competing companies in common ownership lacks coherence from the shareholder standpoint, and it appears to involve internal cross-subsidisation between regulated and competitive businesses.

4.18 Thus, the rationale seems to conclude that competition between natural monopolies in private ownership is preferable to natural monopolies in public ownership. Dieter Helm argues that the small country context of the Irish electricity market places a constraint on the degree of competition; i.e. there is only a small number of generating stations and sets. "Inevitably in the Irish context, generation will be at best oligopolistic, with considerable incentives to collude."[38]

4.19 The argument for privatising the ESB's energy supply business, electricity distribution business, and generation assets is predicated on the assumption that privately owned firms automatically perform better than publically owned firms. However, the theoretical and empirical literature is ambiguous on this point and evidence can be found to support both privatisation and public ownership.[39] The energy supply market has undergone a gradual liberalisation since 2005. In 2010, the ESB controlled a market share of 37.2% of installed capacity on the island of Ireland, down from 56.7% in 2006 (Competition Authority, 2010). The Commission for Energy Regulation reports that in the domestic (i.e. residential) market, ESB (Electric Ireland) has 63.14% of market share in terms of customer numbers and 55.42% of market share in terms of MWhs (CER, 2012). Electric Ireland has a market share of 47.24% of small business customers,[40] 57.73% of medium-sized business customers and 49.57& of large energy users (CER, 2012). A study of electricity reform in the European Union rejected the argument that privatisation, which is not a necessary pre-requisite of liberalisation, leads to lower prices or increased consumer satisfaction (Fiorio, C.V., Florio, M., 2007). The study points to the Nordic countries, where *" highly competitive national markets and a regionally integrated transboundary market is [sic] well supported by an industry where public ownership plays a remarkable role. The fact that generators are often owned by municipalities can be seen as an intrinsic constraint to anti-competitive mergers and acquisition that are often motivated not by economies of scale in production, but by a desire to influence prices. The same reasoning may apply to a public sector owned firm exposed to competition".* (Fiorio, C.V., Florio, M., 2007:36)

[38] "Northern Ireland provides a good example of what happens when the number of generators is bellow five. There is considerable theoretical and empirical evidence on the likelihood of collusion as the number of competitors rises. It turns out that fewer than five creates much greater incentives to collude." Helm, Dieter, "The Scope and Limits of Competition and Regulation in the Irish Electricity Market", *"ESRI Quarterly Review*, 2003, p.7

[39] See Appendix 1 for a discussion on the theoretical and empirical arguments on privatisation

[40] Market share in terms of customer numbers

Transfer of the transmission assets to EirGrid

4.20 The transfer of the transmission assets to EirGrid is long-standing government policy, first articulated in the White Paper on Energy in 2007 and most recently in the Programme for Government 2011-2016. However, the transfer of assets has not occurred. In 2010, the then Minister for Energy, Communication and Natural Resources commissioned a report on the issue by independent consultants Frontier Economics. According to the report, the cost-benefit analysis depends on the structure of the transaction. If the transfer of transmission assets is made at a fair market value, EirGrid would "require a substantial equity investment". (Frontier Economics, 2011: 139)[41] If the transaction were carried out at 50 per cent of the regulated asset base (RAB), the ESB would gain a payment of 50 per cent of the RAB and EirGrid would take on the debt of 50 per cent of the RAB. Frontier Economics believes that this would only serve to worsen the financial position of both companies, and has the potential to significantly increase the cost of debt. Frontier Economics also believes that both companies may have to re-profile their capital investments, which would put the delivery of Ireland's renewables targets in doubt. (Frontier Economics, 2011: 139). The report also argues that Ireland could make an application for an Article 9(9) exemption to the directive, and if *"both the CER and European Commission take a purposive approach to assessment, Ireland is likely to be able to pursue a relatively strong case." However, the report also finds that "there is an element of risk to pursuing this option"* (Frontier Economics, 2011: 140)

4.21 The report also concluded that there may be some improvements to customer service as a result of ownership unbundling but that it would not *"unlock any significant short to medium term competition benefits, given that it removes a further structural barrier to discrimination and may offset even the potential for perceptions of discrimination, which may deter future entry or investment. However, given the lack of evidence in relation to discrimination, it is unlikely that such an effect would be significant."* (Frontier Economics, 2011: p3)

4.22 Thus, conclusions of the Frontier Economics analysis point to a strong economic argument for not transferring the transmissions assets to EirGrid. The Review Group however, did not accept its findings (Review Group, 2011:45).

Bord Gáis Éireann (BGÉ)

	Review Group recommendations on Bord Gáis Éireann and Gas Industry Structure
27	The Group recommends that BGÉ's regulated transmission and interconnector assets should be retained in state ownership. Consideration should be given to the establishment of a distinct state body to own and operate these assets and also to the option of merging these operations into EirGrid.
28	The Group recommends that the remaining operations of BGÉ, other than gas transmission and interconnection, be privatised as a single entity.

4.23 Bord Gáis is the dominant player in the Irish gas market. The market was fully opened to competition in 2007. In 2009 BGÉ sold 42.9 per cent of the gas used in the Irish gas market. It entered the electricity supply market in 2001 and by 2010 it controlled 12 per cent of the

[41] According to the draft conclusions circulated to the stakeholders prior to publication, it would require this substantial investment *"if it is to avoid breaching its borrowing covenants and maintain its projected capital programme"*, Frontier Economics, *Transmission Asset Analysis*, Draft Conclusions, December 2010

market share. In 2009, BGÉ's revenues stood at €1.35 billion. Like other SOEs, its sales have fallen recently due to the economic recession. However, over the past eight years it has invested €2.8 billion; €1.3 billion of which came from borrowings. It is investing heavily in electricity generating capacity, which will account for approximately 30 per cent of its capital employed in the coming year. BGÉ's capital spending over the coming three years will be in the region of €800 million. Thus, as with the ESB, BGÉ is continuing to make capital investments and to successfully borrow on the capital markets.

4.24 In line with its recommendations concerning the ESB, the Review Group advises the retention of the gas transmission and interconnection, and sale of the BGÉ operations as a single entity.

4.25 In common with its recommendations on the electricity market, the Review Group is proposing to transfer ownership of a public natural monopoly to a private natural monopoly. Again, the only rationale appears to be the claim that performance in the private sector is superior to that in the public sector. Consequently many of the same points which were made in the section on the ESB can be reiterated for BGÉ. It is not necessarily the case that private companies outperform public companies, especially in the case of natural monopolies. Competition exists in both the electricity and gas markets, but selling BGÉ as a single entity will not itself generate further competition. Thus, as in the case of the ESB, the only economic rationale for privatising BGÉ would be to raise revenue. As has been discussed in Section 1, given the current economic climate and the real possibility of only securing a fire-sale price from the sale of SOEs, this is not a prudent decision to make at this juncture.

Transport: accessing the world

Overview

4.26 As an island, Ireland is heavily dependent on its ports and airports for access to and from the country. Unlike many competitors in continental Europe, road or rail do not provide alternatives to boat or plane, and therefore safeguarding access routes at a reasonable price is vital to the wellbeing and competitiveness of the economy. Consequently, any discussion on the privatisation of ports or airports must start from this perspective.

4.27 The State currently owns three airports and eleven ports. The airports are Dublin, Cork and Shannon and the ports are Drogheda, Dublin, Dundalk, Dún Laoghaire, Cork, Galway, New Ross, Rosslare, Shannon Foynes, Waterford and Wicklow. Collectively, the seaports handle 95 per cent of Ireland's external trade. The recent financial downturn has inevitably hit the profits of the port companies and the airports, in particular the smaller ports. Dublin Port is predictably the most important seaport and accounted for more than 50 per cent of total revenue for 2009, while Cork accounted for 16 per cent, Dún Laoghaire eight per cent and Shannon Foynes eight per cent. However, although the economic downturn undoubtedly hit the ports hard, Dublin and Shannon Foynes operating profits for 2009 exceeded their operating profits in 2008.

4.28 In the case of the airports, Dublin Airport Authority (DAA) suffered particularly badly over the past two years due to declining passenger numbers and increased borrowing for the purpose of investment in infrastructure. DAA's debt to EBITDA[42] ratio climbed to 4.9 in 2009. The DAA's financial position is forecast to continue deteriorating through 2011. Its priority thus will be to reduce its borrowing levels. The DAA is also responsible for the management of Cork and Shannon airports, although the 2004 State Airports Act provides for their separation by Ministerial decision. The assets and liabilities of Cork and Shannon are also under the control and responsibility of the DAA. Much of the DAA debt can be attributed to the construction of Terminal Two in Dublin Airport, but Cork Airport also borrowed heavily to fund a controversial redevelopment.

4.29

Air and sea ports: Review Group recommendations

	Seaports and Port Industry Structure
29	The state-owned ports, including Rosslare, should be restructured into several competing multi-port companies, built around Dublin, Cork and Shannon Foynes. The Competition Authority should be consulted concerning the amalgamation process.
30	Privatisation of some or all of the ports should be considered, ideally after the recommended restructuring. The adequacy of competition in the sector on an all-Ireland basis should be reviewed prior to privatisation and suitable regulatory arrangements instituted, if deemed necessary
	State Airports
35	As an exception to its general recommendation on dividend policy, the Review Group recommends that no dividend be sought from DAA for the present.
36	The DAA should dispose of its non-core assets, primarily overseas, as a means of substantially reducing its debt exposure. The timing of this deleveraging programme should be determined by the company board. In due course, privatisation of the airports should be considered.
37	Whether DAA's airport assets are privatised or retained in state ownership, the regulatory arrangements need to be reviewed and in particular the scope for political intervention in capital investment decisions curtailed.

4.30 Paul Sweeney argues that that Dublin Airport is a natural monopoly (Sweeney, 2004). Within the EU-27, 82 per cent of airports are held in public ownership and 14 per cent are mixed public private ownership.[43]

4.31 It could be argued that many of Ireland's ports are also natural monopolies when examined in the context of their hinterlands. As such, any consideration of possible privatisation of them should be viewed through this prism. The case for considering Dublin Port as a natural monopoly is especially strong, given its dominance in the country, particularly in the eastern half of the country. Thus, as argued in other sections, the contention that Dublin, or indeed any other port, would perform better under private ownership in the

[42] Earnings Before Interest, Taxes, Depreciation, and Amortization. EBITDA is used to measure a company's financial performance by examining its earnings from core business operations without taking the effects of capital structure, tax rates and depreciation policies into account.

[43] ACI Europe, *The Ownership of Europe's Airports*, 2010

absence of competition is open to question. Dublin Port has privatised a number of its functions over the past number of years, bringing the number of staff down to approximately 150, in the event of full privatisation; it would be mainly land which would be privatised.

4.32 However, a case may be made for the rationalisation of the smaller ports, not necessarily as a precursor to privatisation, but in order to increase efficiency and performance across the sector. In the current economic climate, many of the ports may not be particularly attractive to potential buyers. As the Review Group pointed out, much of the value of the port companies lies in their amenity value, in which case an argument could be made for retaining them in public ownership for local development purposes. The submission on behalf of Dun Laoghaire Harbour Company makes the point that the harbour is fundamentally a public amenity which requires an annual €3 million to maintain the facilities. The revenues earned by the harbour company come from commercial sources, e.g. ferry operations, car parking and marina operations. The company argues that it is not a commercial harbour *per se* and that it is constrained by fixed boundaries.[44] Given its importance to the local area as an amenity resource, and restraints on its commercial growth, it is difficult to see what value to the economy or society privatisation of Dun Laoghaire Harbour would bring. The Port of Cork also emphasises *the "possible loss of focus on non-commercial areas, e.g. leisure, tourism etc."* as a consequence of privatisation. (Port of Cork, 2010:2) In its submission to the Review Group, the Port of Cork argues that with a low revenue stream (1.4% return on Capital Employed in 2009), significant pension liabilities (€9.1m in 2009) and current property valuations at an all-time low, the potential gain by the state from the sale of the port would likely be low. The potential for asset stripping by private owners following privatisation was also highlighted by the port. An analysis of UK port privatisation found *"that it is extremely difficult to conclude that ownership constitutes a significant factor in port performance and efficiency. Instead, factors such as geographical location and deregulation seem to have a greater influence on efficiency"*. (Cullinane, K., Song, D.W., 2010)

Dublin Airport Authority

4.33 Due to its enormous debt burden, the DAA will not be an attractive prospect for many buyers. As was the case with Irish Steel, the excessive debt would hinder the ability of the state to obtain any significant profit from privatisation. It might also hinder the capacity of any buyer to invest further in the company. The company also has a large pension deficit, another factor which makes it an unattractive candidate for privatisation. The experience of airlines utilising privatised airports is that, following the change in ownership, landing fees always rise.[45] *The Economist* argues that over $1 trillion of new investment will be needed globally over the next two decades, and that there are few private airport groups with the capacity to make such investments over the coming years (The Economist, 28 May 2011). The maximum level of airport charges at Dublin Airport is set by the independent Commission for Aviation Regulation. Therefore, it is not clear that privatising airports over the next few years would increase efficiency or indeed would be prudent, especially if on-going investment is needed.

4.34 The Review Group report also recommends divestiture of some of DAA's non-core assets overseas, such as the 20 per cent stake in Düsseldorf Airport and duty-free businesses in

[44] Dub Laoghaire Harbour Company, *Submission to the Review Group on State Assets*, 31 August, 2010
[45] Economist, *Airport Privatisation, Runways Required*, 28 May 2011

airports in Moscow, Montreal, Kosovo, Kiev and Bahrain. This would allow the company to reduce some of its debt exposure.

4.35 However, privatisation of any Irish Airport or Irish-based assets is not recommended, particularly in the short- to medium-term. Taking the position that the airports are indeed natural monopolies, it is inadvisable to privatise them.

Aer Lingus

Review Group recommendation

	Aer Lingus
38	The state's shares in Aer Lingus should be disposed of as soon as is opportune.

4.36 Aer Lingus is a different case, as it was already part-privatised in 2006. This part-privatisation led to a battle for control of the company between the Government and Ryanair. When Ryanair attempted to become the largest shareholder in Aer Lingus, the Commission ruled against it on competition grounds. While an argument could be made that it was the retention of the 25 per cent share by the State which allowed it to block the Ryanair bid and thus ensure continued competition, the Review Group argues that the current EU position on competition will continue to prevent Ryanair acquiring control of the company and that consequently selling the remaining 25 per cent share will not threaten competition.

4.37 The Gulf War of 1990-1991 had a severe impact on the financial health of the airline industry. Aer Lingus, in common with most airlines, was badly affected. A rationalisation plan in the early 1990s restored the company to profitability. This plan included a reduction in employment, sale of assets and the injection of state capital. It also included the granting of 5 per cent holding to the employees. Plans to privatise the company were put on hold following the events of September 11th, 2001. The global airline industry had suffered extreme financial difficulties due to the terrorist attacks and when industrial relations difficulties were taken into account, the Government decided against privatisation. Instead, the airline underwent a second rationalisation. This time 2,000 job losses occurred, there was a further sale of assets and a pay freeze was imposed. Employee share ownership was increased to 14.9 per cent and the decision was taken not to inject further state capital. The Government at the time argued that EU state aid rules prevented the injection of further public money into the company; but this has been rejected by Sweeney (2004).

4.38 The company, now profitable, was targeted for privatisation in 2003. It took a further three years, however, for the Government to sell the company. Palcic and Reeves (2011) attribute some of this delay to political issues such as the strong feelings of Dublin North constituents on the issue. Decisions on the best way of privatising the company also dominated; again, the Eircom experience was an important factor. The management of the company preferred the institutional placement of a stake, while Goldman Sachs advised stock market floatation and the retention of a 20 per cent share by the Government. Following what it saw as the failure of Government to privatise the company to its specification, the management resigned in 2004. In November 2006, the Government finally sold 60.1 per cent of Aer Lingus on the stock exchange in 2006 and retained a 25 per cent share. The remaining 14.9% share was held by the ESOP

4.39 While the management of Aer Lingus was encouraging the sale of the company on its terms, Government policy, tempered by political sensitivities in Dublin North and the Eircom experience, proceeded with partial privatisation in a manner intended to avoid a repeat of the Eircom debacle.

4.40 The issue of the Heathrow landing slots remains a pertinent one. Currently, the 23 landing slots in Heathrow are protected under disposal restrictions contained in the company's articles of association. However the Review Group believes that:

The Heathrow slots would be deployed to their optimum use in the absence of restrictions and optimum use would include the busiest routes: Dublin-London is one of the busiest city-pairs in Europe and it is not plausible that Dublin-Heathrow would be under-served should slot allocation be left to market forces. The London area itself is now served by a number of airports and Irish travellers wanting to make onward connections also have options through other European hubs such as Amsterdam, Brussels, Paris and Frankfurt. (Review Group, 2011:86)

4.41 However, given the imperative to ensure connectivity with not only mainland Europe and the UK, but also with the US and the rest of the world, any action which leaves such vital connectivity under market control may easily be regretted. Once the state has divested itself of all interest in a company, it can no longer influence its investment and operational decisions, as became apparent when the state sold Telecom Éireann. Leaving all airline connections and route decisions to the whim of the market may prove short-sighted and imprudent in the longer term.[46]

[46] See earlier discussion on Eircom for an example of where such and important sector of the economy was left to the markets.

Transport: accessing Ireland

4.42 Public transport serves several important purposes. These include economic development, environmental protection and social cohesion. Sustainable economic development depends on the provision of efficient and high-quality public transport, both urban and rural. In 2009, the transport sector contributed 21 per cent to Ireland's overall GHG emissions. Between 1990 and 2009, transport saw the greatest overall increase in emissions of 156 per cent. However, 2008 and 2009 saw a decrease in transport emissions, primarily due to the economic downturn, with some assistance from the changes in the Vehicle Registration Tax (VRT) and motor tax regime, which were designed to incentivise the purchasing of lower emissions engines. *"The increase up to 2007 can be attributed to general economic prosperity, an increasing population with a high reliance on private car travel due to poor spatial planning, as well as rapidly increasing road freight transport."* (EPA, April 2011).

4.43 Social inclusion is an important policy aim and should be strongly considered alongside economic efficiency in terms of policy goals. A car-dependent city or country can exclude those without the means to pay for private transport. Older people, those with mobility problems or those on lower incomes, especially women, tend to be more negatively affected by diminution in public transport services than those on higher incomes. In general, lower income groups are more dependent on public transport for both work-related and recreational travel. In the context of declining incomes and increased unemployment, ensuring that people have access to reliable public transport in order that they can travel for new employment opportunities and to maintain social connectivity should be a priority when developing policies to facilitate economic recovery.

The policy context

4.44 Current government policy in relation to public transport is enunciated in *Smarter Travel: A Sustainable Transport Future: A New Transport Policy for Ireland 2009 – 2020*. The goals of public policy are stated as follows:

- Improve quality of life and accessibility to transport for all and, in particular, for people with reduced mobility and those who may experience isolation due to lack of transport
- Improve economic competitiveness through maximising the efficiency of the transport system and alleviating congestion and infrastructural bottlenecks
- Minimise the negative impacts of transport on the local and global environment through reducing localised air pollutants and greenhouse gas emissions
- Reduce overall travel demand and commuting distances travelled by the private car
- Improve security of energy supply by reducing dependency on imported fossil fuel

Transport regulation

4.45 On the 3rd December 2009 a new EU Regulation on public passenger services by rail and road came into effect. The main purpose of EU Regulation 1370/2007 is to guarantee safe, efficient and high quality passenger transport services through regulated competition, guaranteeing also transparency and performance of public transport services while having regard to social, environmental and regional development factors.

4.46 In order for the regulation to be properly transposed into Irish law, a fundamental overhaul of how public transport services were regulated was required. Before the transposition of the regulation, the Department of Transport essentially acted as the regulator of public transport services, largely through a licensing system which had been in place for over 50 years. Under the new regime a competent public authority has three options open to it in selecting how public transport services are to be provided:

- A direct award allows a competent authority to award a contract directly without a competitive tendering requirement,
- Competitive award provides for the organisation of public transport services via a competitive tendering procedure, or
- Public service contracts concluded under the rules of general public procurement legislation.

4.47 In the case of Ireland, the recently established National Transport Authority, now the regulator of public transport services, has entered into direct award contracts with the CIE companies for the operation of services within the networks developed by the companies. As part of this process the NTA must be satisfied that the bus companies were efficient operators. An efficiency review carried out by Deloitte confirmed this to be the case. A copy of the Deloitte Review is available on the Department of Transport, Tourism and Sports website. The direct award contracts are subject to periodic review. Thus, the current regulatory regime has the power to ensure efficiency in the service.

Córas Iompair Éireann (CIE)

	Review Group Recommendations on state transport companies
40	The Review Group recommends that CIE's tours business, Rosslare port, Expressway and other bus businesses competing directly with private operators should be disposed of. Policy should seek to limit the level of public subsidy through greater efficiency and the amount of capital to be invested in further transport projects should be severely constrained. The Review Group recommends that the privatisation of all or part of Dublin Bus should be considered in due course, but only after government has decided on a model for competition in the Dublin bus market.

4.48 CIE, as the public transport parent company, is a wholly-owned commercial state company. However, unlike all other SOEs, the State is not a shareholder. Instead, the group is vested in the CIE holding company. The group consists of Iarnród Éireann (Irish Rail), Bus Éireann and Dublin Bus.

4.49 CIE, like most public transport operators, depends on state subsidies to operate its services. It receives annual Public Service Obligation (PSO) payments. In the years 2007-2009 the company received €300 million in PSO payments and over €500 million in capital grants per annum. Unlike the energy companies and the DAA, CIE does not look to private markets to raise capital; instead, it is wholly reliant on the state for both current and capital spending. Passenger numbers across the company are falling and a possible decrease in both capital and current State funding is looming.

4.50 The company also owns a substantial property portfolio, Commuter Advertising Network (CAN), CIE Tours International, Rosslare Europort, Day Tours, and the Airlink bus service.

Iarnród Éireann (Irish Rail)

4.51 Iarnród Éireann can be seen as a natural monopoly, with significant economies of scale and barriers to new firms entering the market; consequently opportunities for competition are limited. It is highly dependent on state subsidies, accounting for 73 per cent of total capital grants paid to CIE and 67 per cent of CIE's total grant-funding. As such, the argument for privatisation is weak, a fact which is acknowledged in the Report of the Review Group on State Assets.

Bus Éireann

4.52 Bus Éireann operates urban and rural bus services outside of Dublin. These include the Expressway inter-urban service, urban services in the larger towns and cities and services to the surrounding rural areas. It operates at a loss and receives approximately €45 million per annum in public support. Its urban and rural services are unlikely to turn a profit in the coming years and as such are not regarded as a candidate for privatisation.

4.53 Its Expressway service, on the other hand, was profitable until recently when it suffered from the economic downturn. It has over 200 coaches, carries 8 million passengers per annum and earns revenue in the region of €50 million.

Dublin Bus

4.54 Dublin Bus has a fleet of around 1,000 buses and a network of about 150 routes. It is the dominant operator in the Dublin bus transport market and subject to regulation. It faces some competition on various routes and services, (e.g. Swords Express, Aircoach). It receives approximately €75 million per annum in subventions and has benefited from increased capital investment (€100 million) by the state in the past number of years. However, while Dublin Bus is dependent on the Public Service Obligation payments, it receives a relatively low subsidy in terms of subsidy to fare ratio (Wickham 2003).

4.55 As the Review Group report states, the companies which are profitable on a stand-alone basis (i.e. CIE's tours business, Rosslare port, Expressway, Airlink and Day Tours), provide little financial relief to a company so wholly dependent on large public subsidies, nevertheless they do provide some relief. The report does not put a figure on the likely yield from these sales but it is unlikely to provide a substantial offset against public subvention. Similar to Aer Lingus, these companies operate in a highly competitive environment and their existence does not impede competition in the sector. One could also argue that, like Aer Lingus, they actually maintain competition in their sectors; a sale of these companies could leave the door open to the threat of purchase by large private bus companies and the development of a less- or non-competitive market structure characterised by a dominant market player.[47] Before any such divestment of these companies, the Government would have to ensure that the proper regulatory environment existed to prevent such a scenario developing.

[47] See Wickham, James (2006) for a good discussion on the privatisation 'in the market' of bus services in the UK.

4.56 Extremely problematic from a competition perspective, given its large market share, is the proposal to privatise all or part of Dublin Bus. Recognising the fact that most of its routes are loss-making, the Review Group argues that it should be possible to design a competitive market which will accommodate public subsidy for loss-making routes. The Review Group suggests that the State should look to the Transport for London model where the public authority (Transport for London) designs the network, sets the level of service provision and tenders the routes to private operators. The UK Government had previously privatised all the garages into competing units.

4.57 This proposal raises a number of issues.

First, Transport for London operates in a very different political and administrative environment. Unlike London, Dublin has no regional government and no transport authority; the Dublin Transport Authority has been subsumed into the National Transport Authority. For such a franchising system to develop there would need to be clear political decision-making on the level of service expected from private operators. The political and administrative oversight which exists in London does not exist in Dublin (Wickham, 2006).

Second, although franchising routes has definite advantages over other forms of privatisation, (e.g. lower costs, more transparent pricing and service levels) there are also drawbacks; in particular, the level of regulation needed to ensure good service (Wickham 2006). As the level of service provision, which can include such aspects as cleanliness and punctuality, will form part of the tender, the regulation required will be complex, expensive and will need a number of years to design. Without the proper administrative and political framework, attempting to design the regulatory framework could prove very difficult.

Third, public transport integration, which is arguably one of the most important factors contributing to a successful and efficient public transport system, can be achieved "at a relatively low cost by better co-ordination of existing facilities" (Wickham 2003). But proper integration means that all aspects of the public transport system must be integrated, including local government. This might be more easily achieved if Dublin Bus is kept in public ownership rather than through constant negotiations between the local authority, regulator and private service providers.

4.58 Thus, it is not at all clear that the privatisation of Dublin Bus, Expressway and other CIE companies would contribute to the key goals of the *Smart Travel* plan:

- Improve quality of life and accessibility to transport for all and, in particular, for people with reduced mobility and those who may experience isolation due to lack of transport
- Improve economic competitiveness through maximising the efficiency of the transport system and alleviating congestion and infrastructural bottlenecks
- Minimise the negative impacts of transport on the local and global environment through reducing localised air pollutants and greenhouse gas emissions
- Reduce overall travel demand and commuting distances travelled by the private car
- Improve security of energy supply by reducing dependency on imported fossil fuel

4.61 If privatisation *per se* does not necessarily increase performance and efficiency, privatising Dublin Bus and tendering routes may not lead to a more efficient or more widely used service. It is difficult to see how the privatisation of public transport companies will contribute towards efficiency goals.

Coillte and Bord na Mona

	Review Group Recommendations on Bord na Móna and Coillte
31	The Group recommends that the Government should seek to dispose of Bord na Móna as a single entity, including peat extraction rights but not ownership of the peat lands.
32	The state should initiate the disposal of Coillte's forest and non-forest assets (but not its forest land), possibly using the New Zealand Crown Forest Licence template modified to make it suitable to Irish conditions. Unforested land surplus to Coillte's requirements should be sold and the proceeds remitted to the Exchequer by way of special dividend.
33	The replanting obligation attached to Coillte and grant-aided forestry should be discontinued.
34	In order to minimise the national cost of climate policy, activities that sequester carbon should be treated equally to those that emit carbon. The Group supports efforts to reward forest owners for the value of carbon sequestered by new forests after 2013. For farmers in receipt of the current range of financial incentives, the Group recommends that these incentives be restructured to explicitly reward the carbon sequestration value but there is no justification for a further increase in these payments.

Coillte

4.59 Forestry policy in Ireland is mainly articulated in the 1996 strategic plan *Growing our Future* and the Programme for Government. *Growing our Future* commits to achieving 17 per cent forestry coverage by 2035 and yearly afforestation levels of 20,000 hectare p.a. to year 203048. Annual planting levels grew from under 7,000ha during the period 2007-2009 to just over 8,300 hectares per annum. The Programme for Government contains an annual target of 14,700 hectare afforestation per annum. Achieving these levels of new planting will require continued state investment.

4.60 Ireland's level of forest coverage is one of the lowest in Europe. Forestry has the capacity to generate and sustain employment in rural areas and has important environmental and amenity benefits.[49] According to the Forest Service, *'the direct and indirect contribution to*

[48] DAFF, *Growing Our Future*, 1996

[49] Pearce *et al* (1989) introduced a typology which recognises three types of environmental value:

Direct use value e.g. the benefit of using forest resources as input to production or as a consumption good. (Wood products: timber, fibre, fuel; Non-wood products: food, medicine, genetic material; Educational, recreational and cultural uses; Human habitat; Amenities: landscape)

Indirect use value, comprising the support and protection provided to economic activity and property by natural forest functions, or forest "environmental" services; (Watershed production; Nutrient cycling; Air pollution reduction; Micro climatic regulation; Carbon storage) *the economy has been calculated at €1.6 billion with some 16,000 jobs dependent on the sector'*.[50]

4.61 A 2003 report by Peter Bacon and Associates illustrates the benefit to the economy and society from continued public support for forestry; the report estimated a benefit: cost ratio of 1.59. The benefits are listed as follows:

- Sustaining of employment in rural areas. Labour markets in those areas are not saturated and alternative employment is not readily available.
- Growing of a renewable resource. Timber and wood products are increasingly being specified ahead of other less environmentally friendly materials. Wood biomass is a renewable source of carbon neutral, green energy that can readily displace some of Ireland's 90 per cent reliance on imported fossil fuel.
- Creation of a carbon sink. Forests are recognised both by the UNFCC and the National Climate Change Strategy as having a significant role to play in sequestering carbon and contributing to the attainment of Ireland's GHG emissions targets.
- Creating added value opportunities. The forest sector supplies a range of wood processing facilities throughout the state and in Northern Ireland. Typically, these processing plants are located in provincial towns, contributing to regional balance.
- Significant amenity and leisure benefits. This is increasingly enhanced by the Forest Service's code of best practice and guidelines. For instance over 50km of the Wicklow Way utilises forest properties."[51]

4.62 Bacon's study concludes that, *"as all opportunity costs are included in the calculations, a positive return from the expenditure of public funds in forestry to overcome a market failure indicates that it is correct that there funds should be spent in this sector."*[52]

4.63 While Bacon's study was conducted in 2003, the benefits which he identified in state funding of the sector are still pertinent. In particular, the benefit of sustaining employment in rural areas has added importance in the current economic climate, due to the sharp increase in unemployment over the past number of years.

4.64 As the state forestry body, Coillte provided a vehicle for increased planting. However, forestry is dependent on receiving premiums and Coillte was *'deemed ineligible in 1999 from receiving premiums'* and thus private planting now represents 100% of new planting. This means that the share of private planting in Ireland's forests has been steadily rising since 2,000. Private forests now represent 45 per cent of all forests in Ireland. Under current policy, the continued growth in private forestry will depend on landowners, in particular farmers, making a long term commitment to forestry and switching land-use.

***non-use* value**, including all other benefits which cannot be characterised in terms of a current or future physical interaction between forest and consumers. (Biodiversity; Culture, Heritage, Intrinsic worth; Bequest value

International Institute for Environment and Development, *Valuing Forests: A review of methods and applications in developing countries*, (2003)

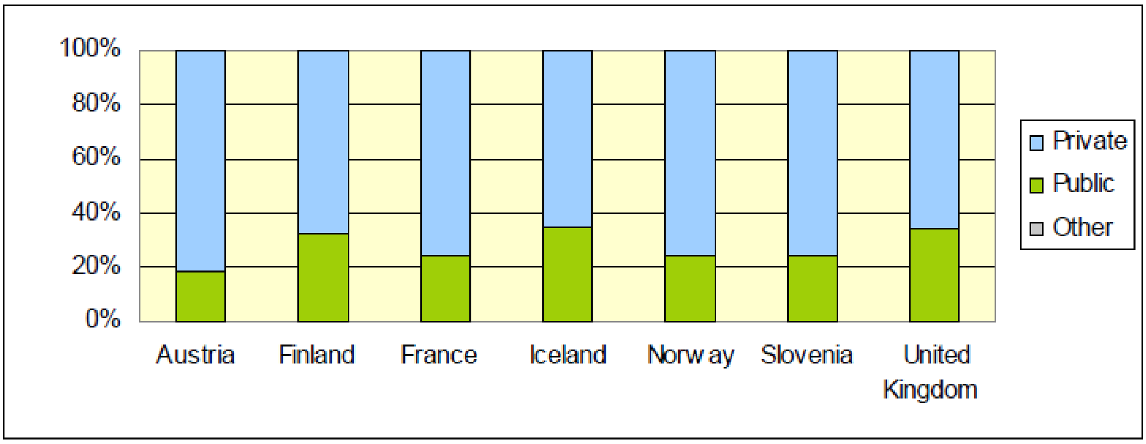
[50] Forest Service, *Brief for Minister*, March 2011, p.137

http://www.agriculture.gov.ie/media/migration/publications/2011/briefforministermarch2011/Chapter%204%20Main%20Brief%20Part%202.pdf

[51] Bacon, p.iii
[52] Bacon, p.iii

4.65 In terms of the level of private ownership, Ireland shares a similar level to countries such as Germany, Hungary, and Latvia. Thus, it cannot be argued that Ireland is somehow out of step in its level of public ownership of forests.

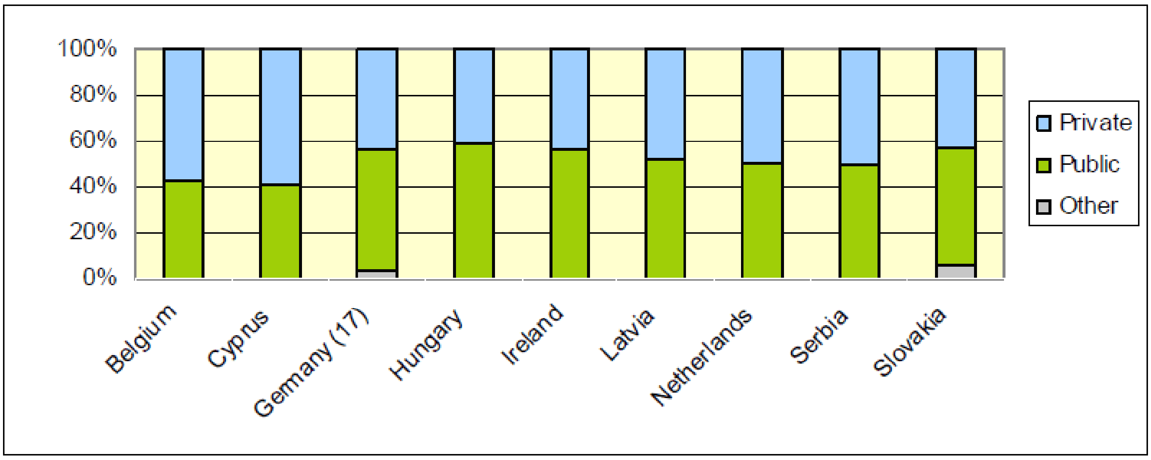
Countries with predominance of private ownership of forest and other wooded land (percentage) 2006 - 2007[53]



UNECE, *Private Ownership in Europe*

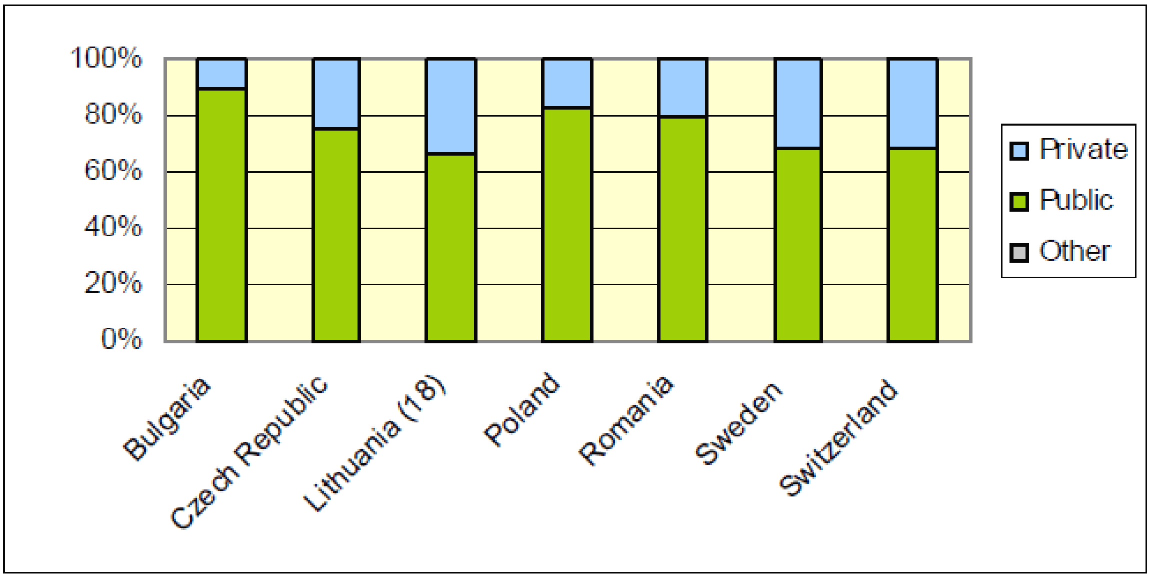
[53] UNECE, *Private Forest Ownership in Europe*, Geneva 2010, p.7

Countries with balanced private and public ownership of forest and other wooded land (percentage), 2006 - 2007[54]



UNECE, *Private Ownership in Europe*

Countries with predominance of public ownership of forest and other wooded land (percentage), 2006-2007[55]



UNECE, *Private Ownership in Europe*

4.66 While the growth in private planting has overtaken the growth in public forests, most of these forests are relatively young[56] and thus Coillte is still a dominant player in the timber supply business, with a large market share. This market share will recede however, with the maturing of private forests. Coillte Panel Products also contributes to its dominance in

[54] UNECE, *Private Forest Ownership in Europe*, Geneva 2010, p.7
[55] UNECE, *Private Forest Ownership in Europe*, Geneva 2010, p.8
[56] Over half of Ireland's forests are under 25 years old, Áine Ní Dhubháin, *et al.*

the wood product sector. Coillte Enterprise is focused on the renewable energy sector, developing wind farms on its land.

A Review of Forestry in Ireland

4.67 Forestry policy is currently under review, as is Coillte. The National Forestry Review Group will examine and update forestry policy goals. The Coillte Review Group will examine the development of Coillte. Its terms of reference are as follows:

"To make proposals for the development of Coillte in the context of national and EU policies on forestry, commercial state enterprises, the national economy, energy, climate change, the environment, tourism and recreation".

4.68 The review will address the role of Coillte and its functions and operations including:

- Business Areas - forest management from afforestation through to log production, panel production, land use and renewable energy;
- Public Goods - climate change mitigation, recreation and protection of the environment, biodiversity, landscape, water resources and heritage;
- Corporate Development - funding, dividend policy, asset disposal, privatisation, wider share ownership, regulatory framework and relationships with stakeholders and organizations both public and private.

4.69 Thus, issues such as the Coillte's role in afforestation, environmental protection and the company's contribution to the development of forestry in Ireland will be examined. However, Coillte's diversification into other business areas, including renewable energy will also be examined. It would be prudent to await the completion and publication of these reviews before decisions relating to forestry policy and Coillte are made.

Bord na Móna

4.70 Bord na Móna, like Coillte has diversified its business over the last number of years. It now has five major business areas, fuel distribution, energy generation, water treatment, horticulture and waste collection and disposal. In 2010 it employed over 2,000, spread over 70 locations in Ireland. It also has some business interest and employees in the UK and the USA. Its core business remains power generation and the production and supply of biomass and peat feedstock. However, it also has a sizeable waste recovery business and continues to produce briquettes for the residential home heating market and gardening products for domestic and commercial customers.

4.71 While Bord na Móna was established in order to provide an indigenous energy source, regional employment was always a very important element of its continued Government support.[57] Its electricity generation is supported by a PSO, which is imposed by the Commission for Energy Regulation.

4.72 The Review Group argues that both Bord na Móna and Coillte have moved beyond their original and stated purposes, that is the extraction of peat and the management and

[57] Touhy, Aidan, et al, *Burning Peat in Ireland: An electricity market dispatch perspective*, Energy Policy 37 (2009)

development of state forests respectively. It is certainly the case that this form of diversification of SOEs should be examined. Both companies are large landowners and have moved into the renewable energy business. It is rational for companies to innovate and seek out new opportunities and improve their balance books. The challenge for a Government is to decide whether this innovation and diversification of an SOE is adding value to the economy and society.

4.73 Were the state to conclude that it is advantageous for these SOEs to continue to develop their non-core businesses, there may be some merit in the idea of merging the companies as outlined in the Programme for Government:

"To accelerate the development of Ireland's forestry and bioenergies, NewERA will merge together Bord na Mona and Coillte to create a new State company called BioEnergy Ireland to become a global leader in the commercialisation of next generation bio-energy technologies, including an annual 14,700 hectare afforestation programme."

This might lead to greater synergies between the businesses and allow for better development of renewables and renewable technologies.

4.74 TASC does not recommend disposing of Coillte and Bord na Móna at this particular juncture. Both companies employ large numbers of people in rural areas. The effect on employment in these areas could be devastating in the event of privatisation. When in a period of full employment this issue, while important, may not be a deciding factor. However, in a period of high unemployment, especially in rural areas, the possibility of job losses must be an important factor in any decision to privatise.

4.75 The state currently provides supports for the forestry sector which cannot be applied to Coillte; therefore it cannot be argued that Coillte is a barrier to private investment and growth in forestry. While there may be issues relating to Coillte's current dominance in the timber supply market, this question should be addressed as part of the review of Coillte. Thus, the purpose of leasing Coillte land would seem to be the raising of revenue. In this case, the Review Group's recommendation that the state engage in long term leasing of Coillte land must also be rejected. Similar to the discussion on the franchising of Dublin Bus, any such move will require tough, time-consuming and costly regulation. In the case of Coillte, regulation will have to cover conditions such as public access. The on-going cost of regulation will impact on the revenue raised and will most likely not contribute in any meaningful way to Ireland's debt reduction.

4.76 The same argument can be made for Bord na Móna. Given the environmental issues raised by the continued extraction of peat for electricity generation, granting licences to commercial companies to extract peat over the next ten years or so cannot be recommended.

5 State holding company and partial privatisation

5.1 The development of a state holding company (SHC) was proposed by the ICTU in 2006 and by Fine Gael in its pre-election policy documents and manifesto. The ICTU argued for the creation of a state holding company as a way of increasing co-ordination between key semi-state companies and attracting private investment, in particular pension funds. Pension funds could play a critical role in addressing the investment deficit. Latest estimates place their combined assets at €78 billion (Irish Association of Pension Funds), over 80 per cent of which is invested abroad. A combination of incentives to attract a further five per cent of these funds towards domestic investment would equate to an additional €4 billion in the economy.

5.2 Fine Gael developed its NewERA proposal in preparation for the 2011 general election. This proposal sought to bring semi-state companies into a holding company (NewERA), to be funded from different sources, including the possible sale of state assets. Fine Gael's proposed mechanism is a commercially driven semi-state company (NewERA Ltd) which will manage five merged/restructured semi-states. Greater access to capital, potentially better governance and enhanced levels of coordination, accountability and transparency are the stated rationales for pursuing the SHC model although, with regard to accountability, it is unclear why the political appointees on the board of management of the proposed holding company will provide more accountability to citizens than, for example, greater ministerial accountability to strengthened Dáil committees.

5.3 Fine Gael's NewERA proposal found expression in the Programme for Government 2011-2016 (p.14): *"In order to ensure that public enterprise plays a full role in Ireland's economic recovery, we will create a holding company to manage the state's holdings of the semi-states, and to coordinate investment in key priority areas identified by the Government, including energy, water and forestry."*

State holding company and corporate governance

5.4 One of the main reasons given for establishing a state holding company is to improve corporate governance. Good corporate governance of SOEs can be hampered by a close relationship between the company and the managing department, which often houses the regulator. It could be argued that this leaves the SOE open to the principal-agent problem discussed in previous chapters. The OECD (2008) recommends that *"Government(s) should develop and issue an ownership policy that defines the overall objectives of state ownership"*.[58] Implementing the Government's ownership policy may be better facilitated through the mechanism of a central State Holding Company governed by a single board. However, to correctly identify appropriate objectives and weigh up the competing strategies for accomplishing those objectives it would be essential that the board have access to the specialised knowledge and expertise particular to each of the relevant sectors of the economy in which SOEs are operating.

5.5 Forfás argues that there is international evidence of potential to implement clearer governance structures by *"establishing a single, consistently resourced centralised agency (or unit)...this unit drawn largely from pooling existing resources and expertise, would be dedicated to SOE supervision which could improve the State's ability to exercise ownership efficiently..."*. (Forfas, 2010)

[58] Cited by Forfás

5.6 This question of good corporate governance of SOEs has been examined by many countries over the past forty years. In the 1970s, many SOEs were regarded as inefficient and governments chose to tackle this problem through reorganising the sector, privatisation or a combination of both. Reorganisation of the sector often included strengthening corporate governance and imposing hard budget constraints[59].

5.7 One of the ways in which governments sought to do this was through the creation of state holding companies.[60] Many OECD countries continue to use a state holding company to co-ordinate their governance of state owned companies. Other countries have a single ministry to co-ordinate governance functions. Some countries such as Belgium have a mixture of both, with a Minister for State Owned Assets with responsibility for SOEs and a state holding company. Finland established a holding company in 2008 into which several government shareholdings were transferred. The rationale for this was to "insulate" the companies through "another layer of corporate board responsibilities", thereby "safeguarding" their commercial orientation.[61] The separation of ownership function from regulation was an important consequence of this reorganisation. Hungary also established a state holding company, and New Zealand has centralised ownership functions in a central agency within the Treasury.[62]

Holding companies and privatisation

5.8 Holding companies can also be used as a vehicle for privatisation and partial privatisation. A 2003 OECD paper on privatising SOEs examined privatisation policies based on the centralised, decentralised and mixed models. Ireland currently has a decentralised model but is moving towards a mixed model with the creation of NewERA.

5.9 The Italian holding company IRI, established in 1933, was not created for the purpose of privatisation but as a means of state intervention in the economy by the Mussolini government. However, by the 1990s the company's mandate had been changed to carry out a programme of privatising assets. Its assets comprised around 500 companies, ranging from transport to manufacturing and banking. During the privatisation process, the Government retained minority stakes in the companies for a limited time and proceeded with privatisation on a tranche-by-tranche basis.

5.10 The Hungarian Asset Management and Privatisation company (Apvrt) was created in 1995 and had a privatisation mandate from the outset. The Government has since separated the management from the privatisation activities. This is to allow the government to ensure that the value of the assets partially or wholly retained by the state is maximized and that privatisation proceeds according to a schedule which maximises value for the state.

5.11 Austria provides another example where a former holding company was transformed into a privatisation body. The Austrian Industries Holding Company (OIAG) was tasked with

[59] Soft budget constraints are where the enterprise does not 'have' to keep to its budgets because ultimately the exchequer will cover overspills

[60] OECD, *Privatising State-Owned Enterprises: An Overview of Policies and Practices in OECD Countries*, Paris 2003

[61] OECD, State-Owned Enterprise Governance Reform :An Inventory of Recent Change, Paris 2011

[62] OECD, State-Owned Enterprise Governance Reform :An Inventory of Recent Change, Paris 2011

privatising the majority stake in its companies in 1993. OIAG was also tasked with developing "the privatisation concept" over the following years. As part of this mandate, OIAG must obtain the maximum possible value for the sales on behalf of the Austrian people.

5.12 In some cases therefore, the mandate of an existing state holding company was changed in order to pursue a policy of privatisation, while in other cases the holding company was created with the purpose of privatising state assets. The use of a holding company to privatise SOEs is considered to have a number of advantages by advocates of privatisation: it can clarify *"the management/ownership decision-making roles and the incentive structure, and can serve as an intermediate step towards privatisation."* [63] This is especially useful if the intent is to reorganise and prepare companies for privatisation.

Separation of the ownership and regulation functions

5.13 One of the rationales for setting up a State Holding Company is the opportunity to construct a governance structure that separates the ownership function from the regulatory function. The regulatory framework for SOEs should seek to reproduce the conditions, such as pricing structure, of a competitive market while taking into account wider societal goals such as employment. A clear conflict of interest exists if the regulatory function and the ownership function reside in the same body. Full separation and independence of regulatory and ownership functions is required to achieve this. Regulatory decision-making and enforcement in Ireland is best placed within the umbrella of the Department of Jobs, Enterprise and Innovation.

5.14 The ICTU proposal suggests that the holding company would be legally owned by a new board of the National Treasury Management Agency (NTMA). Fine Gael's NewERA project envisages that the CEO and board would be appointed by the Taoiseach. One of the obvious dangers with having the CEO and board appointed by Taoiseach is the temptation for electoral political considerations to interfere with the decision-making process. A CEO has been recently appointed by the Taoiseach from within the NTMA.

5.15 TASC has long argued – most recently in the TASC Paper *Public Appointments: Options for Reform* – that we need to reform our system of public appointments to ensure maximum transparency, competence and diversity. Creating a culture of transparency without our public bodies must involve a two-pronged approach: ensuring that such bodies are rendered subject to our legislative 'transparency framework' (i.e., that they are not, for example, excluded from the scope of FOI), and ensuring that their boards are appointed and managed in a way which is accountable to both Government and the wider public.

Greater access to capital and efficiency savings

5.16 It is envisaged the SHC would sell partial shareholdings, with the proceeds used to finance investment in strategic infrastructure, presumably on the basis of greatest return on capital with consideration to wider employment and economic goals. Considering the broader macroeconomic constraints, the potential for accessing investment is the strongest rationale advanced in favour of the SHC model.

[63] OECD, Privatising State-Owned Enterprises: An Overview of Policies and Practices in OECD Countries, Paris 2003

5.17 ICTU argues there would be potential sources of funding available to commercial state enterprises through private pension funds. This funding would primarily come through the sale of a part of the SHC. Funding could also potentially come through bond issuance. For example the NewERA proposals suggest that further capital could be raised through the offering of recovery bonds. ICTU also argues that NPRF resources could be used to invest in the holding company.

5.18 The greater degree of coordination between the SOEs would help exploit scale economies, minimise duplication of effort and might also help ensure that investment is directed towards projects with the highest forecast ratio of benefit-to-cost.

Investment in next generation broadband

5.19 The lack of access to high-speed fibre-based broadband in Ireland is likely to remain an issue of concern for the Irish Government over the next few years. The Telecommunications and Internet Federation estimates the cost of a fibre network for Ireland would be in the region of €2.5 billion (TIF, 2010). Forfás (2011) has estimated that the cost of fibre deployment to the premises in all towns with a population greater than 1,500 will be €2.23 billion. Eircom's severe financial difficulties make it unlikely the company will be able to raise sufficient funding for the construction of such a network. The Irish Government's own public finance difficulties have become so extreme that it was forced to seek outside financial assistance from the IMF and the European Union and entered a programme of financial support in November 2010 (Department of Finance, 2011). In this context it will be difficult for the State to step in to subsidise construction of a next generation network. Collaboration between Government, Eircom and other operators through Public-Private Partnerships (PPPs) is one alternative, although a difficulty is the uncertainty surrounding Eircom's long-term future. One option suggested by Forfas (2010) is for the infrastructure assets of existing State Owned Enterprises to be bundled together and then to allow other operators access to these networks.

5.20 The Programme for Government set out by the incoming Government in 2011 proposes the setting up of a state holding company called NewEra which it is intended will co-invest with the private sector and the commercial semi-state sector to *"...provide next generation broadband to every home and business in the State"* (Department of Taoiseach, 2011, page 14). The stated intent is to achieve this by delivering fibre to the home or kerb for 90 per cent of homes and businesses, with the remaining ten per cent provided with high speed mobile or satellite broadband.

Partial privatisation

5.21 One of the key issues facing governments pursuing a programme of privatisation is the question of staging. For how much and how fast will the company be sold? For many governments, partial privatisation allows them to maximise value and ensure that the necessary competition and regulatory regime is in place. It also allows the company to *"build a track record in the market, and overcome the price discounting arising from information asymmetries."*[64] The staging of privatisation may also be dictated by the relative size of the company and its share of the market: it may be too large to be sold in its entirety, due to the limited absorption capacity of the market. Partial privatisation also

[64] OECD, *Privatising State-Owned Enterprises: An Overview of Policies and Practices in OECD Countries*, Paris 2003, p.76

provides some comfort to the public that the company will be retained in some form of state control, albeit often for a defined and limited period.

5.22 Some argue that partial privatisation provides a happy medium between full privatisation and full state ownership. Schmitz (2000) argued:

It is shown that partial privatization may well be the optimal ownership structure. While in the standard incomplete contract model, joint ownership is usually dominated, it is shown here that joint ownership in the form of partial privatization can be optimal since it mitigates the disadvantages of public ownership (no incentives to improve quality if the manager invests or too strong incentives if the government invests) and of privatization (too strong incentives for the manager to reduce costs).

5.23 Amess et al (2009) find mixed results for partial privatisation. They find that partial privatisation created jobs, in contrast with full privatisation which *"destroys jobs"*. Full privatisation resulted in higher labour productivity than partial privatisation and wage increases only occurred in partially privatised companies. They argue: *"The results suggest partial privatization exploits market discipline to induce labor productivity whilst simultaneously providing welfare improvements for labor. This is the 'win-win' outcome predicted by the 'helping hand' theory of government. Our results suggest that governments are likely to gain wider support for a program of partial privatization rather than full privatization."*

5.24 Guptha *et. al.* (2005) argue that even when non-controlling shares are sold, this still has an impact on performance as even in the case of partial privatisation, the stock market still has a role to play in monitoring and rewarding managerial performance. Looking at Indian SOEs, they find that partial privatisation has a positive impact on profitability, productivity and investment.

5.25 The OECD (2003), however, argues that the partially privatised asset is subject to the same constraints as a state-owned asset. It warns of vulnerability to government interference and the creation of uncertainty for investors. It also argues that the benefits of full privatisation in terms of improved efficiency may not be realised. The full risk is not transferred to the private sector and the government remains exposed to moral hazard where the company is considered too big or too important to fail.

5.26 Sterlacchini (2012), on the other hand focuses on another area of concern: research and development. He argues that processes of liberalisation and privatisation in the EU have led to a 62% reduction in R&D expenditures by electric utilities. The reduction in R&D investment was more acute in companies which were wholly *or* partially privatised.[65] He attributes this decline to the competitive pressure to reduce costs.

5.27 Whether or not one believes partial privatisation to be a good ownership model for commercial companies, it is also important to point out that many consider partial privatisation a step on the way to full privatisation.

[65] Sterlacchini highlights the case of Italian electric utility Enel, which was partially privatised in 1999. The Italian Government owns 30% of the company. The burden of financing public-interest R&D was passed onto the consumer via price increases which were *"unable to guarantee and adequate amount of funds, able to compensate the reduction of research efforts by the former state-owned companies"*. (Sterlacchini, 2012:501)

NewERA and a new governance structure

5.28 The main arguments in favour of establishing a holding company are greater co-ordination between key strategic SOEs, separation between the management of the companies, the ownership function and the regulatory authorities. It may also facilitate greater access to much needed capital for investment. However, a number of questions remain in respect to the Government's plans for NewERA and our SOEs.

- If all energy companies are brought under the umbrella of the state holding company, what effect will this have on competition in the energy market? How will competition, investment and innovation be maintained?
- If partial privatisation is to take place, will it take place at the top level, i.e. the holding company itself? Or will it take place on a company by company basis, i.e. ESB, Bord Gáis etc.?
- If partial privatisation occurs on a company by company basis, what safeguards can NewERA offer so that the wider goals of the holding company or of the Government will be pursued rather than the interest of the minor shareholders?

5.29 Another concern with NewERA, along with other public bodies, is the need to avoid 'groupthink' and other problems of corporate governance. On this basis, good practice would be for all appointments to NewERA to be made on an independent basis. TASC's more detailed recommendations in relation to independent public appointments are available on our website: TASC (July 2011) *Public Appointments: Options for Reform*.

Conclusion

Regulation is paramount to improving the public benefit from the operation of State-owned enterprises and private companies in the economy.

This report has examined the available evidence in relation to privatisation generally, as well as past cases of privatisation in Ireland. This evidence makes it clear that decisions regarding the future ownership of state assets and State-owned enterprises have potentially major consequences.

The concentration of State ownership in certain sectors of the economy is not accidental. Some sectors/markets have the characteristics of 'natural monopolies', making regulation of State ownership a more cost-effective option. Likewise, many of the sectors of the economy where the State has direct involvement are areas with significant positive and negative 'externalities'; that is, side effects on the wider economy, society and environment.

The reality is that Ireland's economy, in common with the economies of practically every industrialised country in the world, contains a mixture of State-owned and private enterprise, often operating in the same sectors/markets. There is a need for much more focused research on the regulation of both public and private enterprises in the economy to ensure the public interest prevails, and that the economy ultimately serves society.

The public interest includes many issues that are poorly measured in a narrow analysis of State-owned enterprises. For example, the public interest includes high levels of good quality employment in all parts of the country, affordable access for everyone to essential utilities like energy and water, and environmental protection that prevents pollution and provides for leisure and public amenity. This is why TASC emphasises the need for a full assessment of the public interest and a full analysis of each sector of the economy as essential minimum requirements before decisions can be made about the ownership of state assets.

Compelling evidence suggests that regulation of different sectors of the economy is crucial to ensure that national strategic goals are met and that the public interest is fully served. A comprehensive analysis and implementation of regulation must logically take place before discussion of ownership of assets is even relevant. Decisions about the ownership of state assets, such as to privatise or part-privatise, can be difficult to reverse. That is why in this report TASC stresses that a comprehensive review of regulation should take precedence over a review of ownership.

When ownership is reviewed, it should include intermediary options such as partial privatisation alongside complete privatisation and should draw on the international evidence of the long-term consequences of either decision.

The corporate governance of State-owned enterprises requires reform.

TASC concurs with the Review Group on State Assets and Liabilities that there is a need to improve regulation and to enhance efficiency and performance of State bodies. However, TASC argues for a much more comprehensive definition of regulation, fully incorporating issues of public interest.

One aspect of regulation is the corporate governance of public bodies, including commercial semi-states. Good corporate governance standards indicate that there should be distance between the owner of a company and its regulator. This suggests that separate Government Departments should perform these different functions and that steps should be taken to preserve the independence of regulators.

There is a need to ensure that the boards of public enterprises operate according to good corporate governance standards, avoiding 'groupthink' and representing the interests of all stakeholders. The lack of a consistent, transparent and open system of public appointments is a weakness in Irish corporate governance that must be addressed as a matter of urgency.

A lack of transparency is also a serious problem in relation to some public bodies, such as NewERA and the National Assets Management Agency (NAMA). Before the State embarks on the biggest development in industrial policy since the 1960s, namely the establishment of a state holding company, a full analysis should be conducted and published on the corporate governance, competition and regulatory consequences, and the possible effects of any privatisation or partial privatisation on the governance of the holding company as well as on the economy, society and environment.

The balance of evidence does not support a number of claims made about selling state assets such as paying national debt or the asserted superior performance of privatised enterprises

The potential for State-owned enterprises to boost economic performance is significant and requires further investigation and public debate about how a more strategic use of these assets could enhance economic activity while simultaneously safeguarding the public interest.

The evidence does not support the argument, which has been made recently, that there are no alternatives to the sale of State assets. In contrast, as detailed in this report, it is far from clear that the short-term benefit of such sales would outweigh the long-term benefits of maintaining assets in State ownership, with particular regard to the full economic, social and environmental benefits. The examples of Telecom Éireann (Eircom) and Irish Steel show long-term costs that do not seem to have been taken into consideration when the decision to privatise was made.

The balance of evidence does not support a number of recommendations made by the Review Group on State Assets and Liabilities in relation to the public interest benefits of privatisation.

The Review Group does not provide adequate evidence to support its recommendations to privatise a wide range of State-owned enterprises and other state assets.

The evidence in favour of selling State assets to alleviate Ireland's national debt is, at best, weak. The potential €5 billion yield from selling state assets, identified by the Review Group, would do little to relieve the burden of Ireland's national debt, which is likely to exceed €200 billion at its peak. The relatively small cash benefit accruing from any such sales needs to be fully weighed up against their potential economic, social and environmental costs.

Appendix: State-owned enterprises and assets in the economy – theoretical discussion and empirical evidence

Theoretical Discussion

The privatisation debate to date (empirical and theoretical) has mostly focused on the impact of privatisation on the efficiency of service delivery (Palcic and Reeves, 2007). Economic theory on privatisation developed alongside privatisation policies themselves, expanding as privatisation policies gathered pace in the UK in the 1980s. Theoretical examinations initially lagged behind public policy; however, they quickly advanced as privatisation accelerated in the UK and gained popularity in other countries (e.g. New Zealand and France).[66]

The theoretical rationale for using privatisation to improve economic efficiency has been provided primarily by the principal-agent theory, buttressed by support from arguments related to Government failure, from property rights advocates and public choice perspectives (Cook, P., Fabella, R., 2002).

De Alessi (1987) provides a property rights argument for privatisation. While the state involvement in the provision of goods and services allows it to rectify allocative and distributive problems (e.g. monopoly, public goods[67], externalities), individuals, in this case public servants, are incentivised to manipulate the power of the state and operate on their own behalf. This leaves them open to pursuing their own interests and those of interest groups. Moreover, Alessi argues that *'government employees are not public-interest maximisers, even if they knew what the public interest is'* (De Alessi, L: 34). Under private property*, 'people bear the value consequences of their decisions'* (De Alessi, L: 34). In a similar vein Buchanan and Tullock (1962) make the argument that political decision-making often results in outcomes that conflict with the actual preferences of the general public. They argue that public ownership is susceptible to corruption, lacks accountability and can be captured by sectional interests or political influence. However, Governments do in fact have an incentive to maximize efficiency in nationalized companies, due to the pressure of future elections. In this sense Governments are also accountable.

Principal-agent literature points to the lack of the profit motive in incomplete contract theory as a cause of inferior performance (Shleifer 1998). The claim advanced is that State Owned Enterprises (SOEs) are run by self-serving bureaucrats, with incentives misaligned with efficiency goals. This is the principal-agent problem – owners and managers have different incentives. The logic advanced is that private ownership will have a greater 'preference' for profit and this will overcome the principal-agent problems by giving appropriate incentives to owners to run the business efficiently by minimising waste. However, if the owners and managers of the enterprise are different, the principal-agent problem may remain. There is no reason to assume improved incentives unless the owners also run the enterprise. The 'self-serving' bureaucrat is simply exchanged for a self-serving manager.

Public choice theory has been advanced as a rationale for, and an explanation of, the development of privatisation policies. Chicagoan public choice theory as developed by James Buchanan and Gordon Tullock (1962) argues that all parties to a decision (political and administrative) act from financial self-interest, thereby assuming that public servants and politicians will make decisions

[66] Florio argues that the theories came after the policies and sometimes 'betray a *post hoc ergo propter hoc* reasoning', Florio, M (p.46) The *post hoc ergo propter hoc* (after this therefore because of this) fallacy is based upon the mistaken notion that simply because one thing happens after another, the first event was a cause of the second event

[67] A public good can be defined as non-rival and non-excludable

based on their own self-interest rather than on the need for the enterprise to make a profit[68] or act efficiently. Virginian public choice theory sees privatisation driven by political, non-economic objectives such as the increase and widening of public share ownership and the reduction of state power.

However, Willner and Parker (2007) argue that the assumption, upon which most theoretical literature has been based, that individuals behave as a *homo economicus* in all their roles in society, cannot be applied to all situations and may not be useful in understanding non-commercial organisations or social institutions. Public choice literature, based on the assumption that public servants or politicians allow greed or laziness to dictate their decisions and overshadow market failures, implies a bias against public ownership and should be an empirical question (Wilner and Parker, 2007). While public servants may be imperfect welfare maximisers, this "does not make it meaningless to identify the scope for enlightened public intervention" (Wilner and Parker, 2007: 224).

Wilner and Parker further challenge the public choice argument proposed by Boycko et al (1996) that elections rather than ownership *per se* are the main sources of inefficiency, which would imply that public ownership would be more efficient in a dictatorship than in a democracy. Empirical evidence has shown the opposite to be true.

Furthermore, Parker (2003) argued that power of the argument for privatisation *"arguably depends on the efficiency of capital markets and the degree to which they constrain managerial (agent) behaviour"*.

Even if privatisation improves enterprise efficiency and profitability, the change may not necessarily benefit wider society or the consumer. There is a tension between the enterprise's need to maximize profits and the government' obligation to provide social support, the primary aim of which is to deliver affordability and quality of service to society. The SOE may have been pursuing functions other than economic efficiency. Universal access is one example. It may not be profitable for a private enterprise to supply a utility (e.g., telephony, water or electricity) to low population density areas, and in the absence of direct state provision such areas may be deprived of the service or forced to pay punitive prices. This has equity implications. The privatization of public services can therefore burden the public if services are removed or prices are increased.

Thus, the theoretical arguments on privatisation and ownership are inconclusive and contested.

Empirical Evidence

While theoretical arguments continue to evolve and become more sophisticated, conclusions drawn from the empirical literature remain equivocal. Although the literature shows that ownership matters, it is far from clear that private ownership is superior to public ownership. In fact, the level of competition has sometimes been shown to be a stronger determinant of better performance than ownership. It could be argued that further empirical studies are needed to address the equivocation in the theoretical literature. While some empirical studies covering large samples of enterprises in different countries have provided evidence of the better performance of privatised companies (see, for example, Megginson et al., 1994) other more in-depth country-based studies do not provide the same level of support for such arguments (see, for example, Martin and Parker, 1997).[69]

In a large-scale survey of the empirical literature on privatisation, Megginson and Netter (2001)

[68] Public choice models leave no room for altruism and assume that all human action is inherently selfish.

[69] (a)Megginson, W. L., Nash, R. C. and Van Randenborgh, M. (1994) 'The Financial and Operating Performance of Newly Privatized Firms: An International Empirical Analysis', The Journal of Finance, 49(2), 403–52; (b) Martin, S. and Parker, D. (1997) The Impact of Privatisation: Ownership and Corporate Performance in the UK, London: Routledge.

argued that research supports the theory that privately-owned firms are more efficient and more profitable than publically-owned firms. They argue that, although there is some limited evidence to suggest that measures such as price deregulation, market liberalization and increased use of incentives can improve the efficiency of a publically-owned firm, it is likely that privatising these firms would lead to greater efficiencies. ***"****We know that privatization 'works', in the sense that divested firms almost always become more efficient, more profitable, and financially healthier, and increase their capital investment spending."* **(**Megginson and Netter, 2001).

On the other hand, in a study on the UK experience of privatisation, Martin and Parker (1995) found that there was insufficient empirical evidence to support the theory that privatised firms are more efficient than public-owned firms, and consequently, this hypothesis was "difficult to sustain" (Martin and Parker, 1995).

Yarrow (1986) argues that the competitive environment in which a company operates is more important than ownership *per se*. According to Yarrow, the evidence suggests that those UK companies which were privatised and operated in a competitive environment saw improved performance following change in ownership. However, for those companies which were still operating in a monopoly, such as British Aerospace and British Gas, the benefits of privatisation were less clear. Indeed, cases where the regulatory environment had not been sufficiently strengthened prior to privatisation, (e.g. British Telecom and British Gas) were particularly worrying in terms of performance.

Yarrow argues that whether or not privatisation was beneficial to society depended on the *"trade-off between possible market failures due to a lack of competition and deficiencies in government control of public firms".* (Yarrow, 1986)

An examination of impact of privatisation on the efficiency of five of the largest Spanish state-owned companies found that improvements in efficiency were not related to the privatisation *per se* and that the *"question is not the dichotomy of public versus private provider but, rather, the economic conditions under which services are delivered."* (Bachiller 2009).

It has also been argued that greater access to capital following privatisation has an impact on performance. Knyazeva, Knyazeva and Stiglitz (2009) examined the influence of change in ownership in the context of access to external capital. They found that where a privatised firm, which has been previously constrained in terms of access to capital, gains access to credit following ownership reform, this will have a positive effect on its performance. However, when financial development, legal environment and prior borrowing constraints are taken into account, the privatised firms sample does not outperform the publically-owned sample.

Methodological issues in relation to measuring performance are also important when assessing State Owned Enterprises. The 'performance indicators' chosen in the literature are often standard financial indicators, such as measures of productivity and cost. Palcic and Reeves (2011) point to the inadequacy of financial indicators (e.g. turnover, profitability, return on capital employed) in assessing the performance of SOEs, as they do not asses non-profit objectives. Pestieau (1989) lists the objectives of SOEs as efficiency, equity, financial balance, and broader macroeconomic goals objectives which are sometimes conflicting. These conflicting objectives, and the use of SOEs as instruments of state policy, make performance assessment of SOEs problematic (Palcic and Reeves, 2011:32). The use of standard productivity measures, such as labour productivity and total factor productivity, which are price based, presents another problem, as SOEs often operate in non-competitive markets. These factors make comparisons with private sector firms difficult. Empirical studies present no definite consensus on the superiority of private versus public ownership. Factors including the degree of competition faced by a firm and the regulatory environment are generally far more important determinants of performance.

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