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Costly Business: Privatisation and exchequer finances in Ireland

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Introduction

In international terms, privatisation policies have been in vogue for over thirty years as governments around the world have adopted such policies in an effort to improve the delivery of public services. The term privatisation is sometimes used to loosely describe various measures adopted for the purpose of transferring functions previously fulfilled by the state to the private sector. These include the divestiture of state owned enterprises (SOEs) such as public utilities, the contracting out of public services (for example, local authority services such as street cleaning) and private sector participation in the provision of physical infrastructure and related services (for example, motorway concessions).

This paper concentrates on the sale of SOEs. By the turn of the century over one trillion dollars worth of SOEs had been sold into private ownership in industrialised, developing and emerging economies (Bortolotti and Siniscalco, 2004). In Europe alone almost US\$970 billion has been raised from the sale of SOEs between 1977 and 2008, with the majority of that revenue raised from the mid-1990s onwards.¹ Ireland has been part of this international trend and roughly half the stock of commercial SOEs in Ireland has been sold over the last twenty years raising over €8.3 billion for the Irish Exchequer.

The rationale for the privatisation of SOEs varies. In both emerging and developed economies privatisation has been central to measures aimed at reducing the overall level of state activity in the economy. In most circumstances privatisation has been promoted as a means of improving the productive efficiency of SOEs by exposing managers and employees to arguably stronger incentive structures under private ownership.

¹ Source: authors' own elaboration of *Privatization Barometer* data for the EU27.

Privatisation has also proved attractive to policy makers on the grounds that it presents a useful means of raising revenues for the Exchequer, particularly in times of fiscal pressures.

There is now a vast literature covering the degree to which privatisation policies have succeeded or failed in the pursuit of these objectives. This paper however focuses on the Exchequer related objectives of privatisation in the context of Ireland. In particular it examines the extent to which Irish governments have maximised the net proceeds from the divestiture of SOEs. Since cost minimisation represents the corollary of revenue maximisation, the paper focuses on the costs associated with privatisation in Ireland and examines the details and magnitude of these costs in an international comparative context.

The costs of privatisation: key issues and international experience

When SOES are privatised the return to the Exchequer depends on the price received for the company and the magnitude of the direct and indirect costs incurred. Indirect costs result from the underpricing of shares or the allocation of shares at preferential rates to employees whereas direct costs consist of promotion, advisory, investment banker, legal and accountancy fees. The nature and extent of these costs has received significant attention in the privatisation literature with critics of privatisation frequently drawing attention to the excessive nature of these costs (Martin, 1993) as well as the wider question of the involvement of large accountancy firms and banking interests in both policy formulation and policy implementation in the sphere of public service reform (Shaoul *et al.*, 2007). The following sections provide a fuller description of the direct and indirect costs incurred when privatising SOEs.

Underpricing and other indirect costs

The indirect costs of privatisation consist of the cost of underpricing, the granting of free or bonus shares to certain investors and other costs such as debt write-offs or indemnities.

By far the largest indirect cost related to most privatisations is the cost of underpricing. The vast majority of empirical studies on the costs associated with privatisation concentrate on this particular aspect rather than direct costs or other less significant costs. Most authors agree that the extent of undervaluation varies according to the method of sale and to the various underlying political and economic objectives of privatising governments.

In relation to share issue privatisations, whenever a company is new to the market and there are no comparable companies already trading on the stock exchange, underpricing is inevitable as all governments wish to avoid political loss of face and minimise the chances that individual investors will incur capital losses. Even when a company is not new to the market or there are comparable companies listed on the stock exchange, Vickers and Yarrow (1988: 171) claim some degree of underpricing is preferable for governments, since overpricing would leave the government with shares on their hands, applicants for shares would face losses and there would be general embarrassment for the government.

The question of whether share issue privatisations are characterised by excessive underpricing has received some attention in the privatisation literature. Dewenter and Malatesta (1997) provide one of the few in-depth studies into this issue. They explicitly compare privatisation initial public offerings (IPOs) with private company IPOs across 109 divestitures in eight countries. They conclude that there is no general tendency for governments to underprice IPOs to a greater extent than private issues. The exception to this general finding was the UK where, for larger privatisations, the existence of political objectives was found to have led to discounts far in excess of those in typical private issues in the UK.

Another standout feature of the UK privatisation programme in the 1980s was the decision to sell a number of SOEs in 'one go'. For example, large companies like British Gas and British Airways were sold all in one go, while half of British

Telecommunications (BT) was offered at the IPO stage in 1984. Buckland (1987), Vickers and Yarrow (1988) and Jenkinson and Mayer (1994) all argue that the methods of sale chosen by the UK government were seriously flawed and that selling a company's equity in several tranches is far superior to selling all the shares at once.² Although there is still the problem of setting the initial share price, 'once the first tranche is sold, a well-established market exists and further tranches can be priced with some accuracy' (Vickers and Yarrow, 1988: 184).

These claims are supported by the findings of Bel (1998), Huang and Levich (1999) and Jones *et al* (1999) in relation to the level of underpricing associated with privatisation IPOs and privatisation subsequent public offerings (SPOs). The results which are summarised in Table 1 clearly show that the average discounts related to the price of IPOs are considerably higher than the discounts related to the prices set for SPOs. For example, Bel (1998) finds that the average cost of underpricing for all Spanish share offerings was 3.4 per cent. Although the average discount for IPOs was found to be 14.4 per cent, most of the revenues from public offerings accrued from SPOs where the average discount was found to be just over 2 per cent.

This available evidence therefore indicates that selling shares in stages is likely to reduce the extent of underpricing when privatising SOEs.

Direct Costs

The direct costs associated with various privatisation programmes include the costs of promotion, professional and advisory fees, and underwriting fees. While the magnitude of such costs has typically not been as large as the cost of

² Indeed, Buckland (1987) estimates that the cost of underpricing associated with the sale of 50 per cent of BT alone amounted to some GBP£1.2 billion. The author claims that 'had 10 per cent of BT been sold at the quotation stage, at a (pessimistic) discount of 10 per cent, followed by further sales totalling 40 per cent at a (pessimistic) discount of 5 per cent on the same market price, discounting costs would have been GBP£924 millions lower' (Buckland, 1987: 247).

Table 1: *Average Underpricing in Privatisation Divestitures (Initial and Subsequent Public Offerings)*

<i>Authors</i>	<i>Year</i>	<i>Country</i>	<i>IPO</i>	<i>SPO</i>
			<i>Underpricing</i>	<i>Underpricing</i>
Buckland [†]	1987	UK	15.9	–
Vickers and Yarrow	1988	UK	18.4	–
Jenkinson and Mayer [†]	1988	UK / France	32.8 / 18.6	–
Dewenter and Malatesta	1997	8 countries	25.6	–
Bel	1998	Spain	14.4	2.1
Huang and Levich	1999	39 countries	32.1	7.17
Jones <i>et al</i>	1999	59 countries	34.1	9.4
Harris and Lye [†]	2001	Australia	13.66	

[†] Authors' own elaboration of results presented in each study.

underpricing, these costs can still result in significant reductions in revenues from privatisation.

A selection of the empirical evidence on the direct costs related to the sale of SOEs is summarised in Table 2. The findings in relation to the direct costs incurred as part of the UK's privatisation programme prior to 1988 differ slightly across studies. Both Buckland (1987) and Jenkinson and Mayer (1988) included every privatised SOE in the UK whereas Vickers and Yarrow (1988) only included the sale of major privatised companies. Buckland (1987) argues that costs were higher in the bigger issues as the government used them as a means of widening share ownership making them more expensive to market. The author claims that 'the attempt to market abnormally large proportions of large business' equity to a fragmented ownership is inevitably costly and adds to the picture of large-scale, avoidable costs of the policy' (1987: 250).

The fact that Vickers and Yarrow (1988) report higher average direct costs as a percentage of proceeds is thus understandable since they concentrate solely on large share issue privatisations. The authors note that in the case of the two most expensive asset sales in their analysis – BT and British Gas – the two largest components of expenses related to the sales were small

Table 2: *Empirical Evidence on Direct Costs*

<i>Authors</i>	<i>Year</i>	<i>Country</i>	<i>Direct Costs as a percentage of proceeds</i>
Buckland	1987	UK	4.20
Vickers and Yarrow [†]	1988	UK	5.18
Jenkinson and Mayer [†]	1988	UK	3.77
Bel	1998	Spain	4.00
Jones <i>et al</i> *	1999	59 countries	3.90
Harris and Lye [†]	2001	Australia	3.18

* Jones *et al* (1999) only report cost of underwriting as a percentage of the issue proceeds and do not include other expenses associated with the flotation process.

[†] Authors' own elaboration of results presented in each study.

shareholder incentives consisting of bill vouchers and bonus shares (totalling GBP£111 million in the case of BT and GBP£185 million in the case of British Gas) and the fees and commissions associated with the underwriting and placing of shares.³

Bel (1998) finds that the direct costs incurred in Spanish privatisations amounted to 4 per cent of total proceeds, with financial intermediary expenses such as underwriting fees accounting for the majority of direct costs. More recently, Harris and Lye (2001) in their study on the fiscal consequences of privatisation in Australia find that the direct costs of Australian privatisations amount to just over 3 per cent, suggesting that Australian sales were reasonably cost efficient in comparison to UK privatisation costs. However, it must be noted that some of the costs presented in their analysis are expected costs sourced from prospectuses and, as such, may be considerably understated.⁴ Buckland (1987), Vickers and Yarrow (1988) and

³ Their analysis, however, excludes the costs borne by the companies themselves, which were substantial in some cases. For example, BT is estimated to have spent over GBP£8 million in advisory fees and approximately GBP£25 million on its flotation advertising campaign (Vickers and Yarrow, 1988: 182).

⁴ Furthermore, the analysis of Harris and Lye (2001) does not include costs borne by the companies themselves during the process of sale and thus may be further understated.

Jenkinson and Mayer (1994) all point out that prospectuses released by companies being privatised tend to significantly underestimate the true costs of the privatisations.

In general, the largest portion of the direct costs incurred as part of privatisation in various countries relates to underwriting fees. Both Mayer and Meadowcroft (1985) and Vickers and Yarrow (1988) argue that there is no overriding reason why governments need to spend large amounts of money on underwriting fees. Governments do not face the cash flow constraints of a private firm. Private firms often depend critically on selling all of the shares being offered when raising funds or else they face becoming severely indebted. It thereby makes good sense for private firms to underwrite their issues. Governments face no such cash constraint as their borrowing powers can more than make up for any shortfall in share proceeds with ease. Secondly, governments are far more capable of bearing risk than private firms and, more specifically, underwriters.⁵

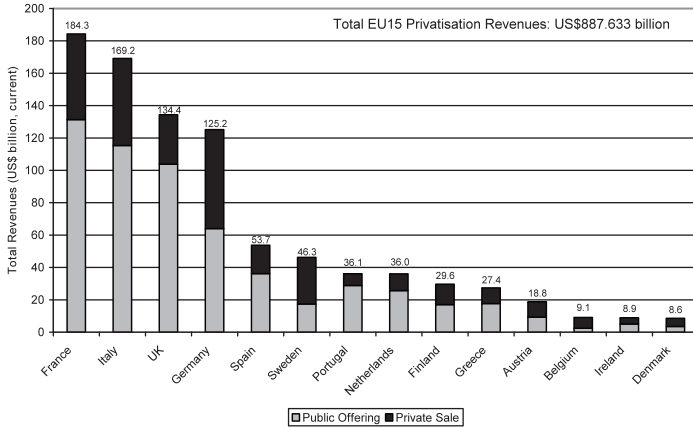
The preceding section highlights the importance of the issue of direct and indirect costs in terms of the objective of maximising the revenue accruing to the government. The underpricing of shares generally accounts for the majority of the costs incurred, however this can be viewed as a necessary sacrifice if widening share ownership is a key policy objective of a privatising government. The following section turns to the case of Ireland and examines the question of how the proceeds from privatisation have been diminished by direct and indirect costs as well as other factors such as employee share ownership programmes that are pertinent to the Irish case.

Privatisation and Exchequer Finances in Ireland

Figure 1 displays the total proceeds from privatisation accrued by each member of the EU-15 between 1977 and 2008. As

⁵ Harris and Lye (2001) corroborate this argument by pointing out that the costs of the sale of the Commonwealth Serum Laboratories (CSL) were substantially lower at 2.2 per cent than other Australian privatisations and this can be attributed to the fact that the sale was not underwritten.

Figure 1: *Privatisation Revenues by EU15 Country from 1977-2008*



Source: Author's elaboration of *Privatization Barometer* data. Note: (1) Luxembourg was not included given the small size of its economy and limited scope for privatisation; (2) *Privatization Barometer* data includes proceeds from both direct and indirect privatisations. In direct privatisations, where the government sells a partial or full shareholding in an SOE, the sales proceeds accrue directly to the Exchequer. In indirect privatisations, where for example an SOE or privatised SOE sells a subsidiary company, the proceeds accrue to the divesting company and not necessarily to the Exchequer. (3) The revenues above are expressed in current prices. When converted to constant prices, the UK privatisation programme is placed first since the majority of its divestitures took place during the 1980s and 1990s, whereas much of the revenue raised by France, Italy and Germany have stemmed from more recent sales.

expected, the four largest countries in the EU15, France, Germany, Italy and the UK have accrued the most revenue with public offerings of shares in their telecommunications and utility companies accounting for a significant amount of the revenue raised. Smaller countries such as Ireland, Denmark and Belgium have generated the least amount of revenue, with Belgium, Denmark and Sweden the only countries to have generated the majority of revenue from private sales rather than public offerings.

Since 1991 Ireland has privatised ten state-owned enterprises generating gross proceeds to the Exchequer of over €8.3 billion.

Although the number of enterprises sold and the Exchequer revenues raised are low by European and international standards, this largely reflects the size of the economy. It should also be noted that privatisation has had a significant effect in terms of reducing the extent of state activity in the direct provision of goods and services in strategically important sectors such as telecommunications and air transport as well as food and steel production.

A number of different methods have been adopted by the Irish state when divesting of its shareholdings. In the first two sales, those of Irish Life and Irish Sugar in 1991, the government floated majority shareholdings on the stock exchange by IPO. The remainder of its shareholdings were subsequently divested between 1993 and 1995 in seasoned public offerings where shares were placed with institutional investors. Shares were also sold by IPO in the case of Eircom and Aer Lingus. The sale of Eircom was the largest ever flotation on the Irish stock exchange with the government selling its remaining shareholding of 50.1 per cent in July 1999. All other privatisations were executed by trade sale with the three state owned banks (ACC, ICC and TSB), the shipping company B&I Line, Irish Steel and the Irish National Petroleum Company (INPC) all sold to going concerns.

Table 3 displays the actual proceeds that accrued to the Exchequer from the ten Irish privatisations to date as well as the direct costs associated with each sale. Direct costs consist of expenses such as advisory, advertising, legal and underwriting fees incurred by the government in order to prepare SOEs for divestiture. Table 3 shows that the direct costs incurred for Irish divestitures amounted to an aggregate of 1.43 per cent of gross proceeds. When compared with international experience outlined earlier in Table 2, the direct costs incurred in Ireland are comparatively low. However, it must be noted that the direct costs displayed in Table 3 exclude the costs incurred by the companies themselves. For instance, Aer Lingus itself is

estimated to have paid some €30 million in commissions, fees and expenses prior to flotation on the stock market in 2006.⁶

Table 3: *Exchequer Proceeds and Direct Costs in Ireland*

<i>Company</i>	<i>Year of Sale</i>	<i>Proceeds (€'000s) (1)</i>	<i>Expenses (€'000s) (2)</i>	<i>(2) as % of (1)</i>
Greencore	1991	210,650.8	1,726.84	0.82
Irish Life	1991	601,930.8	9,404.95	1.56
B&I	1992	10,792.8	—	—
Irish Steel	1996	0	655.68	—
Eircom	1999	6,399,907.9	97,642.86	1.53
ICC	2001	322,274.8	913.49	0.28
TSB	2001	408,350.3	460.66	0.11
INPC	2001	20,000.0	1,480.14	7.40
ACC	2002	154,603.0	1,159.48	0.75
Aer Lingus	2006	240,902.3	6,000.0	2.49
Total		8,369,412.7	119,444.11	1.43

Source: Author's own calculations from Exchequer Statements, Dáil Éireann reports and information requested from the Department of Finance. Notes: (1) TSB and ACC expenses include advisor fees for proposed TSB/ACC merger incurred between 1999 and 2000. Fifty per cent of the total fees of €621,346 was allocated to each company; (2) the table above details direct proceeds accruing to the Exchequer only. Indirect proceeds that accrued to the privatised company are excluded. For example, when Aer Lingus was floated on the stock exchange in 2006, the government allowed the airline to issue new shares which raised over €530 million for the company.

As noted earlier, the direct costs associated with share issue privatisations are generally higher than those incurred when other methods of sale are adopted. This difference can be attributed to the significant cost of underwriting large share issues. For example, in their empirical analysis of share issue privatisations internationally, Jones *et al* (1999) found that the average cost of underwriting as a percentage of the issue amount averaged 3.9 per cent. In the Irish case, the most expensive sale was that of Eircom in 1999, with over €74 million of the €97.6 million in direct costs incurred paid to Merrill Lynch/AIB who

⁶ Aer Lingus Prospectus, 2006.

coordinated and underwrote the IPO. As a percentage of the revenue raised from the IPO this amounted to approximately 1.77 per cent.⁷

An important question that arises is whether large underwriting fees incurred as part of the Eircom flotation, as well as the other three SOEs floated on the stock market, could have been avoided. As noted previously, in comparison to private sector firms, the government's superior capacity to bear risk and the fact that it faces a considerably lower cash flow constraint raises the question as to why it does not underwrite any issue itself? The issue of hiring a private sector underwriter becomes even more questionable when one considers the significant underpricing of shares that occurred during the IPOs of the four Irish SOEs floated to date.

Underpricing

An important set of indirect costs in the case of share issue privatisations concerns underpricing. Undervaluation of shares is calculated here as the difference between the IPO price and the share price after one days trading. This avoids the problems that can arise if later prices are used since they can be affected by news that could not have been taken into account at the time when the shares were originally priced. For example, three days after the flotation of Aer Lingus in 2006, Ryanair launched a surprise hostile takeover bid that valued shares approximately 27 per cent higher than the initial IPO price.

Table 4 demonstrates that the total cost of underpricing in the case of the four Irish public enterprises privatised by IPO amounts to almost €843 million. This figure equates to just over 16 per cent of the proceeds raised from share issue privatisations and almost 10.1 per cent of the total proceeds from the entire

⁷ This figure is based on the €4.2 billion raised by the government as part of the IPO. The total proceeds for the sale of Eircom, which are detailed in Table 1, also include payments received from the Comsource consortium and the ESOP for their respective stakes.

Irish privatisation programme, a substantial loss of revenue to the Exchequer. The level of discounting ranged from 4.38 per cent in the case of the IPO of Irish Life to 18.46 per cent in the case of Eircom. Although significant, especially in the case of Eircom, the discounts related to Irish IPOs have been relatively low when compared with the international empirical evidence outlined previously in Table 1.

The high cost of discounting in the case of Eircom (18.46 per cent) compared to Irish Life (3.6 per cent) and Greencore (8.29 per cent) is attributable to the method of sale chosen in each case. Contrary to indications given just months before flotation the government opted to float its entire 50.1 per cent stake in Eircom in one go. In contrast both Irish Life and Irish Sugar were sold in stages with an IPO establishing a market price which allowed subsequent placements of shares to be priced more accurately, thus reducing the size of discounts. The Irish experience is thus in line with the empirical evidence reviewed earlier where a number of authors argued that this approach to privatisation maximises exchequer proceeds.

In the most recent share issue privatisation, the government opted to retain approximately 28 per cent of its 85.1 per cent shareholding in Aer Lingus at the time of flotation. A valuation range for the airline was set between €2.10 and €2.70 with the government eventually opting to set the IPO price at the lower level of the range at €2.20. This was surprising given that the main objective of the flotation was to raise capital for the airline's future investment requirements. Although the underpricing from the first day's trading amounted to just under 11 per cent, Ryanair's hostile bid for the airline three days after the flotation valued Aer Lingus at €2.80 per share, indicating that the airline had been significantly undervalued.

Debt Write-offs

Direct costs incurred as part of the sales of public enterprises can also consist of debt write-offs and other financial undertakings on the part of the Exchequer in order to prepare a company for

Table 4: *Share Discounts in SOEs Privatised by Flotation in Ireland*

<i>Company</i>	<i>Offer Price</i> (€)	<i>Day 1 Price</i> (€)	<i>Share Discount</i> (%)	<i>Proceeds</i> (€m)	<i>Cost of Discount</i> (€m)	<i>Total cost as % gross proceeds</i>
Greencore I	2.92	3.25	11.30	80.019	9.042	—
Greencore II	3.36	3.52	4.70	41.913	1.970	—
Greencore III	3.49	3.75	7.27	88.719	6.450	—
				210.651	17.462	8.29
Irish Life I	2.03	2.12	4.38	343.337	15.038	—
Irish Life II	2.41	2.54	5.39	132.688	6.634	—
Irish Life III	2.73	2.73	0.00	125.906	0.00	—
				601.931	21.672	3.60
Eircom	3.90	4.62	18.46	4,212.215	777.575	—
Aer Lingus	2.20	2.44	10.91	240.902	26.282	—
<i>Total</i>				5,265.699	842.991	16.01

Source: Exchequer Statements, Irish Stock Exchange, Davy's Stockbrokers, Goodbody's Stockbrokers. Notes: (1) The Day 1 price quoted above for the second and third placements of shares in both Irish Life and Greencore relate to the closing price on the day *prior* to the placement of shares. (2) The total cost of discount in the case of Greencore and Irish Life excludes the cost of free shares granted to employees as well as the offer of further shares at a discount.⁸

divestiture. The sales of B&I, Irish Steel and the INPC all involved significant debt write-offs and the payment of other liabilities outstanding prior to being sold.

In the case of B&I Line, all of the company's substantial long term debt of over €44 million was written off prior to divestiture with the government claiming it was necessary in order for any bid for the company to be made. The rationale behind such a large write-off in conjunction with the low purchase price

⁸ Irish Sugar employees each received some €317 worth of free shares and the option of subscribing for 500 additional shares at a 20 per cent discount ('Irish Sugar employees to receive £250 in free shares', *Irish Times*, Thursday March 21, 1991). Beet growers were also offered shares at a 20 per cent discount as part of the Greencore IPO. Irish Life employees each received approximately €650 in free shares and priority access to a further small portion of shares where they received tax relief on the purchase ('Small investors take bulk of Irish Life public offering', *Irish Times*, Friday July 19, 1991).

ultimately accepted (€10.8 million) was questionable for a number of reasons:

- (1) the company had recently begun to turn itself around after implementing significant rationalisation measures and was projecting an operating profit of over €5 million before repayments on debt in the year of privatisation;
- (2) an accumulated €127 million in corporation tax losses would be transferred to the new owners which would enable them to avoid paying any corporation tax for a number of years;⁹
- (3) the new owners would have access to the surplus on B&I's pension fund which was over-funded by approximately €14 million;¹⁰ and
- (4) the Government had recently injected some €7.6 million into the B&I in preparation for privatisation which, in effect, represented an indirect debt write-off.

It was well known that the government had been conducting private negotiations with B&I's new owner, ICG, since 1990 and was very much in favour of an ICG takeover of B&I, especially given that ICG was an Irish operation. The €7.6 million cash injection into the company prior to divestiture was seen as a further incentive to facilitate an ICG bid for the company.¹¹

While the government's decision to sell B&I Line is understandable given the substantial capital injections it had made in the company since 1965, the timing of the company's sale makes little sense. Had the government written off B&I's debt and then let the company trade profitably without being hindered by debt repayments for a number of years, it could have established a solid trading record and would arguably have

⁹ Dáil Éireann, 'B & I Line Bill, 1991: Second Stage', 10 December, 1991.

¹⁰ Gallagher, J. (1991) 'ICG May Take Over B&I Before End of Year', *Irish Times*, August 23 1991.

¹¹ Dunne, J. (1990) 'Secret Shipping Merger Plan Shelved', *Irish Times*, March 14 1990.

attracted a significantly higher bid if sold.¹² Although it is difficult to estimate the true value of B&I, it is worth noting that ICG was trading at 8.8 times its pre-interest earnings at the end of 1990.¹³ Given that B&I had made an operating profit of €3.17 million in 1991 and was projecting profits of over €5 million in 1992 with further increases likely due to the implementation of more rationalisation measures, the company was arguably worth three to four times the €10.8 million received using even a conservative earnings multiplier.¹⁴

The sale of Irish Steel necessitated the write-off of €21.5 million in debt as well as the payment of approximately €25.7 million to the new owner, ISPAT, to cover various items such as interest charges on debt, environmental works, provision for expenses, indemnities and compensation for future restrictions on production.¹⁵ The rationale for the considerable debt write-off in this case is reasonable given the large losses accrued by the company and its poor performance record despite significant capital investment by the state in the years prior to privatisation. Although the government only received a nominal sale price of IRP£1,¹⁶ ISPAT took on the remaining debt of almost €25 million as part of the deal, as well as agreeing to invest €38 million over a five year period after privatisation.¹⁷ The sale of Irish Steel to ISPAT was arguably the best deal the government could have expected to achieve, saving the company from

¹² It is noteworthy that Irish Sugar had been a loss-maker up until 1986 but after returning to profitability in the four years prior to flotation and eliminating its accumulated losses, its sale generated significant revenues for the Exchequer.

¹³ Murdoch, B. (1990) 'State pulls the plug on B&I loss making', *Irish Times*, September 24 1990.

¹⁴ McGrath, B. (1991) 'B&I Line is going for a poor song', *Irish Times*, December 16 1991.

¹⁵ Over €9 million was paid to ISPAT by way of compensation for the future restrictions on production and sales imposed by the European Commission in return for state aid to be granted.

¹⁶ The fixed euro conversion rate for the Irish punt is IRP£1 = €1.2697381.

¹⁷ McGrath, B. (1995) 'Final agreement on Irish Steel sale concluded', *Irish Times*, September 2 1995.

probable liquidation and securing the future of the company for another five years.

The privatisation of the INPC¹⁸ involved a large debt write-off as well as an €83 million indemnity to cover any future environmental liabilities the new owners might incur due to pollution from the refinery and terminal operations. Prior to the sale of the INPC, the company had invested some €60 million in upgrading the Whitegate refinery in 1999 in order to meet EU Auto Oil 1 emission standards introduced in 2000. The debt associated with this investment was written off as part of the sale with the overall costs and write-offs of the assets and liabilities related to the sale amounting to €76 million. A total consideration of €47 million was received from the sale resulting in a net loss of €28.75 million (INPC Annual Report, 2001).¹⁹ The sale resulted in the cessation of most of the INPC's activities, however the INPC was still left with its outstanding debts after the sale with net debt standing at €54.464 million at the end of 2001.

The large write-off and indemnity granted as part of the sale of the INPC represented a very poor deal for the Exchequer, particularly given the fact that the company had only recently invested a considerable sum of money in upgrading its refining operations. The failure of the government to secure a better deal was highlighted at the beginning of 2007 when Conoco Phillips announced that it was putting the Whitegate refinery up for sale for approximately €350 million.²⁰ Although Conoco Phillips

¹⁸ The privatisation of the INPC had unique characteristics. Only the Whitegate refinery and Bantry terminal subsidiaries were divested in 2001. The INPC continues as an SOE with the principal activities of the company now reduced to the management of the national strategic stock of petroleum products. The costs and write-offs associated with the sale of the refinery and terminal operations and the creation of an employee share scheme were charged to the profit and loss account of the company and as such did not directly accrue to the Exchequer.

¹⁹ €98 million was also received in repayment of the intercompany balances of the two subsidiaries sold (INPC Annual Report, 2001).

²⁰ Hancock, C. (2001) 'Whitegate oil refinery needs \$400m investment', *Irish Times*, June 23 2007.

had invested in further upgrading of the facility since 2001, and in the end decided not to sell the refinery, the high value placed on the Whitegate facility calls into question why the government agreed a sale price of just €116 million for the refinery, while writing off much of the company's debts as well as guaranteeing future environmental liabilities.²¹

In the case of the ACC bank, the government also granted an indemnity of €12.7 million to new owners, Rabobank, to cover them from any potential liability that could have arisen from an ongoing legal case against the ACC.²² This represented a significant transfer of risk particularly given the low sale price ultimately agreed upon. Rabobank acquired the ACC for €165 million, equivalent to the ACC's book value at the end of 2000 but just 0.9 times the expected book value for the 2001 year-end. Although the bank made a loss in 2000 after being fined €21 million in relation to tax arrears, the ACC had improved its profitability significantly in the years leading up to its sale and one must question the rationale of the government in selling the bank at a 10 per cent discount when banks are generally sold at a premium. Indeed, the TSB had been sold to Irish Life and Permanent earlier in the year at 1.8 times its book value.²³ Moreover, when one considers that part of the proceeds to the Exchequer arising from the sale of the ACC were transferred to employees as part of the ESOP agreement, the deal represents a very poor return for the taxpayer.

The rationale behind privatising companies such as the B&I, Irish Steel and the INPC is understandable. However, the

²¹ The €116 million sale price accepted in 2001 also included the oil storage terminal operation at Whiddy Island in Bantry as well as an office block in Dublin.

²² The legal case against the ACC arose out of its involvement as the lead bank of a consortium of lenders in a Dublin city hotel development. The development ran over budget causing the banks to lose money and the ACC was subsequently sued by a number of banks involved in the consortium.

²³ McGrath, B. (2001) 'Dutch Rabobank pays €165m for ACCBank', *Irish Times*, December 6 2001.

government's failure to secure a better return for the Exchequer when selling the INPC and B&I resulted in significant losses for the Exchequer. Had the government allowed the B&I some time to operate without its crippling debt burden, the taxpayer would undoubtedly have recouped some of the investment that went into the company in the preceding twenty-five years. Similarly, in the case of the INPC, the failure of the government to negotiate a better deal, particularly given the substantial capital injections into the Whitegate refinery prior to divestiture, is open to legitimate criticism.

ESOPs

A distinguishing feature of the Irish privatisation programme since 1999 has been the transfer of significant shareholdings to employees as part of the privatisation process. These schemes are commonly referred to as Employee Share Ownership Plans (ESOPs) and are generally granted in return for a restructuring and rationalisation deal. As the conditions attached to ESOPs can involve allocating shares at less than their market value, this can reduce the revenues accruing to the Exchequer considerably.

The first privatisation involving the establishment of an ESOP was that of Eircom in 1999. Prior to the sale of Eircom, unions had been the biggest obstacle to privatisation and the negotiation of an ESOP was used to 'neutralise union opposition to privatisation by means of the substitution of employee participation in companies at board level with financial participation through Employee Share Ownership Plans' (Sweeney, 2004: 16).

In the case of the Eircom ESOP, employees negotiated a 14.9 stake in the company in exchange for a partnership agreement. Five per cent of the shares were granted in return for employees' acceptance of a rationalisation plan²⁴ with the remaining 9.9 per

²⁴ The plan consisted of 2,500 redundancies as well as other cost cutting measures over a period of five years.

cent of shares purchased by the ESOP at a preferential rate of €241 million which was determined by an independent valuation of the firm. As part of the partnership agreement, Eircom agreed to contribute €127 million²⁵ towards the cost of acquiring these shares with the remaining €114 million funded by the ESOP through a loan.

Table 5: *Cost of ESOPs in Irish privatisations*

<i>Company</i>	<i>14.9% Sold For (€'000s)</i>	<i>14.9% Value (€'000s)</i>	<i>Cost of ESOP (€'000s)</i>
Eircom	241,250	1,252,735	1,011,484
ICC	25,141	52,028	26,887
TSB	25,141	64,136	38,995
ACC	12,189	24,585	12,385
INPC	n/a	n/a	n/a
Aer Lingus	n/a	173,730	n/a
<i>Total</i>			<i>1,089,751</i>

Source: Author's own calculations from government publications. Notes: (1) in the case of the INPC, the company contributed €8.87 million to fund an Employee Share Scheme for employees transferred to the purchaser; (2) the Aer Lingus ESOP had been in existence for a number of years prior to privatisation and it was not possible to estimate the cost to the Exchequer.

Based on the proceeds from the sale of the government's 50.1 percent shareholding (which raised €4.2 billion), the 14.9 percent stake transferred to the ESOP was worth some €1.25 billion. The difference between the price paid by the ESOP for its shareholding and its actual value amounts to over €1.01 billion. The establishment of this ESOP set a precedent. Since the sale of Eircom, ESOPs of 14.9 per cent have been agreed in all bar one of the five subsequent divestitures. The costs of ESOPs are presented in Table 5. They are estimated to have cost the Exchequer almost €1.1 billion, which represents over 13 per cent of total privatisation proceeds.

²⁵ Eircom agreed to contribute €127 million in return for employees agreeing to contribute 5.3 per cent of their salaries towards their pension schemes which prior to then had been funded entirely by Eircom.

Conclusion

The privatisation of SOEs offers an attractive opportunity for governments to raise significant revenues for the Exchequer. This paper quantifies both the direct and indirect costs incurred in the execution of the ten divestitures in Ireland to date. Table 6 illustrates that these costs have amounted to over €2.14 billion, or 25.6 per cent of total exchequer proceeds. We find that, with the exception of Eircom, the level of underpricing and direct costs incurred have been modest compared to those in other industrialised countries. However, in the case of Eircom, which accounts for approximately 88 per cent of aggregate privatisation costs to date, these costs have been considerable.

We argue that the relatively high cost of underpricing in the case of Eircom can be largely attributed to the government's decision to sell its entire stake in Eircom in one go. In this regard the case of Eircom is an outlier in European comparative terms. In all other EU15 countries, national telecommunications companies have been sold by floating partial stakes on the stock market followed by the sales of further tranches.²⁶ As the majority of these sales preceded the flotation of Eircom the Irish government's decision to eschew the option of a staggered divestiture is particularly questionable.²⁷

A unique feature of the Eircom privatisation was the transfer of a 14.9 per cent shareholding to employees at a considerable discount. The cost of this discount amounted to over €1 billion in foregone revenue. It is striking that there was no international precedent for either establishing a structured ESOP as part of the privatisation process or for the transfer of a shareholding of such

²⁶ Italy is the only exception, with the Italian government opting to float its entire stake in the firm at the IPO stage. In every other country a partial stake was either floated on the stock market or placed with institutional investors, followed by subsequent sales of partial stakes. Moreover, many European governments still retain sizeable shareholdings in their national telecommunications operators.

²⁷ With the exception of Sweden, Belgium and Austria, all other national telecommunications operator flotations preceded the Eircom IPO.

Table 6: *Gross Proceeds and Total Costs (€millions)*

<i>Company</i>	<i>Gross Proceeds</i>	<i>Direct Costs (1)</i>	<i>Indirect Costs (2)</i>	<i>ESOPs (3)</i>	<i>Total 1+2+3</i>
Greencore	210.651	1.727	17.462	–	19.189
Irish Life	601.931	9.405	21.673	–	31.078
B&I	10.793	–	44.441	–	44.441
Irish Steel	0	0.656	47.328	–	47.984
Eircom	6,399.908	97.643	777.575	1,011.484	1,886.702
ICC	322.275	0.913	–	26.887	27.800
TSB	408.350	0.461	–	38.995	39.456
INPC	20.000	1.480	–	–	1.480
ACC	154.603	1.159	–	12.385	13.544
Aer Lingus	240.902	6.000	26.282	–	32.282
Total	8,369.413	119.444	934.761	1,089.751	2,143.956

Note: Indirect costs include the cost of underpricing and debt write-offs.

magnitude to employees. The establishment of the Eircom ESOP set a standard for all subsequent privatisations and ESOPs of 14.9 per cent are now the norm when Irish SOEs are privatised. Table 6 shows that the cost of ESOPs has constituted the most significant proportion of privatisation costs in sales subsequent to the Eircom IPO.

Once the decision is made to privatise a company, a number of important subsequent decisions arise in relation to the privatisation process. These include decisions in relation to the timing of the sale, the amount of shares to be sold, the pricing of shares and distributional issues such as preferential share allocations. This paper highlights a number of sub-optimal decisions concerning these issues in individual cases of privatisation in Ireland. Whereas the precedent-setting Eircom ESOP as well as the decision to sell the government's entire stake at the IPO stage dominate the aggregate costs incurred, the analysis also draws attention to debatable decisions in relation to debt write-offs (e.g. B&I Lines and INPC), indemnities granted (INPC and ACC) and the valuation of companies (B&I Lines, ACC and INPC).

Looking forward, it is important to note that the Irish state continues to hold majority shareholdings in enterprises operating in important sectors such as energy, transport and communications. The recent deterioration in the Irish public finances has prompted a number of calls for the privatisation of some of these enterprises. Although privatisation can raise useful revenues for the Exchequer in the short to medium term it cannot however be justified on this basis alone. The analysis provided in this paper shows that the revenues from such sales are rarely maximised as policymakers face a number of trade-offs when implementing privatisation policies. Balancing these trade-offs poses significant challenges and the analysis presented in this paper shows that Irish policymakers have much to learn from the privatisation programme to date.

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