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Commercial State-Sponsored Bodies

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[The commercial state-sponsored bodies comprise an important element of economic activity in Ireland. The Exchequer makes a substantial financial contribution to these bodies. In this article the author traces the origins and rationale of the commercial state bodies, examines their performance and discusses some major policy issues arising from their operations].

Introduction

The 'commercial state-sponsored bodies' (CSSBs) are companies that have diverse origins, objectives, capital structures and records of achievement and failure. Some of them are what are referred to as 'nationalised companies' in Britain, others are what are known as 'public utilities' in the United States.

In June 1983 the Oireachtas (Parliament) established a Joint Committee to 'examine the reports and accounts and overall operational results of state-sponsored bodies engaged in trading or commercial activities'. These bodies were specified in a Schedule of 25 companies. The wide range of state-sponsored economic activity in Ireland is evident from the fact that the CSSBs are a significant presence in all of the following sectors:

- Communications,
- Energy,
- Finance and Insurance,
- Industry,
- Services,
- Transport.

Aggregate employment by CSSBs was 81,000 in 1985, representing about 10 per cent of total non-agricultural employment. Their total turnover was £4,254 million and the value of capital employed was £6,485 million¹.

1. The statistics on the CSSBs have been taken from 'Analysis of Financial Position of Commercial State-Sponsored Bodies Based on Latest Published Accounts'. Fifth Report of the Oireachtas Committee on Commercial State-Sponsored Bodies, 1986, Pl. 4486.

The Exchequer's financial contribution to these bodies has been very substantial. The combined total of Exchequer equity and advances employed by them is £1,164 million. This represents over 6 per cent of total public debt. The net external liabilities of the CSSBs totalled £1,924 million at the end of 1985, representing 20 per cent of all external public debt. In recent years borrowing by these bodies has amounted to between 20 and 25 per cent of the Public Sector Borrowing Requirement. The state has guaranteed some £3,000 million long-term borrowing by these bodies.

Origins and
Rationale

The commercial state-sponsored bodies have various origins. No single economic rationale accounts for the state's participation in the wide range of activities now undertaken by them. The Electricity Supply Board was founded in 1927 following the state's financing of the Shannon hydro-electric scheme, as a way of maintaining public ownership of the electricity system under a board of management 'as independent of Parliament and the Government as far as that could reasonably be arranged'. This structure served as a prototype for the numerous state-sponsored entities established for various reasons in latter years. Bodies such as the Irish Sugar Company (1933), Aer Lingus (1936) and Bord na Móna (Peat Development Board) (1935) were set up to undertake major development projects that it was believed would not have been undertaken at all, or not on an appropriate scale, by private enterprise. Irish Shipping Limited was put together to acquire and maintain a merchant fleet during the war-time emergency. The Industrial Credit Corporation and the Agricultural Credit Corporation were founded to overcome the perceived imperfections of the capital markets facing Irish entrepreneurs and farmers. Nitrigin Eireann Teoranta, (the State Fertiliser Co.) came into existence in the 1960s after a long debate about the strategic economic importance of a domestic nitrogenous fertiliser industry. Coras Iompair Eireann (CIE, the State Transport Co.) is an amalgamation under state ownership of pre-existing private companies with a long and troubled history. The Irish National Petroleum Corporation was founded to maintain in operation a refinery that was being closed by private oil companies. Radio Telefis Eireann (RTE) grew from the state radio broadcasting service. The two newest bodies, Bord Telecom Eireann and An Post, were formed by hiving off the postal and telecommunications systems from the Government department that had been responsible for them since the foundation of the state. It has been proposed that the development and management of the state forests should similarly be transferred from the government department that is at present responsible for them to a new state-sponsored body.

Recent controversies about the role of CSSBs reveal that, whatever the original justification for their establishment, their day-to-day operation is influenced by a great variety of social and political, as well as commercial, considerations. It is clear that they are not expected, or even permitted, to act in a wholeheartedly commercial way. The original ideal of freeing them from day-to-day political pressures and interference was never attained, nor was the conflict between their 'commercial' and 'social' obligations resolved. This is clear from the fact that, in addition to the expectation that they provide services for social or strategic reasons as part of their overall mandate, they are also under pressure to generate, or at least sustain, employment in situations where this is not justified on commercial grounds. Moreover, the pricing policies of state companies supplying essential services have to be sensitive to political as well as commercial realities.

Performance

The general public tends to evaluate state companies primarily in terms of their ability to provide goods and services reliably, efficiently and at a reasonable price. Discontent is likely to be expressed about interruptions to supply, strikes, non-availability of service, low standards and high prices, rather than about financial measures of performance such as poor profitability or a low return on capital employed. It is, however, difficult to provide a systematic appraisal of the state sector on non-financial criteria. High levels of unionization may have contributed to a relatively high incidence of strikes in some companies, but this problem is by no means universal throughout the CSSBs. Some companies may have exploited their monopoly situation to the benefit of their employees at the expense of their customers. For example, the high cost of electricity in Ireland and of sea and air transport to Ireland has been laid at least in part at the door of the state companies responsible for providing these services. But many CSSBs are widely perceived as having a good record of service, efficiency and technical development. Indeed some of the companies that are criticised under one heading elicit praise under others. In the absence of a systematic and comprehensive evaluation, it is not possible to generalise about the performance of CSSBs as measured by these non-financial criteria, though the reports of the Oireachtas Committee on individual companies provide a valuable review of some of these issues.

The financial performance of the CSSBs, based on the data collected for the Oireachtas Committee in 1986, is summarized in Table A. In the aggregate they recorded a profit of £18.8 million before tax. This figure excludes Irish Life Assurance plc, for which the appro-

priate figure to include is not clear, but which is operating profitably. There is also a difficulty in the interpretation of the £6.8 million profit recorded for CIE in 1985, which reflects a change in accounting practice from previous years when it recorded a loss of over £100 million. (The new practice is to treat the loss attributable to certain services as a social cost borne by the Exchequer). Large losses were, however, recorded in several companies, of which the most significant are Bord Telecom Eireann (£24 million), the Electricity Supply Board (£27 million), Irish Steel Ltd. (£17 million), the Irish Sugar Co. (£6 million) and the B & I Line Ltd. (£30 million). Moreover, the profit of £94 million recorded by Bord Gais Eireann arises from the collection of the state's economic rent on a valuable natural resource. If this were excluded from the total, the CSSBs as a group would be shown to have turned in a loss of £75 million.

While the trading figures for any one year should not be taken as representative of the long-run contribution of these bodies to the economy, it is clear from this summary that by the simplest financial criterion the CSSBs as a whole are not performing well. This is even clearer when the profit and loss figures are related to the enormous asset base employed by these companies. The weak financial position of many CSSBs is only fully revealed, however, when the effect of accumulated losses on their balance sheets is considered. In 1985 the aggregate of the profit and loss reserves of the CSSBs was a deficit of £470 million. The impact of these losses on the companies' net worth is in several cases devastating. For the companies in the industrial and transport sectors as a group, shareholders' equity of £386 million has been completely eroded by accumulated losses of £398 million.

Another criterion used by financial analysts is the ratio of current assets to current liabilities. For liquidity reasons, it is desirable that this ratio should be high: a target of 2 to 1 is often given. Few of the CSSBs achieve this target. According to the returns obtained by the Oireachtas Committee, eight of them are actually in a net current liability position. (The practice of converting short-term loans into long-term borrowings leads to an understatement of the extent of this problem).

It is therefore clear that, by any of the criteria conventionally applied to commercial companies, the CSSBs are not healthy. One explanation frequently advanced by these bodies for their poor performance by normal financial criteria is their unusual financial structure. Long-term borrowings (exclusive of Exchequer advances)

amount to 53.5 per cent of the total capital employed by CSSBs. For the bodies in the Communications, Energy and Industrial sectors, borrowings amount to 75 per cent of capital employed. Most of the loss-making companies return an operating profit (that is, before interest charges are taken into account). The problem of meeting heavy interest payments even before they started trading has contributed to their accumulated losses. From this it may be argued that the state should inject more equity into their balance sheets, thereby giving them a fairer chance of realising their potential profitability.

The validity of this argument is questionable. It implies, contrary to modern thinking on corporate finance, that the value of a company is affected by its capital structure. It suggests that equity capital has a lower opportunity cost than debt. In fact the record of the CSSBs with regard to payment of dividends to the state has been dismal: only the Industrial Credit Corporation and Irish Life have paid regular dividends. The idea that the Exchequer should be willing to provide funds for enterprises that are supposedly commercial without anticipating at least the same return as can be obtained from risk-free investments is difficult to accept.

Subsidiary Activities

Over the years several CSSBs have become involved in activities that are quite far removed from the purpose for which they were originally established. The Sugar Company has diversified into other types of food production. Aer Lingus owns and operates a large chain of international hotels. Radio Telefis Eireann has acquired a major cable television distribution network. In some of these cases, the subsidiary activity has proved more profitable than the core business. In others, diversification has had to be cross-subsidised by the parent company.

The controversies that have arisen relating to the appropriateness of diversification illustrate the lack of clarity that exists regarding the mandate of the CSSBs. On the one hand, it could be argued that, if they can identify profitable investment opportunities, they should be free to exploit them regardless of their original mandate. It may be that diversification in a manner not foreseen at the time the company was established has become a logical development, even a prerequisite for operating the core business successfully. (The link between international hotel ownership and airline operation may be an example). On the other hand, it can be objected that it is not appropriate for a company enjoying the privileges of state sponsorship to pre-empt opportunities that would have been taken up by private entrepreneurs. The difficulty of deciding the

merits of individual cases illustrates the absence of a clear rationale for the involvement of the state in commercial activities in the first instance.

Future Policy

The National Planning Board's "*Proposals for Plan 1984-87*"² contains a comprehensive review of the policy issues arising in relation to the CSSBs. The Board's views may be summarised in the following terms:

1. Where CSSBs are insulated from the full effect of market forces, a number of proxies for market forces should be used to guide and evaluate their future performance. Among the possibilities are:
 - i. *Borrowing limits.* The total amount that a company can borrow during a year should be agreed in consultation with the relevant government department. This would replace the present practice of giving approval to borrowing as the need arises.
 - ii. *Investment criteria.* Proposed investments by CSSBs should be evaluated using a standard project appraisal methodology. Only projects that can meet the target rate of return equal to the cost of the funds to the Exchequer plus five per cent should be approved.
 - iii. *Pricing policy.* The goal should be to bring the prices of the goods and services provided by CSSBs into line with the prices prevailing in other countries, especially in the EEC.
2. Wide use should be made of performance indicators, comparing the company with its foreign counterparts in terms of productivity, costs, manning levels, etc. Indicators of customer satisfaction, reliability of service and quality of output should also be developed.
3. *Contract payments.* The non-commercial nature of some of the functions of CSSBs should be recognised explicitly. The present practice of cross-subsidising loss-making social activities from profitable commercial ones should be discontinued. Instead, agreement should be reached on the cost of providing certain inherently unprofitable services and a contractual payment made by the Exchequer to the appropriate body. The decision to provide the service should be made explicitly by the Government and reviewed periodically in relation to its cost.

2. Prl. 2309. Stationery Office, Dublin.

4. *Restructuring Balance Sheets.* The Board reviewed the question of how to deal with companies that are so heavily indebted that their prospects of returning to profitability are slight. It was recommended that, in cases where an assessment showed that certain activities would not be able to service the associated capital liabilities (taking account of any proposed Exchequer payment for the social element in these services), then the activity should be discontinued and the cost of servicing the liabilities associated with it should be assumed by the Exchequer. Further conversion of debt to equity was not, however, recommended on the grounds that equity is not free capital. The practice of injecting equity into CSSBs was not favoured because it concealed, rather than acknowledged, past investment errors and avoided writing-off those capital liabilities that could no longer be serviced.

5. The relevant Minister should hold the chairman and board of state-sponsored bodies responsible for achieving the objectives specified above. This responsibility, and the expertise required to discharge it, should be borne in mind in making appointments.

These recommendations seem to have gained fairly wide acceptance. Many of them were explicitly endorsed in *"Building on Reality" 1985-1987*³. It is too soon to judge whether their publication marks a turning point in policy towards CSSBs. However, the closure of Irish Shipping Ltd. in 1985 was without precedent and has changed the climate in which similar bodies are now operating.

Although the Planning Board's review is the best available summary of current thinking with regard to CSSBs, some questions can be raised about specific recommendations. For example, it is doubtful that the use of borrowing limits would have the major impact envisaged by the Planning Board. After all, the present virtual insolvency of many CSSBs has arisen despite the necessity of obtaining departmental approval for borrowing. The ability of government departments to enforce a borrowing limit agreed at the beginning of a year may be doubted. Unforeseen events could repeatedly produce a choice between liquidating a company or violating the borrowing limits. The fundamental problem would remain: Government departments, rather than financial markets, have been made responsible for allocating funds to activities that are supposed to be commercial.

The proposed investment criteria could not be implemented without
3. PI. 2648. Stationery Office, Dublin.

further clarification. Should there be an agreed set of assumptions on the level of interest rates, inflation, economic growth and exchange rates, to be used in all public sector project appraisals? In the absence of such agreement, project appraisals could be prepared that rely on excessively optimistic assumptions to produce the target rate of return. This in fact is what occurred in respect of some of the more egregious investment errors by CSSBs in the past. Moreover, it should be borne in mind that, other things being equal, the mix of equity and borrowing used to finance a project has a major impact on the rate of return on borrowed funds: the higher the proportion of debt the more difficult it is to reach the target rate of return. It would be helpful to employ the debt/equity ratio that is 'normal' in the relevant sector as a benchmark in deciding how to finance new projects and in evaluating the return on funds allocated to them.

A more general criticism of the National Planning Board's recommendations is that they may have too readily accepted the framework of the existing involvement of the state in economic activities. Technology, capital markets, the supply of entrepreneurship and attitudes towards state activity have changed dramatically since most CSSBs were established in Ireland. In the 1930s it was plausible to argue that, if the state had not undertaken radio broadcasting or sugar production or the provision of industrial credit, worthwhile employment and profit opportunities would have been missed. As a result of the changes that have occurred since then, however, the preserves of several important state industries have been invaded by new entrants, even when this was in defiance of the law. The growth of competition in radio broadcasting, inter-city bus and international air transport are the most obvious manifestations of a trend that appears to be gathering momentum. A desire to increase efficiency by promoting competition has led to the deregulation of many sectors that were previously tightly controlled by the state in North America and Europe. In this climate of opinion, the rationale for state monopolies of services of a commercial nature is coming under increasingly critical scrutiny in Ireland.

Another factor that is likely to influence policy towards Irish state-sponsored bodies is the international movement to privatise state-owned assets. Various motives lie behind this policy. Provided it avoids simply replacing public monopolies with private ones, it is complementary to the move towards deregulation. Public flotations of state-owned companies may also be used as a means of achieving widespread ownership of share capital. But the argument that might be most compelling in the Irish case is the opportunity that the sale

of publicly-owned assets could offer to reduce the level of public sector indebtedness. The merits of this strategy have not yet been widely debated, although the issue has been raised in the context of policy towards state-owned forestry. In view of the intractability of the public sector's financial problems, any option that appears to offer some prospect of relief will not be ignored indefinitely.

For all these reasons, it is likely that in the years ahead some fundamental rethinking of the role and functions of commercial state sponsored bodies will take place. In the interim, the guidelines laid down by the National Planning Board should be followed. The future of the state-sponsored companies depends on the successful implementation of the Board's recommendations.

TABLE A
Principal Commercial State-Sponsored Bodies
Analysis of Accounts, 1986

Company	Exchequer		Reserves		Total Borrowings (Liabilities)	Net Current		Turnover or Income	P & L	
	Equity £m	Advances £m	P & L £m	Assets £m		Income £m	Before Tax £m		Employed £m	
Bord Telecom Eireann	335.3	--	(107.0)	943.6	(111.2)	467.1	(24.3)	15,850		
An Post	44.4	--	(2.2)	--	(6.5)	167.2	(1.8)	11,948		
Radio Telefis Eireann	0.25	19.6	1.05	2.0	(10.7)	84.8	0.4	2,367		
Bord na Mona	--	30.8	67.7	105.6	48.7	110.6	5.3	5,694		
Electricity Supply Board	--	36.1	(64.4)	1,143.3	77.5	726.6	(27.0)	12,454		
Bord Gais Eireann	--	--	45.4	48.4	5.5	197.4	93.8	221		
Agricultural Credit Corp.	20.0	2.4	7.1	103.9	N/A	81.4	0.4	479		
Industrial Credit Corp.	8.8	31.7	20.8	444.7	73.2	63.7	2.8	336		
Irish Life Assurance Co.	0.45	--	1.4	132.2	256.1†	472.3	N/A	1,552		
Irish Steel Ltd.	119.0	--	(90.8)	37.7	19.5	49.4	(17.5)	637		
NET	77.5	1.4	(148.1)	140.7	(10.5)	111.5	4.8	715		
Irish Sugar Co.	56.5	--	(42.5)	54.0	37.0	201.2	(6.28)	2,522		
Aer Rianta	0.05	--	--	--	6.04	83.5	11.5	1,769		
Voluntary Health Ins. Board	--	--	27.5	--	24.2	99.8	8.8	282		
Aer Lingus	73.6	--	25.2	118.3	32.4	536.5	18.2	5,976		
B & I Line	59.5	--	(90.2)	23.0	(32.5)	100.1	(29.6)	1,829		
Coras Iompair Eireann	--	54.3	(52.0)	170.1	(30.8)	324.6	6.8	15,628		
TOTAL*	801.3	362.8	(470.5)	3,471.1	372.5	4,254.3	18.8	80,948		

* Including smaller bodies not contained in Table. † See comment in text.

Source: Oireachtas Joint Committee on Commercial State-Sponsored Bodies, Fifth Report, 1986. (Pl.4486).