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SINKING THE MYTHS: PRIVATISATION, B&I LINE, AND IRISH FERRIES

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Attitudes concerning the optimum degree of government intervention in an economy have evolved over time. Paul Sammon illustrates the failures of state intervention in the shipping industry by following the story of Irish Ferries from being an exchequer burden under public ownership to commercial success as a private company. After careful consideration Paul concludes that although the market system led to the displacement of Irish workers this outcome was in the best interests of a growth economy.

Introduction

Over two centuries after Smith had written his seminal work, market capitalism remains under a shadow of doubt in some sectors of the Irish economy. It is thought that the market system systematically fails and that government interference is warranted. This view is nowhere more prevalent than in the transport sector. Despite the successes of privatisation and deregulation, most notably in the airline and taxi markets, there remain gaps in the public perception of private ownership and competition.

Such gaps were evident at the end of 2005 when Irish Ferries announced changes in employment conditions, redundancies, and an expansion of employment of workers from Eastern Europe. Irish Ferries were condemned as greedy capitalists exploiting hard-working labourers. The truth is that their reactions were those of a dynamic company responding to market conditions, and making the painful decisions necessary to guarantee its long term viability.

Such responsiveness is due to the fact that the company is in private hands. When Irish Ferries was a publicly owned company (known as B&I Line) it was a bloated Leviathan; an ineffective and inefficient drain on public finances. This essay will track the evolution of the company from its initial purchase by the state in 1965 up to the present day. Firstly, the shipping industry in general will be examined. Part of the reason for the nationalisation of 1965 was that it was thought that the industry was not competitive, and thus government intervention was required. This essay will,

using the Theory of Contestable Markets, show that this was not the case. Then, the dismal performance of the B&I Line will be shown and explored, with reference to the theoretical debate on State-Owned Enterprises (SOEs). Finally, B&I's performance will be contrasted with the successes of Irish Ferries after its privatisation in 1992. Lack of political interference and the discipline of the market will be shown as being instrumental in its success. The essay will conclude that the controversy at the end of 2005 was symptomatic of competition inducing a race to the top, and not to the bottom. I begin by looking at the nature of the shipping industry.

Baumol, Contestable Markets, and the Shipping Industry

The B&I Line was bought from Coast Lines Ltd. in 1965 for £3.6m. For many in the Irish government at the time of the acquisition of B&I line, it was in the strategic interests of the country to own and control its own maritime fleet. It was thought, like so many other transport sectors, that left to itself the market would seriously under-invest in the industry (Barrett, 1990). It was thought that increasing returns to scale were a characteristic of the industry, perhaps leading to a monopoly being formed which would produce too little output, at too high a price.

Herein lies the gap in political considerations of the role of the market in such a case. For, according to Baumol (1982), even if monopoly power could be exerted in the market, incumbents act 'as if' they were in a perfectly competitive situation. This is the conclusion of the Theory of Contestable Markets. Necessary conditions for contestable markets are:

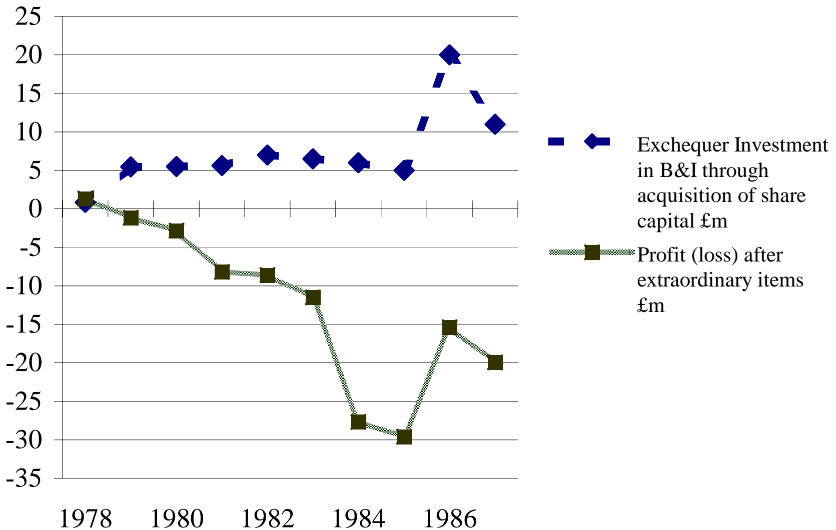
i. Entrant and incumbent are symmetric: They are subject to the same regulations, have access to the same technology, and have similar outputs;
ii. Sunk costs are low: Sunk costs represent a barrier to exit. Thus, capital employed should be reusable, resalable, rentable, or movable (Davis, 1986)
iii. Freedom exists to woo incumbent customers: So, predatory pricing policies must be absent.

The result is a contestable market wherein price approaches long-run marginal cost, and supernormal profits are absent. Otherwise, the industry would be subject to hit-and-run entry; large scale entry; and entry-nullified monopolies/dominance. According to Baumol (1982), even if a history of frequent entry does not exist, a consequence of competitive pricing means that this implies a lack of profitable entry, and few firms may be "a symptom of virtue, not vice." (Baumol, 1982:1)

Davis (1986) shows the conditions necessary for a contestable market hold in the shipping industry in general. In an Irish context, the Larne shipping routes were used by numerous companies, and competition successfully operated without government intervention (Barrett, 1990). However, it would appear that such *bona fida* theory credentials, industry application, and empirical proof were altogether about 20 years too late for the Irish Government. Maybe, had Baumol been around in 1965, he could have convinced those in power to let the market work. With it, he could have prevented B&I Line from being an albatross around the country's neck for over 25 years.

B&I: Bloated and Incompetent

Figure 1: B&I Line's Performance In the 1980s



Source: B&I Accounts; Joint Committee: 3rd Report

When the government bought Coast Lines in 1965 to form B&I Line, major investments were required to expand and refit what was an aged and decrepit fleet. The company was bought during the "Age of Administrative Planning"

(Button & Gillingwater, 1986) when efficiency was linked to integration and coordination, rather than allocative efficiency. This is reflected in the company's corporate objective which stated that B&I Line was "to provide and develop a modern, efficient, profitable, national and comprehensive surface transport system to and from Ireland", but that this was also subject to a "social obligation to the community" (Joint Committee: 2nd Report, 1978). It was to be an "efficient monopoly", to use Garrett FitzGerald's famous oxymoron.

And so the government let flow a stream of funds into B&I Line, which would in time turn into a cascade. Between the years 1965 and 1992, the government invested a total of £142.5m (€180.9m) in share capital in B&I Line. The fleet was upgraded, and new vessels purchased. By the end of the seventies, after a decade of losses, the company turned its first profit. The figures thereafter, though, tell a very different story.

As can be seen from Figure 1, even with continuous injections of exchequer funds into the company, it performed dismally throughout the 1980s. The figures are astounding:

> Despite operating receipts increasing tenfold between 1965 and 1978 (from £4.3m to £42m), the company yielded a loss or insignificant profit in each year. By 1978, it had an aggregate loss of £0.2m (€0.25m) (Joint committee: 2nd Report, 1978);
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> 1978-87 saw the Exchequer invest a total of £72.9m in the company through acquisition of share capital. But at the end of this period, it had accumulated a loss of £125.5m (€159.5m) (Joint Committee: 3rd Report, 1988);
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> By the end of 1991, this figure had grown to £134.4m (€170.7m), representing an average annual loss of €9.1m inflated to 2005 values.

But what explains such catastrophic figures? The main reasons for the failure of SOEs in general, and B&I Line in particular, are as follows:

Political Pressure: Since public firms are controlled by the government, it is inevitable that they will be held responsible for all major (and minor) decisions. Thus, the company's management will be influenced and second-guessed by the government, in order to achieve political or social goals. For example, when B&I tried to end the loss the loss-making Cork-Pembroke service in 1983, the government prevailed in preventing them (Joint Committee: 3rd Report, 1988).

Weak Management and Strong Trade Unions: According to Barrett appointments to SOEs were based on "political loyalty rather than commercial ability" which ultimately "undermined the quality of board members." The result, he continues, was that "with weak management and

politically appointed boards, the commercial state enterprises were captured by public sector trade unions" (Barrett, 2003:4). As a result, labour costs per employee increased 16% in real terms between 1979 and 1984 alone (Barrett, 1990).

Soft Budget Constraint: The availability of government finances exacerbated the problems at B&I. Since the threat of bankruptcy didn't exist, the market was prevented from disciplining the company. The result was over-investments and over-staffing (Joint committee: 3rd Report, 1988).

Principal-Agent Problem: In a private enterprise, the principal is the shareholder, and the agents are the directors. The shareholder has power of exit as well as voice (Robinson, 2003). For a SOE, the public in general is the principal. The public lacks the power of exit, and relies on a complex array of agents to act for them.

Altogether, these factors contributed in making B&I the fat, unresponsive Leviathan it was. In 1987, the company revealed plans to restructure, and to layoff workers. This helped to reduce the company's loss to €1.5m in 1988 (Arthur Andersen, 1992). However, B&I's problems ran much deeper. Between 1985 and 1989, turnover had fallen by 45% in real terms. Even after restructuring, it couldn't control staff costs, which rose by 11% in the years 1988-90 despite the number of staff falling by 8% in those years (ibid). By 1990, its loss had widened again to €3.6m. It had a capital deficiency of £26.5m and a fleet of only two ships (Barrett, 2003). It was effectively insolvent, and dependent on government subventions. Its service remained dire, with management indifferent to consumers. It continued to have a high-cost base, which was imposing further high costs on the economy as a whole (ibid).

By 1990, the government at last saw change was necessary, with the privatisation of B&I seen as being the best solution to cure the ills of the company. In the next section, reasons for the privatisation will be examined, before looking at the theoretical basis for private control, and the eventual success of B&I as Irish Ferries.

Plotting a Course to Profitability: Privatisation and ICG

The privatisation of B&I in 1992 was the result of 3 major changes during the 1980s. Firstly, internationally, the "Age of Contestability" had begun, according to Button and Gillingwater (1986). It was brought about by a changing political philosophy, especially in the US and UK. It was an era wherein deregulation and the reapplication of the concept of allocative efficiency reigned, especially in the transport sector. Barriers to entry or exit were seen as contrary to a redefined concept of the public interest. Instead of

the state protecting the public through regulation and planned competition, the public interest was pursued through creating the conditions necessary for efficient transport operations (ibid). The impact of airline deregulation in 1986 "provided a clear demonstration of the potential benefits of competition to all consumers in Ireland, having a significant effect on public opinion" (Barrett, 2003).

This fed into a changing economic and political climate in Ireland. National debt and unemployment had been rising for much of the decade, and a reassessment of economic policies in general occurred. In October 1990, the Minister for Tourism and Transport told the Dáil that he had commissioned consultants "to recommend the best and most economic means of terminating Exchequer support for the B&I line at the earliest possible time" (Dáil Papers, 1990. 402), and that "the *status quo* cannot be allowed to continue" (ibid). In 1991, the consultants reported that disposal of the company was the best option, with Irish Continental Group's (ICG) bid of £8.5m eventually succeeding. But why would ICG be more successful than the government at running B&I?

Privatisation in Theory

For Vickers (1997), the basis for the success of privatisation is that it changes the nature of the Principal-Agent relationship. Firstly, the principals (and hence their objectives) are changed. Managers are freed from political intervention and bureaucratic constraints. The discipline of the stock market brings about allocative efficiency; objectives which divert from this no longer exist. Also, the agents are changed. As shareholders in the company, they now have an "incentive to monitor the behaviour of managers/employees so that they tend to supply what consumers demand and do so in a cost effective manner" (Hanke, 1987:976).

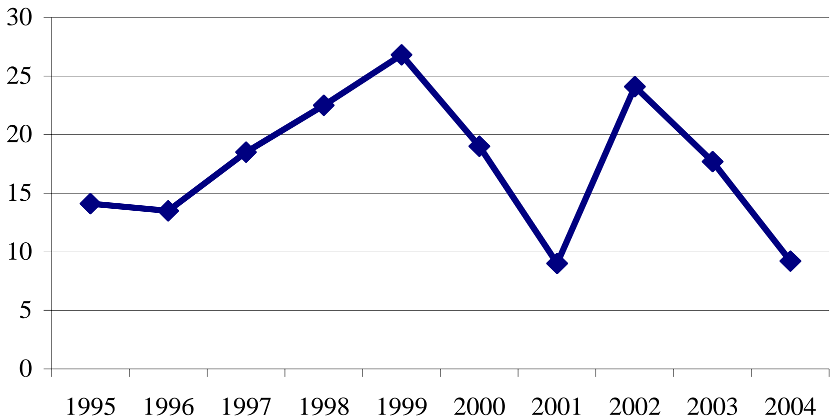
Ultimately, "competitive processes can be set in train which will have efficiency advantages and bring benefits to consumers" (Robinson, 2003). Competitive markets give consumers the power of exit. So, there is constant pressure on producers to set higher standards which competitors must try to emulate. What results is "a race to the top" (ibid). However, is this *ex ante* evaluation of privatisation borne out by the *ex post* experiences of Irish Ferries under ICG?

Privatisation in Practice

Upon acquiring B&I Line, ICG began a process of restructuring and change in the company. It was divided into three separate operating divisions, to enhance efficiency. None of the existing directors were retained. The company made a large number of redundancies as part of their cost-cutting drive. Finally, ICG revealed they had an overall plan for B&I to "enhance customer service, provide long-term employment for its staff, and ensure a reasonable return to its shareholders", (ICG, 2005b). These new priorities are in line with Vickers' (1997) predictions above.

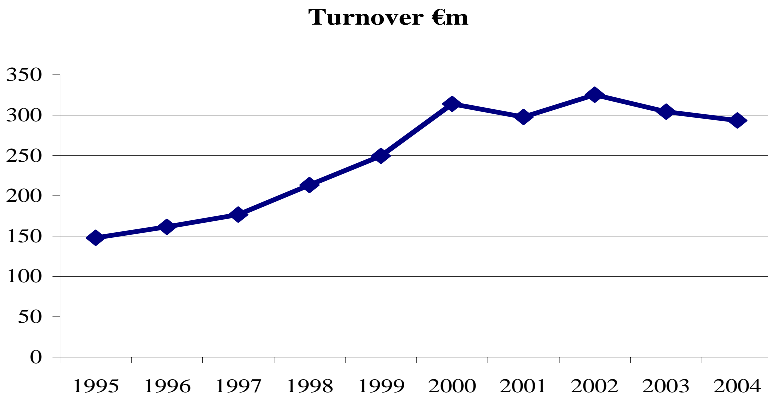
The modernisation was accompanied by significant investments also. Old ships were sold-off or chartered to other companies. Meanwhile, new 'super-ferries' were bought including the £46m (€58.4m) Isle of Innisfree in 1995, and the €100m (€127m) M.V.Ulysses in 2001, which at 50,000 tonnes, remains the world's largest passenger/RoRo[1] ferry.

Such re-organisation, investments, and also a new competitive tariff structure helped make the company consistently profitable for the first time.



Sources: ICG Annual Accounts, 2000-2004

In 1990, the profits of ICG were £2.3m (€2.92m), and the losses at B&I were £3.4m (€4.3m) (Barrett, 2003). As evident from Figure 2, by 1995, profits at ICG incorporating Irish Ferries had risen to in excess of €14m, rising to almost €27m in 1999. The sharp decline in 2001 may be attributed to the government actively discouraging passage to the UK on account of Foot and Mouth Disease. Also, 2001 was a 14-month financial year for the company, in order to bring it in line with the calendar year, resulting in the traditionally loss-making months of November and December being included twice.£3.4m (€4.3m) (Barrett, 2003). As evident from Figure 2, by 1995, profits at ICG incorporating Irish Ferries.



Sources: ICG Annual Accounts, 2000-2004

Figure 3 shows how the company managed to increase turnover rapidly up to 2000, despite rising fuel costs, and intensive competition from cheap airlines. Between 1996 and 2002, Irish Ferries increased its market share in the Irish Sea by 27% for tourist cars, and by 32% for freight (Competition Commission, 2004), implying that its increased turnover was not merely the result of the rise of Ireland's export-orientated growth. Furthermore, Irish Ferries was awarded "Best Ferry" award for the eighth successive year in 2004 by Irish Travel Trade, indicative of its success in providing a customer-orientated service.

[1] Roll-on/Roll-off

Privatisation *in Excelsis*

Despite these successes, from 2003/4 Irish Ferries' financial position started to deteriorate as evident from Figure 2. Its Return on Capital Employed (RoCE) was trending downwards from 9.8% in 2002, to 7.4% in 2003, 5% in 2005, and predicted to be 1.2% in 2007, when the rate of profitability necessary to allow the business to recover and renew its assets (ships) is 15% RoCE per annum (Labour Court, 2005). They faced unprecedented adverse trading conditions with fuel costs increasing by 85% between 2004 and 2006 (ICG, 2005b). The car ferry market was in retreat generally with a 10% decline from 2003-2005 resulting in the closure of Irish Sea Express (150 jobs lost), the ending of 5 P&O Ferries routes from Ireland (1200 redundancies), and 2 Seacat routes (ibid).

Furthermore, given the international character of the industry, most of the company's competitors had a significant cost advantage since they had outsourced crews. P&O, for example, operated six vessels on the Irish Sea, all of them registered in the Bahamas, while Swansea-Cork Ferries' ship sailed under the flag of St Vincent and Grenadines, allowing each to pay wages far less than Irish Ferries'. Stena, another shipping stalwart, admitted that the profitability of its ferry operations was minimal due to intense pricing pressure on fares and high operating costs (Gill 2005). According to ICG (2005b), without change, a loss was forecasted by the end of 2007.

At this point, the supremacy of privatisation and competition became apparent. Irish Ferries responded to market conditions and the signal of faltering profits to restructure the company:

> "Time has now run out for Irish Ferries. Change is needed now to bring the company's cost base into line with its sea competitors, allow it to compete with low-cost airlines and ensure a future for the company" (ICG, 2005b)

The company saw outsourcing of workers as the only possible solution to the problems it faced. 543 seafarers were offered generous voluntary redundancies packages up to 4 times the level of statutory packages. Over 90% took the offer. Incoming Latvian workers would be earning at least €17,300 per anum, four and a half times the Latvian average industrial wage of €3,900. Far from being a race to the bottom, for these Latvian workers it represented a massive step-up on the economic ladder (O'Leary, 2005). The savings to Irish Ferries were hoped to guarantee its long-term viability.

While the Seamen's Union of Ireland (SUI) were broadly in favour of the changes (as evident by their vote), SIPTU came out against. What followed was a story of public relations failure, SIPTU militancy of

Scargillite proportions, and an ill-conceived national day of protest at which almost 100,000 people took part in a economic-blackmail-pride parade.

Doubtless, had Irish Ferries been in public hands in the time, trade union power and political pressure would have prevailed in preventing the painful but necessary changes. But as Bös (1991:54) points out, nationalisation on the basis of stabilisation does not hold:

> "Unpopular decisions… can best be performed by private firms which are not obligated to labour market objectives… [The] long run success of private capitalism is a decisive argument for privatisation…"

Conclusion

Lessons are to be learned from the story of Irish Ferries. For almost 27 years, as B&I Line, the company failed to become profitable, failed to be efficient, and failed to serve the public. Yet B&I's utter failure should not surprise us. As we have seen, the weight of theoretical and empirical evidence is against the viability of SOEs. Political pressures, trade union power, weak management, regulatory capture, soft budget constraints, the social choice model, and the principal-agent problem are among the factors which conspire to doom SOEs to failure. The total cost to the state of this flop is estimated at almost €309m.

The second lesson is that we should listen to Baumol, in that any market can be contestable, and private markets will work. This is nowhere clearer than when the B&I Line was sold to ICG to become Irish Ferries. The discipline of the market was brought to bear on the company. With consumers given the power of exit, competitive pressures forced the company to re-orientate towards what they demanded, and not what the government thought was socially desirable. The result was strong growth in turnover throughout the 1990s, and consistently high profits. Privatisation brought about this 'race to the top'.

In 2003/4, falling profits acted as a signal that change and restructuring were necessary. The company could not seek exchequer handouts, nor would it ignore the problems. So changes were made. In the end, the company will return to profitability, the Latvian workers will climb the economic ladder, and the displaced Irish workers will quickly find new jobs in Ireland's fast-growing economy, or even start new enterprises with their €100,000+ redundancy payments. The free market will result in growth and economic development where government regulation never could. Yet

state monopolies in other sectors may remain, especially in the transport sector with CIE's failings mirroring B&I's. It is over 200 years since Smith (1776:309) told us that crown lands were "a mere waste and loss of country in respect of both produce and population," yet the lessons he taught us, and those learned here regarding public and private ownership, continue to be lost on the public at large.

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