



REVIEW OF AND POSSIBLE PRIVATISATION OF IRISH STATE SECTOR BODIES AND ASSETS

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THE REVIEW OF IRISH STATE ASSETS

On 22 July the Irish Government announced that a Review Group had been set up to examine the operation and value of Irish semi-state companies (“**SSCs**”). The review will encompass the assets and liabilities of the SSCs, including borrowings and pension costs. The Review Group has been asked to provide an interim report to the Minister for Finance before the end of 2010.

The members of the Review Group are:

- Colm McCarthy of University College Dublin (Chair of the Group);
- Donal McNally, Second Secretary General Department of Finance; and
- Alan Matthews, Professor of European Agricultural Policy at Trinity College Dublin.

TERMS OF REFERENCE OF THE REVIEW GROUP

The Review Group has been given the following terms of reference for its review:

- to consider the potential for asset disposals in the public sector, including commercial state bodies, in view of the indebtedness of the State;
- to draw up a list of possible asset disposals;
- to assess how the use and disposition of such assets can best help restore growth and contribute to national investment priorities; and
- to review where appropriate, relevant investment and financing plans, commercial practices and regulatory requirements affecting the use of such assets in the national interest.

ECONOMIC CONTEXT

SSCs have played a significant role in the Irish economy since the foundation of the State and this has continued through the Celtic Tiger era and the current economic crisis.

SSCs have always been and continue to be significant employers and have, to varying degrees, important economic and national roles.

The Electricity Supply Board (ESB) alone employs in excess of 6,800 people. In 2009 ESB made a profit of €580 million and paid a dividend of €280 million to the Exchequer. Bord Gais Eireann made a profit of €100 million and paid a dividend of €38 million to the Exchequer.

The financial position and performance of SSCs is not, however, uniform as is clearly evident from the following table¹:

Company	Turnover From Annual Account (€ million)	Operating Profit From Annual Account (€ million)	Profit for Financial Year From Annual Account (€ million)
An Post	804	5.7	(29.1)
Bord Gais	1,349	200.8	104
Bord na Mona	384.4	23	10.5
Coillte	206.8	20.4	4.2
CIE	789	(391.2)	(77.6)
Dublin Airport Authority	546.7	51.3	(13.2)
Dublin Port Company*	70.6	27	18.4
Eirgrid	410.7	9.3	8.6
Electricity Board Supply	3,014	615	580
Horse Ireland* Racing	65.3	0.8	(2.4)
RTE*	440.8	(19.7)	0.3
TG4*	3.4	(36.7)	(0.15)
VHI*	1,025	3.4	(65)

* Figures from 2008 Accounts

1. Extracted from latest Annual Reports

The current financial imbalance in the public finances significantly limits the Government's ability to continue to subsidise or invest new capital in SSCs.

There has been much debate on the question of privatising SSCs and/or selling State assets as a means of raising funds for the Exchequer and the impact, if any, of any such privatisations on future economic growth and development of the State.

FORM OF PRIVATISATION

There are a significant range of potential transactions which might be considered as part of an asset disposal programme by the State. The terms of reference of the review group refer to the potential for asset disposals. It should however be noted that there are structures which can potentially deliver finance for the State without a change of ownership actually taking place. Some of the most basic potential structures (including structures where no change of control is required), include:

- a sale of shares in an SSC to third parties (either 100% or with the State retaining a percentage holding);
- an IPO of shares in an SSC on a stock exchange (with the State perhaps retaining a percentage holding);
- an IPO of shares in an SPV into which specific SSC assets have been transferred (with the State or the relevant SSC potentially retaining a percentage holding);
- a sale of specified assets (and possibly related liabilities) of an SSC to third parties;
- raising finance using currently unsecured State assets as collateral. For example existing State owned infrastructure projects that are cash positive but not subject to public private partnership arrangements or otherwise encumbered could be used to raise finance. This will have the advantage of ownership remaining with the State;
- joint venture arrangements whereby funding/investment obligations and profit entitlements are shared with third parties; and
- securitisation of future income/revenue/dividend streams. This could be considered at a Government Department, Local Authority, SSC or specific project or projects level. Again this would have the advantage that ownership would remain with the State.

The phrase 'privatisation' in this document refers to each of these types of transactions.

The form and structure of a privatisation will be driven by several factors including some or all of the following:

- the need to maximise sale proceeds - in an Irish context certainty in relation to the regulatory regime, market structure and taxation will be the significant drivers of value. As a consequence of the economic crisis, it will be essential for Government and its advisers to convince international investors that Ireland remains and will continue to be an attractive place to invest and that investors will be able to earn an appropriate rate of return;
- the strategic importance of the relevant assets/ business to the State;
- a decision to proceed with the privatisations in stages may help to overcome the initial reluctance of investors and the public sector, as well as to establish a testing ground for further stages;
- the size of any interest maintained by the Government in the privatised entities relative to the total number of shares issued;
- whether the shares held by the State and third parties are to rank *pari passu*, or whether some will carry special rights – for example, will the Government hold on to a “Golden Share” that might give the Government the right to a veto over certain types

of decisions relating to the company concerned; will the third parties have different income entitlements from certain underlying assets or businesses;

- whether the shares are to be freely transferable, or whether there will be restrictions on the size of individual holdings;
- whether employees will be invited to participate in share ownership or profit sharing schemes;
- future funding requirements of the privatised assets or entity;
- market conditions as they apply to the assets or business which is subject to a privatisation proposal;
- regulatory framework; particularly potential future changes to the regulatory and market framework applying to the relevant sector; and
- terms on which the relevant SSCs have raised debt.

KEY ISSUES

There are a number of key issues which are relevant in varying degrees, to all of the transaction structures:

5.1 Timeframe

Many of the transaction structures, particularly those involving a sale or IPO of an SSC or a significant part of their assets (particularly those in regulated areas) are likely to take a significant amount of time to plan and execute. They are likely to require a significant amount of pre-transaction restructuring and may require the passing of new legislation.

5.2 Maximising Sale Proceeds

Maximising sale proceeds will undoubtedly be the key driver from the Government's perspective. The approach taken to the restructuring of the SSCs in advance of the sale process, certainty in relation to the sector specific regulatory regime, market structure and taxation will all be critical issues in determining value. The position the Government takes in relation to risk allocation (particularly in areas such as environmental and industrial relations) will also impact on value. If, notwithstanding the sale, the Government seeks, for reasons of policy, consumer protection, protection of employment or the national interests generally, to impose controls on the privatised entity then the mechanisms employed to achieve these objectives may impact on value.

5.3 Regulatory Certainty

A key concern for potential investors when considering any potential privatisation opportunity will be to ensure that they will be able to earn an appropriate rate of return to warrant the risks that they will be assuming if they invest. If the regulatory regime and/or market structure in a particular sector is in a state of flux then this may at worst significantly reduce the number of international bidders and at best have a material impact on valuation.

5.4 Employment/Pensions

5.4.1 The management of employee related issues and concerns will be critical to a successful privatisation. Employees and their trade unions will seek guarantees in relation to security of employment and maintenance of no less favourable terms and conditions of employment and of pension benefits following privatisation. However, potential acquirers may look to the State to achieve reductions in employee numbers and greater efficiencies and business flexibility prior to privatisation. That will not be easy to achieve and is likely to involve significant inducements to employees to agree to the privatisation, such as the offer of a stake in the entity. Employee expectations will be for a stake, structured through a tax efficient vehicle such as an ESOP, of at least 14.9%. Having a significant minority shareholder such as an ESOP will clearly impact on an acquirer's valuation of the entity/business. The achievement of staff reductions will only happen through voluntary redundancies and early retirement, both of which may be expensive to implement. Dealing with employee issues will therefore significantly impact on the net return that the State will hope to achieve through any privatisation process.

5.4.2 To the extent that existing SSCs have established ESOPs, the impact of asset disposals on that ESOP will need to be considered especially where the consideration for the disposal is to go to the State and not the SSC. It is likely that employees will seek to negotiate either a cash payment, or an increased stake in the privatised entity, both of which will have an impact on the net return to the State. Where the SSC's pension scheme is in deficit, employees and their trade unions will almost certainly demand that a significant portion of the sale proceeds be applied to eliminating or reducing the deficit. Depending on the SSC concerned, dealing with any deficits in a pension fund and the continuing accrual of pension benefits for active members will

have to be resolved. Potential acquirers will not wish to take over a pension scheme that is in deficit and are likely look to the State to guarantee funding of any deficit accrued up to the time of sale. Nor will they wish to continue or replicate a scheme following privatisation which would be very expensive to fund. Potential acquirers are likely to seek to put in place a type of scheme which gives them greater certainty as to cost.

5.5 Impact of Existing Indebtedness

The impact of any proposed privatisation on the existing indebtedness of the SSC will require careful consideration. As part of the pre-privatisation restructuring, it will be necessary to identify what consents from lenders will be required in order to execute the restructuring without breaching or triggering pre-existing lending covenants, mandatory prepayment provisions or events of default. Given the levels of borrowings Irish SSCs have secured in recent years this may present one of the greatest obstacles to any material asset disposals.

5.6 Financing

The national and international banking crisis has resulted in a significant reduction in the number of banks and financial institutions available to support both national and international bidders pursuing asset acquisition opportunities across all sectors and all markets. The banks and financial institutions that are in the market are in a position to impose much more onerous lending terms and engage in lengthier and more detailed due diligence. The lack of available finance is likely to reduce the number of bidders and leave companies with robust balance sheets and available cash in a stronger position.

5.7 International Backdrop

5.7.1 The international economic crisis has also resulted in many international companies including utilities re-considering and withdrawing from overseas markets and non core activities. This will undoubtedly in the short term have an impact on the number and variety of bidders interested in Irish assets.

5.7.2 Ireland is unlikely to be alone in pursuing a policy of disposal. This combined with the increasing number of distressed asset divestments across Europe and elsewhere means that investors may be looking at a number of potential opportunities. Irish assets and Ireland will be competing with these opportunities.

5.8 Tax

The tax issues arising on any pre-transaction restructuring will require careful consideration. Pre-transaction restructuring may need to be designed in such a way to avail of specific tax reliefs. Particular attention should be given to corporation tax, capital gains tax, stamp duty, value added tax as well as income tax considerations for employees.

5.9 Competition/State Aid

Competition and State Aid considerations on any restructuring or disposal will also require careful consideration. This is especially the case in regulated sectors.

KEY STAGES IN PRIVATISATION

Privatisations usually proceed through a number of stages commencing with the restructuring and reorganisation of the SSC, followed by the design of the regulatory regime the newly privatised entity is to operate in and concluding with the privatisation transaction itself.

6.1 Structuring the Transaction

An early decision as to the most efficient and effective privatisation structure is critical. All of the key issues noted above will play an important part in determining whether a structure can be practically delivered. If a number of structures are achievable, the issues of which structure will deliver value to the State and protect the national interest will be central to the choice of structure and the decision to proceed.

6.2 Reorganising the SSC

6.2.1 If a partial disposal of assets is envisaged, a review of the assets and liabilities to be transferred to the acquirer will be necessary, so as to ensure that each part is viable as an independent entity.

6.2.2 In order to prepare the entity for life in the private sector, it may be necessary to transfer it into a new legal vehicle such as a holding company. Such “unbundling” of existing entities can take time and tends to complicate the privatisation process. There may be a necessity for transitional services arrangements to be put in place to ensure the continued operation of the relevant business until the new entity can independently source such services. Unbundling may not be required where the entity is already a private sector type company, when it can merely be transferred in its existing form. Where SSCs or subsidiaries are subject to the requirements of the Companies Acts 1963-2009 any restructuring and disposals will need to have regard to capital maintenance and other rules in the Acts.

6.2.3 The impact of any proposed privatisation on the existing indebtedness (loan, security and bond documents) of the SSC will require careful consideration. The disposal of material assets, a material change in the nature of business or a change in ownership are all likely to be at the very least restricted if not prohibited under the terms of the financing arrangements. As part of the restructuring it will be necessary to identify what consents from lenders will be required in order to execute the restructuring without breaching pre-existing lending covenants. The amount of debt and long term liabilities (such as in the case of utilities: decommissioning and environmental costs) which the newly privatised companies are to bring with them into the private sector will be key issues for potential investors in seeking to value the assets.

6.2.4 Any such reorganisation is likely to involve the transfer of employees to the new entity with all of the usual industrial relations and employee benefit issues that come with such a transfer.

6.3 Legal Restructuring

6.3.1 The constitution of an SSC entity is more often than not embodied in statute and consequently the relevant statute will need to be amended and/or repealed before it can be transferred to the private sector.

6.3.2 Past privatisations in Ireland have been facilitated by detailed legislation dealing with amongst other things:

- empowering the Minister or SSC to dispose of assets/shares;
- terms and conditions of the disposal;

- guarantees and indemnities required to facilitate the transfer;
- regulatory issues;
- application of proceeds;
- ESOPS;
- transfer of employees;
- alteration of the Memorandum and Articles of Association of the SSC;
- stamp duty and taxation generally; and
- provisions dealing with historical guarantees given by the Minister in relation to obligations of the SSC.

6.3.3 Some examples of legislation which has allowed the privatisation of State assets include:

- The Telecommunications (Miscellaneous Provisions) Act, 1996 and the Postal and Telecommunications Services (Amendment) Act, 1999 which allowed the Minister for Finance or the Minister for Public Enterprise to sell the State's shares in Telecom Eireann (later Eircom);
- The Irish National Petroleum Corporation Limited Act, 2001 which allowed the Minister for Public Enterprise, with the prior consent of the Minister for Finance, to sell the State's shares in or assets of the Irish National Petroleum Corporation Limited;
- The ICC Bank Act, 2000 which allowed the Minister for Finance, after obtaining a prior motion of approval from Dáil Eireann, to sell the State's shares in ICC Bank; and
- The Acc Bank Act, 2001 which allowed the Minister for Finance, after obtaining a prior motion of approval from Dáil Eireann, to sell the State's shares in Acc Bank.

6.3.4 If the privatisation requires the shares to be listed on a stock exchange, the entity will have to satisfy the listing requirements of the relevant stock exchange.

6.3.5 In the case of utilities, it will be necessary to ensure that the new legal structure of the entity is consistent with the appropriate regulatory framework for regulating the utility. In an Irish context it is unlikely that any significant adjustments will be required to regulate the new entity going forward, rather, it will be a case of ensuring that the new entity fits into and complies with the existing regulatory regime.

6.4 Other Considerations

6.4.1 *Pension and other Arrangements for Employees*

Pension arrangements always require particular attention in privatisations. Problems can arise in cases where the accrued pension benefits are insufficiently funded.

A new pension scheme may have to be created as certain types of State schemes may be considered too onerous by private sector investors. An employee share ownership trust and other employee incentive programmes may also have to be implemented.

The management structure and team will have to be looked at and the employment terms and incentives offered to management reviewed, so as to bring them into line with those customary in the private sector. This will be more difficult to do with

employees lower down the scale, whose terms and conditions will likely only be changed through collective bargaining.

6.4.2 *Regulatory Framework*

In privatisations of public services and utilities internationally, the regulatory framework is of key importance as a means of protecting consumers once immediate political/departmental control over the company has been lost.

This should be less of a concern in Ireland especially in the utilities sector where regulators independent of Government (in its capacity as both shareholder and policy maker) and industry participation in the sector already exist and have been functioning for more time. The Competition Authority also plays an important role. On the other hand having a regulatory regime that encourages inward investment is a pre-requisite for attracting international investors. Interested potential investors will focus closely on the existing regulatory regime and market structure.

The key concern for potential investors will be to ensure that they will be able to earn an appropriate rate of return to warrant the risks they will be assuming if they invest. If the regulatory regime and/or market structure in a particular sector is in a state of flux, then this may at worst significantly reduce the number of international bidders and at best have a material impact on valuation.

6.4.3 *Environmental Concerns*

Environmental concerns are also likely to be reflected in valuations, particularly where there are concerns regarding historic pollution or if the activity is regarded as one that attracts environmental risk. Potential purchasers may resist the privatisation of the historic pollution associated with State use of the assets. This attitude by potential purchasers is particularly likely against a background of recent Irish legislation on environmental liability, increases in environmental fines in Ireland, and following on from environmental incidents overseas (Gulf of Mexico, Bartoline and Buncefield). These developments are leading multinational and corporate entities to re-examine approaches to taking on environmental risk. A more conservative approach is emerging in acquisitions than that which applied in previous years. Environmental warranties and indemnities may be sought from the State, which may affect the achievement of a full risk transfer or a 'walk-away' by the State.

6.5 Restrictions, Golden Shares etc.

There are a range of protections which the Government can seek to build into any transaction structures. These would commonly include anti-embarrassment provisions which would apply in the event that the newly privatised company or assets were sold on at a profit within a defined period of time. In addition certain of the transaction structures and protectors will enable the Government to seek guarantees that future funding will be made available / key assets will not be sold / borrowings will not exceed agreed levels etc.

An IPO structure generally offers least flexibility in this regard but in certain cases, the Government may take the opportunity to introduce a special share (commonly known as a "Golden Share") to be held by the relevant Minister which enables the Government to protect the privatised company from certain actions in the early years or from selling key assets. Alternatively it could consider maintaining a minimum shareholding threshold to prevent such actions.

ABOUT MATHESON ORMSBY PRENTICE

We are an acknowledged market leader in privatisations, re-organisation of government entities, legal restructuring, regulatory reform and labour relations. Our privatisation experience includes leading roles on the privatisation of ACC Bank Plc, ICC Bank Plc, Irish National Petroleum Corporation and more recently the Electricity Supply Board's Generation Assets. Our experience of re-organisation of Government entities includes leading roles in the re-organisation of Aer Rianta plc and the establishment of Dublin Airport Authority, Cork Airport Authority and Shannon Airport Authority and the re-organisation of the National Oil Reserve Agency, as well as specialist roles in the transfer of ESB National Grid employees to Eirgrid and the transfer of employees from a government agency to the Health Service Executive.

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