



More Government Constraints = Less Value

The effect of government ownership
on commercial Crown corporations

By Sheldon Schwartz



Introduction

Governments sometimes establish commercial enterprises to achieve social and economic development public policy objectives. The usual rationale for establishing a government-owned commercial enterprise is to address a perceived private market failure by providing essential services at a reasonable cost which either the private sector either does not provide in certain areas, or would only provide at a socially-unacceptable cost.

In Canada, both the provinces and the federal government have used government-owned business enterprises, called commercial Crown corporations, to address such perceived private sector market failures.

For example, the province of Saskatchewan established and still owns commercial Crown corporations to provide telecommunications, natural gas transmission and distribution, electricity generation, transmission and distribution, and property and casualty insurance.

Commercial Crown Corporations— Fewer Options, More Constraints

The aphorism “It’s good to keep one’s options open” conveys the intuitive concept that there is a value in having flexibility and choice. If there is value in having flexibility and choice, then it follows that not having flexibility and choice reduces value.

Consider two entities in the same line of business that are identical in every respect save their form of ownership: one is a commercial Crown corporation, the other a publicly traded corporation. Compared to the private sector corporation, a commercial Crown corporation is more constrained and has less flexibility and choice in its operating and investment decisions.

***A commercial
Crown
corporation
is more
constrained...***

Operating and Investment Constraints

Private sector corporate boards and management are aligned to a simple, bottom-line objective: to act in the best interests of the corporation by seeking to maximize shareholder value for a given risk tolerance. In contrast, commercial Crown corporations have multiple and sometimes conflicting objectives for their boards and management: while still acting in the best interests of the corporation, they are expected to be commercially successful while also achieving certain public policy goals.

These public policy goals generally involve constraints on the investment and operating options available to a commercial Crown corporation. These constraints can include restrictions on out-of-province investment, entering new lines of business or discontinuing existing business lines or services, and restrictions on competing with the local private sector.

A private sector corporation not subject to such investment and operating constraints may be better able to create shareholder value through investing in a wider and more diversified range of prospective investments with an attractive risk-adjusted expected return. To the extent public policy constraints on a commercial Crown corporation result in foregoing attractive investment opportunities and thus conflict with shareholder value maximization, a commercial Crown corporation should be expected to be worth less over time than an otherwise identical publicly traded corporation that is not subject to such constraints.

Compensation Constraints, Risk Aversion and the Goldilocks Constraint

*High profits/
high losses:
Big political
liabilities...*

Compensation for commercial Crown corporation board and senior management may be limited by public sector wage guidelines and by the perceived need to retain some degree of comparability with senior management compensation in the regular civil service. Such constraints may make it harder to attract and retain top management and staff, who may be “poached” by private sector counterparts through the prospect of higher compensation for a comparable level of responsibility. In addition, stock options, widely used by publicly traded companies to help to align management and board compensation with shareholder value creation, are inherently unavailable to the management and boards of Crown corporations.

Crown corporations may also suffer from the Goldilocks constraint: a commercial Crown corporation with high profits may be just as big a political liability for its government owner for “gouging” the public as a Crown corporation with high losses may be for “mismanagement” of the public’s investment. Another political reality of government ownership of a commercial enterprise is that a poor outcome for even a relatively small investment can become a high profile political issue.

Such political and compensation constraints could logically be expected to increase risk aversion and make it harder to attract and retain top management and staff. To the extent that such constraints result in not pursuing otherwise attractive investment opportunities and thus conflict with shareholder value maximization, a commercial Crown corporation should be expected to be worth less over time than an otherwise identical publicly traded corporation that is not subject to such constraints.

An Example: SaskTel and the “Saskatchewan First” Policy

SaskTel is a Saskatchewan commercial Crown corporation. It was originally established as the Department of Railways, Telephones and Telegraphs in 1908 with a mandate to establish and operate local and long distance telephone lines. One century later, SaskTel offers similar products and is in full competition with private carriers. It is federally regulated by the Canadian Radio-television and Telecommunications Commission (CRTC).

In October 2008, in response to the results of a KPMG study, the Saskatchewan government announced a new “Saskatchewan First” investment policy for its commercial Crown corporations. The study by KPMG showed that many of SaskTel’s investments had lost money.

The Saskatchewan First investment policy illustrates many of the issues outlined in this article. The following are excerpts from the October 28, 2008 press release, “Saskatchewan First Policy Adopted”:

- “The government supports a Saskatchewan First investment policy, which will focus the Crowns on investing within Saskatchewan;
- The Crowns will not invest out-of-province;
- Where feasible, existing out-of-province investments will be divested in a thoughtful manner with a goal to maximize returns;
- There may be limited circumstances where an exception to this policy will be permitted if the Government determines the investment supports in-province operations;
- Investing outside the province has not proven beneficial to the people of Saskatchewan and going forward with our new Saskatchewan First Investment policy will add more value to the province through job creation and capital spending;
- In Saskatchewan’s growing economy there exists opportunities for Crown corporations within the province to grow and support the provincial economy. New investments made in Saskatchewan must benefit Saskatchewan people and preferably not compete with the private sector.¹

**New
investments
made in
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Saskatchewan
people...**

1. “Saskatchewan First Policy Adopted”, Crown Investments Corporation of Saskatchewan Press Release, October 28, 2008, <http://www.cicorp.sk.ca/cgi-bin/newsarchive/2008/10>

Saskatchewan citizens... have no information on the equity value of their investment...

This paper's analysis suggests that, by further limiting SaskTel's business options for public policy purposes, the Saskatchewan First investment policy can be expected to have negative impacts over time on the value of Saskatchewan taxpayers' equity investment in SaskTel compared to its publicly traded private sector counterparts, which are not subject to such policy constraints.

At least that's the theory. But how would one really know if that's the fact?

Saskatchewan citizens can look up the value of shares in MTS Allstream or Telus² that they can choose to hold or not as investors, but have no information on the equity value of their investment in SaskTel that they are compelled to hold as taxpayers.

Nor can they determine whether government actions such as the Saskatchewan First policy are more likely to increase or decrease the value of their equity investment in SaskTel, and if so, by how much. Since it's their money, taxpayers have a right to know. As the steward of the taxpayers' investment, the government has a responsibility to tell them.

2. MTS Allstream Inc. is the former Manitoba commercial Crown corporation Manitoba Telephone System. Manitoba Telephone System was privatized in 1997. MTS Allstream Inc. common shares are listed on the Toronto Stock Exchange (trading symbol: MBT). Telus Corporation is the former Alberta commercial Crown corporation, Alberta Government Telephones. Alberta Government Telephones was privatized in 1991. Telus Corporation common shares are listed on the Toronto Stock Exchange (trading symbol: T).

The Need for Periodic Reviews

Unlike shareholders in publicly traded corporations, taxpayers can neither readily assess the performance of the board and management of a commercial Crown corporation, nor the effect of general economic conditions or government policies on the equity value of their investment by observing the share price. Nor can taxpayers as individuals choose to reduce or increase their ownership in particular commercial Crown corporations based on their relative attractiveness compared to other investments or compared to competing uses of the funds tied up in owning them.

Like their private sector counterparts, commercial Crown corporations have faced changes in the commercial, regulatory, technological, strategic and competitive environment in which they operate

It is only reasonable that taxpayers should expect that their government, acting as a prudent and accountable steward of their investment, will ensure a periodic, systematic, objective, rigorous transparent and independent review of each commercial Crown corporation. Such a review should evaluate the situation, outlook and performance of each commercial Crown, in a public and transparent process with full public input and debate. The process and the results should be public.

The review should, at a minimum, answer the following questions, that any prudent investor would want to know and that any prudent steward should be able to answer³:

- What is the current market value of taxpayers' equity investment in the commercial Crown corporation?
- Has the investment maintained or enhanced its equity value relative to private sector counterparts, If not, why not?
- What public policy activities does the commercial Crown carry out that a private sector counterpart would not do without compensation? What would be the amount of the required annual subsidy to a private sector counterpart?
- Has the investment fulfilled its original public policy mandate? For those that have, does government ownership serve a continuing public policy purpose? If so, what is it? For those that have not, why not?

3. For a more complete discussion of the framework for a Crown Review, please see S. Schwartz, "Saskatchewan's Commercial Crown Corporations: Time for a New Crown Review", Saskatchewan Institute of Public Policy, Policy Dialogue, Winter 2008, pp. 10-11.

http://www.uregina.ca/sipp/documents/pdf/Winter2008_PD_online.pdf

and S. Schwartz, "Time for a New Crown Review", Frontier Centre for Public Policy, http://www.fcpp.org/main/publication_detail.php?PubID=2263

Taxpayers should expect that their government, acting as a prudent and accountable steward...

Summary and Conclusions

Commercial Crown corporations have less flexibility and choice in their operating and investment decisions than do their private sector counterparts. In addition, political and compensation constraints may tend to increase risk aversion and make it harder to attract and retain top management and staff.

While a commercial Crown has yet to fulfill its mandate to address a private sector market failure, any negative valuation impacts of such constraints may be swamped by the economic and social benefits for the services it provides as fundamental infrastructure upon which other economic and social development depend.

Conversely, any negative valuation impacts from such constraints may become increasingly important and apparent as and after the commercial Crown corporation achieves its original public policy mandate to address a private sector market failure.

To the extent that such factors result in not pursuing otherwise attractive investment opportunities and thus conflict with shareholder value maximization, a commercial Crown corporation could be expected to be worth less over time than an otherwise identical publicly traded corporation that is not subject to such constraints.

Whether or not it has fulfilled its mandate, citizens as taxpayers are entitled to no less information about the value of their investment in a commercial Crown corporation than they would as investors in its private sector counterparts. Taxpayers are entitled to the information to periodically assess the situation, outlook and performance of each commercial Crown, in a public and transparent process with full public input and debate. Taxpayers are also entitled to make an informed choice whether government ownership of a commercial enterprise continues to be a pragmatic means to an end, whether it has become an end in itself, or whether it has served its purpose and is no longer necessary or desirable to hold as a public investment. After all, it's their money.

Public debate about the retention or privatization of commercial Crown corporations often has been ideologically-charged and emotional. It need not be. Rather than ideology, the pragmatic public policy rationale that was the original impetus for establishing a commercial Crown corporation is the logical starting point for a rational evaluation of the desirability and necessity of continuing public ownership of what, after all, is a commercial investment. And as for emotion, as my mother has observed, you should never love something that can't love you back.

A commercial Crown corp. could be expected to be worth less over time than an otherwise identical publicly traded corporation...

FURTHER READING

Frontier Backgrounder

April, 2009

Knee-Capping the Competition

This paper examines the tax inequity that arises in Canada as a result of the general tax exempt status for Crown corporations. The legal and constitutional basis for this status, how the courts have interpreted and applied it and how governments have or have not attempted to deal with this inequity is outlined. A simple and uniform legislative solution is then proposed.

http://www.fcpp.org/main/publication_detail.php?PubID=2694

October, 2008

Government Investment in Private Enterprises

The public policy purpose of government ownership of a commercial natural monopoly in the early stages of a jurisdiction's economic development is to ensure that safe, reliable, cost-effective economic infrastructure services are made available to all citizens and businesses. Once the infrastructure is in place, and the original public policy purpose is presumably achieved, then citizens can and should determine whether government ownership continues to serve a continuing public purpose.

http://www.fcpp.org/main/publication_detail.php?PubID=2421

Policy Series

October, 2007

Telecommunications Privatization, Services, and Provincial Well-being

Ownership models have little effect on service levels in the competitive telecommunications industry, but they do affect the ability to invest and expand.

http://www.fcpp.org/main/publication_detail.php?PubID=1912

February, 2007

Monopoly Insurance: Unfair at Any Price

Government car insurance monopolies boast that they're giving consumers a better deal, but for the most part such claims are untrue.

http://www.fcpp.org/main/publication_detail.php?PubID=1682

Notes from the Frontier

February 2009

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Sheldon Schwartz worked for the Province of Saskatchewan during a career spanning 25 years, including as Assistant Deputy Minister of Finance, responsible for Saskatchewan's treasury and debt management functions and as the Chief Financial Officer and Vice President of Finance and Administration for Crown Investments Corporation, the Province's holding company for its commercial Crown corporations. Born in Regina, he has a Masters degree in Economics from Carleton University, and holds the Chartered Financial Analyst (CFA) designation. As a semi-retired consultant living in Victoria, British Columbia, Sheldon continues his lifelong interest in public policy in Canada. His recent article, "Saskatchewan's Crown Corporations—Time for a New Crown Review", appeared in *The Saskatchewan Institute of Public Policy's Spring 2008 Policy Dialogue*.



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The author of this study has worked independently and the opinions expressed are therefore his own, and do not necessarily reflect the opinions of the Board of the Frontier Centre for Public Policy.

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