

THE AGENCY THEORY The "Prestige" disaster case

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Abstract

Traditionally the agency-principal relation has been studied in the corporate environment, more specifically in corporate finance to define and study the management and shareholder relations and the expenditures related to that relationship. Agency theory can be applied in any circumstances where management decisions have been transferred. In our case study the agency cost are those that arise when individuals or authorities act in their own self-interest, rather than acting to maximize the interest of the society and their individuals (usually the corporate performance). Agency costs are therefore prevalent throughout an organization or society whenever there is a divergence of interests between the principal and the agent, superior and subordinates, etc. But agency costs are not the unique expenditures in a agency-principal relation. There are also other costs such as the bonding cost paid for the agent to verify if it is acting on principal interest and costs of monitoring. Those costs are very difficult to identify and account for and often are forgotten.

This paper provides an overview of public-private agency coordination from the view of agency theory. The researchers identify the different possibilities and relations between principals and agents in the context of the "Prestige" disaster, a tanker that spilled fuel along the Spanish coast in November 2002 changing the life of the Galicia Society.

Introduction

In economic theory, the agency relationship is defined as the one where one or more people (the principal) delegate their authority to one or more people (the agents), to act and to make decisions on behalf of the first ones. The agent is a person who acts in the name of another. These relationships are studied in Agency Theory by the analysis of how this relation could be maximized for the total value of a company or organization (Jensen, M. And Meckling, W.,

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1976). All traditional relations between two parties can be studied with agency theory. There will be always a principal and an agent. There would be some problems in this relationship when the agent does not act in the interest of principal. In that case, principal pays to the agent the "agency cost" to make agent act in principal interest.

A principal faces two risks when delegating authority to make decisions by the agent: on one hand, there is a risk that the agent won't behave as the principal wants (moral risk or opportunism in the agent's behavior); on the other hand, there is a risk when the agent is not sufficiently competent. To solve those problems and avoid such risks principal need to come into the so-called agency costs.

The agency relationship always implies the existence of the moral risk: the possibility that the agent (political agent, managerial agent) looks for personal objectives to then detriment of the interests of the principal (the citizen or the shareholder) (Mascareñas, J., 1997). The problem orientated in this way is analyzed by the economic decisions of the state and market from an unified vision. There will be a loss of efficiency whenever the costs and damages caused by a decision don't relapse on the individual that decides.

Through the inclusion in the contract of the appropriate incentives, restrictions and penalties, principals can encourage the agent to act according to their interests. By this way, the stock call options for management and other stock incentives are designed with this aim. In many cases the principal can not look over everything that agent does and for this the agent acts in their own benefit: this it is the moral risk. To cover this risk principal tries to carry out a pursuit or control of the agent's actions although it is expensive and sometimes nearly impossible. A typical example of cost of pursuit or control of the agent is the sales commission where agent receives a percentage of the sale price; a partial pursuit cost could consist on an audit expenses used to carry out the sales, decreasing the commission if those overcome a certain level.

When a principal uses an agent to act on their behalf, the reach of the pursuit is an important consideration to establishing efficient assignment of principal resources due to the implied costs. In that way, the probability that an agent incurs in inappropriate behavior is an inverse function of the reach from the control to which is subjected. In this a way there is an optimum amount of pursuit that counteracts the possibility of resources losses due to the lack of an agent's ethics.

The managers of a company or of a State Institution can use their decision making capacity to obtain, in a malicious way, personal benefits against shareholders or citizens. Those benefits can take the form of extra bonuses, big and luxurious offices, private vehicles; they could promote subordinated by reasons of sympathy or relationship; they can hire friends and relatives instead of people more qualified; they can make too chancy decisions or decisions that are beneficial for the company or public organism in the short term but harmful in the long term; they can also make decisions that increase their personal power and allow to avoid the control of the shareholders or citizens; they can provide business or contracts of their department (public or private) to another company where they have financial or any other kind of interest.

All those actions provide management with earnings diverted from the value of the company or of the public institution. The costs of those earnings are inversely related with the participation that have management in the "social capital". Shareholders or citizens suffer a loss of their residual rights over the cash-flows of the company or the State if employees could take advantage of those implicit benefits. This problem is implicit in more or smaller measure in any form of labor contract. A worker hired for any task always has certain capacity of decision and the possibility of avoiding his responsibility and their control, reducing in that way his effort.



Worker control and supervision has a cost, so it is usually effective to hire supervisors. In this way, an intermediate set of agents appears, because it will be necessary to control the controllers. This increases the costs but it will also provide an effectiveness benefit, whenever the supervisors or controllers have a smaller tendency to avoid its responsibility as workers. There are various systems by which agents could control other agents, but those systems have some limits. Special limits can bring about an atmosphere that limit the possibilities of internal cooperation and thereby reduce overall efficiency.

A traditional solution in big companies and in the State consists of associating the agent with the benefits of the company or of their public department; these types of loyalty incentives adopt forms such as salaries linked to benefits, to link the wages to certain previously fixed objectives, participations in the social capital, the stock options, etc.

In agency relationships all costs do not necessarily relapse only on principal, since the agent can also suffer certain costs to transmit information to the principal and to obtain its trust. Usually, when agency relationships settle down in the long term, the moral risk decreases, and improved efficiency in institutional performance and a decrease of control costs are achieved. If the worker or manager wants employment stability, he won't take advantage of the opportunities of obtaining a particular benefit at the expense of the company or the citizens, mainly for the risk of being detected. For this reason in the recruiting process for permanent staff usually involves establishing salary complements for security, transparent systems of internal promotion, range privileges, and other systems of incentives to achieve loyalty and the stability (Mascareñas, J. and Lejarriaga, G., 1993).

The existence of agency problems doesn't mean, necessarily, that the agents (the politicians, for example) don't pursue the interests of the principals (citizens), but rather it is more expensive for these making sure that the agents act like they should. Therefore, the agency cost is an incremental cost, above the cost in the one that has incurred in a perfect labour or financial market.

The problem that faces the principal is to find the contract that minimizes in each situation the total cost of agency. The agency costs are supported by the principal, not for the agent. This last one will refuse to participate if the contract is not to its pleasure and therefore it is necessary to induce him to make it. A form that the agent wants to participate in is one where he understands that he can personally benefit from his own bad behavior; that is to say, the principal should assume that the agent's behavior will be not very ethical if he is left to his own devices. This demonstrates the critical importance of the process of financial recruiting in which the parts should advance the behavior performance because if not made that way in the long term the outcome can be truly expensive.

Agent and principal in the case of the disaster of the “Prestige oil-ship”

As we explained before, the agent is that person or institution that acts on behalf of other, the principal. This paper explores the agent-principal relationships in the case of the "Prestige disaster". The principal is the fishing sector because it delegates the responsibility of the economic and legal negotiation to the State: the State is the agent and it should regulate and protect the fishing activity correctly. Principal and agent could have divergent aims. Which objectives does each have after an oil spill disaster?

1. The fishermen want to return as soon as possible to the situation previous to the disaster. They need to clean the coasts and the beaches to recover the normal revenues; they are also searching for responsibilities, because they have been affected by a problem not of their making, so they are looking for the social, economic and politics responsibilities; they demand solutions to prevent future disasters such as changes in the marine legislation; etc.



2. The National State would like to develop the fishing associated sectors, looking for an equal solution to the problem keeping in mind the juridical and economical limitations that exist.

At this point true agency problem arises, because the interests among principal and agent are in conflict. If there were a perfect information or if the interests between both coincide the agency problems would not exist; the reality is very different because the markets are not perfect, the objectives are different and, therefore, the agency problems are created. In our case they arise because fishermen demands are not assisted sufficiently by the State in the way they wanted (Juste, J., 2003).

The agency costs in the relationships principal-agent can be classified in three types:

1. Financial contracts costs such as the transaction costs of formalizing the contractual agreement; opportunity costs imposed by the restrictions that exclude other good decisions and the paid incentives to the agent to encourage him to act in consonance with the interests of the principal.
2. Pursuit costs or cost for the agent's actions control.
3. The principal loss of wealth regarded to the divergent agent pursues objectives with relation to them (excessive expenses).

As it has been defined the agency costs are those which the principal incurs to be sure that the agent acts in their interests. The fishing sector incurs in the following agency costs:

- ✓ taxes associated to the activity;
- ✓ license of fishing and seafood works;
- ✓ attitude and aptitude;
- ✓ monetary cost and temporary for the manifestations against the performances of the authorities;
- ✓ losses supported by those affected when having to carry out tasks that don't correspond with its activity;
- ✓ costs to avoid the asymmetry of information, because the authorities have information of which the fishermen lack; etc.

The bonding costs are those that the agents incur to make sure that they will act in sympathy with the interests of the principal. A manager can carry out a contract that forces him to remain in the company if there is a merger or an acquisition or a manager on the public sector has to remain in spite of a political change; in this case the manager is incurring an implicit cost when giving up other alternative opportunities of employment. Those costs for the State are the following ones:

- ✓ the whole material related with the cleaning (shovels, uniforms, lodging, the volunteers' maintenance);
- ✓ salary compensations to the fishermen during the time that lasts the fishing prohibition and sea-food working;
- ✓ discussion and it fights for the European economic help (structural funds);
- ✓ incentives and fiscal and economic facilities to all those affected;
- ✓ rent of crafts anti-contamination to other countries that have them, etc.

Conclusions

Unfortunately, the Prestige ship accident will not be the last one, but it should serve as an opportunity to establish measures to minimize the risk. One of the first measures to be taken should be to revise the international legal frame for sailing, with the establishment of severe rules about dangerous materials transport and the prevention of accidents that could cause irreparable damages to marine and the coastal regions. Other proposed measures can be:

- ✓ the establishment of marine roads (i.e., regulated steaming courses);



- ✓ devices of separation of the shipping traffic in specific economic areas;
- ✓ the exclusion of oil tankers sailing in the specially sensitive marine areas;
- ✓ an increase of security inspections in ships;
- ✓ the prohibition of transporting dangerous goods, as the heavy fuel, in monocasco ships;
- ✓ the establishment of a net of refuge ports;
- ✓ the limitless and solitary civil responsibility of the shipping companies and oil companies involved in a catastrophe;
- ✓ demand to the coastal countries of ships with technology anti-contamination, etc.

The European Commission, in a recent document, says that the "European coasts, especially the Atlantic and Mediterranean coasts are extremely vulnerable to the risks of serious contaminations for an accident". This document must get leaders to think about shipping disasters and how to mitigate and prevent them.

The Spanish Government has been involved and seriously worried not only because of actual disasters and their consequences, but also because of the possibility for future disasters. The measures taken by the Spanish Government to limit the possibility of a disaster and to mitigate the impact are the following:

1. The study of the construction of a port refuge in the Galicia area that can minimize the risk of contamination in the event of an accident.

We can suggest some problems that this project could experience:

- ✓ the construction could generate very high agency costs,
- ✓ to have the port supposes the adaptation to some demands like the use of the port for ship of a pre-established depth (for example, ship with less than 30 meters deeps or ships with more);
- ✓ the port must be always open, and that generate a very high costs;
- ✓ not many population in the surroundings to assume the risk that supposes that activity;
- ✓ existence of a navy in the proximities;
- ✓ it must be cost-benefit viable; etc.

The main problems with building the port are the high cost and the lack of an appropriate place to build it. Contradictory reports also exist among public organisms. Not having such kind of port supposes to assume what has already happened and to wait that it doesn't happen again.

2.- National and international legislation change with a double purpose:

- ✓ to give higher security to the sailing;
- ✓ to guide the investments to the acquisition of anti-contamination and rescue ships, etc.

3.- To get funds to assist to those damaged by the catastrophe, such as:

- ✓ economic and tributary funds and benefits;
- ✓ the support to the creation of new activities;
- ✓ funds for the supplies needed for teams dedicated to the cleaning of the costs; etc.

4.- Set up the army as main collaborator, etc.

In the international marine transport the principle of the freedom of the seas prevails and of the impunity of the registering State. For this and other reasons, the European Commission believes it is necessary to approve a series of measures of marine security at the international level, to ensure stricter sailing norms that can be applied to the ships that transport goods and potential pollutants, besides a reinforcement of the control on the part of the registering countries. The society seems to be less and less willing to accept the enormous economic and environmental



costs of contamination of this type; for that, it is important re-examines the effective principles in order to get a bigger protection of the legitimate interests of the States.

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