

OECD Advisory Group on Privatisation

Fourteenth Plenary Session **Managing Commercial Assets under State Ownership**

Synthesis Note

The fourteenth meeting of the OECD Advisory Group on Privatisation took place on 19-20 September 2000 on the subject of "Managing Commercial Assets under State Ownership". The meeting brought together high-level privatisation officials and policy makers from Bosnia and Herzegovina, Brazil, Bulgaria, Chile, China, Chinese Taipei, Croatia, Estonia, Georgia, India, Malta, Russian Federation, Slovenia, experts from international organisations, together with senior privatisation officials from 18 OECD member countries (see attached final participants' list).

The meeting was co-hosted by the Hungarian Privatisation and State Holding Company (APV Rt.). In spite of the privatisation wave that has swept the globe in the last thirty years, in many countries the state still remains a large domestic shareholder. State holdings include businesses from various sectors, most notably utilities and infrastructure. In many ways, public sector assets present a potential for better delivery of key public services. Therefore, as underlined by Minister Istvan Stumpf in his opening remarks, the efficient management of commercial assets under state ownership is an important issue, requiring an adequate legal basis, institutions and policies enabling governments to act as responsible owners.

The meeting succeeded in raising awareness of officials and policy makers of the importance of the issues at hand and the need for continuing the exchange of experience on the approaches and strategies that have been implemented by various countries. Participants felt that there was real value added in the debates and particularly appreciated the timeliness of the meeting, as most privatisation authorities are currently adjusting to the shift in focus from a massive privatisation effort to residual sales and management of the assets to remain for the medium and longer term in state hands.

The meeting was organised around six main topics and a concluding discussion. During the first day, the participants explored the boundaries of privatisation and the scope for asset management, the related institutional framework, and the role of the state as corporate governance principal in commercial enterprises with state participation. During the second day, the discussions covered the methods for managing residual state holdings and the lessons from the recent experience with public-private partnerships (see attached agenda). The meeting explored the changing pattern of state asset management by comparing policies across a large number of countries. The presentations drew upon the experience of OECD (Hungary, Turkey, Sweden, Finland, Italy, Czech Republic, the Netherlands and the UK) and non-OECD economies (Brazil, China, Russia, Bulgaria and Chinese Taipei).

The following highlights the important points made during the presentations and discussions that ensued.

Defining the boundaries of privatisation and the scope for asset management by the state

- A discussion on the boundaries of privatisation raised the question as to how far can privatisation be taken, and where the boundaries are. From an economist's perspective everything can be privatised, unless the presence of important externalities can be identified (e.g. defence). In addition, historically, private provision or contracting out of some key infrastructure services have been quite widespread in most countries (For example, in the early 20th century, only 8-10 per cent of GDP was produced by the state). With time, many industries or services have been nationalised, or regulated, although the pattern has varied across countries and sectors. Wars and economic depression gave another boost to nationalisation and stronger regulation. However, poor performance of state-owned companies,

precarious government finances and new technology have triggered the recent privatisation wave from the 1970s onwards.

- Ownership reform clarifies the roles and makes private enterprises more efficient than state-owned companies to the extent that the former are better able to focus on value maximisation. In addition, there is overwhelming evidence that privatisation has had positive effects on incentives, profitability and performance of privatised enterprises. When private incentives are allowed to work and corporate governance improves, productivity and efficiency at the firm level increase. This, in turn, boosts competitiveness in the relevant product and factor markets and increases the potential for consumer benefits.
- Privatisation also creates tradable property rights in corporations, contributes to deeper and more liquid capital markets and thus changes the market for corporate control and the finance patterns of companies. From a social welfare perspective, the more important objective should be to help create markets and to ensure that competition can take place in a credible way. In some countries, this has been possible by letting state-owned enterprises compete with private firms on a level playing field. But in the majority of countries such an arms-length treatment of the SOEs has proven to be an illusion. Politicisation, hidden subsidies and other means of protecting the "national champions" have undermined attempts at combining state-ownership with credible competition.
- In spite of the benefits of private ownership, the state still retains stakes in many enterprises for multiple reasons, such as fiscal reasons, potential for share price appreciation, underdeveloped capital markets, and sovereignty concerns. The state uses different arrangements to safeguard its interests in partially owned enterprises, representation on boards of directors, or direct nomination of management. Different institutional arrangements have a cost, which has often been underestimated. If not well defined, the implementation of such arrangements might penalise enterprises by reducing investors' interest, delaying privatisation or reducing proceeds.
- Excessive power by a single enterprise, in the case of privatised natural monopolies, has also been used as a justification for keeping ownership in state's hands. In many developing countries there is concern about the risk of regulatory capture. Institutional arrangements should address this very real possibility. It is important to find an arrangement that ensures efficiency gains without risking abuse of market power by the dominant privatised entity.
 - A sustainable ownership arrangement in network industries requires a rent-sharing system that protects consumers, provides owners with incentives to operate the network efficiently and reduces the temptations for governments to exploit monopoly rents for political advantage.
- While complete privatisation of state-owned enterprises was advocated by most, it was noted that gradual privatisation of the very large enterprises might be a wiser approach. When an entity is first brought into the market, there is no observed track record and information about its performance, which leads to serious information asymmetries between the buyers and the seller. Gradual privatisation also avoids flooding equity markets, especially in countries where they are just starting to develop. Finally, a careful strategy of "tranching" might increase privatisation receipts for the Treasury.

Institutional framework for managing state assets

- The balance of power and role of different parts of the administration in privatisation and state asset management have important implications for the success of the process. The issues related to the institutions responsible for the management of commercial assets under state ownership were discussed at the example of Hungary, Turkey and Brazil. Despite their differences, all three country experiences highlight the need for consensus and a clear strategy on the management of commercial assets under

state ownership. It is also very important for the government to be clear as to what enterprises / assets it needs to privatise, what to keep in its hands to manage and to have a clear timeframe.

- In the Hungarian case, supervisory responsibilities for the sale and asset management functions are the sole responsibility of the Privatisation and State Holding Company (APVRt.). Within the agency there is a clear separation between the asset management and privatisation functions. Company accounts are also subjected to external audit.
- In Brazil the decision making process with respect to state assets involves line ministries. This makes the process quite complicated. However, in a quite unique way, the largest stock of state assets is with a bank --the National Development Bank (BNDES). BNDES is responsible for privatisation, capital investment and management of state equity participations. The latter function is exercised by the investment corporation of BNDES called BNDESPAR, which is the most important venture capital agency in Brazil focusing mostly on minority stakes with a clear possibility of future exit. In Brazil the fact that local authorities control many assets creates considerable problems.
- The framework for privatisation and state asset management in Turkey is quite complex. It is governed by different legal acts and is carried out by several government agencies, including the Privatisation Administration, the Ministry of Energy and the Turkish Telecom Tender Committee. Their activities are overseen by a Privatisation Council. Oversight of enterprises in which the state has a stake is exercised, *inter alia*, by nomination of officials on the boards. In the discussion it was felt that board representation should in principle be sought only where the state has a substantial minority holding, as state representatives are easily captured by management and might also be tempted to create obstacles to privatisation in order to retain their position. In Turkey, the fact that the ministries are responsible for policy and management of assets represents an advantage in terms of industry specific expertise, but it might also lead to conflict of interests and moral hazard. Involving ministries in company management might be problematic, given their vested interest in retaining control of industries and the barriers to competition stemming from their parallel function as regulators.
- For both Brazil and Turkey, bank privatisation, which has been lagging behind, is currently a priority. Private financial institutions are important to ensure financial intermediation in the privatisation process itself, but also to encourage financial discipline of enterprises. Experience from other countries suggests that sequencing of privatisation does matter and that banks need to be privatised at the beginning of the process.

The state as a corporate governance principal

In many instances governments retain residual assets to address political or strategic concerns. The purpose of retaining such assets often determines whether they will remain in state hands for the longer term or will be privatised. The discussions dealt with both OECD (Sweden and Finland) and non-OECD countries (Russia, Bulgaria and China). In Sweden and Finland the government has sought to improve and increase value by taking steps to act as an active owner. The experience to date has been very good compared to what has been achieved by other governments. This has raised the question as to whether state asset management can be a substitute to privatisation when there is a lack of public support for privatisation and whether the experience of Nordic countries is applicable to other settings.

- In Sweden the government is by far the largest owner of corporations. The presence of a quite large portfolio of state-owned enterprises and residual assets to be kept in state hands for the medium or long term has faced the government with the difficult task of improving the profitability of these enterprises in order to successfully face global competition. Thus, value creation, enhanced governance, a leaner capital structure, provision of incentives for workers and managers and more coherent internet strategy have been defined as the main goals of the state as a corporate governance principal. However, it appears that for the Swedish approach to be applicable elsewhere, it requires considerable "new-

economy" potential, together with strong institutions with a tradition of openness and accountability by state institutions.

- To maximise shareholder value, the Swedish government has separated regulatory policy from ownership/shareholder functions. Deregulation has been implemented early on and as a result 85% of the SOEs are facing competition in their respective markets. The success of the Swedish policies is to a great extent, due to the concentration of most corporate ownership function in one body the Ministry of Industry, Employment and Communications, responsible for a large portfolio of state assets. It acts as a virtual investment company aiming to create value through a profit strategy and cutting edge corporate governance policies. It also employs a number of professionals with backgrounds in business restructuring and corporate finance, and are remunerated competitively.
- Important methods for value creation in the Swedish case are business streamlining, corporatisation and deregulation of public utilities and capital restructuring. Transparency and disclosure of financial and other results is considered to be essential to this process. Therefore, special efforts have been made to improve reporting by enterprises with state holdings and bring it in line with practices of private enterprises. Boards of directors have also been made more accountable through the setting of specific guidelines and by hiring more outside directors. In order to achieve shareholder value maximisation, more than 50% of managers and 1/3 of board members have been replaced in SOEs.
- Performance-related remuneration is difficult in non-listed SOEs. For this reason performance-related remuneration models that simulate market value are being designed. Their market value has yet to be proved. It was also acknowledged that majority state ownership might keep a company from adapting its capital structure to meet market demands, and this divergence might create a handicap for SOEs and limit their growth.
- It has been acknowledged that the scope for value creation can be significantly increased by coupling the financial transformation of state-owned enterprises (pay dividends, borrow on private capital markets) with 'e-transformation'. The electronic strategy of enterprises is based on the assumption of a large potential for economies of scale and thus focuses on internal processes, supplier / procurement management and customer / distribution management.
- In Finland the state is applying an active and pragmatic approach. The state shareholding unit is currently a separate entity also in Ministry of Industry and Trade. Dividends, from SOEs have grown 20 times over the last 20 years. The role of professionals in the Boards of Directors of SOEs is increasing, together with representation of independent shareholders.

Participants also discussed the experience of the state as a corporate governance principal in three non-OECD economies (Russia, Bulgaria and Chinese Taipei) with widely diverging governance patterns.

- The Russian Ministry of State Property retains minority stakes in 12000 enterprises and majority stakes in 3000. Such a broad share-ownership can be difficult to match with active governance. Further privatisation might be in the order of the day before the state can become more efficient as a shareholder. Management of such a large stock of assets requires the implementation of adequate policies and a serious capacity building effort in the relevant state bodies. Currently more than half of the appointed directors are civil servants. Better definition and enforcement with respect to the role of directors and reporting requirements appears necessary together with adequate remuneration of directors in order to enhance corporate governance of state-owned companies.
- In Bulgaria, the state retains residual shares in approximately 1150 companies. The shareholder functions of the state are exercised by line ministries and the Privatisation Agency. The government acknowledges the importance of corporate governance and the lack of a modern legal framework in this respect, while it does not seem to be addressing the complex institutional structure and the underlying

potential for conflicts between different state bodies. A recent initiative for development of corporate governance “best practices” is an important step for enhancing governance, including by the state.

- The Chinese presentation focused on corporate governance of publicly listed companies, which represent only a small subset of China’s state-owned enterprises – generally a better performing group. Nevertheless, market capitalisation in China has reached 50% of the GDP and there are more than 1000 listed companies. A typical listed Chinese stock company has a mixed ownership structure with three main groups of shareholders, the state, legal persons and domestic individual investors. Insider control, strong block-holders (mainly state-related institutions) and weak minority shareholder protection are among the main characteristics of the corporate governance patterns of publicly listed companies. The fact that the key controlling shareholder, the state, does not operate according to clear and transparent rules when exercising its ownership rights might also be problematic. Current efforts to improve governance should focus on the improvement of legal rules and their enforcement, ownership diversification towards the private sector, and independence and responsibility of the boards of directors.

Methods for managing state holdings

The methods for managing state holdings were discussed at the example of Chinese Taipei. In order to meet a range of objectives, such as concerns over the liquidity of capital markets, avoiding hostile takeovers, or specific policy concerns, the state has retained a considerable volume of residual shares in the network and competitive industries.

- The current institutional framework of state assets management includes line ministries and the Council of Economic Planning and Development; however, the introduction of a centralised approach is being debated in order to increase efficiency and accountability. The government exercises its property rights by selling residual shares and by retaining a “golden share”, which in the case of Taipei does not only permit a veto on corporate control transfers, but also on company’s decisions. The discussion focused on the experience of other countries with golden shares and signalled the importance of a clear definition both in terms of scope and time of this corporate control device. If for example “golden shares” do not have a sunset provision, they may result in long legal procedures in order to be transformed into ordinary shares and thus delay privatisation. If their scope is too broad they might have a negative impact on the share value of the companies.

Governments in the market: case studies

In this session the participants discussed a number of cases from the Czech and Italian experience with management and privatisation of residual state stakes.

- The Czech presentation underlined the importance of adopting a clear and coherent sector strategy at the outset, in particular when privatising infrastructure assets. The presentation focused on the privatisation of the electricity sector and underlined the fact that lack of a coherent sector strategy had created problems for the subsequent regulatory efforts. It also showed that the method for primary sale determines to a great extent the effectiveness of the method used for the secondary one.
- In the Czech case, the initial partial privatisation of electricity distribution companies led to significant municipal stakes. While the state was redefining its energy strategy, it attempted to acquire control by buying shares back, in order to have better chances to pursue its intentions. However, control had meanwhile been acquired by foreign investors, who in addition to their minority shares had purchased the municipal stakes and shares held by institutional investors.
- The Italian presentation showed that the government could be a force for better corporate governance once in the market. It started with the experience of Telecom Italia and its impact on the market for corporate control in Italy. The company was successfully restructured prior to privatisation in order to

increase value. Its corporate governance was also considerably improved. Another important change had to do with the liberalisation of take-over regulations. The government retained a "golden share" with a 3-year sunset provision in order to oppose the transformation of a public monopoly into a private one, if need be. Within a year, two companies launched take-over bids, namely Deutsche Telecom and Olivetti. The government did not directly intervene in the take-over process.

- In the case of the privatisation of Aeroporti di Roma, the bidders were state-owned companies and the Italian Treasury decided that some of its fundamental privatisation objectives would not be fulfilled by such sales. The bidders started legal proceedings against the Treasury, which they lost. In contrast Brazil has allowed bids from foreign SOEs in its privatisation but not by domestic ones.

Lessons from the recent experience with public private partnerships (PPPs)

The last session discussed PPPs as a cutting-edge area of getting private input into state asset management. The need for financing to up-grade existing infrastructure and utilities has led to the design of policies transferring expenditure to the private sector in return for long term concession. PPPs represent joint investment programmes, involving private sector capital and expertise, while keeping public ownership responsibility. The experience of the UK, Netherlands and World Bank were discussed during this session.

- PPPs are broader than private project finance. In the case of the London underground, controls and operation were transferred to a private company in the framework of a 30- year concession with periodic revisions every 7 and ½ years. Special incentives were introduced to ensure that important state objectives, such as capacity, availability and service quality are fulfilled. A key issue is how to allocate risk between the public and private sector and make the investment attractive for the private sector, in the absence of extensive guarantees by the state.
- PPPs involve ex-ante contractual risk sharing for long stretches of time. Due to difficulties in evaluating these risks, earlier attempts at PPPs seem to have shifted too much risk to the private sector. As a result a significant number of contracts had to be re-negotiated before their time limit. An important lesson from these is that both governments and the private sector need to build expertise in this area. But it is particularly important for the governments to develop expertise with the design and negotiation of PPPs, and to centralise the expertise in bodies such as Treasuries.
- Penalties and rewards need to be built into PPP arrangements. The contracts need to have benchmarks built into them. A key instrument for avoiding moral hazard and strategic behaviour by private parties is the establishment of clear exit provisions of the incumbents.
- The World Bank noted the example of the Chilean toll roads as a way to avoid the need for contract renegotiation, which can arise as a result of faulty initial assumptions about demand. The Chilean government offered a solution that focused on the value of revenues over time rather than on a rigid time frame for the concession: if more people drive on the highway than expected the concession term became shorter.
- Government financing of projects does not necessarily mean a real lower cost of capital. In effect it is the taxpayers that are bearing the risks associated with the projects rather than the capital markets.
- Introduction of an external source of financing could expose the projects to an added level of due diligence and monitoring and protect against moral hazard. Moreover PPPs can make the costs associated with the operation and maintenance of projects transparent, and thus force governments to deal with the affordability of the projects in up-front manner.
- The Dutch case focused on the experience with a high speed rail link and underlined that from a policy perspective, PPPs increase value for taxpayers and are an important instrument for focusing government on its core business. However, PPPs design and negotiations are complex, need to be

handled with caution and require strong political commitment, coherence and continuity of state policies.

Future work

The fifteenth meeting of the AGP will be hosted by Turkey and will take place in September 2001, possibly in Istanbul. It will discuss issues related to Employees, Employment and Privatisation.