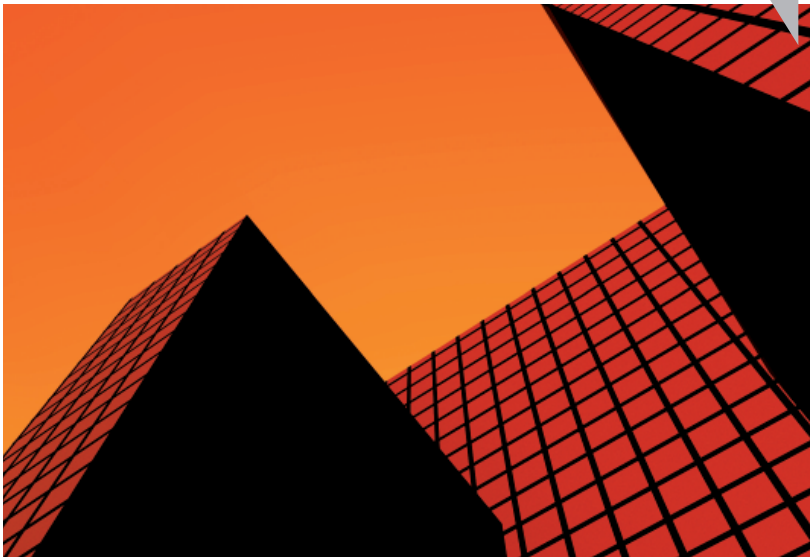
Privatisation in the 21st Century

SUMMARY OF RECENT EXPERIENCES



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Foreword

OECD countries differ in respect of the number of state-owned enterprises (SOEs) they have in their economies. Some governments own hundreds of enterprises employing millions of people. Others have virtually none. The OECD does not take a position on whether or not public ownership of enterprises is a good idea. However, we do say that a State that owns enterprises should ensure that these enterprises are held to high standards of corporate governance.

Among other things this implies an effective legal and regulatory framework establishing a level playing field between SOEs and other companies, as well as well-functioning SOE boards and management, and high standards of transparency and accountability. This is the essence of the *OECD Guidelines on Corporate Governance of State-Owned Enterprises*, an official OECD instrument prepared by the Working Group that I chair. However, if governments are either unable or unwilling to bring their SOE sectors up to commonly agreed standards then privatisation should be considered.

It appears to me that we live in a "new privatisation landscape". A large number of enterprises have been subject to privatisation processes, but not transferred to private ownership in their entirety. OECD governments have listed large equity stakes in some SOEs on stock exchanges through public offerings, and sold stakes in others to strategic investors, but remain majority or significant minority owners of shares. Through this they seek to use the disciplines of stock market listing or private ownership to enhance the efficiency and commercial orientations of the SOEs without relinquishing the perceived benefits that led governments to invest in these companies in the first place. This pragmatic fluidity between private and public ownership makes it important for governments to ensure that processes for transferring shares and corporate assets are well structured, competently managed and held to high standards of accountability.

The document summarises and draws conclusions from OECD country experiences with optimising their privatisation processes during the years 2000-2008. It is based on discussions within the Working Group and has

also benefited from many constructive comments from OECD's advisory bodies, the Business and Industry Advisory Committee (BIAC) and Trade Union Advisory Committee (TUAC). I would like to express my thanks to all the officials, experts and practitioners who through their contributions have led to the completion of the document.

Keeping in mind the amorphous nature of privatisation across national and sectoral boundaries, this document is not intended as an authoritative guidance – and even less a one-size-fits-all recommendation for privatising SOEs. However, I hope and believe that it will serve as a valuable tool for both newcomers to the privatisation process and experienced practitioners aiming to refine their methods. The document allows public officials to learn from the first hand experiences of their colleagues in other countries.

Paris, 30 March 2010

Pekka Timonen
Chair of the OECD Working Group on Privatisation and Corporate Governance of State Owned Assets

Table of Contents

Introduction and Context

The OECD Working Group on Privatisation and Corporate Governance of State Owned Assets finalised and derestricted at its meeting in November 2008 a best practice report entitled *Privatisation in the 21st Century: Recent Experiences of OECD Countries* (the "Best Practice Report"). The present document provides a summary of the main findings and conclusions of this report. It is intended to assist policy makers and public officials considering whether and how to privatise state owned enterprises, by bringing to their attention the recent experiences made by their peers in other OECD countries.

The document should be viewed against the background of the *OECD Guidelines on Corporate Governance of State-Owned Enterprises* (the "SOE Guidelines") and the *OECD Principles of Corporate Governance*, with which it is fully compatible. A government seeking to improve the efficiency of its state-owned enterprises faces a choice between either reforming the corporate governance arrangements of these enterprises in a scenario of state control – which might include opening them to private market disciplines by admitting outside minority shareholdings – or transferring them entirely to the private sector through privatisation. In the first case, the consensus among OECD countries would call for such reform to be conducted in accordance with the best practices codified in the SOE Guidelines. Privatising governments will normally also want to put SOEs on a corporate footing, subject to the recommendations of the SOE Guidelines, prior to the sell-off. They need to take into account the corporate governance framework in which the enterprises will operate following the transfer to the private sector.

The document does not propose a common definition of what constitutes privatisation. However, the Best Practice Report on which it is based applied a relatively encompassing approach: *As privatisation may be considered any material transaction by which the state's ultimate ownership of corporate entities is reduced.* This definition includes direct divestment by the state, divestment of corporate assets by government-controlled investment vehicles as well as the dilution of state positions in SOEs by secondary share offerings to the non-state shareholders. It may also include some instances

of divestment of subsidiaries by SOEs, for instance where SOEs shed subsidiaries in consequence of government decisions rather than reflecting purely commercial considerations.

By the same definition the transfer of certain commercial activities from SOEs to private operators (e.g. through concessions, delegated management contracts, leasing or other forms of public-private partnership) is normally not considered as privatisation. Nor is the dilution of government control over incorporated entities through means other than share transfers (*e.g.* share class unifications; changes to the articles of association; cancellation of golden shares). "Privatisation" in the context of the current document refers to a transfer of corporate assets to the private sector rather than a transfer merely of activities.

The following document is divided into two main parts: (1) the Framework for Privatisation and (2) the Process of Privatisation. The two parts cover five and six topic areas, respectively The "Framework" includes administrative responsibility for privatisation; legal considerations and approvals; regulation and competition; conditions of employment and control arrangements following privatisation. The "Process" is organised according to the chronological order in which government owners normally have to address privatisation challenges: the decision to privatise; preparing a company for privatisation; privatisation methods; timing and sequencing; corporate governance of privatisation; the role of external advisors; changing employment conditions; and assessment and auditing of the privatisation process. Each topic area contains two sections. First, a text box recapitulates, sometimes in a condensed form, the main findings of the Best Practice Report. Secondly, a bulleted section proposes a few pointed conclusions to which these findings give rise.

Part 1

The Framework for Privatisation

I. Administrative responsibility for privatisation

Background

Consistent with the OECD Guidelines on Corporate Governance of State Owned Enterprises (the "SOE Guidelines") most OECD countries have centralised the ownership function of all or most SOEs. SOE Guideline II.D states that a clear identification of the exercise of ownership rights may be facilitated by "a co-ordinating agency or, more appropriately, by the centralisation of the ownership function". The annotations to the Guidelines further observe that "centralisation of the ownership function… is probably most relevant for SOEs in competitive sectors and is not necessarily applicable to SOEs that are mainly pursuing public policy objectives". One might conclude that the recommendation concerning a co-ordinated ownership function is particularly pertinent to SOEs being prepared for privatisation. As regulation is separated from ownership, competition introduced and a professional board of directors taking charge, the state has a strong incentive to ensure that its ownership function is exercised by a specialised unit (or units) of professionals with the relevant expertise.

Conversely, it is not always clear whether the reliance on a privatisation agency or a similar centralised unit should be considered as a good practice. Clearly, a government need to ensure that those entrusted with privatising SOEs are competent, well resourced, and subject to high standards of accountability and transparency – and all of this can be effectively achieved by relying on a specialised agency. However, governments also need to safeguard efficiency – that is, ensuring that the benefits are obtained at the lowest cost – and this militates against specialised agencies unless the volume of privatisation is large.

Conclusions:

A. Government needs to ensure that the administrative unit(s) entrusted with privatising SOEs are competent, well resourced and subject to high standards of accountability and transparency. It should also safeguard the efficiency of the privatisation process.

B. When the function of state ownership is assigned to a specialised unit best practice calls for this unit to be mainly responsible for the privatisation process. Where this is not the case, governments would normally establish or assign coordinating functions or rely on existing such functions for SOE ownership:

1. Specialised privatisation agencies are recommended where the expected volume of privatisations is so large that the accumulated expertise that they bring to the process is sufficient to justify their cost.

2. Where there is no central privatisation agency, establish a coordinated approach to privatisation, reporting to one clearly identified part of the executive powers and subject to the highest standards of transparency and accountability.

II. Legal considerations and approvals

Background

The needs for, or discretionary decisions to invoke, legislative authorisation of privatisation vary greatly according to specific cases and national contexts. Obviously in the case of statutory corporation and other SOEs that have been established by specific law, another piece of legislation is usually needed to change their status or ownership. Likewise, some SOEs may be subject to specific legislation (e.g. in some countries laws are in place prohibiting a state ownership beneath 50% in certain enterprise) that would have to be repealed to allow full privatisation.

Apart from this, it would appear that the legal and approvals frameworks for privatisation fall in two main categories: First, countries that still have large, active privatisation programmes mostly rely on framework authorisation acts – in part, presumably, because parliament does not have the time and inclination to monitor each transaction. Secondly, infrequent privatisers are mostly either required to seek parliamentary approval or chose on their own to involve legislators in order to gain acceptance around the privatisation efforts.

It is not clear that general "good practices" can be formulated concerning national legislative frameworks, which are firmly embedded in national political and constitutional realities. At the same time, it should be recognised that embedding privatisation in the legislative process can have important beneficial impacts on the transparency and predictability of the process. Even governments that are formally entitled to privatise state assets without specific legal authorisation, or which need only to seek the "approval" of parliament, have sometimes chosen to pass a sales act setting out the agreed modalities of privatisation. Where different parts of the political spectrum differ on privatisation – and not least in the current environment of large, sequenced privatisations – this may be useful in signalling a political commitment to investors and reassuring them concerning the likely future path of sell-offs.

Conclusions:

A. The legal frameworks bearing on SOEs should encourage a periodic reassessment of whether each company is most appropriately operated under public or private ownership.

B. The legal framework should establish, with a maximum degree of public disclosure, which entities are authorised to make privatisation decisions and under what circumstances. Dependent on national circumstances and legal traditions:

   1. Infrequent privatisers may choose to rely on one-off authorisations from parliament;

   2. Countries with large privatisation programmes are encouraged to create framework laws for privatisation or embed such provisions in their fiscal legislation.

C. Even where the executive powers are legally entitled to sell SOEs without parliamentary approval, governments may consider passing a sales bill prior to large transactions insofar as this does not endanger the efficiency of privatisation processes. This raises the transparency of the process and may serve as a useful signal of political intent to investors.

III. Regulation and competition

Background

The consensus position among OECD countries is that a government should not privatise an SOE before an appropriate regulatory framework for the privatised entity has been established. Key organising principles for this framework are proposed by the Principles as well as the SOE Guidelines. These imply that a privatising government needs to ensure itself that two separate, but related, regulatory frameworks are in place. An adequate competition, or anti-trust, regulation backed by effective enforcement mechanisms is needed. The consensus view is that privatised entities involved in any activity where competition on general market terms is feasible should be made subject to competitive pressures. This leaves a residual role for sectoral regulation (for instance, third party access regulation) of activities that will necessarily involve an element of monopoly subsequent to privatisation. A further consequence of the consensus is that safeguards must be taken to ensure the independence of the relevant regulatory agencies, in general, and vis-à-vis any remaining ownership function that the government may retain.

Where corporatisation of SOEs goes hand in hand with the introduction of competition and/or regulation then the first thing the government will normally want to do is to ensure the separation of the ownership from the (evolving) regulatory functions: in the absence of an independent regulator, most other concerns about regulatory quality are somewhat obscure. This issue has come to the forefront lately in OECD countries because of privatisation programmes' increasing focus on the network industries. The solution chosen by most governments is to transfer the ownership and/or financial responsibility for SOEs to a central ownership function or an economics ministry, while retaining the regulatory functions (in most cases, the previously self-regulatory functions) in the relevant sectoral ministry.

Alternative models include keeping both functions in a sectoral ministry, but shifting the regulatory function into an autonomous, specialised unit. Several OECD countries further take the position that the separation of functions can be buttressed by codifying the respective responsibilities in separate laws. In practice, though, the quality and credibility of the separation has more to do with public than corporate governance: when the ownership and regulatory function are part of the same state administration subject to the same political oversight, a potential for confusion exists. A degree of regulatory certainty is paramount to an effective sale process, particularly in the case of a partial privatisation. The best way of gaining credibility for regulatory independence is to demonstrate, over time, the de facto independence in concrete cases.

An additional issue is the degree to which the SOE considered for privatisation – or parts of it – can be subjected to competition. In the network industries this brings up the question of "structural separation". SOEs in this sector generally consist of many parts, some of which will remain monopolies. Through the process of structural separation the latter parts are separated from those that are capable of operating in a competitive environment. Governments may, of course, decide to privatise vertically integrated SOEs en bloc, but in practice this complicates the process of introducing competition and may be best suited if the

privatised entity is intended to continue as a regulated monopoly. In individual cases policy makers may perceive a temptation to pursue this line of action because the monopoly elements can boost the privatisation revenues. However, in the longer term this conflicts with the ultimate goal of maximising economic efficiency through privatisation.

A course of action pursued by most countries is to separate "commercial" parts of a utility, typically including the retail side of business, as part of the corporatisation process. What then happens depends on national preferences. These units may be privatised subject to standard competition policy safeguards, or they may be retained as independent subsidiaries of the SOE whilst their competition with private entities is introduced.

The final choice is whether the hard core monopoly elements of utilities SOEs should themselves be privatised. The retention of such "natural monopolies" under public control is widely supported by economic theory, and in practice the main argument for transferring them to private ownership is normally a need to address major operational inefficiencies that have accumulated due to the public ownership. Privatising such enterprises more than anything else highlights the need for independent and well-resourced regulation. A case in point is the so-called universal service obligations (USOs) that will normally follow this part of the enterprise. A means of treating USOs post privatisation will need to be established. If the SOE is corporatised, and perhaps sequentially privatised, then the SOE Guidelines imply that this will involve an identification process, a costing process, a funding process and, ultimately, a contractual process. In the case of en bloc privatisation the state may of course simply impose USOs on buyers and let the competitive sale process sort the costing and funding out.

Conclusions:

A. Governments should normally not privatise SOEs before an appropriate regulatory framework has been established. This framework includes anti-trust regulation to ensure competition where feasible, and specialised regulation to oversee activities where an element of monopoly is likely to persist.

B. Existing laws and regulation (including anti-trust and takeover rules) should apply to the privatisation itself. If exemptions to this principle are granted, such exemptions would need to be fully disclosed and motivated in advance.

C. The regulatory functions whose domain will be affected by privatisation need to be separated from the privatising unit, the state's ownership unit and the executive. This can be obtained through the creation of an autonomous regulatory body outside the control of the executive powers or through, at least, a complete functional and legal separation within the state.

D. Good practice calls for exposing as much as possible of an SOE's activities to competition no later than at the time of privatisation. If monopoly activities necessarily remain the government faces a choice:

1. Break up the company , sell the competitive parts and make specific regulatory arrangements for the rest;

2. If the company is to remain vertically integrated during and after privatisation then the need for independent and well-resourced regulation is further exacerbated.

IV. Conditions of employment

Background

Public employees may or may not be better paid than their private sector counterparts, but as a general rule they enjoy better-than-average job security and pension schemes. To this comes the fact that SOEs tend to be overstaffed. Empirical studies of privatisation generally identify the downsizing of a bloated payroll in SOEs among the main sources of efficiency gains – although, it should be added, the long-term employment changes in privatised SOEs can be either positive or negative depending on the degree to which the company's post-privatisation prospects are enhanced. A key question to be dealt with in the privatisation process is therefore what legal and contractual rights SOE employees have, and how these are affected by the transfer from the public to the private domain.

Again in this context the question of whether or not the government chooses to corporatise the assets prior to privatisation imposes itself. Un-corporatised activities are typically staffed with civil servants or comparable categories public employees, subject to an employment regime established by specific laws. A fully corporatised SOE is subject to a similar legal regime, including concerning staff relations, as that applying to private incorporated entities. In consequence, the privatisation of corporatised entities should be relatively less complex in terms of employment conditions, because the state will already have settled the staff issues as part of the process of corporatisation.

Conversely, the decision to dispose of an unincorporated entity will normally involve considerations about whether or not to reassign staff, offer them a compensation for transferring to the private sector, or reaching an agreement with the purchaser concerning the future employment conditions. In both cases, special problems may arise when the employees invited to accompany the SOE during privatisation enjoy a legally guaranteed civil servant status. This issue has been highlighted in recent years as more countries have proceeded to privatise utilities companies, the SOEs in which civil servant status was most common.

Conclusions:

A. Where the transfer of ownership affects the job security, wages and benefits of incumbent staff, the general rule applies that contractual rights should continue to be honoured. However, the grandfathering of the existing entitlements of civil servants and other public employees is not a good practice.

1. If SOEs are restructured prior to privatisation, the time of restructuration is the point where future employment conditions, wages and benefits should be discussed with SOE employees. The new regime would be compatible with prevailing conditions in the private sector.

2. Insofar as benefits are legislated then the state may simply change the relevant laws, but this needs to be considered carefully against the risk of a public backlash against the privatisation process.

3. Specific contractual entitlements, such as pension rights, may be best dealt with by rescinding them up front in return for a compensation corresponding to their market value. The issue of successor rights, where applicable, also needs to be addressed.

4. Demanding that the buyer guarantees wages, employment or benefits for a transitory period is not optimal from an economic efficiency perspective. However, if fully disclosed prior to privatisation it may not be inconsistent with good governance practices.

V. Post privatisation controls

Background

Short of retaining a majority ownership, governments have employed a number of mechanisms for continuing to control or influence partly privatised enterprises in excess of the state's ownership share. The formal justification for doing so is mostly "strategic concerns" such as security of supply, access to vital resources and safeguarding national security in the post-privatisation era. Additional reasons have involved the political economy of privatisation. Resistance to privatisation from influential national constituencies have been overcome by the state promising to maintain a continued veto over key corporate decisions. The mechanisms for disproportional government control range from regulation bearing on corporate decisions; to control enhancing mechanism akin to the ones used by private sector companies; to "golden shares" conferring special voting rights in almost totally privatised enterprises. Many such measures effectively reduce transparency, create additional risks and could impede the free movement of capital across borders. Also, amid a growing number of international trade and investment arrangements it is not clear that the government owners of SOEs always or necessarily have the leeway to decide themselves what constitutes legitimate "strategic" concerns.

A frequent argument in favour of maintaining control instruments post-privatisation is that their absence might not lead to privatised companies with a more contestable ownership, but rather discourage governments from privatising. This argument does not hold general validity, but in sensitive sectors it could be true, so an assessment of the merits of the approach would have to hinge on weighing the societal benefits of an improved efficiency of the SOE following its stock market listing against any negative corporate governance and capital market consequences of the chosen control structures. Moreover, the complementary methods of retaining state influence reviewed above do not have identical adverse effect and the more potentially harmful such instruments should be avoided.

The SOE Guidelines to some extent discourage the use of control mechanisms in state-owned enterprises. Chapter III prescribe equitable treatment of all shareholders including (Annotations, citing the Principles) by protecting them "from abusive action by, or in the interest of, controlling shareholders acting either directly or indirectly". In the case of SOEs, as opposed to other listed companies, the "abusive action" would presumably take the form of extracting political rather than pecuniary private benefits from the enterprise. Furthermore, "the potential for abuse is marked when the legal system allows, and the market accepts, controlling shareholders to exercise a level of control which does not correspond to the level of risk that they assume through exploiting legal devices to separate ownership from control".

Conclusions:

A. When governments retain an influence in SOEs following privatisation they should adhere to the standards provided by OECD's corporate governance instruments.

B. Arrangements or instruments that allow for a degree of influence disproportionate to the ownership of cash-flow rights should be exceptional, and they should be compared, and their proportionality assessed, in the light of normal company law. They should be fully transparent and provide adequate safeguards for minority shareholders.

C. Veto rights conferred through golden shares or disproportionate specific legislation are potentially very damaging. Other control mechanisms like, for example, fully disclosed shareholder agreements or voting right differentiation should be disclosed for greater transparency.

Part 2

The Process of Privatisation

VI. Preparing companies for privatisation

Background

To policy makers the decision on whether or not to privatise has often had three vital elements namely, first, whether to corporatise the activity (or asset) in question; secondly, whether to reform corporatised assets to the point where they are largely equivalent with private firms; and thirdly, whether to keep the asset wholly or partly under public ownership. The SOE Guidelines provide essential guidance for these considerations. Their recommendations on the corporate governance of state-owned enterprises may be taken to represent a consensus among OECD countries concerning the good practices governments will want to aim for in the corporatisation and commercialisation processes.

An important secondary consideration whether, in the context of privatisation, the restructuring should be undertaken by the government owners prior to the selloff or left for the new owners. An evolving consensus in academic literature seems to be that pre-privatisation restructuring should not be attempted or, at most, be kept to a minimum. This argument is, however, based mostly on an analysis of trade sales to one out of a few prospective buyers. Since these buyers know better than government what restructuring is relevant to their company, the expected cost of restructuring will then simply show up as a discount in the privatisation proceeds. This discount is likely to be smaller than what would have been the cost of restructuring the SOE within the public sector. That said, if the government are uncertain of the identity of the likely buyers or expect a widespread general interest, then a degree of pre-privatisation restructuring may help widen the scope of potential investors and hence nevertheless boost privatisation proceeds.

When an SOE is being prepared for stock market floatation, thoughts must be given to securing the viability of the enterprise after the transfer of ownership. Here, the challenge may be greater when the state plans to sell all or a substantial part of the SOE in the first transaction since, especially if the subsequent ownership is dispersed, then the well-known agency problems between owners and corporate insiders may influence subsequent restructuring. Conversely, if the state retains the majority owner then it would be in a position to pursue any further restructuring in the interest of all shareholders, but this strategy would likely come at a cost to the public purse in the form of a lower pricing of the IPO.

The capital structure of SOEs is often reviewed prior to privatisation. Country experiences in this respect differ significantly across the OECD area according to national and sectoral contexts. On the one hand some SOEs, especially in the network industries and other low-competition environments, are reliant on government guarantees and tend to be overleveraged. On the other hand, governments might not want to leave excessive capital in an SOE to be privatised. Dependent on the exact nature of the privatisation process it could reduce the net privatisation proceeds, and where governments hope for a successful continued operation of the enterprise they may not want to attract investors mainly interested in "bidding for the cash".

Management and board changes should ideally be rare because companies whose shares are to be offered to the general public would normally be fully corporatised and operating in a competitive environment. However, if corporatisation has been less than perfect then board and management may at the time of privatisation reflect the old rather than the new reality and have to – particularly in the case of an IPO – be changed. Corporate governance also sometimes needs to change according to the listing rules of the respective stock exchanges.

Reducing the payroll in the case of overstaffed SOEs, or adjusting employment conditions, prior to privatisation is arguably one form of restructuring in which the government holds a comparative advantage. This is particularly the case where SOE employees hold special entitlements such as civil servant status, employment for life or privileged pension plans, which, unless discontinued, may deter potential buyers. The government has options such as engendering legal change to alter the status of SOE employees, offer them reassignments within the public sector or grandfathering their pension rights. Some OECD countries have moreover slimmed the payroll of SOEs in preparation of privatisation through voluntary redundancies and/or early retirement. Here, however, it is less obvious that the government is better placed to undertake such change than the future buyer, and anecdotal evidence suggests that the SOE employees who have volunteered to accept such offers were often the ones that the future buyer would have preferred to retain.

There may also be a need to divest SOEs of certain assets prior to privatisation. This question has for example arisen when the company had subsidiaries that were either incongruent with its own business plans and hence could complicate privatisation; when the subsidiaries were held jointly with enterprises other than the potential purchasers; and where the combined market share of the subsidiaries and the potential purchasers gave rise to anti-trust concerns.

Beyond the act of "restructuring" a final act of preparing privatisation in most countries consists of establishing a proper valuation of the SOE to be privatised. While some might argue that privatisation based on competitive bidding will in itself establish the value of the enterprise there are several reasons why the state seller will want to establish (a) pricing benchmark(s). The choice of sales methods – or in the case of public offerings, sequencing – may depend on the valuation of the company in alternative scenarios, as may the ultimate decision whether to privatise now or postpone the transaction. Moreover, specific decisions in the privatisation process such as share allocations (in the case of public offerings), incentive fee structures to external advisors, *ex-post* evaluations of the outcome of privatisation as well as, ultimately, the propriety of the process itself may all hinge on a benchmark established up front.

Conclusions:

A. Objectives for the privatisation should normally be formulated and communicated to the general public. The essential choice between selling SOEs en bloc and privatising them gradually would be considered in consequence of the chosen objectives

B. Privatisation plans would need to be made subject to an evaluation of the degree to which they are likely to fulfil the objectives and the expected costs of doing so.

C. Whether and to what extent to restructure SOEs prior to privatisation will depend on the choice made between rapid and gradual privatisation. The state should normally limit itself to the areas where it has a proven advantage over prospective buyers. This would involve:

   1. Where an SOE is trade-sold to an established company the state should normally leave most of the restructuring to the buyer, except for areas such as staff conditions and capital structure. It should, however, be mindful of the fact that restructuring can sometimes widen the range of potential buyers.

   2. SOEs that are to remain in partial public ownership for a period should operate in accordance with the SOE Guidelines no later than the point at which they enter into competition with other enterprises. And, they should operate in accordance with the OECD Principles of Corporate Governance no later than the point at which they obtain their first minority shareholders.

D. A thorough and independent valuation of SOEs prior to privatisation is generally very helpful in ensuring a positive outcome. Measures to safeguard the integrity of the procedures and avoid conflicts of interest among the valuators are strongly advised.

VII. The role of external advisors

Background

The role of external advisors in privatisation varies greatly among countries, *inter alia* reflecting their preferred methods of privatisation and the size and scope of their privatisation programmes. As for the first point, market sales – in particular IPOs – call for much more specialised expertise than for example trade sales, raising the likelihood that governments will need to draw on external resources. Secondly, governments with many SOEs and large privatisation programmes normally have better resourced privatisation or government ownership agencies than others and have the opportunity to amass greater experience in the relevant areas of expertise. In addition to resource considerations, governments may chose to rely on independent service providers for functions that could, if carried out by the state administration itself, cast doubt on the integrity of the privatisation process. In any case, a government with a privatisation programme needs to decide where to position itself within a trade-off between providing expert services in-house and factoring them from the private sector.

The main challenges in selecting external advisors are ensuring that (1) they are free of conflicts of interest with other interested parties; and (2) they are properly incentivised so that even their self-interested actions are likely to produce a socially optimal outcome. A crucial distinction needs to be drawn between, on the one hand, initial strategic advice to help governments decide whether and how to privatise (the "advisory mandate") and, on the other, specialised advisory functions of a financial, legal or technical nature (the "sale mandate") during the privatisation process. According to a long-standing OECD consensus, the same external advisor should normally not be allowed to serve in both capacities – or, at least, that candidates for the two mandates be selected through separate, independent procedures. A key conflict of interest inherent in allowing the same external advisor to act in both capacities he/she may have incentives to under-value the assets as a means of facilitating the sales.

Certain potential conflicts of interest arise when external advisors are involved in (or hope to be involved in) business relationships with either the potential buyers of the SOEs to be privatised or the management of the SOEs themselves. Ex ante, if the privatising government becomes aware of such conflicts of interest it will in almost any case lead to the exclusion of the relevant advisors from the process. In terms of ex-post safeguards, OECD countries have guarded themselves against this in different ways reflecting their national legal frameworks. In some countries operating amid conflicts of interest would in itself be illegal for the external advisors. In others, the state usually makes its advisors disclose any actual or potential conflict of interest, subject to legal or civil penalties in the case of erroneous disclosure. Governments mostly forbid their advisors from at the same time advising the management of the SOEs.

Conclusions:

A. The decision to use external advisers would be based on an assessment of most efficient use of public resources. Governments are advised to neither abstain from contracting external expertise for reasons of short-term savings, nor to rely on private sector expertise as a way of safeguarding themselves from responsibility.

B. Sound contractual and legal framework need to be established to safeguard the integrity of external advisors' involvement in the process. In particular:

   1. Conflicts of interest must be avoided. Advisors should be required to disclose any business relationship with third parties interested in the outcome of the privatisation. If justified by the complexity and scale of particular privatisation projects, advisory functions in different parts of the privatisation process should be administered by different advisors.

   2. Processes must normally be established for the selection of the best and most cost efficient advisors. In addition to most countries' public procurement rules, additional mechanisms for a transparent prequalification of potential advisors may have to be established.

   3. Governments should give careful consideration to the incentivisation of advisors. While positive impact of "success fees" on the overall outcome of privatisation is worth considering, granting excessive incentives – e.g. schemes that reward performances not exceeding what would normally be expected – should be avoided.

VIII. Privatisation methods

Background

The preferred privatisation methods depend largely on two sets of considerations. One dimension spans the nature of the company to be privatised, the commercial reality into which it is to be transferred and the absorptive capacity of the relevant capital markets. Another dimension reflects the main objective(s) that public decision makers have set for the privatisation.

On the first of these issues, it is important to separate further between the case of one-off privatisation of an entire enterprise and the process of gradual or partial privatisation. When a whole SOE is to be sold off within a relatively short time frame then the consensus view is that if the enterprise is too small to justify the cost of more sophisticated privatisation methods and/or deemed to be commercially non-viable on its own then the method of choice is a trade sale to an existing private company. In the category of "commercially unviable" SOEs come enterprises that are badly in need of industrial partners, technological upgrades or corporate restructuring that the public owners are not well placed to provide.

The two main factors that may militate against trade sales of an entire enterprise are (1) competition concerns related to the combined market share of the acquirer; and (2) the case where the SOE to be privatised is very large relative to the size of domestic (or, if the SOE operates internationally, relevant) markets and existing competitors. Either factor would normally induce the government as a first step to seek stock market listing through an IPO. The size of the IPO and the size and sequencing of subsequent share offers will depend on the size and absorptive capacity of the relevant stock exchanges. An important secondary consideration is the fact that the pricing of subsequent offers can be boosted by allowing the partly privatised company sufficient time to establish a track record for its financial performance.

As for the second point, most privatising governments consider that (one of) their top objective(s) is maximising the net proceeds (after deductions of the cost of privatisation) to the public purse – and, according to national legislation, they may indeed be required to do so. But some countries have complementary, or sometimes conflicting, objectives that they may or may not choose to disclose fully. Examples of multiple objectives that have in the past been communicated to the public include, alongside with maximising proceeds, employment; the location of managerial and intellectual-property related activities; supporting the government's industrial policy; and nurturing national capital markets.

Obviously one single competitive bidding process cannot target multiple objectives. Governments may exact a promise from would-be purchasers that they will respect certain limitations, but such declarations may not be legally binding and, at any rate, different bidders are likely to make different levels of commitment to the individual objectives listed by governments. The main options available to governments are relying on complex, multiple bidding processes; specifying non-pecuniary objectives beforehand and conducting the bidding with these as a sub-condition; and relying on a formal or informal prequalification of bidders.

To some extent this points to a general conundrum that dogs the process of privatisation. In most cases the SOE to be privatised was put in the public sphere for a reason – in pursuit of some concern to the public interest. In the case where some of these concerns are still valid, but privatisation is nevertheless deemed necessary (e.g. because the SOE in question has become inefficient), the government will have incentives to privatise in a way that transfers the benign role previously assigned to the government unto the new owners. One frequent example of this is the assumed externalities to the general economy from retaining a domestic presence in "strategic industries". In this case the nationality of ownership *per se* may be less important, but the delocalisation of key parts of the value chain will appear to the government as a thing to be avoided. A closely related example is found in the airline sector where the national localisation of transport hubs is often deemed important to other parts of the business sector.

Such considerations have led to numerous cases of privatisation of dominant shareholdings – or at least blocking minorities – into the hands of national institutional investors or business interests variably referred to as "strategic investors", "hard core", etc. While not casting in doubt the right of governments to act in the public interest, from a corporate governance perspective this particular model does give rise to concerns. In particular, the national interest may often not be fully aligned with the interests of minority shareholders, who, consistent also with the SOE Guidelines, at a minimum should have access to full information about other investors' obligations in this respect at the time of purchasing their shares.

Conclusions:

A. The choice of privatisation methods is be guided by the size of the enterprises to be sold, market conditions and the objectives of the privatisation process.

B. Governments should rely, to the greatest extent feasible, on competitive bidding in privatisation. Trade sales should involve an auction between potential investors. In buyouts alternative bids to those of the corporate insiders should be sought.

C. Privatisation by allowing SOEs to adjust their own capital structure is supported by the SOE Guidelines. Strong governance mechanisms are in this case needed to ensure that SOE management continues to act in the interest of the government owner.

D. If targeted strategies are pursued then some additional safeguards should be considered:

   1. It is more fair and efficient to work through pre-qualification following by bidding among the selected candidates than allowing the targeting to interfere with the selection of individual buyers;
   2. Full disclosure of any preferred potential shareholders, the selection criteria and the objectives these shareholders are expected to pursue following privatisation.

IX. Timing and sequencing

Background

In previous decades a crucial question for authorities pursuing policies of privatisation was in what order to privatise individual SOEs. They generally chose to begin either with "easy case" companies already operating in a competitive environment or with companies that combined the virtues of being otherwise easy to sell and likely to raise large revenues to the public purse. However, more recently there are fewer companies to sell and those remaining are typically very large compared to the domestic capital markets (or other relevant markets) and the absorptive capacity of potential investors. Authorities may have little choice but to embark on a process of sequential privatisation of these enterprises. In consequence, questions concerning the optimal strategies for timing and sequencing arise.

A closely related issue is whether or not to opt for full or partial privatisation. The cases of partial and sequential privatisation may in practice appear observationally equivalent: a government may in practice opt for selling off a minority share without a clear commitment – or indeed a clear plan – concerning future steps. Moreover, in some countries and sectors privatising governments make clear from the outset that only a limited share of SOE stock will eventually be offered to the public.

The main reason governments cite for opting for a partial privatisation is that it allows them to reap (most of) the efficiency gains from a private operation without having to relinquish control. This argument is most frequently voiced in those industries (e.g. utilities, finance) where a continued public interest in the operations of the SOE is assumed. The "control" may consist of a continued majority ownership in which case the state remains free to dispose over the SOE subject only to the protections of minority shareholders laid down in the relevant legislation and listing requirements. Or, it may imply a minority share large enough to prevent unsolicited bids or, through super-majority provisions, changes to the corporate articles of association. Another reason for partial privatisation has to do with the political economy of the process. Political opponents of privatisation – and often entrenched interest groups as well – generally take more kindly to a partial asset sale accompanied by some form of assurance that it is not a precursor to full privatisation.

In practice, sequencing is often chosen for the pragmatic reason that it helps boost long-term privatisation revenues. The listing of an SOE does, as discussed elsewhere, help improve corporate governance and efficiency. Consequently, several governments have preferred a first, limited-sized IPO followed by more sizeable secondary and tertiary offers once the company's improved performance and prospects have become reflected in its share price.

Insofar as the government has supplementary or conflicting privatisation objectives to maximising proceeds these normally influence the sequencing decision as well. Most basically, if for "strategic" or industrial policy reasons the state wants to ensure the viability of the SOE as an independent entity following privatisation (an objective that would also have militated for IPO and against a trade sale) then it will want to tailor the sequencing of the offerings to the absorptive of those investor groups that are consistent with the strategy.

Another consideration sometimes encountered is a desire to move gradually while the competition and other regulatory frameworks are still evolving. Since it takes time for competition to develop in a former monopolised market and the liberalisation process often needs adjustments, sequential privatisation may be seen as a cautious approach where the state retains some measure of control through ownership. However, this strategy may in practice compel governments to walk a tightrope: the SOE Guidelines recommend a separation of regulation and ownership function that is difficult to reconcile with the use of majority shareholdings to remedy regulatory failures, and doing so may also jeopardise the interests of minority shareholders in the partially privatised SOE.

Conclusions:

A. When selling only part of the shares in an SOE the state needs to decide, and it should consider communicating to the public, whether this represents the first step in a sequenced privatisation or the state intends to remain a significant shareholder.

B. Sequenced privatisation should be considered where SOEs in question are large relative to capital markets, and where performance enhancements emanating from the listing of the company are likely to raise the value of subsequent offerings.

C. Partial privatisation should be considered where the state intends the SOE in question to continue operating in accordance with some public policy objectives.

D. Whether privatisation is partial or sequenced, it is of important to ensure that the investors in the first tranches are fully informed of any public policy objectives that the SOE is expected to continue to pursue in the duration of the process.

X. The corporate governance of privatisation

Background

As governments corporatise or restructure SOEs in contemplation of privatisation they will normally wish to benefit from the agreed good practices that the SOE Guidelines establish for the state's role as an owner and the function of SOE boards. Whilst not specific to the privatisation process these recommendations carry special weight when an SOE is, for example, in the process of preparing an IPO and hence has an interest in convincing markets of its commercial viability, or when partly privatised SOEs aim to shore up their market valuation with a view to further stock offerings. Put bluntly, excessive political intervention before and during privatisation depresses privatisation revenues and could in more extreme cases call into doubt the integrity of the entire process.

The SOE Guidelines do not militate against the appointment of ex-officio directors drawn from civil services. They do not take an explicit position against politically-connected board members either, but the Guidelines' annotations do recommend that board members should "not act as individual representatives of the constituencies that appointed them". This is potentially problematic in the context of politically charged privatisation programmes. Many OECD governments reserve the right (as alluded to in earlier sections) to use changes in SOE board composition as a short-term tool to change corporate directions.

One question is therefore, how best a government can enhance the credibility of a SOE's board arrangements prior to or as part of the privatisation. In the early phases this argument can be taken only so-and-so far, even amid a strong formal commitment to full corporatisation of the enterprises concerned. In the pre-privatisation period it is unlikely that the incumbent board will agree to a company policy that will generate a high political cost for the government, no matter what its impact might be on the firm's performance. Subsequently, privatised companies need to have a state-of-the-art board nomination process. At a minimum, this might justify cumulative voting or similar mechanisms to ensure that the minority shareholders in partly privatised SOEs gain board representation. Another way to do this would be to follow a board nomination process, which allows minority shareholders to participate in the shareholder committee that nominates board members.

In respect of SOE board independence, an interesting distinction is between governments that own their SOEs directly and those that hold them via an incorporated holding company. The holding company will normally be subject to company law and its directors subject to fiduciary obligations. This creates a *de jure* independence from government which also, though in practice independence may *de facto* be more limited, makes it easier for the ownership function to pursue "opportunistic" privatisation practices responding to market opportunities rather than political pressures.

Once a credibly independent and competent board has been established potential conflicts of interest between the board and the (majority) government shareholder may arise. According to national legislation board members are usually subject to fiduciary obligations defined *vis-à-vis* either the shareholder body or the company. In both cases (and, arguably, particularly in the first) board members would be expected to deny following instructions

that they deem to be inconsistent with the interests of non-state shareholders. In the context of privatisation, this issue may for instance arise when the state owners propose as part of the process to divest or otherwise dispose of corporate assets in ways that the board is not convinced is in the interest of minority shareholders.

The management of SOEs considered for privatisation, and to a certain extent also non-executive board members, have a direct interest in whether or not a privatisation goes ahead and, if so, what privatisation methods are employed. As a general rule, if an SOE is loss-making and inefficient then incumbent staff fears privatisation on account that the new owner(s) are likely to downsize the payroll. Managers will share this fear, except where the preferred privatisation method is management buyout, in which case they obviously stand to be the ultimate beneficiaries of post-privatisation efficiency gains.

The question is how much SOE managers can actually do to discourage or prevent privatisation of their company. In most OECD countries it would not be acceptable for high-ranking SOE employees to speak out publicly against their government's privatisation policies. However, they have scope for collusion with (other) employee groups, which may be protected by powerful political interests and trade unions. In countries with mandatory employee representation on corporate boards (especially in the case of SOEs that are already listed) this scope for collusion may extend to the SOEs' non-executive board members as well.

Managers and boards often have a freer hand in influencing the method of privatisation. Here, they will normally prefer public share offerings over trade sales on account that they are more likely to retain their positions in a listed company than if the SOE is converted to a subsidiary of a competing enterprise. SOE managers have a manifest interest in initial public offerings which, firstly, maximises their own chances of staying employed. Secondly, given that they do stay employed, a widely dispersed share ownership post-privatisation will normally be in their long term interest. The well-known "free rider problems" tend to weaken shareholder powers vis-à-vis corporate managers in a situation where owners are many and small. Some countries have in the past tried to address this problem by privatising block holdings into the hands of a "hard core" of stable investors but have in recent years been more reluctant to do so because of the value discounts on stock offerings when this method is employed.

In the case of trade-sale privatisation other incentives may arise, depending on the financial health of the SOE. If the enterprise is loss-making or otherwise not likely to be retained as a separate entity after privatisation the managers must consider the prospect of not remaining on their posts. The main incentive problem is keeping them actively engaged in the SOE's operation until privatisation. If management foresees a realistic chance of remaining in their jobs then the challenge for the state owners is that, as soon as a (group of) likely purchaser(s) has been identified then the managers face strong incentives to align themselves with the interest of these people rather than those of the – still – state owners.

Given the sometimes conflicting interests of managers of companies to be privatised, one solution would be to "incentivise" them. One way of doing this would be for the state owners to design benefits packages for the managers of pre-privatisation SOEs so that the managers' financial interests become aligned with the objectives of the government. Another would be to oblige managers legally or contractually. In doing so there can be no one-size-fits-all solution: depending on the situation such incentivisation measures would have to neutralise radically different sets of adverse incentives.

Conclusions:

A. The credibility of the privatisation process often hinge on the quality of SOE corporate governance. An important aspect is safeguarding a sufficient board independence to enable SOE boards to protect the minority shareholders, including against further privatisation measures that are not seen as being in their interest.

B. Governments should ensure that managers and non-executive board members in SOEs are not able to influence, in their own interest, the privatisation decision and privatisation methods. In particular:

   1. Mechanisms to ensure that managers and board members who are uncertain of their positions following privatisation remain loyal to the government's objectives are worth considering. Where applied, these could include rewards as well as penalties.

   2. Governments will want to prevent that SOE managers during the privatisation process become incentivised by third parties. This is particularly an issue where new owners are identified prior to the actual transfer of control.

XI. Auditing and accountability of the privatisation process

Background

Ex-post controls on the privatisation process in most countries take the form of some kind of audits performed by an independent body, e.g. a "supreme audit institution (SAI)", reporting to parliament. A commonly agreed set of good practices in this respect, the *Guidelines on Best Practice for the Audit of Privatisations*, was issued by the International Organisation of Supreme Audit Institutions (INTOSAI) in 1998. In practice, the involvement of auditors and oversight bodies can rarely be deferred to the post-privatisation phases. In most countries the SAI is the auditor of the business when still in state ownership – a role which, in turn, gains in importance at the time of privatisation as the transaction will take place partly on the background of financial information that the SAI has previously audited.

The role of supreme audit institutions obviously differs according to the choice of privatisation methods. However, the general recommendations of INTOSAI (Section 2 of the Guidelines) intended to cover all privatisation situations are the following. In overview, the supreme auditing institution should: (i) become involved in the privatisation process as soon as constitutionally possible; (ii) consider developing explicit guidelines relating to the right of bidders to obtain access to the SAI's audit working papers; (iii) plan to cover all major aspects of the sale that have a bearing on propriety and value for money, to identify the key parties to the sale, and to be alert to identifying lessons from the sale; (iv) ensure that it understands the vendor's objectives in carrying out any pre-sale restructuring, and what the vendor did in pursuit of those objectives; (v) ascertain whether the vendor obtained a pre-sale valuation of the business and, if not, review the reasons for not doing so; (vi) examine what options the vendor considered before deciding on the sale method used, and what criteria the vendor applied in deciding on the chosen sale method; (vii) examine whether adequate safeguards were in place to secure that the sale was properly and honestly carried out; and (viii) assess the adequacy of the state's structural arrangements to manage any residual issues.

Of particular importance, arguably, is INTOSAI's recommendation that SAI not merely limit themselves to performing *post festum* audits but become involved at an early state in the privatisation process and interact as closely with the main actors as its independence and constitutional safeguards allow. In practice, individual countries oversight and accountability arrangements will of course differ, reflecting factors such as the organisation of the SOE ownership function within the government, how privatisation is anchored in national legislation and the degree of direct parliamentary involvement in the privatisation process. There is a continuum from countries that make each privatisation transaction the subject of a separate audit by the SAI; to those where the SAI may, acting on its own or in response to a request from government or parliament, decide to audit a transaction; to the cases where the auditing of privatisation is part of a more general audit of state ownership agencies.

As a general rule the more stringent procedures will be applied by countries that have, or have had in the past, rather active privatisation programmes. However, some such countries rely relatively less on SAIs and relatively more on a stronger-than-average direct

parliamentary scrutiny of privatisation. It would appear that specialised parliamentary committees (or fiscal committees, in the countries that handle privatisation as part of the government budget procedures) either exert some of the oversight functions themselves or, in some cases acting via governments, direct SAIs to undertake audits of privatisations that are seen as meriting special attention. In addition to the SAIs themselves, authorities may rely partly on internal and external auditors of the public administration, the state ownership units/holding companies and in some cases the privatised SOEs themselves.

The privatising agencies are almost invariably held accountable *ex post* through mandatory disclosure to either parliament or the general public. When the privatisation agency is *de facto* the ownership entity, this reporting is done along with the usual reporting to the Parliament, and/or through the aggregate report, for the few countries who are publishing such a report. Aggregate reports give general information on the evolution state ownership and comment on the large privatisation having been undertaken in the year covered. As for reporting to Parliament, privatisation transactions can be included in the periodic reporting occurring annually and usually associated with the approval of state budgets. They can also give rise to an *ad hoc* reporting, at the request of the Parliament to seek information on matters of immediate concern or on important and politically charged events, which privatisation might well be. In some cases the privatisations will have to be approved *ex ante* by the Parliament and as such they will be a reporting for approval, providing the necessary information to the Parliament to secure the authorisation.

Conclusions:

A. High levels of transparency and accountability must surround the privatisation process. In particular:

   1. Regular disclosure to parliament and the general public is of importance, though in countries with few privatisations it may have, on cost efficiency grounds, to be replaced by *ad hoc* reporting.

   2. The authority charged with privatising, as well as the auditing body, should be held accountable, including to the legislative powers.

B. Privatisation needs to be subject to independent oversight from an auditing body such as a supreme auditing institution (SAI), which is well resourced and independent from the public authorities engendering the privatisation process and those carrying it out. The following considerations offer themselves:

   1. Ideally every transaction would be audited. If, because of resource constraints or other reasons, this is not feasible then the transactions to be audited should be selected on the basis of objective and fully transparent criteria.

2. If not all transactions are audited, the SAIs may well act on the suggestion of parliamentary and government entities in identifying suitable targets, but it is essential that the SAIs have the powers to initiate procedures on their own.

3. SAIs may be involved during the different phases of the privatisation process. Audits should include, but not be limited to, pre-sale restructuring and valuation; sale objectives; timing; sale methods; vendor integrity; and integrity of the sales process.

4. SAIs could work with other similar bodies where these exist – including the internal auditing functions of government, parliamentary oversight units and the external auditors of SOEs – subject to proper protections of the independence of all institutions involved.

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