

State Owned Enterprise Governance

by

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1. Introduction

1. The core difference between state and private ownership, from a governance perspective, are the rights, obligations and pay-offs attaching to ownership. Private ownership confers extensive rights on the individual to enjoy the income from ownership, and control and change the use to which resources are put, including transferring ownership to another party. The private owner faces directly the wealth consequences from exercising those rights, and therefore has greater reason to ensure that they are put to best use.

2. Government ownership, in contrast, confers only a very limited set of rights on the ostensible owner or shareholder (in New Zealand, the shareholding Ministers). The shareholder has limited powers to control or change the use to which a resource is put, and in particular is not able to transfer ownership without Parliamentary consent. The shareholder does not face any direct wealth consequences from exercising those rights, but is likely to face significant political costs or benefits from doing so.

3. These differences in the nature of ownership lead many commentators to argue for moving commercial activity into private ownership. The authors do not take on that issue in this paper, but would merely note that, in practical terms, governments continue to own commercial businesses, and it is in this context that this paper addresses SOE governance issues.

4. *Section 2* of the paper provides contextual information to assist the reader in understanding SOE governance arrangements in New Zealand. *Section 3* explores the differences between government and private ownership, and the implications of these

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differences for economic efficiency and governance. Policy responses to those differences are discussed in *Section 4*, followed by concluding remarks in *Section 5*.

2. New Zealand SOE background

Corporatisation and privatisation history

5. Prior to the creation of SOEs, government-owned businesses in New Zealand were largely operated within various departments whose functions also included advising the government on policy issues. These include electricity generation and transmission, provision of postal and meteorological services, coal and forestry production, farming and office accommodation, and control of domestic air traffic. How SOEs use the resources under their control, therefore, has a major impact on New Zealand's economic performance. This situation entailed frequent Ministerial involvement in their operations; multiple, sometimes unclear and often conflicting goals (e.g. employment creation versus profitability); and thus unclear accountability. Their transformation into SOEs through corporatisation resulted in a clear commercial focus, and greatly improved accountability arrangements.

SOE governance arrangements

6. Each SOE is formed as a company under the Companies Act 1993 and subject to its general provisions. In addition, each SOE must comply with specific governance and accountability provisions under the State Owned Enterprises Act 1986. The Act sets each SOE the primary goal of being "a successful business", and defines this as being as profitable as a comparable business not owned by the Crown, plus being a good employer and socially responsible. SOE voting shares may not be sold without Parliamentary approval. All SOEs are 100% government owned, with the voting shares held equally by the two shareholding Ministers -- the Minister of Finance and the "responsible Minister" (who by convention is normally the Minister for State Owned Enterprises).

7. Shareholding Ministers hold the formal rights to appoint the SOE's directors, determine its constitution, and appropriate (on behalf of government) its residual earnings plus residual assets if the company is abolished. The Companies Act requires the directors of an SOE to act in good faith in what they believe to be in the best interests of the company.

8. The SOE Act requires each SOE board to provide the shareholding Ministers an annual Statement of Corporate Intent (SCI) setting out the scope of business of the SOE, plus its broad goals and specific performance targets. The shareholding Ministers monitor the performance of the SOE and its board of directors. The Act also permits the

shareholding Ministers to direct an SOE board to include particular items in the SCI, or omit them from it. Use of this power is subject to Parliamentary scrutiny. Moreover, if the shareholding Ministers direct an SOE to provide goods or services that it normally would not provide as part of a commercial arrangement, the SOE can require the government to compensate it for any resultant financial detriment.²

3. Differences between government and private ownership

9. As mentioned in the introduction, the key differences between government and private ownership lie in the nature of the rights and obligations in the two cases, and how these differences affect incentives and decision making.

10. Under private ownership the owners typically have:

- the right to income from the resources. The owner faces directly the wealth effects from the way in which the resources are used.
- the right to control and change the manner in which the resources are used³, including the ability to transfer ownership to another party.

11. The combination of the right to income and the right to control provides private owners with both the incentive and the ability to move their resources to their highest value use. This approach to resource management lies at the heart of the allocation of capital within open market economies.

12. Under government ownership the Shareholding Ministers have:

- the right to income on behalf of taxpayers. The Shareholding Ministers do not personally face any wealth effects from the way in which resources are used, but are likely to face political costs or benefits from decisions that they make in relation to how resources are deployed.
- a more limited set of rights to control and change the manner in which the resources are used. Shareholding Ministers are not able to transfer ownership without Parliamentary approval, and any direction these Ministers give to an SOE is subject to Parliamentary scrutiny.

² This has happened on one occasion only.

³ These rights are in practice constrained by a range of legislative prohibitions on resource use, including for example the Resource Management Act.

13. Government ownership breaks the nexus between personal wealth effects and the ability to control and change resource use. Instead government shareholders can be expected to be concerned primarily with political (rather than economic) outcomes, and to have limited ability to effect change. For this reason the allocation of capital under this arrangement is likely to be significantly less efficient than under private ownership.

14. These special features of the ownership structure of SOEs lead to a number of issues for the governance of these companies:

- *Weak equity capital disciplines on the board and management.* The absence of active trading in SOE shares - or owners with a personal equity stake - weakens the discipline on these companies to maximise value. Furthermore, the constraints on the shareholders in relation to divestment, remove any credible takeover threat that would otherwise face the board and management of an under-performing company. This weak discipline is likely to feed through to a tendency to operate less efficiently than otherwise would be the case, and to undertake projects that are not justifiable if allowance is made for the full opportunity cost of capital.
- *Weak debt-holder monitoring.* Private debt holders have weak incentives to monitor an SOE's performance, to the extent they consider SOEs to be implicitly government guaranteed. Although all New Zealand SOE debt instruments are required to include an acknowledgement that the debt is not guaranteed by the government, the financial markets have seen little evidence of a New Zealand government being prepared to let any SOE fail financially. In cases of financial distress the government has provided additional equity or the promise of additional equity, rather than rely on its limited liability status to restrict its financial exposure. Nevertheless, the structure of debt capital obligations - which typically include specified cash payments throughout the life of the loan - can be expected to provide a greater financial discipline on SOEs than that afforded by equity capital.⁴
- *Less certainty and clarity about shareholder business policy commitments.* Shareholding Ministers' commitment to a particular set of business policy parameters governing an SOE's operation is likely to be seen as less certain than if such a commitment were issued by private shareholders. Private shareholders tend to be more focused on a single clear goal of improving the value of their business. SOE shareholders, in contrast, typically are likely to

⁴ Jensen (1986) outlines agency issues associated with a company's free cash flows and the use of debt as one means of addressing these issues.

be influenced by multiple goals (e.g. changes of government⁵ and changes in electoral factors within an electoral term).⁶ Predicting how such factors are likely to impact on SOE related policies is more complex and uncertain than with private ownership.

4. Policies for Enhancing SOE Governance

15. This section discusses policies to improve SOE governance from the perspective of a government concerned with the overall efficiency of the economy. This is a wider perspective than that held by the private shareholder which is typically concerned only with improving the value of the entities it owns. This wider view results in policies that:

- improve the *efficiency* with which SOEs are governed;⁷ and
- reduce the extent to which assets remain under SOE control (subject to constraints on privatisation), as there are alternative (private) governance arrangements that can be expected to yield more efficient results.

16. The policies fall into three groups:

- **focusing the SOEs on their core activities**, with an expected reduction in their scale and scope. This could include focusing an SOE on particular markets, and *also* adopting operating structures that change the boundaries of the firm. The key boundary here is between relying on the SOE's internal governance rules for decision making and contract enforcement, as compared with relying on external market mechanisms;

⁵ Shareholding Ministers and their SOE policies may change whenever the political party, or coalition, holding executive government power changes. Control of executive government is contested at least every three years.

⁶ Moe (1991) and Horn (1995) discuss how political institutions are designed partly for performance and partly for protection against political uncertainty, but often at a cost to the performance goals.

⁷ We accept value maximisation through time as a proxy test for achieving both productive and dynamic efficiency, and as consistent with allocative efficiency where an SOE's product market is either subject to significant competition, or an effective regulatory regime.

- **strengthening financial disciplines** on SOEs by withdrawing more of their free cash flows, through substituting debt for equity, and raising dividend levels; and
- **strengthening the management of the government - SOE relationship** by clarifying and communicating the government's intentions for these businesses, *ensuring* a well structured director appointment and assessment process, introducing value based reporting, and bolstering other monitoring processes.

17. For purposes of the discussion on accountability, this paper will focus on the third policy: managing the on-going relationship between the government and SOEs.

Managing the Government - SOE relationship

18. Continued government ownership of SOEs raises the issue of how the relationship between government and the SOE should be managed through time. Managing this relationship warrants close attention in the absence of the salutary impact of capital market pressures, that privately owned businesses typically face. In New Zealand this relationship is prescribed in broad terms by the State Owned Enterprises Act 1986 - this section explores various aspects of the relationship within that context.

Clarifying and communicating the government's intentions

19. At present SOEs and the shareholding Ministers (and their advisers) tend to debate issues about the capital structure and scope of an SOE's business on a case by case basis. The focus of such debates is usually on implications for the SOE's value. Discussion of the issues, and any ensuing decisions, would be better informed if the shareholding Ministers both were to articulate their medium term preferences and expectations, and communicate them to the interested parties. A public commitment to clearly stated expectations would enhance their credibility by raising the cost to the shareholders of deviating from them.⁸ A possible means for achieving this would be for the shareholders to issue a statement of shareholder expectations (SSE). Such a

⁸ This approach would make the contact between shareholders and the SOE more "complete". See Hart (1993) and Aghion & Bolton (1992) for a discussion of incomplete contracting issues.

statement would apply to SOE policy some of the principles already adopted in relation to fiscal policy through the Fiscal Responsibility Act.⁹

20. If the shareholding Ministers signal to each SOE that it should focus on its core activities and pay out more of its free cash flows, they will also need to communicate clearly that the value of the government's equity in the SOE may decrease over time. This would encourage SOE management to concentrate on the task at hand, rather than seeking out value-adding projects in related (but not core) areas of business.

21. In summary, providing greater certainty and clarity to an SOE's board and management about its shareholders' expectations and preferences, and the higher costs to shareholders if they deviate from a publicly committed direction, should improve the efficiency of SOE governance arrangements. More particularly, it could be expected to facilitate management of SOEs within clear parameters that are aligned with the preferences of the shareholders.

Monitoring and value-based reporting

22. The relative lack of capital-market related pressure on SOEs means that the shareholding Ministers need to rely on administrative monitoring procedures to hold SOE boards accountable. Current practice includes setting expected financial performance targets in the SCI for the future three years, and reporting against those targets at quarterly, half yearly and full year intervals. Boards are required to explain significant deviations from expected financial performance targets. In addition, each SOE may be subject to a business review at periodic intervals, normally no more frequent than five yearly. Such monitoring provides a suitable basis for the shareholding Ministers to consider the future direction of the company, and any changes that may be required.

23. This monitoring is basically reactive and focused on published ex post financial performance measures.

24. The absence of capital market disciplines to help align the interests of SOE shareholders and their agents (boards and management)¹⁰, forces greater reliance on in-

⁹ For an explanation of this legislation see New Zealand Treasury (1996). The Act sets out to achieve the following: (i) to increase the transparency of policy intentions and the economic and fiscal consequences of policy; (ii) to bring a long-term focus to budgeting; (iii) to disclose the aggregate impact of the budget prior to the detailed annual allocations; (iv) to ensure independent assessment and reporting of fiscal policy; and (v) to facilitate parliamentary and public scrutiny of economic and fiscal information and plans (p.7).

house performance monitoring. Setting clear goals for SOE boards to achieve, and strengthening incentives for them to do so (consistent with the SSE), is one form of such monitoring.

25. The general adoption of value-based reporting (VBR) by SOEs would enhance shareholding Ministers' ability to assess the extent to which an SOE is creating or eroding value. VBR involves a company reporting its economic returns, the opportunity cost of the capital used to produce those returns, and the extent to which its various activities add to or reduce its value.¹¹ It is a very useful tool that the shareholding Ministers could use both to set performance targets and to measure performance, in a way that takes account of the opportunity cost of the equity capital involved.

Director appointments and performance

26. An SOE's board of directors has a crucial role in maintaining and improving the company's performance. From the government's viewpoint, therefore, it is important both to obtain sufficient suitably-skilled directors to oversee these companies, and to ensure that each board of directors has strong incentives to enhance a company's value. This is not a small task - as there are about 90 SOE directors, and some 350 directors of all Crown owned companies.

27. The following are measures that could help the government to secure the best performance from its SOE directors.

- *Ensure independence and objectivity in the selection process:* This needs to involve selecting SOE directors on the basis of systematically matching candidates' skills and *experience* to meet a particular set of job specifications tailored (as necessary) to suit a particular SOE.
- *Clearly specifying the equity holders' expectations of directors:* This could be achieved by the equity holders providing clear terms of reference for individual directors when they are appointed, and each board as a whole via the proposed SSE.
- *Strengthening directors' incentives to ensure the company performs well:* Directors' incentives could be strengthened by introducing performance-

¹⁰ Takeovers are not possible, and shareholders cannot sell their voting shareholding without Parliamentary approval.

¹¹ See Rappaport (1986) and Stewart (1991) for a comprehensive explanation of VBR.

related rewards and sanctions, and enhancing accountability mechanisms (including shareholder monitoring of the SOE, and value-based reporting). This should include re-appointment being contingent on good performance (i.e. given factors within the board's or direct sphere of influence), thus preserving the value of reputation.

5. Conclusions

28. In New Zealand a significant number of SOEs have now been privatised. For those SOEs that remain government owned (and where privatisation is ruled out), an important issue remains how best to govern them. This paper has outlined a set of measures that, if adopted, would both limit exposure to the problem of SOEs' inherently weak governance structure, and strengthen incentives for SOEs to perform where the exposure remains.

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