The Governance of Mixed-Ownership Enterprises in Latin America: Discussion Paper

Acknowledgements

The OECD Secretariat wishes to thank consultant Richard Frederick for his preparation of this draft issues paper for the OECD/CAF Latin American SOE Network's October 2012 meeting in Lima, and also has been provided for background to the 2013 Latin American Corporate Governance Roundtable discussion of this topic. It does not necessarily reflect the views of the OECD nor its member countries and is intended for the purposes of discussion and to prompt further reflection and research on these issues. It has been developed under the supervision of Senior Policy Analyst Daniel Blume of the OECD Corporate Affairs Division.

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Introduction and background

1. This background paper was developed for the meeting of the Latin American SOE Network of October 11-12, 2012 and as a reference for the June 20-21, 2013 meeting of the Latin American Corporate Governance Roundtable. It was developed for sessions held at each of these meetings on governance issues arising from the mixed ownership of state-owned enterprises (SOEs). Its purpose is to examine the particularities of the governance of SOEs with mixed ownership structures.

2. In 2012, the OECD conducted a survey of members of the Latin American SOE Network regarding their governance practices. Respondents to the survey included: Argentina; Brazil; Chile; Colombia; Ecuador; Mexico; and Peru. The survey responses allow the division of SOEs into categories based upon whether they are wholly owned by the state, partially owned or listed. Accordingly, 34% of SOEs are wholly owned while 66%[1] have mixed ownership. Among those with mixed ownership, approximately 7% are listed.

3. The data suggests that the challenges related to the governance of mixed ownership SOEs in the Latin American context are broadly relevant. It also shows that there are two distinct forms of mixed ownership: 1) listed SOEs that have institutional and retail investors; and 2) SOEs that have large or strategic shareholders. The governance issues that affect these two groups tend to be distinct. The first group are usually passive investors with little impact on governance and limited recourse, while the second group usually has a greater ability to influence the governance of the SOE and defend its shareholder rights.

Table. Ownership structure of SOEs in some of the largest Latin American Economies

Country	SOEs	Wholly owned	Partially owned	Listed
Argentina	112	23 (21%)	89 (79%)	19 (17%)
Brazil	147	38 (26%)	109 (74%)	8 (5%)[1]
Chile	33	30 (91%)	3 (8%)	3 (8%)
Colombia	105	18 (17%)	87 (83%)	3 (3%)
Ecuador	24	21 (88%)	3 (12%)	0 (0%)
Mexico	110	NA	NA	0 (0%)
Peru	31	23 (74%)[2]	8 (26%)[2]	9 (29%)[2]
Total	**562**	**153 (34%)**[3]	**299 (66%)**[3]	**40 (7%)**

Notes: Based upon OECD, Regional Trends: Ownership Oversight and Board Practices of Latin American State-Owned Enterprises (2012). Countries are ordered alphabetically. Countries in order of PPP-adjusted GDP in 2011: 1) Brazil; 2) Mexico; 3) Argentina; 4) Colombia; 5) Peru; 6) Chile; and 7) Ecuador. Survey data was not available from Venezuela that would normally rank 4 in PPP adjusted GDP.

[1] Figure includes only federal SOEs. Individual Brazilian states also have 17 listed enterprises.

[2] Peru figures only refer to SOEs overseen by FONAFE and do not include SOEs overseen by the Ministry of Finance, most of which are municipally-owned enterprises. Normally, listed companies are assumed to be partially owned. However, in the case of Electro Peru, Egesur and Sedapal, the SOEs are listed, but with 100% state ownership.

[3] Percentage figures for wholly and partially owned SOEs do not include Mexico. The Brazilian government's official definition of state-owned enterprises only includes enterprises with 50% or greater state ownership

4. This breakdown represents ownership structures in a simplified form. In reality, SOEs have a range of ownership structures that make categorization difficult. For example, in 2006, Ecopetrol was authorized to carry out an IPO on the Colombian Stock Exchange for 10% of its common stock. At the

[1] The data does not include Mexico for which the breakdown between partially owned and wholly owned SOEs was not available.

time of its IPO, the subscription of Ecopetrol shares went 62% to individual shareholders, 37% to pension funds with the remainder going to corporations.[2] It is thus partially owned and listed.

5. On the other hand, in Peru, Electro Peru is a listed SOE with 100% state ownership. The state (FONAFE) holds 22% of shares while the remaining 78% is held by FCR, the state-owned pension scheme. Presumably, FONAFE could pursue more policy-orientated objectives while the FCR could potentially take a more shareholder-driven approach. To complicate the matter, FONAFE retains 100% of the voting rights. Thus, ownership structures are quite varied and each case poses different governance challenges.

6. Though the data might seem to suggest that the relatively low number of listed SOEs means that their governance is of lesser concern, this ignores the large impact that listed SOEs have on national stock exchanges. For example, in Brazil SOEs currently account for approximately 25% of total market capitalization on the BM&F BOVESPA exchange. Petrobras alone makes up 17% while three companies (Petrobras along with Banco de Brasil and Electrobras) make up 21%. In Colombia only three SOEs are listed. However, these three (Ecopetrol, ISAGEN and ISA) constitute 52% of the National Stock Market and 70% of the total value of SOEs.[3]

7. Listed SOEs are often the most valuable companies in the stock markets of both developed and developing countries (Megginson and Netter, 2001). Evidence suggests that SOE issues promote the development of financial markets. The importance of listed SOEs and their governance is, thus, not to be underestimated. In addition, SOE governance can be expected to have a profound impact on investor perceptions of markets and significantly influence their development.

The promise of mixed ownership

8. Mixed ownership of SOEs tends to be more widespread globally than one might think.[4] The explanation may lie in that mixed ownership has distinct advantages from a government perspective. Mixed ownership allows the state to achieve efficiency gains from privatization, and raise needed revenues while maintaining control over the SOE (Roland). In addition, partial privatizations do not carry the same political costs as full scale sales. They allow the state to do a gradual implementation of reform and reduce both the economic and political risks of a wholesale divestiture.

9. The evidence shows that the benefits of mixed ownership are not just political. Mixed ownership, where the government retains majority ownership and management control, has been shown to lead to an improvement in the operating performance of SOEs.[5] With the influence of new owners, profitability, sustainability and a greater client orientation often move to the forefront of considerations.

10. Mixed ownership under the right conditions may in fact be an optimal ownership structure from an overall welfare perspective since it mitigates the disadvantages of public ownership (inefficiencies, non-

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[2] Francisco Reyes & Asociados (2008), The Oil & Gas Industry in Colombia and the Ecopetrol Partial Privatization, Presentation at the Dallas Bar Association.

[3] OECD (2012), Ownership Oversight and Board Practices for Latin American State-Owned Enterprises.

[4] Roland G., Introduction to Privatization: Successes and Failures, Working Paper Series, Initiative for Policy Dialogue, Columbia University.

[5] The evidence on the impact of partial privatization is less clear than for full privatization. It is strongest when new owners are strategic investors though there are also studies that find improvements in performance after exchange listings and sales to passive portfolio investors. See: World Bank, PPIAF (2009), How to Improve the Performance of State-owned Infrastructure Service Providers: Evidence from a Global Study; Gupta (2002), Partial Privatization and Firm Performance: Evidence from India, WDI Working Paper no. 426.; Asian Development Bank (2009) Finding Balance: Making State-owned Enterprises Work in Fiji, Samoa and Tonga; and Bouri, Nankbogo, Frederick (2010).

economic decision making, lack of incentives) and the disadvantages of private ownership (strong incentives to grow profit and reduce costs at expense of labour and environment).[6]

11. But, one should be wary of sweeping generalizations. Mixed ownership appears to have beneficial effects by enhancing the monitoring and functioning of SOEs. But it may also keep alive inefficient forms of government intervention.[7]

12. It is expected to lead to improvements in firm performance when new owners (whether strategic or through listing) monitor and discipline (Holmstrom and Tirole, 1993). On the other hand there may not be any performance gains if the government exercises inappropriate control. In particular undue interference to achieve political or policy objectives can hamper the economic performance of SOEs (Shleifer and Vishny, 1997).

13. State-ownership and intervention is usually defended because of the need to pursue strategic policy goals that cannot be accomplished under private ownership. However, a distinction should be made between legitimate direction by the state in pursuit of policy goals and undue or inappropriate interference. Legitimate intervention in the pursuit of policy goals is handled through appropriate governance arrangements.

14. Intervention is inappropriate when it is in pursuit of political objectives and/or when the state's intervention is unpredictable, unfair, or non-transparent. If, when shares are sold to outside investors, the state is clear that it will be pursuing strategic or public policy goals and has set a framework for this, shareholders will build this into their risk/return assessment of their investment. On the other hand, unpredictable or politicized interventions and opaque decision making will likely lead to loss of investor confidence, and eventually damage to the reputation of the state and the markets.

15. How well the mixed-ownership SOE performs will, thus, be determined largely by the governance practices of the state and how the state exercises its governance rights.

The challenges of mixed ownership

16. Wholly-owned SOEs typically present less of a governance risk to the state because the state is able to control the SOE as it sees fit. On the other hand, a straightforward full sale of the SOE to an outside investor or a full flotation disconnects the state from the operations of the company and poses limited risk to investors. In contrast, mixed ownership leaves room for a wide range of behaviours.[8]

17. Mixed ownership poses risks both for outside shareholders as well as the state. For the state, the principal risk is a loss of control that can hinder its achievement of social and political goals. The typical response of the state is to strengthen its influence by direct or indirect intervention. For the investor, there is the risk that the state acts to the detriment of the economic interests of the shareholder. Retail investors have few ways to mitigate such risks, though strategic investors may take advantage of information asymmetries to gain an advantage in negotiations with the state. These risks are the opposite sides of the same coin. They represent the sometimes conflicting interests of public and private owners.

[6] Schmitz, P.W. (2000), Partial Privatization and Incomplete Contracts: The Proper Scope of Government Reconsidered, Finanz Archiv, Vol. 57, 2000, pp. 394-411, and Rupayan P. and Ritika J. (2012), Mixed duopoly, cross-ownership and partial privatization, Journal of Economics, September 2012, Volume 107, Issue 1, pp 45-70.

[7] Roland G., Introduction to Privatization: Successes and Failures, Working Paper Series, Initiative for Policy Dialogue, Columbia University.

[8] Chong and Lopez-de Silanes (2003).

18. Examples of conflicts between the state's policy interests and the interests of private owners can be: 1) investment in projects that the state deems of strategic importance, versus investment in economically viable projects; 2) provision of products or services with social outcomes versus provision of profitable services; 3) pricing at socially acceptable levels versus pricing at economic levels; 4) dividend payments that respond to the state's fiscal requirements versus the SOEs financing and investment needs; 5) changes in the capital structure of the SOE to provide greater control and decision making to the state versus the expectation of investors to maintain control rights proportional to their investment; and 6) related party transactions that serve the interest of the state versus serving the economic interests of the SOE.

19. These examples illustrate the classic conflict and tradeoff between social and business goals. In addition there are political economy issues. Direct intervention into SOEs is not just used to achieve legitimate social and policy outcomes. It is not infrequent for intervention to be motivated for political reasons, personal interests and sometimes even rent seeking. Such interventions are not generally in either the SOE's or the public interest but are often excused by making reference to social outcomes.

20. Mixed ownership is, thus, an insufficient condition to promote better performance. A number of other conditions need to exist. The critical factor is how the government exercises its influence on the SOE. To the extent that the state continues to exert direct and/or informal decision-making control, or indirect control via regulators, and does so in an opaque fashion, the governance, decision making, and incentive structures do not change from the long-ingrained practices that may have contributed to poor performance in the past.

21. On the other hand, to the extent that there are no clear alternatives to intervention and alternative means for the state to achieve its legitimate policy objectives, there will be continued pressure to intervene. In a worst case scenario, shareholders can face the risk of expropriation. Thus, the problem of mixed ownership is not just a question of enforcing and ensuring respect for shareholder rights but also for finding effective alternative tools for the state to achieve its legitimate goals.

The hydrocarbon sector

22. The hydrocarbon sector is cited here as an example to illustrate some of the problems that arise when the interests of the state and shareholders conflict. Over recent years, Latin America has witnessed the growing interest of outside investors in its oil and gas industries, which has resulted in an increase in asset purchases, joint ventures and equity acquisitions. This increase in interest is linked to a long-term increase in global energy prices, as well as the discovery of new oil and gas reserves in the region.[9] The hydrocarbon sector is interesting to observe because energy is of strategic interest, because the sums of money are large, and because the sector is highly visible.

23. Significant partial privatization in the hydrocarbon sector in Latin America began with Petrobras in Brazil in 1997. Repsol acquired Argentina's YPF through a trade sale in 1999 and Ecopetrol in Colombia was partially privatized in 2003 through a public offering. In each case, these enterprises benefited from their partial privatization, increasing their capacity to attract capital for exploration and enhancing their capacity production.[10] Yet, such mixed ownership arrangements have not been without their share of conflict.

24. In Brazil, there has been pressure to make investments that the state deems of strategic importance. In recent years Brazil has placed work requirements on Petrobras with respect to existing

[9] Carano B. and Alexander A. (2012), Current Issues Involving Latin American Upstream M&A, Bloomberg Law Reports.

[10] Ibid.

partners and projects. So, for example, the Brazilian state requires Petrobras to be an operator and a significant investor in exploration of a geological formation on the continental shelves off the coast of Brazil the development of which is of long-term strategic importance. As a result, Petrobras may find it necessary to prioritize certain development activities over others, potentially to the detriment of certain partners. [11]

25. In 2010, controversy arose over the issuance of shares of Petrobras to the Brazilian state in exchange for access to oil reserves. This issue provided oil reserves to Petrobas but diluted existing shareholders while increasing the state's ownership. The capital markets reacted negatively. It focused their attention on the risks associated with transactions between SOEs, or between a company with a substantial state presence in its ownership and the state itself.[12]

26. In addition, Latin American countries have at times changed contractual agreements ex post to favour the government or a government operator. In the beginning of 2004, Venezuela increased the government's stake in all oil fields managed by foreign companies, and installed its own company as the operator in these fields. Some companies agreed, but others refused and forced arbitration upon the government.[13] Earlier this year, legislators in Brazil had considered proposing a law to increase royalties under certain contracts.[14]

27. Nationalization is the most extreme case of government intervention. In 2006, Bolivia nationalized all oil and gas reserves, forcing YPF, Petrobras, BP and Total to renegotiate their investments. More recently, the Argentine government expropriated 51 percent of YPF owned by Repsol. The object of citing these cases is not to enter into a debate on the merits of individual cases, but to raise the broader policy issues that arise when state and private investor interests conflict, and how to manage these conflicts in a way that maximizes positive outcomes for all and minimizes disputes.[15] Irrespective of the justifications that may be given, such conflicts can shake investor confidence, cast doubt on contract rights, and raise concerns regarding the risks associated with mixed-ownership arrangements.[16]

28. The next question is how to resolve these conflicts, if not to the satisfaction of both parties, then at least equitably. The examples show that the least satisfactory outcome for investors is when conflict is resolved by fiat of the state. Preferred resolution is by respect for agreements and following agreed procedures. While resolution depends fundamentally on the commitment of both the state and private investors to the principle of equitable treatment, the risks for both parties can be attenuated by clarifying and respecting governance and decision making rights. All of this suggests that greater clarity is needed with respect to the state's approach to ownership of public companies.

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[11] Ibid.

[12] OECD (2012) Latin American Roundtable Corporate Governance Roundtable Task Force Report on Related Party Transactions (unpublished, forthcoming).

[13] Carano B. and Alexander A. (2012), Current Issues Involving Latin American Upstream M&A, Bloomberg Law Reports.

[14] Ibid.

[15] Caiman Valores (2012), The Real Fallout From Argentina's Nationalization Of YPF Sociedad Anonima.

[16] As the Repsol case in particular is the subject of legal challenges in national courts and has already been raised for more specific discussion in the OECD Investment Committee in relation to principles of equal treatment under the OECD National Treatment Instrument, Network participants are encouraged not to use the discussion in the meeting to debate the merits of individual actions taken in this or other specific cases.

Directions for sound governance

Governance at the SOE level

29. Mixed ownership structures are not always successful—either from the perspective of the state or the outside investor. Some of the elements that can cause mixed-ownership to fail are: 1) opaque processes with heavy state involvement; 2) insufficient or poor regulation, and poor contractual agreements; and 3) weak corporate governance policies and structures. The common element of failure is unstructured interaction between government and shareholders.[17]

30. Success, on the other hand, appears to be predicated upon a structured predictable interaction between government and shareholders and a number of additional conditions. These differ depending upon whether the SOE is listed or whether it is partly owned by large or strategic investors.

31. The conditions that make mixed ownership effective in the case of a sale to a strategic investor are: 1) a reduction in the overall level of state presence in the SOE; 2) a clear delineation of the decision making rights of the state and the decision making rights of strategic investors; 3) non-interference in business decisions by the state; and 4) respect of commitments. [18]

32. The conditions under which mixed ownership through listings are effective are the same as above, but with some added factors. Additional conditions are: 1) listing on an exchange with sufficiently rigorous regulation; 2) adequate rights for minority investors that is clearly distinguished from the ownership rights of the State; 3) informed and active investors; 4) a jurisdiction where recourse is available to shareholders; and 5) an active business press and other civil society institutions.[19]

33. Additional guidance is provided by the *OECD Guidelines on Corporate Governance of State-owned Enterprises*. The OECD Guidelines are the global reference point for best practice in the governance of SOEs. The Guidelines' chapter on the equitable treatment of shareholders is mainly aimed at situations arising in the case of listed SOEs. Overall, the Guidelines suggest that shareholders exercise a degree of control over the corporation that is proportionate to the shareholders' equity ownership in the SOE. This, by extension, means limiting the use of golden shares and means of decision making that do not pass through established and agreed governance structures.

Box 1. The state and state-owned enterprises should recognise the rights of all shareholders and in accordance with the OECD Principles of Corporate Governance ensure their equitable treatment and equal access to corporate information

A. The co-ordinating or ownership entity and SOEs should ensure that all shareholders are treated equitably.

B. SOEs should observe a high degree of transparency towards all shareholders.

C. SOEs should develop an active policy of communication and consultation with all shareholders.

D. The participation of minority shareholders in shareholder meetings should be facilitated in order to allow them to take part in fundamental corporate decisions such as board election

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17 Chong and Lopez-de Silanes (2003).

18 Bouri, Nankobogo and Frederick (2010).

19 Ibid.

34. The Guidelines place great importance on disclosure, transparency and communications. At a minimum, they seek ensuring that investors are properly informed of the risks that they take on. They advise that minority and other shareholders have access to all the necessary information to make informed decisions. In addition, the state should not make any abusive use of the information they might obtain as controlling shareholders or board members. Though the Guidelines stop short of prohibiting special shareholders' agreements and capital structures that allow a shareholder or the state to exercise disproportionate control, they suggest transparency with respect to such agreements

Box 2. OECD Guidelines on transparency and disclosure vis-à-vis outside shareholders

- SOEs should observe a high degree of transparency towards all shareholders.
- Shareholders' agreements and capital structures that allow disproportionate control are disclosed.
- The ownership entity ensures that SOEs have mechanisms to ensure easy and equitable access to information for all shareholders.
- Significant shareholders and the ownership entity do not make any abusive use of insider information.

35. The main concern that shareholders will have will be decisions being made outside the company's shareholder meetings or board meetings. The issues with which they are particularly concerned are the nomination of board members; the election of executives; intervention in the operations of the SOE; investment decisions and so on. The state should thus provide outside shareholders with sufficient information on issues that will be subject to state decision and ensure that proper decision making procedures and channels are followed. Where possible, active consultation with outside shareholders will improve the decision making process, reduce likelihood of conflict and improve the likelihood of acceptance of key decisions

The framework for good governance

36. The last issue to be addressed in this paper is the connection between the success of mixed ownership and the existence of an institutional and regulatory framework that promotes good SOE governance.

37. Mixed ownership of SOEs requires well-functioning legal and economic institutions that promote transparent decision making within the mixed-ownership SOE. These include: 1) a clear definition and protection of property rights; 2) contract enforcement and fair dispute settlement; 3) regulators with sufficient capacity and independence to make decisions in the interest of both investors and consumers; and 4) a public administration that is competent, honest and predictable. [20]

38. These legal and economic institutions provide stability and predictability to the governance of the SOE; as a general rule, the success of mixed ownership depends on the degree to which decision making can be rationalized and depoliticized. The more the decision-making process of the SOE is depoliticized and predictably follows rules and regulation, the more likely the company is to make economically based decisions.

39. Special attention is warranted with respect to regulation because a common element of failed mixed ownership appears to be inadequate regulation of pricing. The dilemma of regulation is how to give

[20] Based on Nellis J, Menezes R. Lucas S., Privatization in Latin America: The rapid rise, recent fall, and continuing puzzle of a contentious economic policy.

outside owners sufficient protection to earn a fair return, while at the same time protecting the public interest. Regulation of SOEs with monopoly powers thus needs careful consideration in mixed ownership enterprises. In principle, price setting and market regulations can be done by independent regulators. However, independent regulators often face pressures from government on the pricing structure of essential and sensitive goods.

40. In this regard, the work of the OECD on competitive neutrality of SOEs is relevant. Competitive neutrality refers to a situation where entities operating in a market compete on a “level playing field” and have no competitive advantage or disadvantage due to public ownership. The attention to competitive neutrality is increasing with a growing number of cases where public and private entities compete in the market place. The objective of the OECD’s work is to ensure that the commercial activities of public bodies, municipalities, or non-profit organizations do not distort competition.

41. The issue of competitive neutrality was already touched upon in the *OECD Guidelines*. The OECD’s new report *Competitive Neutrality: Maintaining A Level Playing Field Between Public and Private Business* develops the issue further. It analyses how to balance commercial objectives in the face of important public policy functions that SOEs and other government bodies are entrusted with and describes ways for government to ensure fair competition in fields ranging from: debt, tax and regulatory neutrality; to how to calculate market consistent rates of return over a reasonable period of time; to ensuring transparent accounting and compensation for public service obligations.

42. Ultimately, the challenge for the state is to draw clear lines between its role as an owner, its role as a regulator, and as the organizer of an arena in which fair competition takes place. There needs to be a fundamental commitment by the state to principles of non-intervention, fair competition, the respect of contractual agreements, and the equitable treatment of outside shareholders. Mixed ownership without such a commitment will likely fall short of its promise.

Issues for discussion

1. **The state’s perspective:** What is the experience of the state with respect to mixed ownership of SOEs? What are the problems that have been encountered? Can specific cases of problem interactions be described? Can any suggestions be made with respect to how to remedy such problems?

2. **The investor’s perspective:** What is the perception of the outside investor of mixed ownership? What problems have been encountered from the perspective of outside investors? Can any specific cases of problem interactions be described? Can any suggestions be made with respect to how to remedy such problems?

3. **Listing versus strategic participation:** Are there different governance issues that arise when the outside investor is a strategic investor, versus when outside investors came through listing on an exchange? Are there any indications that sales to strategic investors are more or less successful than listing?

4. **The experience in OECD markets:** Are there significant differences in terms of the challenges of mixed ownership in OECD markets versus some of the Latin American countries, or are these challenges broadly similar? What lessons/recommendations could be drawn from OECD experience?

5. **Solutions:** What are the key governance areas on which to focus in order to ensure equitable and successful governance of the mixed-ownership SOE (ex. board member nominations; formalized

decision-making channels; CEO nominations, or alternatively, the institutional and regulatory framework)?

6. **Commitment:** Will good governance policies work in the absence of commitment by the state to the equitable treatment of shareholders? What can be done to increase the commitment of the state?

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