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STATE-OWNED ENTERPRISE REFORM

KEY POINTS

- Successful SOEs operate using the same principles as efficient private sector companies.
- Directors should not be elected officials or civil servants responsible for executing the government's sector policy agenda.
- No SOE portfolio remains free of political interference for a sustained period.
- With effective regulation, governments can achieve policy objectives and service delivery targets without incurring the risks and costs associated with direct investment in commercial enterprises.

PSDI policy briefs articulate the context and rationale underpinning the support PSDI provides through each of its five core work areas.

Throughout the world, governments have established state-owned enterprises (SOEs) to address perceived market failures, promote economic development, and pursue social and political aims. With few exceptions, however, SOEs have performed poorly, creating a drag on economic growth and diverting public resources away from key sectors such as health and education.

When SOEs dominate domestic markets such as power, telecommunications and water, they can drive up the costs of doing business for the private sector, while stretching the limited financial resources of the public sector.

Improved SOE performance requires strong governance arrangements, profitability incentives, hard budget constraints and exposure to competition. These are the same conditions that are essential to successful commercial ventures.

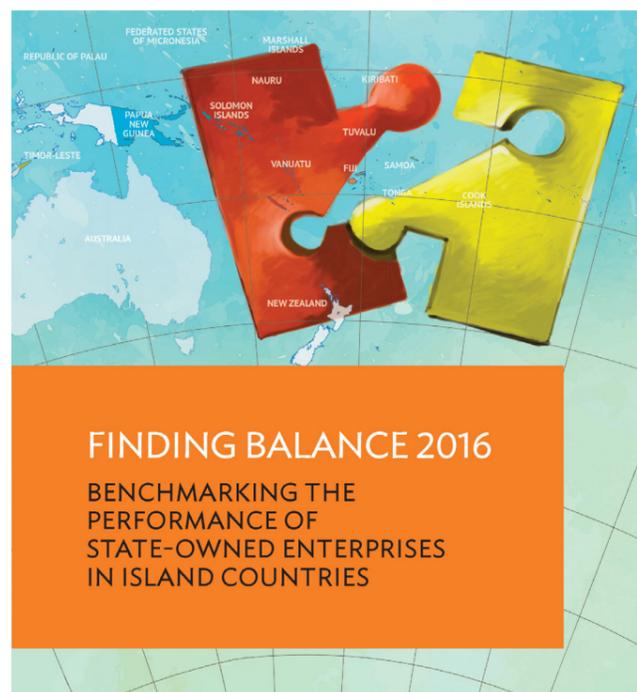
Giving SOEs a clear commercial direction, opening markets to competition and encouraging partnerships with the private sector are the best ways for governments to improve service delivery and SOE performance.

COMMERCIALIZATION

Commercialized SOEs should operate using the same principles as efficient private sector companies—with full accountability to their shareholders. In the case of SOEs, the “shareholders” or owners are the citizens of the country. Commercialization requires results-based measurement of SOE performance and promotes increased transparency and accountability. It provides clear incentives for managers to increase efficiency and maximise the value of the SOE on behalf of its shareholders.

FIND OUT MORE

Download the fifth edition of *Finding Balance*, PSDI's ongoing comparative study of SOE performance in island economies
www.adb.org/publications/finding-balance-2016



ASIAN DEVELOPMENT BANK



“The SOE model was never intended to be a long-term ownership model, but rather a way to transition from public to private provision of services.”

Commercialization can be seen as a process, with increasing accountability, management independence, and profit orientation at each stage, as illustrated in the diagram on the back page. Key actions in the commercialization process are:

- (i) Strengthen corporate governance;
- (ii) Develop robust budgeting and strategic planning processes;
- (iii) Establish mechanisms for delivery of community service obligations; and
- (iv) Increase transparency and accountability.

CORPORATE GOVERNANCE

The governance structure of an SOE is composed of its management, board of directors and shareholder oversight. The board of directors is responsible for setting the strategic direction of the SOE, appointing its Chief Executive Officer (CEO), and establishing regular SOE and CEO performance reviews.

Good corporate governance requires robust processes to select and replace directors, ensuring that directors are qualified and suitable for the role. These directors should not be elected officials or civil servants responsible for executing the government’s sector policy agenda. When SOE directors also have these roles, they will be conflicted in pursuing the commercial mandate of the SOE.

An effective SOE governance model supports and strengthens the commercial mandate of the board while ensuring appropriate oversight by the responsible minister as the owners’ representative. These roles are very different but equally important. If they are mixed, and political objectives take precedence over commercial considerations, the effective operation of SOEs will be jeopardized and value will be destroyed.

BUSINESS PLANNING AND PROFITABILITY

Commercialized SOEs typically adopt an annual budgeting and business planning cycle within a medium-to-long-term strategic plan. SOEs should be required to generate an adequate return on investment whilst competing on equal terms with the private sector.

A statement of corporate intent (SCI) can be used to communicate the SOE’s objectives, business activities, performance measures, key strategic and operational targets to the wider public. The board of the SOE usually drafts the SCI in consultation with the responsible minister. The process of developing the SCI provides greater clarity around business goals and a common understanding of what constitutes “success.” SCIs are, therefore, a key planning and accountability document that can help to improve performance.

COMMUNITY SERVICE OBLIGATIONS

SOEs are often directed to provide services to communities on non-commercial terms. Such services, also known as community service obligations (CSOs), are sometimes only partially compensated through a government subsidy. This undermines SOE profitability and reduces accountability. Moreover, CSOs can also be used by SOEs to request excessive budget support in order to compensate for operational inefficiencies.

The introduction of CSO contracting frameworks addresses this issue by requiring all CSOs to be clearly identified, costed, contracted and funded. This allows for CSOs to be contracted on a commercial basis, reinforcing the SOE’s commercial mandate and introducing efficiency incentives, but also provides the government with the option of seeking third party providers of CSOs where they can be more cost-effective than SOEs.

TRANSPARENCY, ACCOUNTABILITY AND MONITORING

A key factor in achieving gains from commercialization is the increased level of transparency and accountability in the SOE's decision-making process. With greater transparency, stakeholders can determine SOE board and management performance, particularly through regular review of financial and operational outcomes against SCl targets.

Moreover, increased transparency facilitates monitoring of SOE performance by the government, the media and the general public. Such scrutiny encourages greater accountability in SOEs, especially among key decision makers. SOE legislation can be used to specify the reporting requirements for SOEs.

Just as large institutional shareholders and professional investors monitor the performance of companies in which they have invested, so governments must monitor the performance of SOEs. Performance should be monitored against the commercial targets and strategic goals identified in the business plan and the SCl.

An alternative approach is to use partial privatization to increase transparency and accountability. In India, for example, a number of SOEs experienced increased sales and profitability after floating minority shareholdings on the local stock exchange.

Part of this effect is attributed to the improved accountability and monitoring that resulted when SOEs were required to comply with the reporting requirements of the Indian stock exchange.

In Indonesia and Malaysia, similarly, the largest and most profitable SOEs are also publicly listed and therefore subject to commercial disclosure requirements.

COMPETITION AND REGULATION

Competition is a powerful mechanism

for improving the performance and responsiveness of SOEs, while at the same time facilitating much needed private investment. Where possible, SOE commercialization should be conducted in parallel with market liberalization to introduce competitive pressures that force SOEs to operate efficiently.

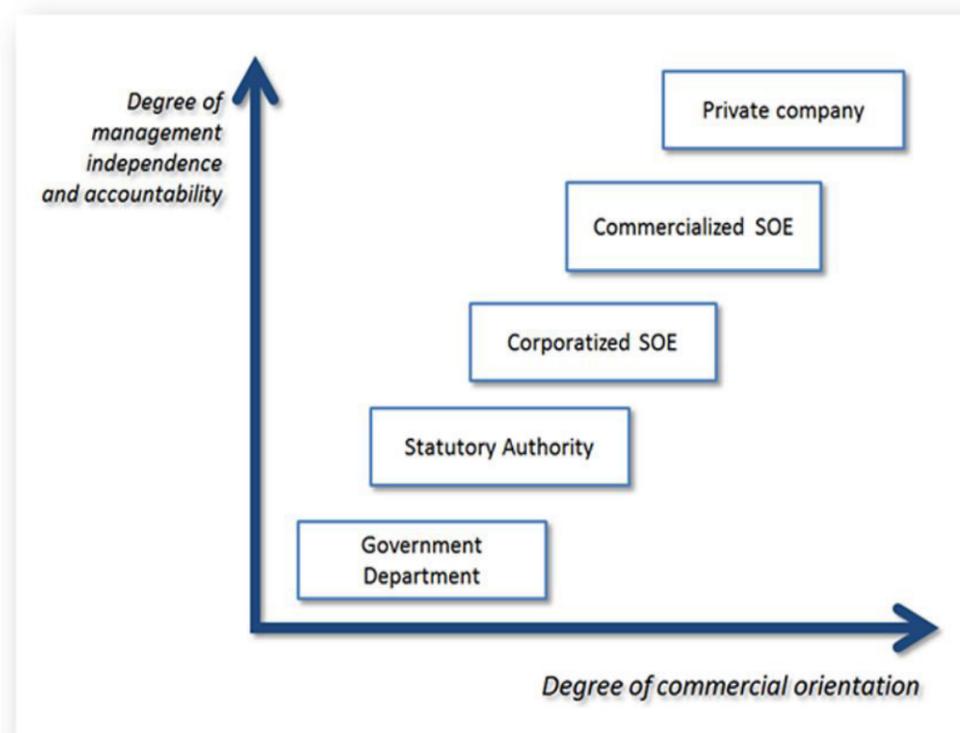
In many cases, SOEs are the sole providers of key infrastructure and services such as power, water and transportation. These businesses may include a 'natural monopoly', but large parts of the business may be well suited to competition. The natural monopoly segments could also be included in concession contracts that could be competitively tendered. Strong regulatory arrangements would be required to protect consumers and extract the efficiency gains that private provision can bring.

In many countries, SOEs continue to benefit from subsidized credit, government guarantees and preferential access to government contracts, giving them a competitive advantage over private firms. In Malaysia, studies show private investment is much lower in sectors dominated by SOEs than in other sectors.

The benefits of competition are only fully realized when there is a level playing field and licensing and other barriers that can prevent private companies from entering markets are eliminated. One only has to look at the impact competition has had on the dramatic transformation of the telecommunications markets around the world to see how it can lead to investment and a rapid expansion of services.

Regulatory authorities can complement the SOE commercialization process by promoting competition and carefully regulating sectors in which competition is not possible. The commercialization process should also ensure that technical standards and regulations are not used to create barriers to market entry. This will generally require that regulatory functions are reassigned from SOEs to independent regulators.

“SOEs should be required to generate an adequate return on investment whilst competing on equal terms with the private sector.”



PRIVATIZATION

Fully commercialized SOEs operate much like private companies, but with one important distinction—as public companies, they remain vulnerable to possible interventions such as government shareholder representatives seeking to impose non-commercial outcomes.

International experience has demonstrated that no SOE portfolio remains free of political interference for a sustained period.

For this reason the SOE model was never intended to be a long-term ownership model, but rather a way to transition from public to private provision of services.

Privatization, which involves the transfer of at least part of the SOE's ownership

to the private sector, can help to lock in the gains from commercialization and significantly reduce the risk of inappropriate political intervention. From the mid 1980s to the mid 2000s, close to one trillion US dollars of SOEs were privatized in more than 100 countries. The experience resulted in a marked improvement in the productivity of state assets, service quality and a reduction in state budget burden.

This has also been true in the Pacific, where all privatized assets in recent years have resulted in expanded services and improved budget balance. With effective regulation, governments can achieve policy objectives and service delivery targets without incurring the risks and costs associated with direct investment in commercial enterprises.

The Pacific Private Sector Development Initiative is a regional technical assistance facility co-financed by the Asian Development Bank and the Governments of Australia and New Zealand.

PSDI works with ADB's 14 Pacific developing member countries to improve the enabling environment for business and support inclusive, private sector-led economic growth.

Since 2007, PSDI has been helping Pacific countries to:

- Develop better financial markets and services
- Modernize business laws
- Reform state-owned enterprises and consider public-private partnerships
- Promote competition and protect consumers
- Advance the economic empowerment of women

The Asian Development Bank, based in Manila, is dedicated to reducing poverty in the Asia and Pacific region through inclusive economic growth, environmentally sustainable growth, and regional integration. Established in 1966, it is owned by 67 members—48 from the region.

Pacific Private Sector Development Initiative

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