Issues in Reforms of State-Owned Enterprises: *Perspectives from ADB's Experiences*

11 June 2018
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Korean Development Institute, Seoul

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   - Information asymmetry
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4. Three lessons from broad governance reforms (with implications for SOE reforms)
5. Issues for discussion

Gambhir Bhatta
Asian Development Bank, Manila

Some Relevant Context

In early 2017, Moody's Investors Service warned that specific countries (such as PRC, Venezuela) were most exposed to debt from SOEs.

Indeed, Moody's warns that for many countries SOEs represent a material source of financial risk for governments, a risk on contingent liabilities for governments that ranks after financial sector crises and natural disasters.

"Sovereign Contingent Liabilities; Public Enterprises Represent a Material Source of Fiscal Risk to Some Sovereigns,"
Global Credit Research, 25 January 2017.

"State control has helped Alrosa during previous slumps… That's our competitive advantage over DeBeers" – Igor Sobolev, Deputy Chief Executive, Alrosa, Russia

"Alrosa treading a rocky path towards eventual privatization." Financial Times, Tuesday, 11 April 2017

"London goes on offensive in effort to entice Aramco IPO" *(FT, 14 July 2017)*

Said to be the world's biggest flotation (Saudi Aramco is targeting a $2tn valuation before its IPO in 2018)

List a 5% stake in Saudi Aramco; the biggest pubic offering ever.

But London would propose new listing for SOEs that would loosen governance restrictions (exempt companies controlled by governments from some curbs)

Friday, March 23, 2018 — The New Zealand Herald — The Business | 7

Politics

Matthew Hooton
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Flying in the face of reason

Why should the government own a majority stake in Air NZ?

Those of us who still believe in mainstream economics have Shane Jones to thank for again highlighting the lunacy of a government minister owning 51.9 per cent of Air New Zealand.

ROBERTSON'S MOM PORTFOLIO

Company	Market Capitalisation	Govt Share	P/E Ratio
Meridian	$7.6b	$3.9b	41.3
Mercury	$4.4b	$2.3b	21.4
Air New Zealand	$3.8b	$2.0b	10.6
Genesis	$2.4b	$1.2b	21.6
Total	$18.2b	$9.4b	

the MOMs, or any other companies on the NZX.

In their typically excellent Investment Statement this week, Robertson's own Treasury officials gave five plain-English reasons why the government should own things:

- When the social and economic benefits of government ownership outweigh the costs
- When service delivery involves specialised assets that the private sector has trouble providing on an ongoing basis
- When risk cannot be efficiently transferred to the private sector through a contract
- When the government has the most relevant expertise
- When the government needs to be directly accountable for outcomes

None applies to the MOMs.

Grant Robe...

NZ Treasury says 5 reasons why govt should own things:

1. Benefits (social, eco) > costs
2. Private sector not able to provide regularly
3. Risk cannot be transferred to private sector through a contract
4. Government has the most relevant expertise
5. Government needs to be directly accountable for outcomes

OMIC TIMES

THURSDAY, 9 FEBRUARY 2012

Corporate Games are Fun, they also Contain Learnings for Executives

SPECIAL FEATURE: FUN@WORK

offs, India Inc
ts Hari Sadu

How Not to Lay Off Employees

MISTAKE 1
Ask people to leave on a Friday

IMPACT
Rest of the employees were scared to come to work on Monday thinking it is their turn next

MISTAKE 2
Laying off in batches

IMPACT
Employee morale in shambles. Star performers begin to leave

MISTAKE 3
Giving selective help with career transitioning

MISTAKE 4
Not having a 'how to' script to effect layoffs

BUDGET TO TARGET FISCAL DEFICIT

Pranab Losing Sleep Over Subsidy Burden

"As finance minister when I think of enormity of the subsidies to be provided, I lose my sleep. There is no doubt"

PRANAB MUKHERJEE
Finance Minister

OUR BUREAU
NEW DELHI

“As finance minister when I think of enormity of the subsidies to be provided, I lose my sleep. There is no doubt”

MARKETS & INVESTING

Analysis. Equities

India's privatisations back on track

This year's bull run makes conditions ripe for selling off state-owned companies

KIRAN STACEY — NEW DELHI

The stellar run in Indian equities this year has reignited interest in a long-running aim of successive governments: selling off some of the country's biggest companies from state ownership.

For years, New Delhi has promised to divest billions of dollars' worth of state enterprises, spanning the national oil and gas company, insurance, and parts of the railways. A lack of political will, powerful trade unions and, occasionally, adverse market conditions, have stymied the plans.

This year, however, experts say the conditions are right for ministers to hit their disinvestment target for the first time in seven years, not least because Indian stocks have enjoyed a world-beating bull run.

$11bn
Value of India privatisations planned this financial year

28%
Increase in India's Nifty 50 stock market index so far this year

“For years, New Delhi has promised to divest billions of dollars’ worth of state enterprises… A lack of political will, powerful trade unions, and occasionally, adverse market conditions have stymied the plans”

“It needs to restructure, which it is not able to – it cannot get rid of people that easily because there are too many union issues. It positively needs a change in mindset from the government”.

Thursday 6 April 2017

Airlines. Legacy carriers

Air India flies into uncertain future

Auditor raises concerns as struggle with debt and costs continues despite bailout

ALIYA RAM — NEW DELHI

It was a humbling moment for India's national airline.

Air India, which finally turned a profit last year after at least eight years of pre-tax losses, was revealed last month by the country's auditor to have understated its operating losses by Rs64.2bn ($964m) between 2012 and 2015.

In a sharply worded report, India's comptroller and auditor general said the state-run carrier had failed to meet targets on selling assets, forcing it to take on costly short-term loans that had "largely eroded" the benefits of a Rs422bn bailout in 2012 by New Delhi.

The rebuke, which came less than a year after Air India returned to profita-

“The transformation process that we have under way (for Air India) includes governance, operating performance, fleet acquisition, and ownership changes”

(India’s Aviation Minister quoted in FT, 26 June, 2017)

Performance (based on 2015 report)

- **Loss**: Rs. 7b annually (**approx $70m**)
- **Accumulated losses** (FY 14/15): Rs. 26.7b
- **Liability to GON**: Rs. 49.6b as share capital, and Rs. 94b as secured long-term loan

Nepal Electricity Authority

NEA is one of three public utility SOEs (the other two: water and telecoms); and is the biggest SOE to run on a loss every year

Some constraints

NEA self-assessment

- HR lapses (eg, 25% of posts vacant, including 5 of 9 at Deputy MD level)
- Government unwilling to revise tariff upwards
- High-level commitment missing

External-assessed

- Political interference, *including frequent government changes*
- Organizational lapses (eg, unionism, lack of meritocracy)*

From IMF, Article IV consultation report for Nepal, 2015…

Directors stressed the importance of unlocking the country's hydropower generation potential and sustained reforms to improve the investment climate… large SOEs in the energy sector should be put on a sound financial footing to reduce losses and contingent liabilities.

Tuesday 19 July 2016

FINANCE

COMP

Oil & gas. Class

Investors reel as Petrobras corruption claims persist

Prosecutors allege ex directors conspired with politicians to defraud state-run company

JOE LEAHY — RIO DE JANEIRO

Aggrieved investors in Brazil's Petrobras have suffered over the past two years as an investigation into the state-run oil company has showed how corrupt former directors spent the group's funds on everything from art collections to Range Rover Evoques.

But the most recent allegations in the scandal, in which prosecutors claim former directors conspired with politicians and contractors to defraud the company, take this one step further.

Prosecutors claim Paulo Ferreira, a former treasurer of Brazil's erstwhile ruling Workers' party, took money originally destined for a research and development centre for Petrobras's ultra-deepwater oilfields and used it to pay a samba queen a monthly stipend.

"At the request of Paulo Ferreira, there were made diverse payments to the non-governmental organisation Sociedade Recreativa e Beneficente Estado Maior da Restinga, a samba school, and people linked to it, such as Viviane Rodrigues da Silva, the battery queen," said a court document outlining Mr Ferreira's arrest. Mr Ferreira was not available for comment.

The stream of corruption claims is proving an irritant for Petrobras, not just with investigators in Brazil but with institutional investors in New York.

In a class-action lawsuit led by the

Hamilton, the company's lawyers, did not immediately respond to requests for comment. Pedro Parente, Petrobras's new chief executive, said last month that the company was a victim of fraud, estimated to have cost it about \$2.5bn in losses directly related to corruption.

Analysts highlight how any damages ruling against Petrobras would add to its already enormous debt load. Some in the market say the investor lawsuit could result in the third-largest payout in a securities fraud case after Enron and WorldCom.

Concern over Petrobras's financial profile is driven by its large amount of borrowings coming due — \$26.5bn out of total gross debt of \$126bn — between April this year and the end of 2017. The company has the largest debt load in the energy industry.

"They have to sell a lot of assets or have market access to avert a default," says Nymia Almeida of Moody's Investors Service.

She adds that while the investor lawsuit was factored into Moody's B3 junk rating for the company, which implies some level of government support for Petrobras should it run into greater financial difficulty, the details of any payout would be important. This includes how long Petrobras would have to find the money.

Pedro Parente: new Petrobras chief highlighted \$2.5bn in losses directly related to corruption

The steady stream of allegations again

1999-2012: ~ 1/3 of all bribery cases involved bribery of SOE employees, while 80.1% of the value of all bribes were paid to SOE employees*

Norway's largest pension fund blacklisted Petrobras over concerns that the state-controlled oil company at the center of a Brazilian bribery scandal is "prone to further corruption problems beyond its home market". It says there is "unacceptable risk" of future problems (and "severe corruption") at the company.*

Need for focus on institutions

"The greatest challenge Asia faces in its endeavors to realize the Asian Century: **transforming governance and institutions.**"

Core Concept 1: Information Asymmetry

Imperfect Information Paradigm: incorporates information (or the lack of it) into standard economic analysis to explain the rise of certain institutional settings and lack of efficiency

Inefficient institutions result from imperfect and costly information

1. Lack of information across time
 (*we know more at time T-1 than at T+1*)

2. Asymmetry across space
 (eg., *between core and periphery; organizations, etc.)*

3. Asymmetry when static in perception and interpretation
 (*differential in making sense of available information*)

4. Proximity to policymaker/regulator
 (varied access to decision-makers, separate from space asymmetry)

Application: National Resource Governance Institute analyzed 74 state-owned extractive enterprises (to assess how countries manage oil, gas and mineral sectors). Called on Saudi Aramco to ***"disclose closely held data ahead of its planned 2018 IPO"***. Its research ranked the country among the world's most opaque oil-producing nations.* (64th out of 74)

Therefore, all players are at best boundedly rational…

Core Concept 2: Transaction Costs (TCs)

Differential access to, and ability to interpret, information (as well as voting for association) leads to transaction costs

Variable in impact
(Some businesses/firms more able to meet and internalize)

Search and information costs

Bargaining costs

Policing and enforcing costs

North (1990):
"The inability of societies to develop effective, low-cost enforcement of contracts is the most important source of both historical stagnation and contemporary underdevelopment in the third world"

Core Concept 3: Credible Commitment (CC)

- Assumption of a repetitive game
- Expectation: of *quid pro quo* in commitment to transaction
- **Policy reversals—or more aptly, the threat (or perception) of such reversals—lead to a failure to commit credibly**
- **Corollary of CC: credible threat**

$$CC\downarrow = TCs\uparrow$$

Core Concept 4: Political Economy

THE HIMALAYAN TIMES
SUNDAY, SEPTEMBER 23, 2012

MANAGEM

Who pays?

WHY SHOULD PEOPLE BEAR THE LOSSES OF PUBLIC ENTERPRISES?

breakingviews

Koshish Acharya
Kathmandu

Every year the government subsidises, provides loans, incurs bad debts and hence manages to save public enterprises — covering the losses from the taxes that citizens pay of their hard earned money. But is it fair for the people to bear the cost of the failure of public enterprises?

THE PRELUDE

The government of Nepal has provided total loan amounting to Rs 96.16 billion to public enterprises, of which Rs 10.25 billion was granted in the fiscal year 2010/11 alone.

"Other issues like corruption, inefficiency, low productivity, trade union issues, political appointments and political manipulation in the management of the public enterprises have hampered its progress"

- "Politics has more to do with change than economics, but we are not yet ready to let politics out of the closet."
- "Lack of understanding of the political economy of reform is increasingly seen as a risk to development effectiveness…"*

Political economy – *Definition and Lens*

*"… all the many activities of cooperation, conflict and negotiation involved in decisions about the use, production, and distribution of resources"**

Area of coverage	Examples
Historical context	Central Asian countries (part of former Soviet Union)
Political context	Move to federalism (*Nepal*)
Economic context	Regional cooperation in the *Greater Mekong Subregion*
Values, development philosophy	GNH (*Bhutan*), focusing on holistic development
Power relationships	Among political parties (eg, in *Bangladesh*), judiciary-executive tussles, trade unions, civil society, media, etc.
Policy environment	Subsidy regimes

Politics and institutions influence the direction and pace of SOE reforms

Key issues here are:

1. Nature of broad governance reforms
2. Historical antecedents (**path dependence**)
3. Political commitment as circuit breaker

Corporate Governance and State-owned Enterprises

How improvements in ... markets address their ...

The reality is that many SOEs are accountable only to whatever political party is in power. Herein lies the fundamental governance problem

The reality is that many SOEs are accountable only to whatever political party is in power. Herein lies the fundamental governance problem

Fixing SOEs: improving governance as part of a holistic approach

Beyond the profit motive

Politics and good governance: a complicated mix

Fixing SOEs: improving governance as part of a holistic approach

INTERNATIONAL EFFORT
Improving SOE transparency has been a global challenge

STATE-OWNED ENTERPRISES: A GLOBAL SNAPSHOT

Issues:
Subsidies, dividends, taxes, contingent liabilities, weak corporate governance (ownership), corruption, bureaucratic contestation*

ADB sees SOE reforms also as part of a bigger picture…

Target 17.1: "strengthen domestic resource mobilization… through domestic capacity for tax and other revenue collection"

Macro-economic governance: capital market development, PPPs, progressively hard budget constraints, legal and regulatory measures, etc.

Sector governance and SOE-specific inputs: independent regulation, unbundling and corporate and financial restructuring, enablers for project finance

Project finance, equity, and corporate finance investments: NSO loan, equity, advisory and transaction services

SOE reforms

Procurement reforms
(savings level varies in developing countries)

Base Erosion Profit Shifting
($240b/year loss by tax avoidance) *(OECD estimate)*

Encourage private capital, use of remittances
($600b, in 2016, *WB estimate*)

Stemming illicit financial outflows
($5.6t est. loss; 2001-2010; Asia accounted for 61% of such loss)*

Better use of publicly owned commercial assets
(at the central government level, these have a book value of $75 trillion… and about the same at the local government level *(FT, 1 June 2017)*

ADB's SOE Work

Policy		Operations		Research	Evaluation
SPD	**PPFD**	**Regional Departments**	**PSOD**	**ERCD, ADBI**	**IED**
• Overarching framework on SOE reforms (eg, in Strategy 2030) • Policy work by SPD, on operational procedures related to RD and PSOD investment space	• Use of country systems • Procurement guideline for SOEs • Risk analysis of procurement lapses at agency level	• Investments by Regional Departments in sovereign operations, related to SOE reforms, policy matters, broader macroeconomic environment	• Investments by PSOD in non-sovereign operations (NSOs), related to corporate governance reforms, equity investments, rating enhancement; corporatization	• Ad hoc (also on-demand) analysis of SOE reform issues • Country experiences • Corporate governance in SOEs	• Evaluations of ADB operations • Thematic Evaluation Study on SOEs

Analytical and operational work support to RDs and PSOD by the SOE Working Group in 3 specific areas (as per TOR approved by Management)

Database

Knowledge Exchange

Skills Development

Separate working group – chaired by SPD – working on specific SOEs for public sector NSO lending

Table 2: ADB Loans to Sovereign Projects with SOE Engagement, By Approval Year, By Sector, 2004 to 2016
(In US$ Million)

Sector	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	[illegible]	[illegible]	2016	Total 2004-2016
ENE	120	615	632	192	799	401	1,159	1,374	606	2,108	1,590	3,639	1,913	15,149
TRA	0	1,208	402	490	876	377	685	189	64	203	327	33	684	5,537
WUS	30	56	53	80	40	177	16	641	351	312	142	[illegible]	[illegible]	2,566
PSM	223	378	200	350	325	1,131	506	25	31	0	[illegible]	[illegible]	[illegible]	4,841
FIN	40	26	1,005	1,000	165	100	200	240	40	632	[illegible]	[illegible]	[illegible]	4,740
ANR	0	74	45	0	0	0	0	110	0	80	[illegible]	[illegible]	250	604
IND	0	0	0	0	0	0	0	0	0	0	0	[illegible]	375	375
ICT	0	0	0	0	0	0	0	0	0	0	0	25	0	25
MUL	0	15	442	315	280	420	250	11	0	0	0	0	0	1,732
EDU	0	0	0	0	0	0	100	0	0	0	0	0	0	100
HLT	0	0	0	0	0	0	0	0	0	0	0	0	50	50
Total	**413**	**2,372**	**2,779**	**2,427**	**2,485**	**2,606**	**2,917**	**2,589**	**1,092**	**3,335**	**3,382**	**4,890**	**4,431**	**35,719**

In Energy sector, $15 billion

In Transport sector, $5.5 billion

$35.7 billion

Source: ADB SOE Database

SOV SOE, as % of total SOV loans
2016: 38.9%
2015: 46.6%
2014: 39.7%

Notes:

1. Huge increase in loans to ENE sector in 2010. Almost $ 2 billion be 2016.
2. Spike in 2009 in PSM sector. ADB assistance to DMCs hit by 2009 financial crisis – CDOs (collateralized debt obligations) crash. Almost all SOE reforms. IED undertaking evaluation of ADB support for SOE reforms.

In hard core infrastructure sectors (ENE, TRA, WUS): 64.7%

Table 2: ADB Assistance to Non-Sovereign Projects with SOE Engagement, By Approval Year, By Sector, 2004 to 2016
(In US$ Million)

Sector	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	[illegible]	[illegible]	NA[1]	Total 2004-2016
ENE	0	450	330	107	712	174	4	377	128	200	104	542	500	0	3,628
TRA	0	0	0	206	0	0	0	0	0	100	0	0	0	250	556
WUS	0	0	0	0	0	100	46	0	195	120	0	[illegible]	[illegible]	0	761
PSM	0	0	0	0	0	0	0	0	0	0	0	[illegible]	[illegible]	0	0
FIN	33	125	216	125	87	105	0	100	54	74	475	[illegible]	[illegible]	[illegible]	1,669
ANR	0	0	0	0	0	0	0	0	24	0	0	[illegible]	[illegible]	0	24
IND	0	0	0	0	0	0	0	0	400	0	0	0	0	0	400
ICT	0	0	0	0	0	0	0	49	0	0	0	150	0	0	199
MUL	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
EDU	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
HLT	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Total	33	575	546	438	799	379	50	526	801	493	579	1,067	700	250	7,237

In Energy sector, $3.6 billion

In Finance sector, $1.6 billion

$7.2 billion

Source: ADB SOE Database
Notes:
1. Approval year not publicly available for PN 43912 Bangalor [illegible] RRP date March 2011.

NSO SOE, as % of total NSO loans
2016: 32.0%
2015: 49.6%
2014: 33.8%

In hard core infrastructure sectors (ENE, TRA, WUS): 68.3% (2004-2016)

ADB Assistance to Sovereign and Non-Sovereign Projects with SOE Engagement, By Sector and DMC, 2004-2016

Type	Sovereign (of $35.719b)		Non-sovereign (of $7.237b)	
Country	**India**	**17%**	**India**	**41%**
	Pakistan	15%	PRC	25%
	PRC	13%	Azerbaijan	7%
	Vietnam	13%	Indonesia	7%
	Indonesia	11%	Uzbekistan	6%
	Bangladesh	8%	Others	13%
	Azerbaijan	5%		
	Uzbekistan	5%		
	Others	13%		
Sector	**Infrastructure**	**65%**	**Infrastructure**	**68%**
	Public Sector Management	14%	Finance	23%
	Finance	13%	Industry	8%
	Others	8%	Others	1%

Where some of the gaps are (from ADB's SOE Experiences)

("poor SOE performance is the norm for most countries")

Stylized conclusions:

- **Government control** ➔ political interference & noncommercial decision
- **Lack of political will generally** (➔ institutional reforms slow)
- **Strong reporting processes needed** in SOEs make accountability easier
- **Risk of reputation loss high**
- **Weak corporate governance** (eg, director selection not based on skills, inadequate performance incentives, and soft budget constraints)

"While corporate governance reforms cover a broad spectrum of issues (ownership, disclosures, rules for internal management, etc.), cross-country evidence suggests that **hardening budget constraints is key to improve operational performance**."

Maliszewski, W., et al. 2016. "Resolving China's Corporate Debt Problem." IMF Working Paper, WP/16/203, p. 14

(1) Difference between 'what ought to be' and 'what can be': *Good Enough Governance over Good Governance*

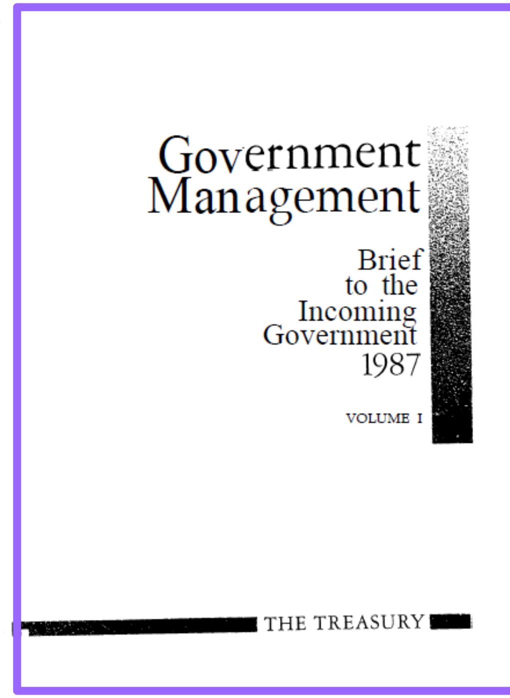
Note earlier concepts of bounded rationality

"… good governance is deeply problematic as a guide to development"

Merilee Grindle: Good Enough Governance: A Cautionary Tale

Notions of country context and 'country systems' are important

(2) Beware difference between best practice and best fit



Government Management

Brief to the Incoming Government 1987

VOLUME I

THE TREASURY

"… developing countries, which are dominated by informal markets, are risky candidates for applying the New Zealand model… basic reforms to strengthen rule-based government and pave the way for robust markets should be undertaken first."

Allen Schick. 1998. "Why Most Developing Countries Should Not Try New Zealand's Reforms". **World Bank Research Observer** Volume 13, Issue 1, Pages: 123 – 131.

(3) Stay for the long haul

"The three completed programs in Assam, Mizoram, and West Bengal were generally effective … ADB should consider providing longer-term follow-on support to help cement reform gains and institutional development."

Questions?

Please contact:

ADB's Governance Team

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Questions for Discussion

1. What is the main SOE reform issue in your country at the moment?

2. How are the reforms progressing?

3. What do you see as the biggest risk to this reform process?

4. How can ADB help in the SOE reform agenda?