



Cameron Partners Insight Series

Developing the SOE Model

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The Underlying Ideas

The original objective behind the development of the SOE model was to improve the efficiency of Government owned trading enterprises.

The development of the SOE model recognised that the efficiency with which we used the resources and how these enterprises performed was determined by their:

- Exposure to competitive markets for their products, services and inputs.
- Control and governance arrangements.
- Interaction with capital markets.

Therefore the key elements of the SOE model were designed to:

- Expose SOEs' inputs and outputs to competition by deregulating the markets in which they operated and removing special assistance.
- Adopt a commercial organisational model within the Companies Act framework and based on standard corporate control arrangements such as:
 - Boards of Directors.
 - The removal of centralised Treasury and SSC controls.
 - Exposing SOEs to the disciplines of capital markets, disclosure, monitoring and contracts as much as possible.

For much of the 1990s, this model was not applied to the SOEs in the way that had been envisaged. Over this period, many of the SOEs were in 'prepare for sale' mode. SOE capital structures were tightly reigned in, limiting the scope for major strategic decisions. These decisions were essentially deferred and left to 'the new owner'.

More recently, the current Government has confirmed that SOEs are in a long term hold environment and there is a renewed commitment to long term Government ownership of SOEs. Accompanying this commitment have been progressive changes in SOE governance and control regimes. The changes recognise that what had evolved in the 'prepare for sale' period is not going to work in a long term hold environment. The changes also recognised that SOEs are confronted with significant competitive threats and changes in their markets. This is perhaps particularly evident in the electricity sector which, unlike the 1990s, now has no significant overcapacity and major investment decisions are necessary.

The Government's response has been to encourage SOEs to play more actively in their markets and to transfer more decision rights to SOE boards and CEOs in respect of the development and implementation of business strategy and plans, and the associated investment decisions.

The greater empowerment of SOE boards and management teams has resulted in transactions and

investments by SOEs that would have been highly unlikely to occur under the 'prepare for sale' approach. Examples include:

- Meridian's acquisition and subsequent divestment of Southern Hydro.
- New Zealand Post's divestment of 50% of Express Couriers Limited to a joint venture with DHL.
- Mighty River Power's gas exploration joint venture with Swift Energy.
- Genesis Energy's partnership in two oil and gas developments.

These changes represent a significant evolution of the SOE model beyond the 'prepare for sale' approach, and represent steps towards a better model for long term Government ownership.

We believe the model can be further improved. In particular there are a number of potential initiatives which could significantly improve the performance measurement and monitoring regime of SOEs. They include:

- An advisory panel to assist shareholding ministers with assessing board effectiveness and discussing board performance with SOE chairs; and
- Adoption of a best practice information disclosure regime, matching that of public listed companies, to facilitate better monitoring; and
- Outsourcing regular reporting on the value and performance of SOEs to suitably qualified private sector analysts.
- Exposing SOEs to capital markets disciplines through the listing of non-voting equity.

Issuing listed non-voting equity in SOEs has the potential to significantly enhance the SOE model. It would enable direct monitoring and measurement of SOE performance and value by the equity capital markets. It would also significantly enhance SOEs' access to capital and financial flexibility.

It would bring SOEs much closer to the performance pressure of the listed company environment without compromising Crown ownership and control of SOEs. It would also improve the size and depth of the New Zealand capital markets and widen the range of alternatives available to New Zealand investors. It is also worth noting that such securities were contemplated in the drafting of the initial SOE Act, and are provided for in the Act.

The Government has shown that it can co-exist alongside listed company investors in examples such as Air New Zealand. In that example, the Government is able to maintain the monitoring it desires within the constraints of the continuous disclosure regime and Air New Zealand's purely commercial mandate. It would be straightforward to accommodate existing SOE Act processes alongside listed equity securities. This would sharpen the commercial incentives of SOEs. If there was concern on this point, we note that the SOE Act already has provisions which allow the Minister to explicitly require (and fund) non-commercial activities.

The choice about listed equity securities should not be driven by whether SOEs or the Government 'need the money'. The performance monitoring benefits alone are worth pursuing.