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Governance of SOEs: Is the current design of the SOE Model a Recipe for Failure?

A Presentation to the The Centre of Accounting Governance and Taxation Research Conference

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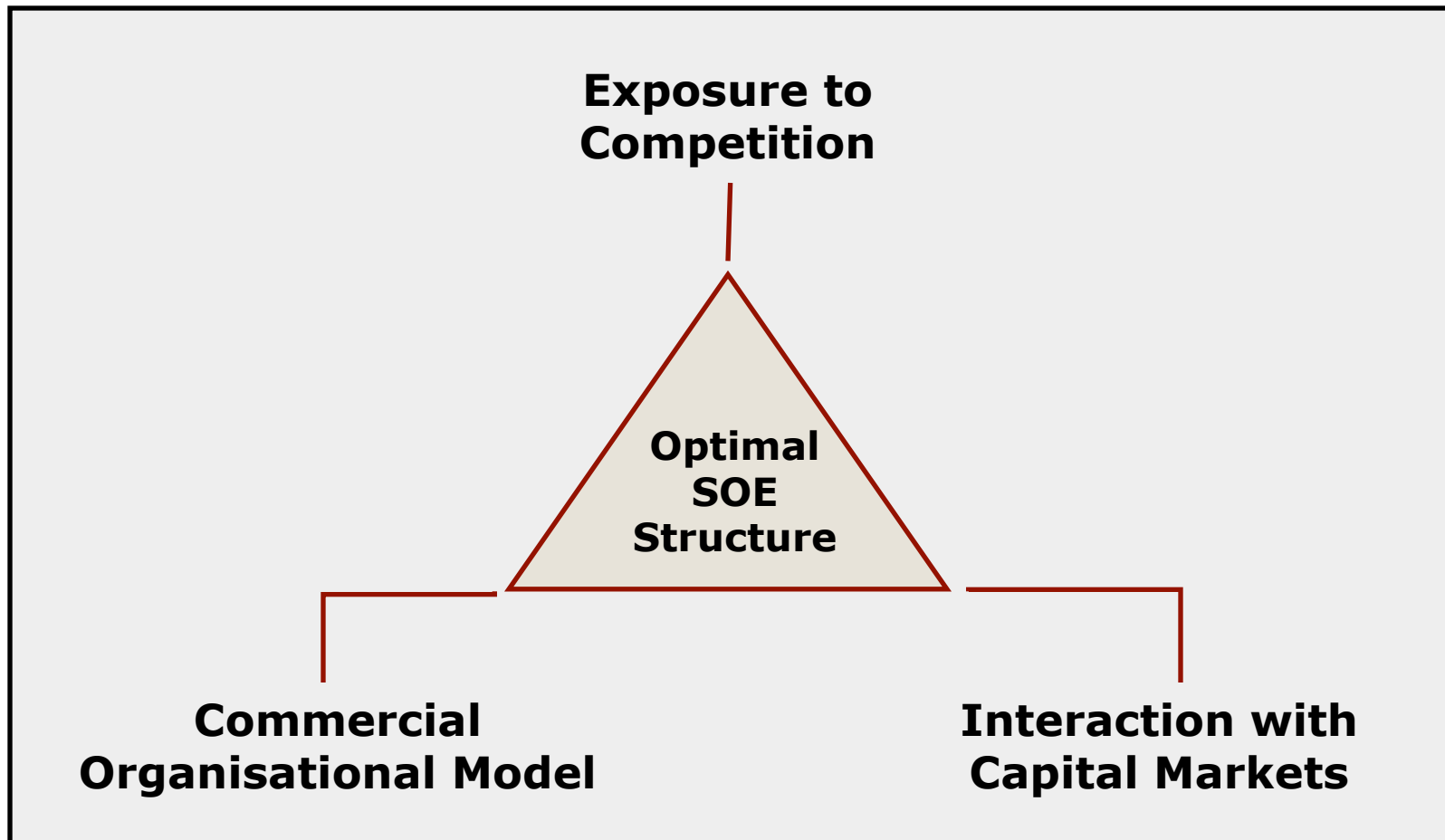
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November 2008

Presentation Agenda

- The Ideas Underlying the SOE Model
- The Prepare for Sale Approach – An Early Application
- Towards an Optimal SOE Model
- Recent Developments – The Long Term Hold Approach
- Shortcomings of the Current SOE Model
- Conclusion

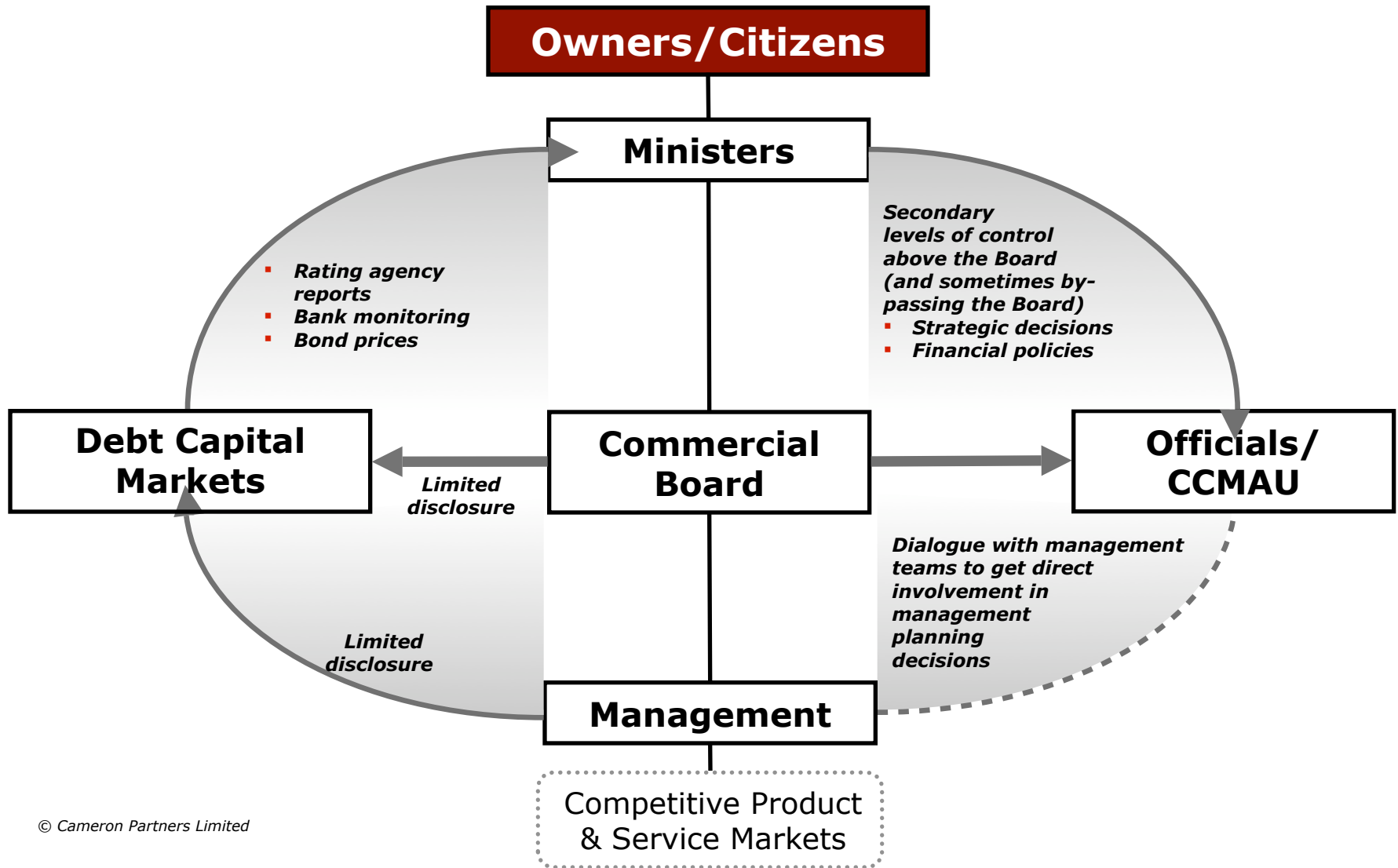
Key Ideas Underlying the SOE Model



Prepare For Sale Approach – An Early Application

- Long term value-creation was put aside.
- Tight controls were imposed.
- Impact on SOEs and value mitigated because:
 - Short timeframe expected until sale.
 - SOE markets were in early stages of deregulation (less competitive).
 - In some areas there had been significant over investment in capacity in pre-SOE period.

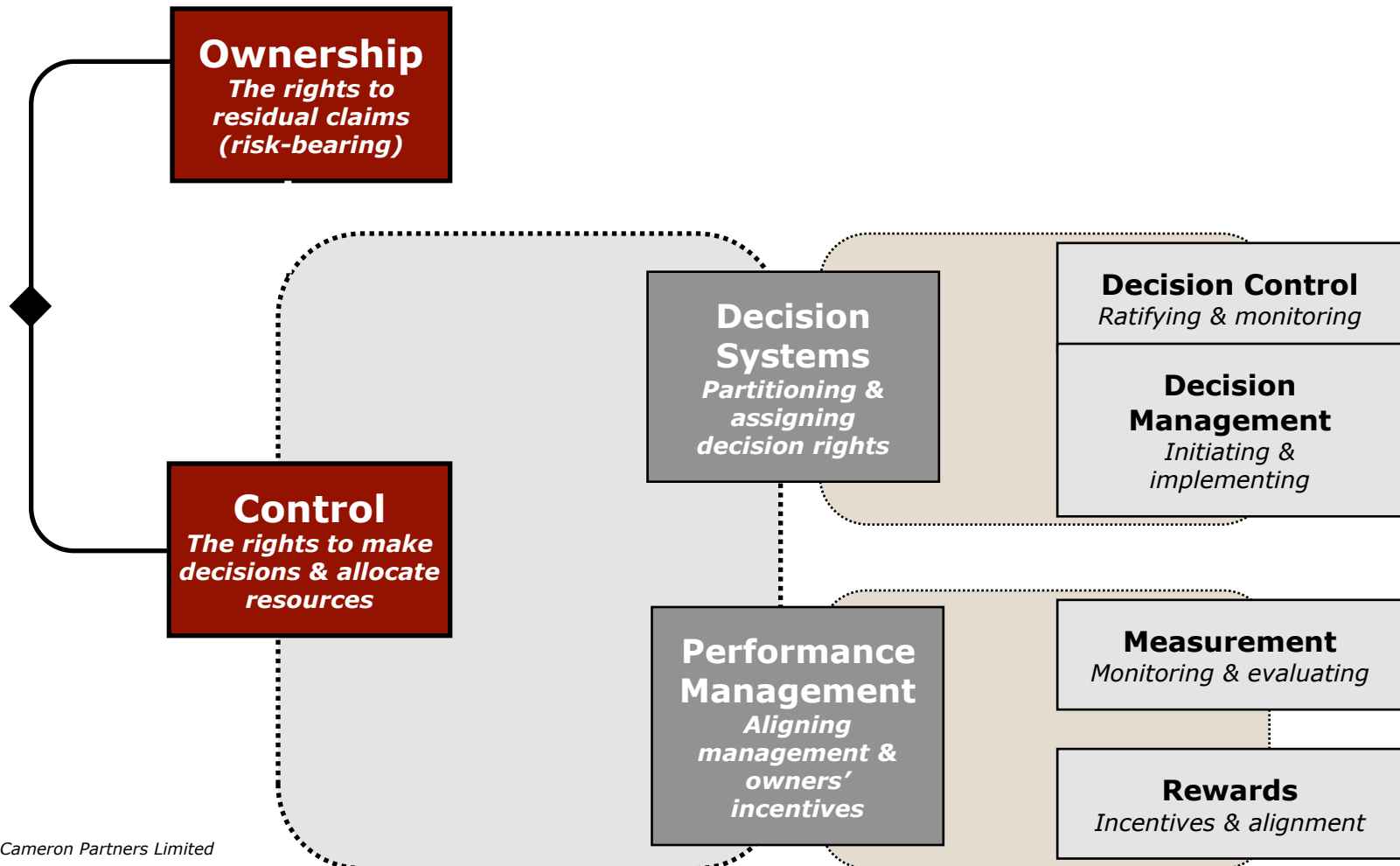
Prepare for Sale Approach – the Way the Model Worked



Towards an Optimal SOE Model – Organisational Architecture

- Organisational Architecture is concerned with:
 - Allocation of decision rights to those with specific information and capability.
 - Control arrangements to ensure alignment of decisions with shareholder interests:
 - Decision systems.
 - Performance measurement and rewards.

Towards an Optimal SOE Model – Organisational Architecture



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Towards an Optimal SOE Model – Organisational Forms to Consider

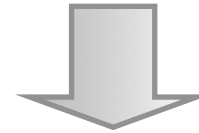
Closed Corporate

Overlap of Ownership and Control



Open Corporate

Separation of Ownership and Control



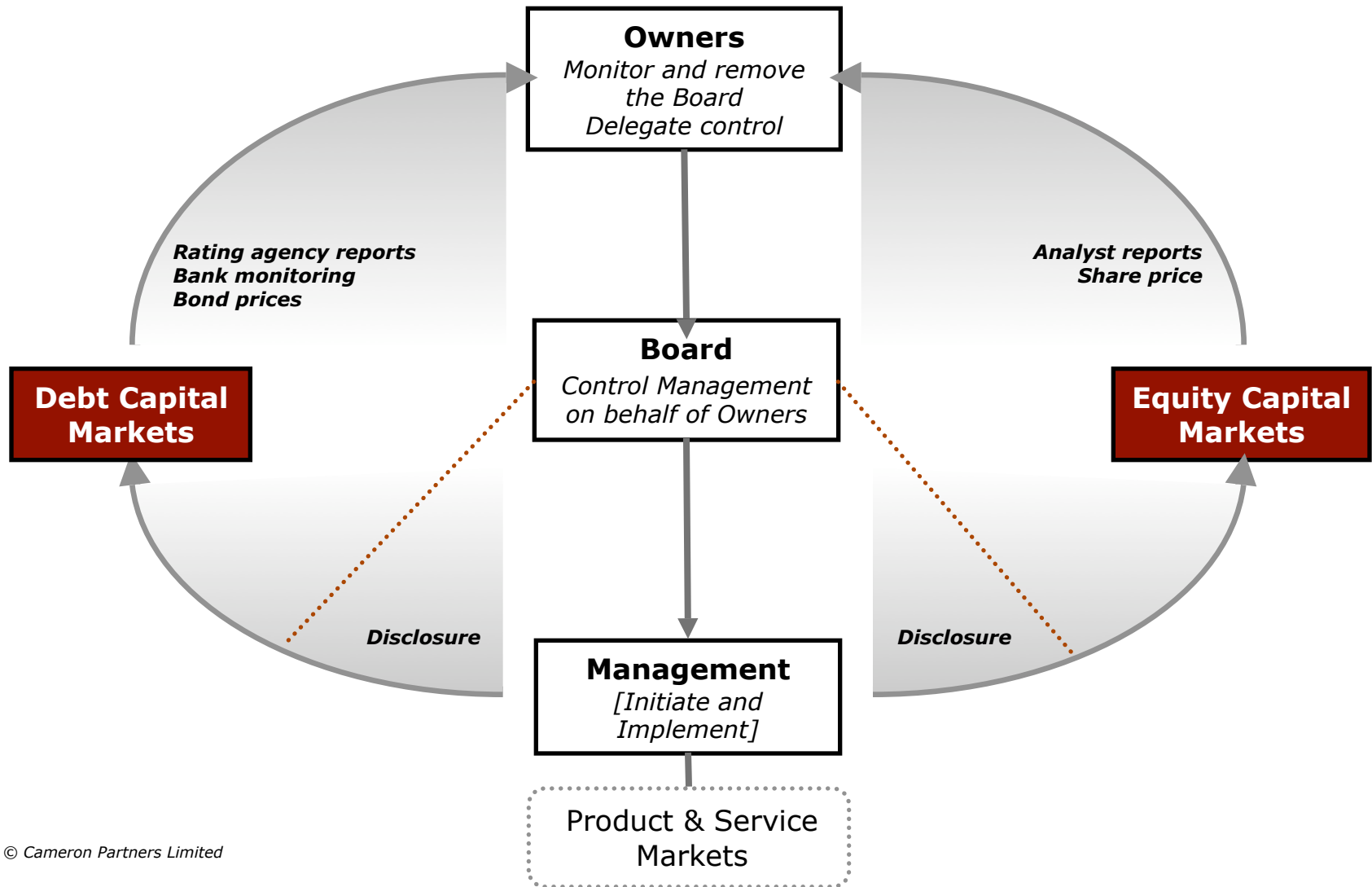
Requires

- Allocation (delegation) of decision rights
- Performance management system

Improved by

- Interaction with capital markets

The Open Corporation Model



Towards an Optimal SOE Model

The Open Corporation Approach

- An optimal SOE model should be based on the open corporation model, and incorporate the following elements:
 - Decision rights allocated along public company lines focusing particularly on the relationship between Ministers and the Boards of SOEs.
 - Effective measurement and monitoring of organisational performance.
 - Exposure to the disciplines of equity capital markets to the greatest extent practicable.

Towards an Optimal SOE Model – Key Elements

- **Decision-rights allocated along public company lines focusing particularly on the relationship between Ministers and the Boards of SOEs.**
 - Ensure that SOE Boards have the authority to make strategic, financial and investment decisions.
 - Focus the role of the Shareholding Ministers on removing the Chair of the Board where necessary, ratifying high-level ownership decisions and monitoring Board effectiveness.
 - Allocate decision rights to SOE Chairs and Boards on other governance matters:
 - Board appointments
 - Director succession
 - Director's tenure
 - Set Directors' compensation at appropriate levels:
 - Proposed by Chairs/Governance Committees based on sound advice
 - Ratified only by Ministers

Towards an Optimal SOE Model - Key Elements

- **Effective measurement and monitoring of organisational performance.**
 - Acquire an advisory capability which will assist Ministers in monitoring the effectiveness of SOE Boards.
 - Adopt a disclosure regime comparable to that of large publicly listed companies.
 - Engage experienced and qualified private-sector analysts for monitoring SOE performance.

Towards an Optimal SOE Model – Key Elements

- **Exposure to the disciplines of equity capital markets to the greatest extent practicable.**
 - Provide for SOEs to partner with third-parties who provide external equity.
 - Connect SOEs to equity capital markets by issuing and listing voting or non-voting equity.

Recent Developments – The Long Term Hold Approach

- Recognition that:
 - The 'prepare for sale' approach will not work in a long term hold environment.
 - SOEs are now confronted with significant threats, opportunities and change in their markets.

- SOEs now encouraged to play actively in their markets.

- Decisions rights have been progressively transferred to Boards and CEOs:
 - Business strategy
 - Financial strategy
 - Investment decisions
 - Organisational arrangements to undertake activities

Recent Developments – The Long Term Hold Approach

- The CPL/VUW School of Management survey of SOE Directors indicates that Boards have been in control of strategy and investment decisions since mid 2005.
- The empowerment of SOE Boards and management teams has been accompanied by:
 - Developments in measurement/monitoring of SOE performance involving private sector equity analysts.
 - Organisational arrangements which introduce 'outside' ownership, with equity and monitoring incentives.

Recent Developments – The Long Term Hold Approach

- Examples include:
 - New Zealand Post's divestment of 50% of Express Couriers Limited into a joint venture with DHL.
 - Mighty River Power's gas exploration joint venture with Swift Energy.
 - Genesis Energy's partnerships in two oil and gas field developments – Kupe and Cardiff-2.
- **These changes represent a significant evolution of the SOE model beyond the 'prepare for sale' approach.**

The SOE Model still has Serious Shortcomings

- The current SOE model is far from optimal.

- Four major areas of concern:
 - Issue 1 - The application of the SOE model
 - Issue 2 - Allocation of decision rights between Boards and Ministers
 - Issue 3 - Director compensation
 - Issue 4 - Measurement and monitoring regime
 - Issue 5 - Lack of exposure to equity capital markets

SOE Model Shortcomings – Issue 1

The Application of the SOE Model

- The SOE model is designed to generate “efficiency” and commercial performance through a combination of exposure to competition, interaction with capital markets (at a minimum debt capital markets) and the implementation of the open corporate form (commercial profit-maximising organisational model). Where one or some combination of these conditions do not hold, it may not be an appropriate model.
- We believe the SOE model does not work for Transpower’s core transmission business:
 - It has insufficient exposure to competition or comparable business benchmarks in its output market.
 - Concerns about the monopoly power have led to the development of a complex, unwieldy and expensive regulatory apparatus.
 - This in turn has resulted an organisational architecture for Transpower which departs from the ‘best practice’ principle that the Board and management should control and be accountable for major investment decisions.

SOE Model Shortcomings – Issue 1

- Better outcomes for Transpower's core business are likely to be achieved by:
 - Establishing a more proscribed mandate which focuses on the quality and efficiency of the core transmission network.
 - Carefully considering which of Transpower's existing assets belong in the 'revised' organisation.
 - Radically reducing the role and scale of the regulatory structure which has been imposed on Transpower.
 - Providing the Transpower board with more decision rights in respect of building and operating such a network.
 - Reviewing Transpower's 'network operator' powers within such a new industry and organisational framework.

SOE Model Shortcomings – Issue 1

- On the other hand we believe that the SOE model should be applied to TVNZ:
 - It is not (no longer) a monopoly provider of (TV) media and broadcasting services and is, in fact, facing an increasingly competitive and rapidly changing environment.
 - It would consequently benefit from the greater independence and strategic flexibility provided by the SOE model (amended as in the recommendations below).
 - Its non-commercial (charter) requirements would be more transparently and efficiently delivered through an arms-length commercial contract.

SOE Model Shortcomings – Issue 2

Allocation of decision rights between Boards and Ministers

- Currently Ministers retain decision rights on governance matters which should be allocated to SOE Chairs and Boards:
 - Board appointments
 - Director succession
 - Directors' tenure
- Ministers and their advisors do not have the specific information and capabilities to make the best choices about these matters.

SOE Model Shortcomings – Issue 2

- In the survey of Directors of the nine largest SOEs, two thirds of respondents thought that:
 - "...the inability to determine the selection of the Directors reduced the effectiveness of the Board..."; and
 - "...Boards and particularly Chairs should have the responsibility for recruiting and selecting new Directors, with the Ministers having the right of veto..."
- In the same survey Directors raised questions about the selection process and the capabilities, skills and experience of some chosen Directors. Two thirds of Directors surveyed thought that the process for appointing Board members was "...too politically influenced..."

SOE Model Shortcomings – Issue 2

- The survey showed that there was considerable frustration in respect of governance decision rights:
 - "... a number of comments suggest that the issue of tenure, Board appointments and Director succession more generally should be the responsibility of SOE Chairs and their Boards rather than being determined by formula or imposed by Ministers ..."
- The policy announcement on SOE diversification on 2 June 2006 appeared to provide SOEs with flexibility to expand ('diversify') into new areas that are linked to their existing activities. But it also imposed conditions that are non-commercial (internal financing of any initiatives and the requirement to demonstrate 'spill-over benefits'). It also makes Cabinet the final decision-maker on such initiatives.

SOE Model Shortcomings – Issue 2

- These changes should be reversed:
 - Cabinet should hand back decision rights for all major SOE investments to Shareholding Ministers.
 - Shareholding Ministers should, in turn, pass on decision rights for investments (and acquisitions) to SOE Boards except where Government is being asked to inject equity to fund an investment.
 - Externally (politically) imposed conditions that investments be internally financed and demonstrate spill-over benefits should be removed.

SOE Model Shortcomings – Issue 3

Director Compensation

- Results of the SOE Director survey in respect of Director compensation was unequivocal:
 - “....[SOE] Directors believe they are under-compensated for their roles and responsibilities, both absolutely and relative to private sector benchmarks...[T]his adversely impacts the availability of capable Directors...”.
- Director compensation requires urgent attention. The SOE model (and the open corporation) depends critically on the ability to attract top Director talent.
- We believe that under-compensation of Directors of Government owned organisations (SOEs, Crown Entity Companies, CRIs) is impacting on the quality of SOE Boards and, more generally, distorting New Zealand’s talent market.

SOE Model Shortcomings – Issue 3

- Director compensation should be reviewed and set by the Chairs/ Governance Committees of each of the SOEs, using qualified advice. Ministers should ratify these decisions and be prepared to publicly justify any veto of compensation proposals.

SOE Model Shortcomings – Issue 4

Measurement and Monitoring of SOEs

- Ministers and their advisors are not equipped to monitor SOE performance. In the CPL/VUW School of Management Survey two thirds of Directors thought that Treasury's focus on financial analysis and control compromised the ability of their Boards "to focus on the longer term maximising of shareholder wealth...". It was also noted that "There is a tendency to see SOEs as short-term cash cows...".
- The SOE performance monitoring regime would be considerably enhanced by:
 - Introducing a standard disclosure regime to match that of publicly listed companies.
 - Engaging private sector equity analysts to monitor and report on SOE performance/value and make these reports widely available.
- Shareholding Ministers should instead be focused on monitoring Board effectiveness. An advisory panel should be established with the sole role of supporting Ministers in their assessment of Board effectiveness and ratification Director compensation. The advisory panel would have no involvement in the decision making of individual SOEs.



SOE Model Shortcomings – Issue 5

Lack of Exposure to Equity Capital Markets

- The lack of exposure to the disciplines and benefits of equity capital markets is a major 'gap' in the SOE model.

- This could be readily addressed by issuing and listing non-voting shares:
 - Is already provided for in the SOE Act.
 - Does not compromise Crown control of SOEs.
 - Would enable monitoring and measurement of SOE performance/value by the share market.
 - Would enhance SOE access to capital.
 - Would significantly enhance the quality, depth and attractiveness of the New Zealand capital market.
 - Would release capital for use in higher social/public priority spending.

SOE Model Shortcomings – Issue 5

- Note that listing non-voting shares would obviate the need for the 'bureaucratic' monitoring regime outlined in Issue 4.
 - Monitoring would instead become 'market based'
- The SOE model would be further strengthened if Government sold a portion of its voting shares to the NZ Super Fund (ie, Government's 'expert investor') which would have the right to appoint Directors to SOE Boards.

Conclusion

- The SOE model has evolved significantly from the early 'prepare for sale' approach.
- The Government's 'Long-Term Hold' approach has seen a number of improvements.
- But compared to the open corporation model (on which the SOE model is based) there are a number of serious flaws in the current model.
- These flaws can be readily addressed within the SOE Act.
- If they are not SOE performance will be impaired and eventually it will lead to commercial disasters.