

Government in Business: The Evolution of the SOE Model

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In this chapter I outline the evolution of the SOE model, including the circumstances in which the SOE model (commonly referred to as ‘corporatisation’) was introduced by the State-Owned Enterprises Act 1986 (SOE Act), the objectives that were sought at that time, and the way in which the model was later adapted to align with the intention of the fourth Labour Government and the National Government to sell government enterprises. I then evaluate the existing ‘organisational architecture’ of SOEs in the light of the current Labour-led Government’s commitment to long-term public ownership. Finally, I recommend changes to the model to improve its architecture and enhance the performance of SOEs.

The Original SOE Model

Increased efficiency in the state sector was one element of a comprehensive programme implemented by the fourth Labour Government to lift the performance of the New Zealand economy. The Treasury’s briefing to the incoming Government in July 1984 pointed out that the resources used by the public sector (excluding transfers) amounted to around 25 % of GDP. The state owned trading enterprises alone accounted for over 12 per cent of GDP and 20 percent of gross investment (Treasury, 1984, p. 275). It was argued that contribution of these enterprises to national economic performance could be substantially improved by the removal of specific obstacles to the introduction of appropriate incentives for efficiency (ibid, p. 284). The Treasury’s analysis was developed within a theoretical framework that seriously questioned the extent of existing government intervention in the market, particularly in ‘the fairly extreme form’ represented by state ownership of trading activities (Jennings and Cameron, 1987, p. 130).

Central to the operation of market economies is the system of private property rights — government ownership removes a significant area of economic activity from that system. This has important implications for decision-making by state trading enterprises about how they use resources. Building on work on ‘transaction costs’ and agency theory, the Treasury began directing attention in 1982 to the relative efficiency of various forms of ownership and, in particular, to the mechanisms governing relationships between principals and their agents (for transaction cost analysis see, for example, Coase, 1937, Alchian and Demsetz, 1972, Williamson, 1975 and De Alessi, 1983; for agency theory, see Jensen and Meckling, 1976 and Fama and Jensen, 1983).

The Treasury analysis recognised that the efficiency with which firms use resources and perform financially is determined by their:

- Exposure to competitive markets for their products, services, inputs and labour services.
- Control and governance arrangements.
- Interaction with capital markets (specifically the terms on which financial markets acquire and price the financial claims issued by firms).

This was the ‘template’ against which the existing departmental structures of state trading enterprises were then judged. The organisation of these activities was characterised by political intervention, conflicting objectives, an absence of contestability for the goods and services they provide, and centralised constraints on the use of resources. The Treasury analysis also highlighted the scope for agency problems in these organisations arising from control mechanisms that were ‘grossly inadequate’ (Jennings and Cameron, 1987, p. 136). Consequently, the main thrust of the State-Owned Enterprises Act 1986 was to develop surrogate incentive and monitoring mechanisms in order to promote managerial behaviour which is in line with the interests of the ultimate shareholders’ (ibid). The key elements of the SOE model¹ were 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 based on standard corporate control arrangements such as the introduction of a board of directors and the removal of Treasury and SSC controls affecting the organisations’ ability to manage their resources; and
- Expose SOEs as much as possible to the disciplines of capital market disclosure, monitoring and contracts.

On 1 April 1987 nine corporations were established under the SOE Act.² Over the next few years a number of other departmental trading activities were corporatised and the SOE model was later extended to other public sector enterprises: ports, airports, retail electricity distributors, health services, science, education and local government trading activities. The SOE model has reshaped the ownership, governance, organisation and efficiency of New Zealand public sector commercial entities and has influenced the reform of commercial activities in Australia and other overseas jurisdictions.

¹ For discussion of the provisions of the SOE Act 1986 see Jennings and Cameron (1987) and Duncan and Bollard (1992).

² The agencies to which the State-Owned Enterprises Act was initially applied (with the new SOEs in brackets) were the Ministry of Energy (Coal Corporation of NZ, Electricity Corporation of NZ); New Zealand Forest Service (Forestry Corporation of NZ); Lands and Survey (Land Corporation Ltd); Post Office (NZ Post Ltd, Telecom Corporation Ltd, Post Office Bank Ltd), SSC (Government Property services Ltd) and Ministry of Transport (Airways Corporation of NZ Ltd).

The Impact of Privatisation

In 1988, shortly after the creation of the first SOEs, the Government embarked on a wide-ranging series of privatisations.³ The SOE model was effectively adapted to a ‘prepare-for-sale’ approach. This entailed putting aside long-term value creation in favour of short-term financial performance that was perceived as assisting in the maximising proceeds obtainable in a sale process. Financial policies were imposed that limited the financial flexibility of SOEs in respect of capital structure and dividend policy and significant strategic decisions were deferred to await the new owner. Officials focused on the execution of SOE divestment rather than the development and implementation of the SOE model.

Not all SOEs were targeted for early sale — for example New Zealand Post or Television New Zealand — but the same approach was taken across the board. This emphasis on ‘prepare-for-sale’ prevented the full development and application of the SOE model as initially envisaged. But at the time it appeared to be acceptable for a number of reasons.

First, the ability to make major strategic decisions was regarded as a valuable ‘option’ for the new owner which would be reflected in its view of value and ultimately sale proceeds. Second, *ex ante* any disadvantages of the ‘prepare for sale’ approach were calculated to be minimal because the time frame to sale was expected to be short. Third, industry deregulation was in its early stages and there was at least in the short-term, little downside from restricting SOEs’ flexibility to design competitive strategies survive and ‘win’ in a competitive market. Finally, in some sectors such as electricity, there had been significant ‘over-investment’ in capacity prior to corporatisation and thus pressing strategic and investment decisions were able to be deferred.

An Evaluation of the Existing SOE Model

The present Government has made a commitment to long-term public ownership of SOEs. It is therefore timely to review the governance and control regime that has effectively remained in ‘prepare for sale’ place for the greater part of two decades.

The current arrangements are not necessarily appropriate in a ‘long-term hold’ environment in which SOEs face relatively rapid technological and structural changes in their markets and significant competitive threats. For example, the electricity sector no longer has significant over capacity and is facing major investment decisions. Moreover the depletion of the Maui gas field will affect the costs and flexibility of thermal generation and will thus impact on investment decisions of a number of generators. The current control regime hinders the responses of SOEs to competitive threats and can distort investment signals in the markets in which they operate.

³ The Government’s objectives, principles, criteria and guidelines for asset sales were set out in Annex 4 to the 1988 Budget.

In a 'long-term hold' environment SOEs are meant to behave as commercial entities seeking to maximise shareholder value. To do this in a competitive and changing environment SOEs must be able to develop and pursue sustainable *competitive* strategies. They must also shape their *organisational* and *financial* strategies to align with this competitive strategy. Developing and pursuing these strategies inevitably requires each SOE to make a myriad of decisions throughout the organisation.

The question to be asked is: does the existing SOE model hinder the effective making and implementation of these decisions? The answer is unequivocally 'yes'. In particular, the control arrangements which have developed under the existing 'prepare for sale' model have the potential to misallocate decision rights, the mechanisms for measuring organisational performance are ineffective and often inappropriate, and capital markets are used to only limited advantage.

Decision rights are poorly allocated because SOE boards and management do not have sufficient responsibility, authority or accountability for key decisions. At best these decisions are negotiated with officials and arbitrated by ministers who retain the ultimate decision rights on strategy, capital structure and investment. Ministers and officials are politicians and policy advisers respectively; they cannot be expected to have either the capability or the specific information that SOE management and boards require to make and control decisions. Nor can they be expected to have the ownership, governance and business expertise of their private sector counterparts.

Ministers and officials do not have real ownership claims. They do not bear the wealth effects of SOE performance, and the 'long-term hold' model is an acknowledgement that they cannot or will not transfer ownership. Indeed compared to the value-based focus of private sector owners, the incentives of ministers and officials are often skewed by the potential political and bureaucratic downside of SOE activities.

In the 'prepare-for-sale' model the mechanisms for measuring SOE performance are either ineffective or unreliable because the involvement of ministers and officials means that decisions are not solely focussed on maximising value and there are no external market-based measures of performance. For these reasons company performance and board effectiveness cannot be reliably assessed.

Capital markets are not being used to best advantage while SOEs remain in the 'prepare-for-sale' model. SOEs have only limited exposure to capital market disciplines through debt markets and they do not receive information signals from equity capital markets. In this situation, the expected impact of key decisions on SOEs' value is not transparent.

SOEs vie for investment capital with other government investment needs. Given the competing public demands for investment capital the shareholding ministers must make capital allocation decisions against a complex background of commercial, social and public good requirements. There is a shortage of clear and explicit signals for investment in new projects. What external capital hurdles are new projects required to clear? Where is the information signalling clearly that new projects are creating value? In the present

circumstances, political and bureaucratic bidding wars are likely. The consequential uncertainty about the Government capital allocation process feeds into the private sector capital markets where competitors cannot be sure of the economics of new capacity decisions by SOEs.

In summary, the outcome of applying the ‘prepare-for-sale’ model in a ‘long-term hold’ environment is:

- Poor decision-making arising from a misallocation of decision rights to agents with inadequate information and non-ownership incentives;
- A weakening of effectiveness in the role of the board as the organisation’s primary control mechanism;
- A weakening of accountability structures;
- SOEs that are less effective — in strategy, financial structure and investment decisions — than they should be; and
- Perverse impacts on the markets in which SOEs operate.

Towards an Optimal SOE Model

In developing views on the ‘optimal SOE model’ I have drawn on insights from the literature on ‘organisational architecture’⁴. Organisational architecture is concerned with two key issues that confront all types of organisation (including partnerships, cooperatives, and corporations):

- How to best ensure that the rights to make decisions within an organisation are allocated to the individuals who have the relevant ‘specific information’ to best make decisions.
- How to ensure that the decisions made at all levels of the organisation are aligned with the objectives of the organisation and of its owners.

Diagram: [organisational architecture involves a cascading sequence of choice about here]

The explicit intention of the 1986 Act is that the state enterprises should adopt the corporate form. It is therefore useful to start by examining the organisational architecture of corporations in the private sector.

There are two broad types of corporate form: the *closed* corporation and the *open* corporation. The difference between the two is the degree of separation between ownership and control. In the *closed* corporation there is only limited separation between ownership and control. Usually, important decision agents — that is, members of the board or senior management — also own a significant share of the residual claims. The

⁴ For a comprehensive discussion of this literature see ‘Managerial Economics and Organisational Architecture’ Brickley, Smith & Zimmerman, 3rd Edition, McGraw Hill Irwin 2004.

board is the central decision-making authority. Ownership representation on the board gives simple and effective alignment between key decisions and owners' interests.

By contrast, in the *open* corporation there is a marked separation between ownership and control. This allows for specialisation in both ownership and in control. Owners are specialist risk bearers, and do not need to have detailed specific information to make key decisions. In terms of control, boards and managers can be specialist decision-makers with specific information and experience appropriate to the corporation's situation.

The owners appoint a board of expert directors as their primary control mechanism over the organisation; performance measurement, reporting and reward systems are in place to ensure that the decision-makers act in the owners' interest. Ultimate responsibility for company performance rests with the board which sits at the top of the corporate decision hierarchy. However, in the event of board under-performance, owners reserve the decision rights to remove the board and/or the chair either directly by voting or indirectly by exiting their shares to other parties who will change control.

In the private sector the performance management system of the open corporation is augmented by interaction with the equity capital market. The tradability of ownership claims (shares) means that the current and expected performance of an open corporation is closely monitored by the market. The market's view of the company's performance is reflected in the company's market value (share price). The equity capital market reinforces the open corporation's performance management systems by introducing strong disclosure obligations, monitoring by independent expert analysts (which provides valuable feedback to the owners, board and management); and by facilitating a 'market for corporate control' which transfers ownership when outsiders with capital consider that a change of control will enhance value.

In terms of this typology, SOEs should be conceptualised as open corporations. There is a high level of separation between the ultimate risk bearers (citizens) and control (the board and management). In this regard ministers and officials are not effective proxies for real owners (as in the case of the closed organisation). As noted above they have no 'wealth at stake' and cannot be expected to have either the specific knowledge capabilities or the time to become centrally involved in SOE management and decision-making. On the other hand, there is clearly a benefit to be had from specialist decision-making by expert boards and management.

This suggests that the control arrangements of SOEs should be designed to mimic as closely as possible the control architecture of open corporations in the private sector.

A Revised SOE Model

Based on the analysis outlined above, it is my view that SOEs should incorporate a number of features from the private sector open corporation model. I have grouped them into three broad areas.

Best practice governance should be promoted by revising the relationship between ministers and the SOE boards in three key respects:

- The authority of the boards to make strategic, financial and investment decisions should be clearly established.
- The role of the shareholding ministers should be refocused on the effectiveness of boards and the appointment and/or removal of boards.
- To make accurate judgements of board effectiveness shareholding ministers need to have available adequate tools and information.

More effective measurement of organisational performance should be promoted by providing shareholding ministers with an advisory capability to assist them in monitoring the effectiveness of SOE boards, and by making use of experienced and qualified private sector analysts to monitor SOE value and performance.

Disciplines of equity market interaction should be introduced to the greatest extent practicable. This will require an improvement in SOE disclosure to support monitoring by private sector analysts, the ability for SOEs to partner with third parties who provide external equity, and the issue and listing of non-voting equity in selected SOEs.

I expand on each of these areas below.

A Revised Relationship between Ministers and Boards

A ‘best practice’ SOE model should clearly assign responsibility, authority and accountability for key (strategic and operating) decisions to those with the specific knowledge and capabilities to make such decisions – the boards and management of SOEs.

The role of shareholding ministers should instead be focussed on ‘high level’ control decisions specifically:

- Appointing the chair of each board;
- Ratifying strategy; and, if necessary,
- Removing the board and replacing the chair.

The shareholding ministers should publicly position themselves as watchdogs of board effectiveness rather than being directly responsible for SOE decisions and performance. Under this approach the ministers continue to have at their disposal the most important and ultimate control mechanism — *the ability to appoint or remove the board*. That is how shareholders in the private sector exercise influence over the corporation.

Best practice requires the shareholding ministers appoint the chairs of SOE boards but leave the chair (and/or the board appointments committee) to take responsibility for the composition of the board and appointments. The role of the ministers is to test and ratify

the chair's choices, not to impose on a chair board members who may or may not have the capabilities or personal chemistry required to maximise the effectiveness of the board.

The tenure of directors' appointments should also be a matter for the chair and fellow directors. There should be no fixed term. The current two term restriction risks the loss to the board of valuable experience. As in the private sector, directors' terms should be determined with no expectation of a minimum term and no limit on a maximum term.

Director remuneration is a matter for which final approval must remain with the shareholding ministers. They should, however, receive advice from an experienced panel of advisers and from the chair of each board. This advice should have regard to the required experience, responsibility and remuneration of SOE directors relative to their private sector counterparts. It is possible that some potential directors will be willing to accept low fees to 'learn'. But SOEs are major enterprises involving significant business and financial risks. They require experienced directors.

More Effective Measurement of Organisational Performance

In addition to better allocating decision rights among SOE boards, managers and shareholding ministers, an optimal SOE model requires that ministers have the ability to monitor the effectiveness of SOE boards and that the value and high level financial performance of SOEs is appropriately measured and monitored.

Three specific initiatives would improve the monitoring of SOE organisational performance:

- The establishment of an advisory panel both to mentor and advise boards, and to assist shareholding ministers with assessing board effectiveness.
- Adoption of a best-practice information disclosure regime to facilitate better external monitoring by analysts.
- Outsourcing regular reports on the value and performance of SOEs to private sector analysts.

An advisory panel as envisaged would comprise senior business people with commercial board experience, significant business knowledge, and strong relationship management skills. The panel would assist *ministers* by supporting their dialogue and understanding with boards; by providing advice about board leadership, composition, priorities, processes and performance; and in monitoring the effectiveness of the boards. The advisory panel would assist *boards* with coaching, mentoring and networks. It would, however, have no direct involvement on SOE decision-making and should not act in any way as an SOE 'super board'.

It is desirable that SOEs adopt a more rigorous disclosure regime comparable to that under which listed companies operate. This regime is described by the New Zealand Securities Commission (in its 2004 *Corporate Governance Handbook*) as best practice in New Zealand. Adoption of such a regime by SOEs would have two key benefits:

- Accountability of both board and management would be strengthened.
- It would ensure the availability of the information set that will encourage high quality private sector monitoring and analysis comparable to that conducted on the SOEs' private sector competitors and counterparts.

Because of their capability, experience and access to data, private sector analysts are best suited to providing high level monitoring of SOE performance and value. Moreover making analysts reports publicly available will tend to enhance the accountability of SOE boards and encourage directors to protect their 'reputational investments'. The advisory panel should directly engage such analysts to produce regular (say annual) reports on value and financial performance.

Introducing the Discipline of Equity Capital Market Interaction

The SOE model would be significantly enhanced by exposure to equity capital markets. This could be achieved through two initiatives.

The first entails enabling SOEs to partner with third parties who would introduce external equity ownership with higher quality wealth incentives and monitoring. Nothing in the SOE Act prohibits this and in selected instances this current Government has permitted SOEs to enter into such arrangements.

The second and potentially most powerful mechanism entails the issue and listing of non-voting equity instruments. This is also provided for in the original Act (sections 11(2) and 12) in the form of redeemable preference shares and/or equity bonds. No legislative action is required.

The issue and listing of non-voting equity with characteristics aligned to the Crown's ordinary shares has the potential to considerably improve to the present SOE model in four key respects. First, the flow of information to shareholding ministers would be enhanced by the capital market's direct monitoring of SOE performance and value. Second, non-voting equity would provide SOEs with access to external capital when ministers are faced with competing demands for government investment.

Third, the issue of non-voting equity by selected SOEs, along with the associated move to a continuous disclosure regime, would encourage 'real-time' market-based monitoring of SOEs by a wide range of private sector analysts. This will not only improve the flow of information and market feedback on performance to the board, but also enhance its accountability.

Finally the public listing of non-voting shares of SOEs is likely to improve the flow of board and managerial talent between the private sector and SOEs, especially if the public listing of SOE non-voting shares is part of a wider revision of the SOE model incorporating the initiatives outlined above. In such an event executives and directors will view SOEs as much more comparable (in terms of decision rights and governance) to

their publicly listed counterparts in the private sector, and the equity market will provide them with much higher quality information on the performance and future prospects of SOEs.

Empirical evidence supports the analysis of the benefits of listing non-voting shares. A study by Nandini Gupta⁵ on the impact of the public listing of minority interests in state-owned enterprises in India (where the Government maintained control) shows that, even when the data is controlled for changes in the competitive environment, such organisations exhibit higher sales, profit, employment, average product of labour, assets and returns to labour than firms which remain under full state-ownership. Moreover the study notes that such firms also significantly reduce the borrowing from government after public listing.

This option would not compromise Crown ownership and control of SOEs. Control would continue to be exercised in the ways discussed earlier and future capital raising would still require the consent of the shareholding ministers.

Future Directions

The focus of SOE debate in the foreseeable future is likely to shift from ownership and privatisation to the development of a ‘long-term hold’ model. Wholesale privatisations are unlikely under any government — although some assets could be shifted to private ownership for competition reasons. Instead, governments and their officials are likely to focus increasingly on developing a ‘sustainable’ model addressing specifically the following issues:

- What should be precise the relationship between ministers and advisers on the one hand, and ministers and boards on the other?
- What are the politics and practicalities of listing non-voting shares?
- To which organisations should the new model apply?

The purpose of this chapter is to contribute to constructive debate about these issues.

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⁵ ‘Partial Privatisation and Firm Performance’ Nandini Gupta, The Fondazione Eni Enrico Mattei Note di Lavoro Series, December 2002.

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