

**EMBARGOED**

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## THE EVOLUTION OF THE SOE MODEL

### The Underlying Ideas

The development of the SOE model recognised that the efficiency with which firms used resources and performed financially was determined by:

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

The key elements of the SOE model 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.
  - The removal of centralised Treasury and SSC controls affecting their ability to manage resources.
- Expose SOEs to the disciplines of capital markets disclosure, monitoring and contracts as much as possible.

The SOE model framework has been applied to government enterprises, ports, airports, retail electricity distributors, health services, science, education and local government trading activities.

### The Prepare for Sale Approach

The SOE model was never applied to government enterprises in quite the way envisaged.

Shortly after the creation of the first SOEs in 1987 the Government embarked on a wide-ranging series of privatisations.

In the expectation of an ongoing series of privatisations the SOE model was adapted to a 'prepare for sale' model.

This approach entailed putting aside long-term value creation.

- Financial policies were imposed which limited the financial flexibility of SOEs (capital structure, dividend policy).
- The focus was placed on short-term financial performance.
- Significant strategic decisions were deferred for the 'new owner'.
- Officials focused on the execution of SOE divestments rather than on developing a sustainable SOE model.

The 'organisational architecture' which evolved during the 'prepare for sale' environment had shortcomings that hindered SOE performance because:

- The 'control' arrangements misallocated the responsibility for important decisions and disempowered boards and management teams.
- The mechanisms for measuring organisational performance were ineffective and often inappropriate.
- Capital markets were not used to best advantage.

## TOWARDS AN OPTIMAL SOE MODEL

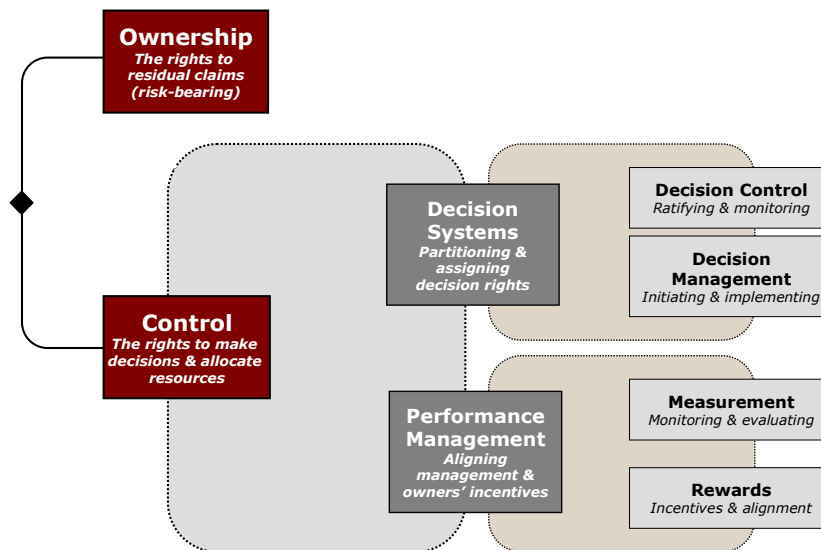
### Organisational Architecture

The relationship between ownership claims and control (decision rights and performance management) is the subject of 'organisational architecture'.

Organisational architecture is particularly concerned with two key issues:

- 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.

These two key issues are relevant to all types of organisation form, including corporations, partnerships, co-operatives, proprietorships, etc.



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### Characteristics of Private-Sector Corporations

The private sector exhibits a range of organisational forms (eg. Cooperatives, partnerships, closely held private companies) and control arrangements.

In the open corporation there is a marked separation between ownership and control.

- This allows for specialisation in both ownership and in control (boards and management).
  - Owners are specialist risk bearers, and do not need to have detailed specific knowledge appropriate for key decisions.
  - 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 the decision-makers act in the owners' interests.
- Ultimate responsibility for company performance rests with the board, which sits at the top of the corporate decision hierarchy.
- But the owners reserve the decision rights to remove the board and/or the chair in the event of board under-performance.
  - Either directly by voting, or indirectly by exiting their shares to other parties who will change control.

Capital markets reinforce the open corporation's performance management systems by introducing:

- Strong disclosure obligations.
- Better information signalling and visibility of value – both performance expectations and the impact of strategic decisions are immediately impounded into the company's share price.
- Monitoring by independent expert analysts provides valuable feedback to the owners, board and management.
- A market for corporate control which transfers ownership when outside experts consider that a change of control will enhance value.

### The Open Corporation Approach

The SOE model is based on the open corporation. The 'optimal' model should thus incorporate the following 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 the role of appointing and/or removing the Chair of the Board, ratifying high-level ownership decisions and monitoring Board effectiveness.
- **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.
  - Make use of experienced and qualified private-sector analysts for monitoring SOE performance.
- **Exposure to the disciplines of equity capital market to the greatest extent practicable.**
  - Provide for SOEs to partner with third-parties who provide external equity.
  - Issue and list non-voting equity in selected SOEs.

## RECENT DEVELOPMENTS: THE LONG TERM HOLD APPROACH

A significant evolution of the SOE model beyond the 'prepare for sale' approach has occurred under the current Government's long-term hold policy.

Over the last few years there has been a progressive change in the SOE governance and control regime which recognise that:

- What had evolved through the 'prepare for sale' period is not going to work in a long-term hold environment.
- SOEs are now confronted with significant competitive threats and change in their markets. This pace of change is unlikely to slow.
  - In particular the electricity sector has no significant over-capacity and major investment is necessary.
  - The 'prepare for sale' regime hindered SOEs responses to these competitive threats, and distorted investment signals in the markets in which they operate.

SOEs have been **encouraged to play more actively** in their markets and **more decision rights have progressively been transferred to SOE Boards** and CEOs in respect of:

- The development and implementation of business strategy and plans.
- The development and implementation of key investment decisions.
- The development and implementation of financial strategy and policies.

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 Energy's acquisition in Australia and subsequent divestment of Southern Hydro.
- 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 partnership in two oil and gas field developments (Kupe and Cardiff 2).

This development was formalised in the policy announcement of 2 June 2006 by the Minister of State Owned Enterprises, the Hon. Trevor Mallard:

*"... [Minister's words] consider proposals from SOEs that broaden their scope of business by diversifying their technological, product and market portfolios and that extend the time horizon over which they seek to capture a return on investment."*

This change in decision rights and empowerment of Boards and management teams has been accompanied by **developments in the measurement and monitoring of SOE performance**. A number of the largest SOEs (specifically the generation companies, Meridian, Might River Power and Genesis) are now monitored and reported on by equity analysts employed by leading investment banks and brokers. These 'bespoke' reports benchmark these SOEs against both their government owned and private sector competitors (Contact, TrustPower) and draw on data from the Australasian and global industry.

A further significant development in policy environment surrounding SOEs has involved the preparedness to contemplate and ratify organisational arrangements (such as joint ventures and other jointly owned vehicles) which introduce external ownership, equity and monitoring incentives. 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.

## FUTURE DIRECTIONS

Notwithstanding the progress in the SOE policy environment there is **still a way to go** in the evolutionary process **to reach an 'optimal' SOE model**.

We see the policy focus on SOEs shifting from privatisation versus government ownership to addressing the following issues:

- Which organisations should the model be (and not be) applied to?
- Is the allocation of decision-rights between Ministers and officials on the one hand and SOE Boards on the other 'optimal' or should more decision rights be allocated to Boards?
- Can the measurement and monitoring of SOE performance be enhanced?
- Should the SOEs be exposed to increased capital market disciplines through the listing of non-voting shares or other securities?

### Determining When the SOE Model Works and When it Doesn't

The SOE model applies only to those organisations that operate in competitive goods and services markets and have sufficient scale to benefit from application of the open corporation approach.

So, is it appropriate to apply the model to organisations such as Airways and Transpower which do not face competitive markets or should some other Crown-owned entity model be applied which incorporates some of the key elements of the SOE model but not others)? Profit-maximising behaviour in a monopoly environment can result in cost-inefficiency and higher prices.

For example, while Transpower undoubtedly meets the scale test, we seriously question whether the regulated nature of Transpower's environment means that it should operate as an SOE:

- It has insufficient exposure to competition in its output market to ensure that its SOE status will generate the envisaged organisational and performance benefits.
- Behaving as if it is a profit-maximising corporation is costly in terms of the organisational structure and capabilities required to manage its environment.

A **more proscribed mandate for Transpower**, which focused on the quality and (cost and technical) efficiency of a 'core' transmission network (which might exclude low voltage lines), provided it with more 'network operator' powers and gave the Board more decision rights to get on with building such a network, **may produce better outcomes at lower cost**.

Similarly are there other Crown-owned entities to which the model **should be** applied, such as TVNZ (provided the non-commercial elements of their mandate are dealt with through contract or 'spin-off')?

### Making Boards more Responsible for Good Governance

In most respects the decision-rights allocated to SOE Boards matches that of their counterparts in publicly listed corporations. The major difference is in respect of governance matters.

While the Shareholding Ministers should retain decision-rights in respect of the removal of the Chairperson **other governance decisions should be ratified by Ministers but be primarily the**

**responsibility of the Chair and the Board** (and/or the Appointments or Governance Committee).

They include:

- Director succession;
- Appointment of new Directors; and
- Tenure of Directors.

Part of the responsibility of the Chair and Board is to understand the company's strategic challenges, ensure that the Board has the necessary capabilities to address these challenges and that the Board works as an open and effective decision-making forum.

The survey undertaken by CPL and VUW School of Management showed that there was considerable frustration in respect of the process and criteria for choosing Directors and determining tenure.

*"... a number of comments suggest that the issue of tenure, Board appointments and Director succession more generally should be determined by the SOE Chairs and their Boards rather than being determined by formula or imposed by Ministers ..."*

As noted in the Optimal SOE Model section final approval of **Directors' compensation** must rest with Shareholding Ministers.

Ministers should receive advice from experienced external professionals and SOE Chairs on Director compensation. This advice should take into account the size of the SOE, the challenges it faces, and the capability and experience required of Directors.

This **is an area which requires urgent attention**. The results of the CPL/VUW School of Management survey on this issue were 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 ..."*

## Improving Measurement and Monitoring of Performance

As noted earlier we believe that three initiatives in the measurement and monitoring of performance would promote an optimal SOE model:

- An Advisory Panel to assist Shareholding Ministers with assessing Board effectiveness and discussing Board performance with SOE Chairs.
- Adoption of a best-practice information disclosure regime to facilitate better monitoring.
- Outsourcing regular reporting on the value and performance of SOEs to private sector analysts.

It is important to emphasise that the Advisory Panel would have no involvement in SOE decision-making but simply support the Ministers in their assessment of Board effectiveness and performance, and determining Director compensation.

A standard 'best-practice' disclosure regime that matched that of publicly listed companies would encourage private sector analysts to monitor and report on SOE performance and value for all SOEs. These analysts are best equipped to undertake monitoring of SOE performance and value. We believe that such reports should be made widely available.

## **Achieving More and Better Exposure to Capital Markets**

Issuing and listing **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 market. It would also significantly enhance SOEs' access to capital and financial flexibility.

From a long term hold perspective non-voting equity has two advantages:

- It is already provided for in the SOE Act (redeemable preference shares and/or equity bonds).
- It does not compromise Crown ownership and control of SOEs.

Moreover, listing non-voting equity in selected large SOEs has further very important benefits for New Zealand's capital markets:

- It would materially improve the size and depth of the New Zealand share market.
- It would widen the range of alternatives available to New Zealand investors.

It would significantly improve the quality and attractiveness of New Zealand's capital market.