The Treasury

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Release Document

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THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: Improving the performance of State-Owned Enterprises

Date:	19 December 2008	**Report No:**	T2008/2368

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	Note contents	None
Minister for State-Owned Enterprises (Hon Simon Power)	Note contents	None

Contact for Telephone Discussion (if required)

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Minister of Finance's Office Actions (if required)

None.

Enclosure: No

Treasury Report: Improving the performance of State-Owned Enterprises

Executive Summary

Earlier this week the Minister for SOEs signed outlook letters to SOEs. These letters gave SOEs a strong message on the need to improve their performance and productivity.

We have a number of suggestions for improving SOE performance which we would like to discuss with Ministers, before the SOE business planning round begins in early 2009.

In our view, while the SOE model is sound, the operation of the model, and the performance of SOEs, has eroded over time. We think the model needs to be reinvigorated.

While recognising Government policy, and the broad political support for retaining state control and ownership of current commercial assets, we think better performance will be achieved by moving towards greater private sector involvement in SOEs. There are a range of options for achieving this while retaining 100% government ownership.

As well as greater private sector involvement in SOEs, we think there is a need for other steps to improve SOE performance:

- Improve the quality of, and possibly the process for, appointments to SOE boards;
- Put pressure on SOEs to increase their gearing (which as a side-effect will result in greater dividends being paid to the Crown). The way that Ministers think about SOE gearing and special dividends may link to the wider Crown balance sheet management issues that Ministers are interested in;
- Encourage SOEs to be more transparent with the public about their performance; and
- Improve the monitoring of SOEs.

The body of this report provides further details of our proposals.

Recommended Action

We recommend that you **note** the contents of this report and discuss it with officials.

Chris White
Manager, Climate Change, Energy and Commercial Operations
for Secretary to the Treasury

Hon Bill English	**Hon Simon Power**
Minister of Finance	Minister for State Owned Enterprises

Greater private sector involvement in SOEs will improve performance

1. SOEs are exposed to most of the commercial disciplines faced by private sector companies, and as a result, the performance of SOEs has been significantly better than the performance of government trading organisations prior to the SOE Act.

2. However because their shares are not publicly tradable:

    - SOE management do not face the threat of takeover if the SOE is underperforming; and
    - SOE performance is not subject to the same level of scrutiny by the public and by market participants.

3. Given the broad political support for the government retaining control and ownership of the current SOEs, SOEs will not face the threat of takeover.

4. However, there are options to improve the scrutiny of SOEs by the public, while retaining Government control and ownership. In our view greater private sector involvement with and scrutiny of SOEs would be the most effective way of improving SOE performance.

5. This is backed up by comments from two Chairs of large SOE, who are also on the Boards of large publicly listed companies. Both said that they found feedback and scrutiny on their public companies from informed commentators was highly valuable, and that they did not get the same level and quality of feedback from officials on their SOEs.

6. There are a number of options for encouraging greater private sector involvement in SOEs.

7. One option is to encourage SOEs to issue bonds to the public. At present SOEs raise their debt from institutions. Genesis has recently issued bonds to the public, and we understand Meridian is planning to do the same in 2009. We think this should be encouraged.

8. However, the gains from issuing public bonds would be relatively modest. Holders of SOE debt do not share in any gains in SOE performance, and only share in the downside if the SOE were to fail and could not repay the bonds. Therefore they have limited incentives to scrutinise SOEs.

9. Other options would not be consistent with the Government's policy to retain 100% ownership of SOEs. SOEs could be allowed to partially list their subsidiaries on the stock exchange. A number of SOE have already entered into joint venture subsidiary arrangements with private sector partners (NZ Post's courier business and Solid Energy's Spring Creek mine are the two main examples). It is a relatively small step in substance to move from the Government owning less than 100% of an SOE subsidiary, to non-Government owned shares in a subsidiary being publicly tradable. Again, we think the gains from this would be relatively modest, given that the vast majority of SOE value is in the SOEs themselves, rather than their subsidiaries.

10. A further step would be to partially list some SOEs on the stock exchange – in the same way as Air New Zealand is partially listed. This in our view would deliver the greatest performance gains (short of fully privatising some SOEs, for which there is no public or political support). The gains would come from: better monitoring and feedback to the SOE from the private sector investors and their agents, and from the SOE's share price; more public transparency from the SOE; and greater constraints on non-commercial influence in the SOE from the government.

11. Only large SOEs would be suitable for partial listing – small and medium sized SOEs would not attract serious private sector monitoring. However the bulk of the Crown's equity is concentrated in the largest SOEs.

12. Again, we note that this is not consistent with Government policy, and we do not intend undertaking any work on partial listing of SOEs.

Appointments to SOE Boards are critical

13. Appointments to SOE Boards are the single most important lever that Ministers have for influencing SOE performance. The Minister for SOEs is responsible for SOE Board appointments.

14. Our view, supported by a number of external commentators, is that the quality and performance of people appointed to SOE Boards could be improved. Obviously this means changes to the individuals appointed to SOE Boards (Treasury has no involvement in this), but it could also mean changes to the process for appointing SOE Boards.

15. We suggest two potential options for changes to the process:

    - Ministers appoint only the Chair of the SOE, who is then responsible for selecting the other board members, subject to Ministerial and Cabinet signoff (the Air NZ model); or
    - Ministers appoint Board members nominated by an independent committee (the Guardians of NZ Super model).

16. We prefer the Air NZ model. However this approach places much more weight on the selection of an appropriate Chair for each SOE, and strengthens the power of the Chair relative to other Board members.

17. We also think that the size of SOE boards should be reduced over time from the current 7-9 directors to 5-7 directors.

Increasing SOE gearing will encourage better performance

18. There are strong arguments for the Government to put pressure on SOEs to increase their gearing - i.e. encouraging SOEs to borrow more from the private sector and pay special dividends to the Crown.

19. Higher debt levels put increased pressure on SOEs to perform, by committing a fixed part of their future cashflow to debt servicing, meaning they must focus more on core business profitability, and on selecting new investment projects carefully.

20. Low debt levels may encourage complacent behaviour by SOEs, for example misjudging business risks because their strong balance sheet allows Boards to think they can ride out any problems, or a greater willingness to expand into new and risky areas of business.

21. Higher debt levels do put SOEs under greater financial stress and increase the chance that they will require additional capital from the government. High debt levels may also constrain SOEs from making value-adding investments without seeking additional equity from the Government. SOEs have been very reluctant to ask Ministers for equity even in a time of strong Crown financial performance and encouraging signals from Ministers.

22. The credit crisis also tempers our advice around increasing SOE gearing. The expected recession will impact on the finances of SOEs, reducing their ability to take on debt (although it may also lead to them reducing or delaying planned capital expenditure). However since most large SOEs are utilities their finances are likely to be less affected by an economic downturn. So far we have had no indication that as a result of the credit crisis the large SOEs are having difficulty raising debt, or will have to pay significantly higher interest rates on their debt.

23. All of this means there is a need to strike an appropriate balance in SOE capital structures between the incentives to perform and the risks of too much debt.

24. Shareholding Ministers and SOEs are likely to have different perspectives on the appropriate balance. SOEs will favour lower than optimal gearing levels, as that reduces the personal risk to directors resulting from company failure, increases the SOEs operational flexibility, and reduces the likelihood of having to ask shareholders for additional capital.

25. Without sustained and effective pressure from Ministers, SOEs will tend to err on the side of having too little debt on their balance sheets.

26. Increasing SOE gearing will have fiscal benefits to the Crown. It provides additional cash for the core Crown to use as it wishes, either on capital spending or to reduce gross core Crown debt. This is at the cost of that cash not being available to SOEs to use as they wish.

27. The fiscal gains to the core Crown from increased gearing could be significant, although they would be one-off gains rather than ongoing improvements, and might be partially offset by the need to provide some equity to more highly geared SOEs in the future if they wished to undertake significant capital spending.

28. In our view increasing SOE gearing should be undertaken as part of a strategy to deliver a sustained increase in SOE performance. The short-term fiscal benefits should be seen as a side-effect, not the driver of the gearing policy.

29. Past efforts to influence SOEs to increase their gearing through Ministerial persuasion have had limited success. We suggest that if persuasion continues to be ineffective, Ministers should consider directing an SOE or SOEs to pay a special dividend.

30. Ministers have never directed an SOE over dividends in the past. Such a direction could undermine the Board's accountability for running an SOE, and so Treasury has been reluctant to recommend this in the past. As part of wider discussions on SOE policy we informally consulted two senior SOE Chairs on whether such a direction would be appropriate, and received mixed feedback. One Chair said that capital structure was quite rightly a matter for owners to decide and therefore he had no concerns with Ministers directing an SOE on this issue; the other said that he would see it as undermining the Board – in his view a good Board would have the shareholder's interests at heart and so should not need to be directed.

Improved monitoring of SOEs is required

31. There are two aspects to monitoring of SOEs:

- Monitoring by officials, on behalf of Ministers; and
- Public monitoring based on disclosure by the companies.

Monitoring by officials

32. Monitoring by officials is an input into shareholding Ministers relationship with SOEs, and the views expressed by Ministers to the companies. This monitoring is generally not made public as it relies on commercially sensitive information supplied by SOEs.

33. Improving monitoring by officials requires better analysis, particularly more benchmarking of SOEs against comparable companies, and more comprehensive financial performance analysis in the business planning round, in the quarterly SOE performance reporting to Ministers, and in commenting on SOE annual reports.

34. Monitoring is of no use unless it changes SOE behaviour. Therefore improved monitoring needs to result in clear performance targets and expectations set for the SOEs by Ministers. Ministers also need to be willing to take action if these targets and expectations are not met by the SOEs.

35. There is an opportunity for greater private sector involvement in monitoring of SOEs, building on private sector experience in monitoring listed companies. Our engaging private sector equity analysts to carry out SOE valuations is an example of what can be done here, although the value of this is dependent on the information the SOEs make available to the public.

36. There is also a question of to what extent the views of Ministers and the analysis by officials can be made public, without compromising the SOE's commercial position.

Monitoring by the public

37. Public monitoring of SOEs is currently very limited and is generally below what would be expected for publicly listed companies. SOE annual reports and SCIs currently provide insufficient information to enable an informed assessment of SOE financial performance. We are concerned that this lack of public disclosure does not sufficiently expose SOEs to public scrutiny, analysis and informed comment.

38. SOEs need to be encouraged to improve the quality of their public disclosures. This will be difficult, as, unlike listed companies, SOEs have incentives to keep information about their performance confidential, particularly unflattering information. In our view an SOE's willingness to make information public, and to subject itself to outside scrutiny and criticism, is a strong indicator of whether or not it is performing well.

39. SOEs should publicly provide greater analysis of their financial performance, particularly an assessment of their performance against their previous targets (e.g. in the SCI) and benchmarking against their competitors and comparable companies. SOEs also need to provide more credible estimates of their commercial value on an annual basis, so that changes in this value over time can be used to assess their performance.

40. To promote public participation and review of SOE performance, the level of disclosure should be comparable to large publicly listed companies. SOEs also need to make greater use of less formal disclosure routes such as annual meetings, investor presentations and public announcements of any material variances in expected profitability.

41. Insufficient public disclosure by the SOEs could be balanced by greater public dissemination of information and analysis by officials (subject to the commercial sensitivity test).

Which SOEs?

41. The level and degree of performance disclosure should be proportionate to the scale of the SOE. Therefore improving the level of public disclosure about financial performance should be targeted at the larger SOEs: Genesis, Meridian, Mighty River Power, NZ Post, Landcorp and Solid Energy. Together, these six SOEs make up around 87% of the total SOE portfolio by value[1] (excluding NZRC, which is technically an SOE but is not fully commercial).

42. The other large SOE is Transpower, which is a regulated monopoly subject to oversight by the Electricity Commission. Transpower is between 5 and 10% of the SOE portfolio, depending on whether revenue, assets or equity is the measure.

[1] These six SOEs made up 87.3% of total SOE revenue, 87.7% of SOE assets and 86.7% of SOE equity for the year ended 30 June 2008.