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Some Options for Improving the Governance of State-Owned Electricity Utilities

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THE WORLD BANK
GROUP



The Energy and
Mining Sector Board

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The World Bank, Washington, DC



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FOREWORD

Access to a reliable supply of electricity is vital for economic growth and poverty reduction, yet electricity companies in most developing countries fail to satisfy the reasonable demands of firms and citizens. Improving electricity supply is therefore a priority for most developing-country governments, as well as international development agencies such as the World Bank.

Perhaps the most important part of a strategy for improving electricity supply is to improve the markets in which electricity companies operate, by strengthening competition where that is feasible and designing regulation that encourages improvements when competition is not feasible.

Another part of the strategy is to ensure that the owners of electricity companies pressure the companies to improve their performance—for example to seize opportunities to supply potential customers who remain unserved and to provide more reliable service to existing customers. Privatization is one option for achieving this goal; but privatization is sometimes very difficult. In the last couple of years, large energy companies in the United States and Western Europe, under pressure to reduce debts and take fewer risks, have shied away from making new investments in developing countries. And privatization remains a hotly contested political issue: many politicians are unwilling to risk the certain controversy and possible loss of support that privatization may entail, in the hope of future gains in performance, especially when investors express skepticism about becoming involved.

This paper therefore looks at options governments have for improving the performance of state-owned utilities, short of privatizing them. It focuses, in particular, on improving the relationship between state-owned electricity companies and governments as their owners—or in other words on improving corporate governance.

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ABSTRACT

Most government-owned utilities in developing countries perform poorly when judged as providers of electricity, in part because politicians and officials use their power, not to encourage the utilities to increase sales, improve the collection of bills, and cut costs, but to transfer resources to politically influential groups and, sometimes, extract bribes. To improve the performance of government-owned electricity utilities as electricity utilities, rules and practices must be changed in a way that reduces politicians' willingness or ability to use the utilities for political purposes and subjects the utilities to new sources of pressure to perform well. This paper considers ways in which a government might seek to achieve this goal without privatizing. It focuses on changes in corporate governance—that is, changes in the rules that structure the relationship between the company and the government as its owner. It concludes that governments should be cautious about the prospects for improvement without privatization—since, among other things, creating a truly arms-length relationship between the government and the utility will always be difficult as long as the government remains the utility's owner—but that improvements in corporate governance are still worth pursuing.

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EXECUTIVE SUMMARY

This paper considers ways in which a government can improve the performance of an electricity company it owns, short of privatizing it. It focuses on changes in corporate governance—that is, changes in the rules that structure the relationship between the company and the government as its owner.

Most government-owned utilities in developing countries perform poorly when judged as providers of electricity, in large part because politicians and officials use their power, not to encourage the utilities to increase sales, improve the collection of bills, cut costs, and so on, but to transfer resources to politically influential groups and, sometimes, extract bribes. To improve the performance of government-owned electricity utilities as electricity utilities, rules and practices must be changed in a way that reduces politicians' willingness or ability to use the utilities for political purposes and subjects the utilities to new sources of pressure to perform well.

Privatization is probably the most effective way of changing the relationship between politicians and electricity utilities, because private owners will resist efforts by politicians to interfere in the businesses. But a government can also try to change its relationship to utilities without privatizing by changing the rules determining, or influencing, the utilities' corporate governance under state ownership. Among its options are the following:

- subjecting the utilities to company law and other laws that apply to private-sector companies—in order to bring to bear new rules governing the relationship between the utilities and the government as their owner,
- legislating for additional constraints on the relationship between the government, as owner, and utilities—to address the special problems afflicting the governance of state-owned utilities (such as the weak influence of the utilities' ultimate beneficial owners, citizens, over the proximate owner, the government),
- requiring additional public reporting by the utilities—for example, of directions given to the utility by politicians and of the utility's policies toward theft and corruption by employees,
- taking further steps to instill a commercial culture in the utilities, such as appointing independent directors from successful businesses,

- requiring electricity companies to borrow from private lenders without the benefit of a government guarantee, to bring to bear the benefits of scrutiny by lenders and credit-rating agencies,
- listing a minority of the companies' shares, to create market information on commercial performance, allow equity-linked compensation, and create monitoring by other shareholders.
- strengthening more transparent and efficient means of redistributing resources, such as direct subsidies to electricity customers, and
- reducing the conflict of interest it faces as policymaker and owner, by separating responsibility within government for policy and ownership—for example, making the former the job of the minister of energy and the latter the job of the minister of finance.

While the paper focuses on corporate governance and related policies, other policies matter too. Among the most important are policies affecting the environment for businesses generally, such those affecting contract enforcement, and, among electricity-specific policies, those affecting the opportunities for competition between electricity providers.

The paper examines practice in four countries in which the government is a major owner of electricity companies—Mexico, New Zealand, the Philippines, and South Africa—and reviews some of the available empirical evidence on the success of reforms in various countries.

It concludes that governments should be cautious about the prospects for improvement without privatization—since, among other things, creating a truly arms-length relationship between the government and the utility will always be difficult as long as the government remains the utility's owner. Nonetheless, the reforms discussed above are likely to be better than nothing.

INTRODUCTION

During the 1990s, most reforms designed to improve the performance of electricity industries in developing countries included as one of their components some form of privatization, either through divestitures or concessions. In many countries, however, privatization now looks more difficult than it previously did, because of domestic political opposition as well as diminished interest on the part of traditionally important investors in Europe and the United States (see Harris 2003, for example).

This paper considers some of the options that governments have for improving the commercial focus and performance of government-owned electricity businesses, short of privatizing them. In doing so, the paper is not intended to imply that privatization is inappropriate or that these options are likely to be as effective as privatization; the implication is, rather, that when privatization appears impracticable, less far-reaching reforms of corporate governance may be better than no reform.

To provide examples of the approaches taken by governments in other countries, annexes to the paper describe the governance of state-owned electricity companies in four countries in which significant electricity reforms have occurred, but in which the state remains a dominant owner of electricity companies:

- Mexico—where the dominant electricity company, the Comisión Federal de Electricidad (CFE), is owned by the federal government,
- New Zealand—where the government owns three large generator–retailers, as well as the transmission company,
- The Philippines—where the government owns the largest generation company, Napocor, and the transmission company, Transco, and
- South Africa—where the dominant electricity company, Eskom, is owned by the government.

The countries differ in several respects as well: the Philippines and New Zealand, for example, rely on competition more than do Mexico and South Africa. Their approaches to corporate governance also differ, Mexico and the Philippines following relatively traditional

public-sector norms, while New Zealand and South Africa have modeled corporate government for state-owned electricity companies on private-sector practices.

The rest of the paper proceeds as follows. Section 1 analyzes the problems that state-owned electricity companies tend to suffer from in developing countries, the types of solution that might address those problems, and the potential role of reforms of corporate governance in those solutions. Section 2 describes the main features of corporate governance in the four case-study countries. Section 3 suggests a range of options for improving the corporate governance of state-owned utilities. And Section 4 reviews empirical evidence relevant to an assessment of the effectiveness of the corporate-governance options under discussion.

1. PROBLEMS AND APPROACHES TO THEIR SOLUTION

Symptoms

Some government-owned electricity companies perform reasonably well, but in developing countries most perform poorly. Some of the problems are common to government-owned businesses in all sectors—including excessive staffing, low profitability, and limited innovation (see, for example, Megginson and Netter 2001 and World Bank 1995). Other problems tend to be specific to industries providing basic services under conditions of monopoly or strong market power, including electricity as well as other utilities. Prices in these industries typically reflect neither costs nor demand. Average prices are often lower than average costs, eventually causing utilities to experience financial distress and to cut back on maintenance and investment. Customers often suffer losses of supply, and many potential customers remain completely unserved. In addition, the relative prices paid by different customers frequently fail to reflect differences in costs or demand: some politically powerful customers tend to pay very low prices relative to the cost of supplying them, while others pay high prices. Technical losses tend to be high, and billing and collection tend to be poor.

The problems of government-owned electricity businesses in India illustrate the problems (Dubash and Rajan 2001 and Rao 2002). Average electricity prices are lower than average costs, and the state-owned electricity boards that dominate the industry are making increasingly large losses. Farmers pay particularly low prices, and sometimes have a right to free power. As the government notes, the electricity companies' ability to serve their customers is impaired:

From the viewpoint of households and firms in the country, the power sector has been delivering unsatisfactory performance in terms of reliable access to electricity. The energy and peak shortages of power have been around 7.5 percent and 12.1 percent, respectively, leading to brownouts and blackouts across the country. Scheduled power cuts, unscheduled outages and incorrect voltages are common in most states, leading to enormous disruptions in all aspects of economic life (Government of India, 2003).

Much of the state electricity boards' financial problems stems from low prices. Yet overstaffing, technical

losses, and theft also contribute to their poor financial performance.

Fundamental problems

The precise causes of problems besetting electricity utilities differ from country to country and case to case, but a common core of fundamentally political problems appears to underlie most cases.

First, politicians and officials do not act as ordinary, largely profit-motivated shareholders. Instead of pressuring the company to increase sales and reduce costs, they pressure it to pursue noncommercial goals and in some cases obtain bribes. The result is that politicians, officials, and certain other stakeholders extract benefits from the utility at the expense of others: some customers get charged very low prices, and some employees collect bribes, pilfer stocks, or receive salaries for little work. The outcome is generally undesirable not because—or not only because—of the transfer of resources from the ultimate owners (citizens at large) to certain stakeholders *per se*, but because of the nature of the transfers. In particular, the transfers are generally opaque when compared with budgetary subsidies; neither the beneficiaries nor the benefits they receive are transparent. And the transfers are also typically inefficient—direct budgetary subsidies would generally provide a larger benefit to the recipients at a lower cost to the benefactors.

Second, the government faces a conflict of interest that undermines the quality of policy. In setting rules relating to competition, for example, the government has an interest in protecting the firms it owns, so is more likely than otherwise to restrict competition. Moreover, because it owns the industry, government can get away with regulating the sector in a somewhat arbitrary manner. Rules about tariffs, for example, can be changed at will, even if they effectively bankrupt firms.

Necessary characteristics of a solution

If this diagnosis is right, any solution to the problems afflicting government-owned electricity utilities needs to achieve one or more of the following objectives:

- reducing the net benefits to politicians and officials of using the utilities to achieve political goals in non-transparent or inefficient ways—either by raising the cost or by reducing the benefit,

- subjecting the utilities to commercial pressures from sources other than the government, and
- removing or alleviating the conflict of interest the government faces as owner and policy-maker.

But if the problems arise because officials and politicians face incentives to put the wrong sort of pressure on utilities, can we expect those same politicians and officials to adopt reforms that help solve those problems? Won't their incentives necessarily prevent them from undertaking the reforms that would limit their powers?

We assume that politicians will often but not always oppose such reforms. First, we assume that politicians' preferences may change over time. One possibility is that new politicians come to power with, at least initially, more idealistic preferences, which cause them to prefer welfare-enhancing reforms to, say, collecting bribes. Another is that a crisis may occur during which the costs of not introducing reforms increases relative to the benefits of maintaining the status quo.

Second, politicians' preferences may differ according to the level at which decisions are made. Higher-level decisions, as we use the term, are those that create rules about making lower-level decisions. For example, decisions about constitutions create rules governing the making of laws, which in turn create rules governing lower-level administrative decisions. Even if politicians and officials currently prefer to make low-level decisions that reduce social well-being (for example, causing the utility to hire more people than it needs), they may sometimes prefer to change higher-level rules in ways that make it easier for them to make better lower-level decisions (just as governments may prefer to create independent central banks that reduce their ability to change monetary policy and independent regulatory agencies that reduce their ability to set tariffs). For example, they may be prepared sometimes to privatize utilities even though that makes it harder for them to continue to use the utilities to transfer resources to politically powerful groups whom they previously helped. When making these decisions, politicians are unlikely to be motivated only by concerns to improve public policy; they may, for example, want to use privatization receipts to redistribute even more resources to politically powerful groups. But we assume that improving public policy may be one of their concerns and, specifically, that they may agree to new rules about their relationship to the utilities that make it harder for them to direct the utility on a day-to-day basis.

What, then, are the options for changing the higher-level rules about the relationship between politicians and officials, on the one hand, and a utility, on the other?

Privatization as a solution

One approach is to privatize the utility. Because the privatized utility is legally and functionally independent of the government, the government cannot so easily pressure it to pursue noncommercial goals in nontransparent ways. Moreover, the utility's new owners will pressure it to increase profits, partly by lobbying for price increases—which is not always helpful, but is helpful when prices are too low—and partly by increasing profitable sales and cutting costs.

In addition, after privatization, the government no longer faces a conflict of interest between its role as owner of the utility and its role as policy-maker. And the costs and benefits of arbitrary use of the policy-making power also change: the government now has more to gain than before from a set of rules that encourage investment and change only after reasonably careful consideration of the effects of the changes.

Privatization can therefore address the problems discussed here. Yet it is not easy. First, it requires the government to make a credible commitment to cost-covering tariffs (or to a cost-covering combination of tariffs and subsidies); otherwise, private investors will not buy the utilities. Second, it creates new political problems. Some are corollaries of the economic benefits of privatization—namely the utility's demand for cost-covering tariffs and its desire to reduce costs by ending excessive staffing, preventing theft, and so forth. Others result from concerns about privatization per se and, in particular, about private, possibly foreign, companies profiting from the supply of basic services.

Other approaches to the problem

At times, these concerns appear insuperable. When they do, must the government accept the status quo while it waits for the environment to change? Or can it do more to improve the performance of the utilities while waiting for the climate for privatization to improve?

There are many things it can do outside the domain of corporate governance (the relationship between the utilities and their owners). It can facilitate competition in the electricity industry and improve regulation of functions

that cannot be competitive. It can also work on improving the business environment for all firms—for example, improving mechanisms for enforcing contracts, improving employment law, and simplifying tax administration—which will help electricity companies among others. And, at the highest level, it can work on improving mechanisms of political governance: for example, on improving the accountability of governments to citizens.

In this paper, however, we concentrate on what the government can do to improve corporate governance, that is, the structure of its relationship with utilities as their owner. Few if any of the ideas considered here are new; for other presentations of the same or similar ideas, see, for example, Muir and Saba 1995 and World Bank 1994.

Taken individually, the options listed below seem likely to have at best quite small benefits; it is easy, in particular, to see how politicians and officials, facing pressures to interfere, could overcome the intended effects of these options. Yet, even if the options, taken one by one, seem unlikely to be able to offer much resistance to a determined politician, the hope is that the collection of them will make a difference.

2. FOUR COUNTRIES' APPROACHES TO CORPORATE GOVERNANCE OF STATE-OWNED ELECTRICITY UTILITIES

Before discussing options for improving performance, it is useful to describe some aspects of governance of state-owned electricity companies. We discuss four cases—Mexico, New Zealand, the Philippines, and South Africa. Table 1 provides a summary of some important aspects of policy and corporate governance. The Annexes provide details.

In each country, government-owned electricity companies are important. Each country has also reduced significant reforms, of different types. All have independent utility regulators, although their roles with respect to the government-owned utilities differ. Competition is very limited in Mexico and South Africa, but important in the Philippines and New Zealand. Corporate governance in Mexico and the Philippines follows traditional public-sector norms, while in New Zealand and South Africa it is largely modeled on private-sector practices.

Table 1. Corporate governance of state-owned electricity companies in Mexico, New Zealand, the Philippines, and South Africa

	MEXICO	NEW ZEALAND	PHILIPPINES	SOUTH AFRICA
<i>Extent of competition from private sector</i>	Minor (some independent power producers—IPPs—sell to CFE)	Significant in both generation and retailing	Significant in generation	Minor
<i>Who regulates</i>	Ministry of treasury and public credit for CFE, the independent Comisión Reguladora de Energía (CRE) for IPPs	The independent Commerce Commission, though generation and retail are largely unregulated	The independent Electricity Regulation Commission	The independent National Electricity Regulator
<i>Public and private providers regulated differently</i>	Yes. See above.	Not in principle	Not in principle	Not in principle, but all providers are currently public
<i>Legal identity of state-owned enterprises</i>	Separate from the government	Separate from the government	Separate from the government	Separate from the government
<i>Objectives, performance targets, and incentives</i>	The law sets out the main objectives.	Law sets out objective to be profitable. Statements of corporate intent set out specific targets.		Shareholder compact sets out key performance objectives including financial indicators and social targets.

continued

Table 1. Corporate governance of state-owned electricity companies in Mexico, New Zealand, the Philippines, and South Africa - continued

	MEXICO	NEW ZEALAND	PHILIPPINES	SOUTH AFRICA
Shareholding ministry	Ministry of Energy	Minister of State Owned Enterprises and Minister of Finance	Department of Energy	Department of Public Enterprises
Responsibility for hiring and firing board members	By law, the board consists of specific government officials, <i>ex officio</i> .	The ministers of state-owned enterprises and finance jointly appoint the directors and choose the chairman.	By law, the board consists of specific government officials, <i>ex officio</i> .	Minister of public enterprises
Responsibility for determining remuneration of the board members		The ministers of state-owned enterprises and finance determine total remuneration of the board and the board determines the allocation.		
Number of non-executive directors	9 out of 9	All directors are at present non-executive	8 out of 9	13 out of 15
Criteria for appointing directors	Law specifies that board be made up of specific government officials.	Skill (with some attention to demographic diversity)	Law specifies that board be made up of specific government officials.	
Professional experiences of non-executive directors	By law, five are cabinet secretaries, one is director of state owned petroleum company, and three are from the labor union.	Typically, business background. None are from the government departments.	All 8 are cabinet secretaries	Most have business background. One works at Department of Public Enterprises, one is an academic, and one is from union organization.
Tenure of the directors		Directors are appointed for three-year terms, with the expectation of one renewal.		Three years
Legal duties of the board of directors		Managing the company and appointing chief executives, among other duties.	Managing the company and appointing general manager, among other duties.	
Audit Committee and Remuneration committee	Not mentioned in annual report	Boards have both committees.	Not mentioned in annual report.	Board has both committees.
Financial reporting requirements or practice	Annual reports, complying with Mexican GAAP	Annual and semi-annual reports complying with New Zealand GAAP	Annual reports complying with Philippines GAAP	Annual reports complying with international standards and South African GAAP
Auditor	Private auditing firm	The government audit office, which delegates execution to private accounting firms	The government's Commission on Audit	Private auditing firm
Profitability of companies	CFE's recent accounting profits are low.	All state-owned generator-retailers made moderate profits in 2002.	Losses recorded since 1998.	Real rate of return on total assets has recently been low

Source: Annexes.

3. OPTIONS FOR IMPROVING CORPORATE GOVERNANCE

The challenge facing governments is in some respects similar to the challenge facing any owner. Like other owners, governments want a set of rules and practices that allow them to

- monitor the utility effectively,
- make strategic decisions about the utility's direction, and
- hold the utility's managers accountable for its performance.

Private-sector corporate governance aims to address these problems. Accordingly, ideas and lessons from the field of private-sector corporate governance can help governments wishing to transform the governance of state-owned businesses.

Boxes 1 and 2 set out some views about good corporate governance in the private sector. Box 1 lists the principles formulated by the Organization for Economic Cooperation and Development (OECD); these principles can be thought of as the common core of the continental European, Japanese, and Anglo-American systems of corporate governance. Box 2 gives an example of a more constraining set of recommendations from one OECD country, Australia. Shleifer and Vishny 1997 and Megginson 2000 provide more-detailed policy-oriented surveys of private-sector corporate governance.

Further, some rules governing the relationship between private companies and their shareholders may be useful for government-owned utilities even though their purpose in the private sector may not be relevant in the public sector. For example, many of the rules of private-sector corporate governance aim to protect minority shareholders by giving them access to detailed information on the performance of the firm. There is no need to protect minority shareholders when the government is the sole shareholder, of course, but imposing private-sector reporting standards nevertheless ensures that the government has access to detailed information on the financial performance of the utilities that it might otherwise lack. If the law requires the financial reports to be made public, ordinary citizens also have access to detailed information.

Yet governments are inherently different from private-sector owners, because they care less about profits and more about the achievement of other, political goals. Corporate governance in the private sector attempts to solve the principal-agent problem between shareholders (the principals) and management (their agents). As Takahashi (2000: 2) notes, "the major principal-agent problem in the governance of state-owned enterprises exists between taxpayers and the government rather than between the owner, which is actually the government, and the state-owned enterprises." Thus the adoption of practices of governance from the private sector cannot be expected by itself to solve the problems of government ownership.

BOX 1. The OECD principles of corporate governance

In 1999, the OECD published a set of principles of corporate governance that might command widespread agreement, despite important differences between approaches to corporate governance among members of the OECD. The principles are that the corporate governance framework should

- Protect shareholders' rights.
- Ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.
- Recognize the rights of stakeholders as established by law and encourage active cooperation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.
- Ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.
- Ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders.

See OECD 1999 for elaboration of these principles.

BOX 2. Corporate-governance disclosure requirements of the ASX—excerpt

The Australian stock exchange, ASX, requires listed companies to disclose whether they abide by the following “best practice recommendations” for corporate governance and, if they do not abide by them, explain why not. For brevity, we have excluded some recommendations about providing information. Original numbering has been retained.

- 1.1 Formalize and disclose the functions reserved to the board and those delegated to management.
- 2.1 A majority of the board should be independent directors.
- 2.2 The chairperson should be an independent director.
- 2.3 The roles of chairperson and chief executive officer should not be exercised by the same individual.
- 2.4 The board should establish a nomination committee.
- 3.1 Establish a code of conduct to guide the directors, the chief executive officer (or equivalent), the chief financial officer (or equivalent) and any other key executives as to: 3.1.1 the practices necessary to maintain confidence in the company’s integrity and 3.1.2 the responsibility and accountability of individuals for reporting and investigating reports of unethical practices.
- 3.2 Disclose the policy concerning trading in company securities by directors, officers and employees.
- 4.1 Require the chief executive officer (or equivalent) and the chief financial officer (or equivalent) to state in writing to the board that the company’s financial reports present a true and fair view, in all material respects, of the company’s financial condition and operational results and are in accordance with relevant accounting standards.
- 4.2 The board should establish an audit committee.
- 4.3 Structure the audit committee so that it consists of: only non-executive directors; a majority of independent directors; an independent chairperson, who is not chairperson of the board; at least three members.
- 4.4 The audit committee should have a formal charter.
- 5.1 Establish written policies and procedures designed to ensure compliance with ASX Listing Rule disclosure requirements and to ensure accountability at a senior management level for that compliance.
- 6.1 Design and disclose a communications strategy to promote effective communication with shareholders and encourage effective participation at general meetings.
- 6.2 Request the external auditor to attend the annual general meeting and be available to answer shareholder questions about the conduct of the audit and the preparation and content of the auditor’s report.
- 7.1 The board or appropriate board committee should establish policies on risk oversight and management.
- 7.2 The chief executive officer (or equivalent) and the chief financial officer (or equivalent) should state to the board in writing that: 7.2.1 the statement given in accordance with best practice recommendation 4.1 (the integrity of financial statements) is founded on a sound system of risk management and internal compliance and control which implements the policies adopted by the board; and 7.2.2 the company’s risk management and internal compliance and control system is operating efficiently and effectively in all material respects.
- 8.1 Disclose the process for performance evaluation of the board, its committees and individual directors, and key executives.
- 9.1 Provide disclosure in relation to the company’s remuneration policies to enable investors to understand (i) the costs and benefits of those policies and (ii) the link between remuneration paid to directors and key executives and corporate performance.
- 9.2 The board should establish a remuneration committee.
- 9.3 Clearly distinguish the structure of non-executive directors’ remuneration from that of executives.
- 9.4 Ensure that payment of equity-based executive remuneration is made in accordance with thresholds set in plans approved by shareholders.
- 10.1 Establish and disclose a code of conduct to guide compliance with legal and other obligations to legitimate stakeholders.

Applying private-sector company law

One way of raising the cost of political interference is to ensure that the utility is legally separate from the government and the government can influence it only in certain ways. One way of at least partially achieving this outcome is to make the utility a company subject to standard private-sector company law—an option adopted by New Zealand and South Africa. While the effects of this will obviously depend on the nature of the laws regarding companies in the country, applying company law may:

- ensure the utility has a legal identity separate from the government's, implying that, from a legal perspective, choices of the government are not automatically choices of the utility,
- give the directors of the utility certain legal rights and duties that make political interference more difficult (for example, it may establish that directors, not shareholders, are legally responsible for managing the company), and
- subject politicians and officials to new legal disciplines—for example, ministers in New Zealand are warned that company law may deem them directors and thus subject them to potential personal legal liability if they direct state-owned enterprises (CCMAU 2002a).

Legislating and contracting for new public-sector governance

Because general company law is not designed to deal with the special problems affecting the relationship between government and government-owned utilities, establishing additional or different rules to govern that relationship may be helpful (see Box 3 for an example). Because we are looking for higher-level rules that can constrain politicians' and officials' lower-level decisions, the rules need to be embedded in legislation or other instruments that are not easily changed. These rules might, for example,

- give the utility the objective of operating as profitably as possible (while relying on competition or regulation to constrain the utility's ability to achieve this objective by increasing prices),
- establish the ways in which politicians and officials can, and cannot, direct or influence the utility—for example, setting up procedures for negotiating contracts or business plans between the government and the utility,
- provide for the government to pay the utility to pursue noncommercial goals and prevent it from directing the utility to pursue such goals without paying,

BOX 3. Legislating for new governance arrangements for state-owned enterprises in Uganda

In 1993 the Government of Uganda enacted legislation (the Public Enterprise Reform and Divestiture Statute) to define new governance arrangements for public enterprises and enable their restructuring and privatization. The legislation required public enterprises to report financial and operational performance, including: submission of audited accounts within a defined period and annual certification of the safekeeping of the enterprise's assets.

The law also required public enterprises slated for privatization to seek approval from the privatization agency for investments with a recovery period greater than one year.

Compliance with the requirements of the PERD statute was monitored by the government, reported to parliament, and disclosed to the public. The government also established a specialized agency, the Parastatal Monitoring Unit, which prepared and published reports summarizing for each public enterprise (i) financial and operational performance, including agreed actions to improve performance, (ii) the value of direct and indirect government subsidies, and (iii) the value and terms of its debt stock.

The PERD statute also transferred the ownership of the shares in companies slated for privatization to the Minister of Finance, the chairperson of the "Divestiture and Reform Implementation Committee", which was established by the same law with the authority to implement public-enterprise reform and privatization. The combination of disclosure of information on financial performance, coupled with clearly defined authority in the government to appoint the directors of public enterprises and implement their restructuring, is believed to have been an important factor in improving the financial performance of public enterprises and preparing them for reform and privatization.

- require the appointment of directors who are not government employees and thus cannot be directed on a day-to-day basis by shareholders and don't face the threat of punishment in their main job if they resist political interference,
- specify the procedure the government must use to appoint directors,
- establish additional criteria for the appointment of directors that favor people that are more likely to resist political interference (perhaps people with considerable experience as directors of other, similar businesses and a certain standing in the community), and
- establish performance pay for directors (who in turn may establish it for managers).

The case studies of Mexico and New Zealand illustrate the importance of the utilities' objectives. In Mexico, CFE's problems have been blamed in part on its being given conflicting electricity-related and development-related objectives. In New Zealand, the State-Owned Enterprises Act gives government-owned businesses the objective of being "as profitable and efficient as comparable businesses not owned by the Crown". However, the existence of other legal objectives relating to being a good employer and member of the local community makes it harder for the government to hold managers accountable for profitability and facilitates the use of the companies to pursue noncommercial goals.

In both New Zealand and South Africa, governments use annual documents (statements of corporate intent and shareholder compacts, respectively) to set out objectives and structure the relationship between the government and the companies.

Requiring additional public reporting of performance and policies

Rules requiring the public reporting of information may also help, since they help interested outsiders (journalists, think tanks, academics, and interested customers, taxpayers, and other citizens) to understand utility's performance. They can help clarify the existence of poor performance and its costs and increase the likelihood of informed pressure to improve performance. Possible reporting requirements include the following:

- periodic reporting according to standards applying to all private-sector companies or specifically to those that are listed on the local stock exchange—for

example, according either to local generally accepted accounting principles (GAAP) or, if those are inadequate, an internationally accepted set of standards such as United States GAAP or the International Financial Reporting Standards promulgated by the International Accounting Standards Board,

- auditing of financial reports according to private-sector auditing standards, in addition to public auditing requirements,
- further reporting of financially relevant information not required by private-sector reporting standards, such as of economic profitability, taking into account an estimated cost of the government's equity in the utility,
- disclosure of certain events or aspects of performance that are matters of particular concern with government-owned utilities, including, for example,
 - any directions given to the utility by the government (or parties related to the government) during the reporting period,
 - any "non-financial" transactions between the government and the utility, that is, transactions in which the benefits received by the government were not financial (for example, dividends) but of a political nature,
 - any instances of corruption or theft or fraud associated with the company,
 - the utility's performance in billing and collection, and
 - the number of the utility's employees, possibly relative to other variables such as the number of customers or amount of energy produced or sold, and
- disclosure of the utility's policies relating to the issues just listed (for example, policies toward corruption, billing and collection, employment, non-financial transactions with the government).

All the utilities in the case studies prepare financial reports based on local generally accepted accounting principles. All except Napocor in the Philippines have their accounts audited by a private-sector auditing company (sometimes under the delegated authority of the public audit body). Napocor's report is the least detailed, while that of the Comisión Federal de Electricidad is one of the most detailed, even though its corporate governance is generally traditional, perhaps reflecting the influence of US disclosure requirements on Mexican firms (see Campos and others 2002). In New Zealand, the government-owned transmission company, Transpower, reports economic as well as accounting profitability.

Instilling a commercial culture

There may be benefits not only in changing the formal rules applying to the utility and its relationship with the government, but in taking other steps to instill a commercial culture in the utility. Appointing business people as directors may help, for example, by increasing (slightly) the probability that directors will resist political interference and ensuring the top management of the company has commercial rather than political habits. Eskom in South Africa decided to adopt the code of corporate governance set out in the “King II” report, which may have similar benefits.

One big difference among the case studies is the use of nongovernmental directors. In South Africa, the Board of Eskom has only one government employee, while in New Zealand the boards have no government employees. In Mexico and the Philippines, on the other hand, the boards are dominated by government officials. One might expect this difference to have a significant impact on the behavior of the firms.

Subjecting the utility to new pressures from lenders

In addition to changing the incentives that politicians and officials face to pressure the utility, the government can use its power as owner to impose new sources of commercial pressure on the utilities that may, to a greater or lesser extent, substitute for the pressure created by private owners.

Lenders are a common source of commercial pressure on privately owned firms, and the government may be able to make use of that pressure by requiring a state-owned utility to borrow (or borrow more) from lenders other than the government. It could either refuse to provide new equity funding or make a capital withdrawal. If lenders’ money is genuinely exposed to risks related to the utility’s performance, the lenders should care about the utility’s financial performance and position.

For this approach to work, of course, the utility must be sufficiently creditworthy to get a loan from outside, if only for a small amount and short term. Further, the lenders cannot believe that the utility’s debt is guaranteed by the government; otherwise, they will care only about the government’s creditworthiness, not the

utility’s. Thus the government cannot provide an open-ended guarantee of the utility’s debt and may have to require the utility to state, when borrowing, that it benefits from no government guarantee (as happens in New Zealand). The government could, however, provide selective guarantees relating to certain aspects of the utility’s performance. For example, it could provide a guarantee of the utility’s debt callable only if the utility defaulted because the government refused to increase tariffs according to a specified agreement.

Similarly, the lenders must be independent of the government if the borrowing is to be effective; more lending from state-owned or state-controlled banks cannot be expected to help in the same way as lending from independent private banks.

Requiring the utility to borrow will encourage it to get credit ratings from agencies such as Standard and Poor’s, Moody’s, and Fitch. Scrutiny by credit-rating agencies may provide benefits in addition to those deriving from lenders’ monitoring. And, even if the utility did not borrow, the government could require the utility to obtain and disclose a credit-rating from a reputable credit-rating agency (see public reporting above).

In typical Anglo-Saxon arrangements for corporate governance, shareholders alone appoint directors and directors must represent the interest of all shareholders. Nonetheless, bankers are not uncommon on the boards of American companies (Kroszner and Strahan, 2001). And, in other systems, directors sometimes represent other stakeholders, such as employees and lenders. For example, the Board of Mexico’s Comisión Federal de Electricidad must by law contain three union members, while in some countries lenders can appoint directors. Where it fits with existing principles of corporate governance, including in the board representatives of private-sector lenders (not benefiting from government guarantees) may help bring new commercial pressures on the company.

Listing a minority of shares

Minority shareholders offer another potential source of pressure. Because shareholders have a residual rather than a prior claim on the firm’s assets, the value of minority shareholders’ investments in the utility depends more strongly on the performance of the utility than does lenders’. The lenders get all their money back in

most circumstances, risking losses only in the case of very poor performance or high leverage. As a result, minority shareholders should monitor the firm in ways that complement monitoring by lenders.

The government can retain control of the firm (and thus achieve at least some of the goals of full public ownership) while selling a minority of shares. It can also sell hybrid securities that are not ordinary shares, but have some of the characteristics of equity. For example, if it doesn't want to give up any voting control at all, it can sell securities that give their holders the same rights to cashflows as its own ordinary shares, but to which no voting rights attach (New Zealand SOEs may issue "equity bonds" with such characteristics). If the utilities' performance is sufficiently fragile, ordinary bonds will also come to take on some of the characteristics of equity because of the increased risk, as with any junk bond.

Listing the minority shares on a stock exchange would also bring to bear the exchange's rules of corporate governance. Depending on the exchange, it may require the utility to include independent directors on its board, treat minority shareholders fairly, and provide comprehensive and timely financial reporting—all of which may help temper noncommercial political interference. A public offering of a minority stake in the utility also means that an estimate of value of shares in the utility will be available in the share price. That in turn may help reveal the commercial cost of political

interference and allow performance pay based on market values (employee share ownership, option grants, and so on).

For this approach to work, of course, the utility must be able to satisfy listing requirements, which may not be easy if, for example, those requirements include a track record of reliable accounts or even profitability.

Box 4 describes Pakistan's experience with the privatization of minority shareholding in two natural-gas utilities.

Although minority private shareholdings bring potential benefits for corporate governance, they also create risks for the government as the majority shareholder. In New Zealand, where the government has generally chosen to divest all or none of its shares in government-owned business, the Crown Company Monitoring and Advisory Unit (2002a: 37) notes that minority shareholdings have created problems when the government has wanted to sell its shares and when it has wanted to refinance a company in financial distress.

There may be other ways in which similar pressures can be brought to bear on the company. One of the license conditions imposed by the Rail Regulator in the United Kingdom on Network Rail is that it must follow rules of corporate governance set by the financial-market regulator, even though the company is financed entirely by debt (Department of Transport [United Kingdom]. 2003).

BOX 4. Minority ownership in state-owned gas utilities in Pakistan

The government of Pakistan is the majority owner of two gas transmission-and-distribution utilities, Sui Northern and Sui Southern, which have had minority private shareholdings for many years. In the case of Sui Northern, the larger of the two companies in terms of consumers (about 2.2 million as opposed to 1.6 million), private shareholders hold 40.5 percent of the equity while they hold 29.6 percent in Sui Southern.

Each company has 14 directors. In both cases, ten of the directors are selected by the government and government-controlled institutions and the four remaining directors are selected by private shareholders. The managing director of each company sits on the board of the other. Three directors sit on both boards.

Information on Sui Southern shows that the key audit committee only contains one of the three directors sitting on both boards and does not contain either the chairman or the managing director.

Both companies have a reputation for being well run and commercial in culture—even though there is no direct competition between the two businesses and only partial competition with alternative fuels.

Source: SASEI.

Strengthening more-efficient instruments of social policy

The policies identified earlier under the heading of corporate governance are mainly intended to make it more difficult for politicians and officials to interfere inefficiently and nontransparently in the operation of the utility. Facilitating efficient, transparent interventions designed to address the same or similar goals may also help. As mentioned above, higher-level rules can clarify the ways in which politicians can legally direct the utility, perhaps requiring a cash subsidy, or an explicit estimate of the financial cost of the direction. In addition, strengthening the government's influence over instruments of social policy not tied to the utility will be useful.

Alleviating the government's conflict of interest as owner and policy-maker

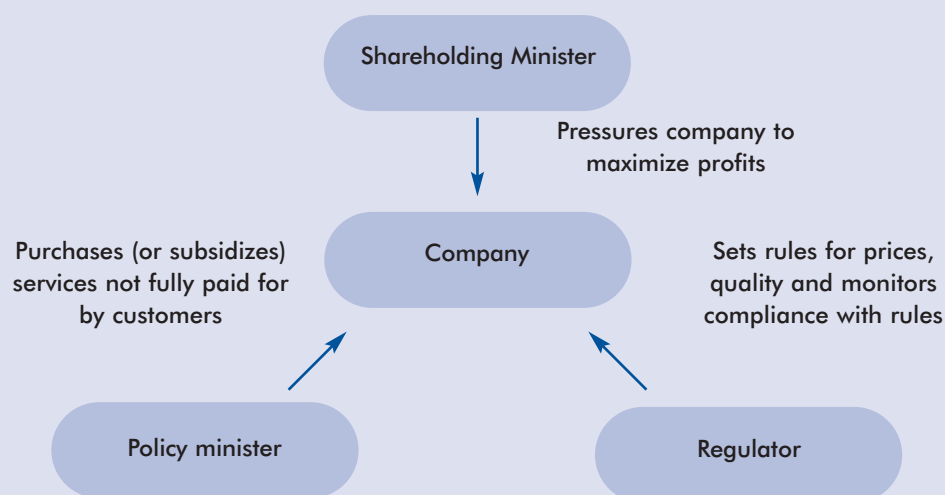
As policy-maker for the electricity sector, the government should have an interest in setting rules that enable customers to receive the best service they can, now and in the future. Such rules are likely to allow competition in at least some segments of the electricity industry. But as an owner of a utility the government has an interest in protecting the utility from competition—not necessarily to increase profits, as governments are typically tolerant of low profits, but to allow it to continue to use the utility to make (inefficient and nontransparent) transfers to favored groups.

Three options may alleviate, without entirely removing, this conflict of interest:

- changing which minister or ministers in the government are, legally, the shareholders and making them different from the minister or ministers with responsibility for other aspects of electricity policy (Annex 2 notes that in New Zealand the ministers of state-owned enterprises and finance have responsibility for shareholding, while the ministers of energy and commerce have responsibility for electricity policy—an approach adopted more recently in the electricity sector in Uganda and mentioned by the government of the United Kingdom as one way of “becoming a better shareholder” (United Kingdom government 2000: 31))
- creating and using independent utility-regulatory and competition-policy agencies to make and enforce some of the rules (in all the case-study countries, governments have created independent regulatory agencies, though in Mexico the independent regulatory agency's responsibility only extends to private companies), and
- establishing high-level rules that create a bias in favor of competition that politicians and officials cannot easily undermine when making lower-level decisions.

Figure 1 shows one way the government can allocate roles among two ministers and a regulator so as to have one minister acting as a shareholder and only a shareholder.

FIGURE 1. Separating government roles: one option



4. SOME EMPIRICAL EVIDENCE

If the diagnosis of fundamental problems afflicting government-owned utilities is correct, there is some reason to think that the options discussed above will improve the performance of utilities if they can be introduced. High-quality empirical evidence on the effects of different reforms would, however, give us much more confidence. As is often the case with difficult policy questions, such evidence is in short supply.

Studies of the effects of different approaches to government-owned utilities, especially electricity utilities, potentially provide the most-relevant evidence about the effectiveness of the options addressed here. Unfortunately, while some evidence relating to the package of reforms known as “corporatization” is available, information on many of the specific proposals discussed here is, as far as we know, scarce or nonexistent. Some evidence is available from the case studies, but as with all case studies, generalizing is difficult.

More common, especially in the last decade or so, are studies of the effects of the privatizing utilities. Since one of the avenues by which privatization is intended to improve performance is bringing to bear commercially oriented corporate governance, studies of the effectiveness of privatization may tell us something about the benefits of commercial corporate governance. It also bears on the question of whether the pursuit of such reforms is likely to achieve the same benefits as privatization. There are also studies of the effects of different forms of governance of private companies, which—to the extent that the government-owned companies resemble private companies—may shed light on the effects of reforms such as those discussed here. We review in turn some of the relevant evidence under each of these rubrics.

Studies of private versus public ownership

Although the question remains controversial among researchers, two recent surveys conclude that the weight of the evidence suggests private ownership in general (not specifically in electricity) improves performance, holding other things constant (Megginson and Netter 2001 and Shirley and Walsh 2000). Two particular studies are interesting for our purposes because they consider the benefits of partial private ownership. Boardman and Vining 1989 undertook a large study of the performance of publicly and private owned firms in

competitive environments and found that private ownership was better than public. The worst type of ownership, they found, was part private, part public. In a subsequent study, however (Vining and Boardman 1992), looking at a different sample, they found that mixed ownership was better than public ownership (private ownership was again the best).

Evidence for the electricity industry and other industries where competition is difficult to create is not clear-cut. For example, many of the studies that have compared the performance of publicly and privately owned electricity utilities in the United States find in favor of public ownership (Kwoka 1996). Some argue that the inefficiencies caused by price regulation of private companies in the United States are as great as those caused by public ownership. In developing countries, the evidence while scarce is more favorable to private ownership (see Gray 2001 and Briceño 2003 for surveys and also Pollitt 1995 and Zhang 2002).

Studies of the effects of different types of governance in the private sector

Studies that examine the effects of corporate governance in the private sector may also be relevant.

Several recent studies consider whether good corporate governance affects firms’ market values. In a study of the firms in the United States, Gompers and others 2003 find that the market value of firms with good corporate governance is higher, relative to their accounting book values, than for firms with poor corporate governance. Campos and others 2002 provide evidence that good corporate governance is also valued in emerging markets. They argue that in their sample from six developing countries “a firm could expect a 10 to 12 percent increase in its market valuation by moving from the worst to best on any one of the 15 elements of corporate governance” (page 17). In another study of developing countries, Klapper and Love 2002 find that “better corporate governance is highly correlated with better operating performance and market valuation”.

Studies of the effects of performance pay are also relevant. Some argue that it is crucial, because it is the only way of aligning the interests of owners and managers. Others argue that it can be counterproductive, because it allows managers to extract excessive profits or because extrinsic motivation (such as money)

sometimes seems to reduce intrinsic motivation (such as wanting to do a good job for its own sake)—see Gibbons 1998 and Abowd and Kaplan 1999 for surveys. Most economists would probably conclude that performance-pay is important and for senior managers should be based in some way on share prices. There is at least some evidence that shareholders also believe such governance mechanisms are valuable (Morgan and Poulsen 2001).

Studies of the effects of corporatization

Kikeri, Nellis, and Shirley (1992: 16-17) provide a summary of evidence, as of 1992, of the effects of “state-owned enterprise reform” that is worth quoting at some length:

During the past twenty years virtually all developing countries have adopted reform programs—short of ownership transfer—to remedy the causes of poor SOE performance. These reforms aimed at (a) exposing SOEs to domestic and external competition and ending preferential treatment in order to create a level playing field; (b) eliminating easy SOE access to credit from the budget and banking system and instituting a hard budget constraint; (c) increasing the autonomy of SOEs and freeing managers from government interference in day-to-day operational decisionmaking and from noncommercial goals; and (d) developing institutional mechanisms, such as contract plans and performance evaluation systems, to hold managers accountable for results.

Recent assessments of SOE reforms reveal that some improvements in performance have indeed taken place But three problems have emerged.

- First, SOE reforms are technically and politically difficult to implement...
- Second, performance does improve when the full package is put in place, but the necessary reforms are numerous and hard to coordinate, and the entire reform program has seldom been enacted....
- Third, and most important, performance improvements have proved difficult to sustain once the crisis that instigated the reforms has dissipated.

More recent evidence is also mixed. On the one hand, a detailed study undertaken by the World Bank (and reported in World Bank 1995, Shirley 1998, and Shirley and Xu 1998) provides further evidence casting doubt on the value of corporatization as an alternative to privatization. Among the conclusions are the following:

- “[p]rivatization and corporatization have similar political costs and tend to succeed or fail together. Where reform was politically desirable, politically feasible, and credible, countries privatized and corporatized successfully.” (“Corporatization is defined in this article as efforts to make SOEs operate as if they were private firms facing a competitive market or, if monopolies, efficient regulation”) (Shirley 1998: 115).
- Performance contracts don’t work. Performance targets tend to be too soft or too numerous and bonuses for meeting them tend not to be credible (World Bank 1995 and Shirley and Xu 1998).

Over the last couple of decades, China has undertaken a massive program of reform of state-owned enterprises that has been the subject of many empirical studies. Shirley and Xu (2000) look at the use of performance contracts in China and also conclude that they generally do not work: “Our findings indicate that on average PCs did not improve performance and may have made it worse (page 2).” The authors do note, however, that the performance contracts “were not uniformly bad ... Successful PCs were those which simultaneously provided sensible targets, stronger incentives, longer terms, and were in more competitive industries (page 2).” In a review of evidence privatization that also touches upon corporatization, Megginson and Netter (2001: 48) come to a more positive view of the evidence of SOE reform in China. They conclude “that there is limited empirical evidence, especially from China, that suggests that non-privatizing reform measures, such as price deregulation, market liberalization, and increased use of incentives, can improve the efficiency of SOEs, but it also seems likely that these reforms would be even more effective if coupled with privatization”.

The evidence from the case study of New Zealand, where reforms were introduced many years ago and have been the subject of some research, is mixed but, on balance, probably positive. Early studies of electricity and other corporatized industries generally found

significantly improved performance (Spicer and others 1991, Duncan and Bollard, 1992). There are some concerns that the improvements have not endured, but the evidence of actual declines in performance does not seem strong.

5. CONCLUSIONS

Many reforms in the fields of corporate governance and sector policy seem likely, if implemented, to improve the performance of government-owned utilities. In particular, performance could be expected to improve as a result of measures that

- reduce the net benefits to politicians and officials of using the utilities to achieve political goals in non-transparent or inefficient ways—either by raising the cost to politicians of such actions or reducing its benefits,
- subject the utilities to commercial pressures from sources other than the government, and
- remove or alleviate the conflict of interest the government faces as owner and policy-maker.

This paper has identified many reforms that could be expected to further these goals. While welfare-enhancing reforms appear available, however, grounds for caution remain. Many of the reforms discussed here have been discussed for decades. Yet most governments have either chosen not to adopt them or to undermine them in practice: it is much easier to discuss such reforms than to implement them rigorously.

Privatization is different from commercialization under public ownership in that it directly brings to bear the influence of new parties with stronger incentives than state-owned enterprises to resist political interference. Thus it seems more promising as a way of resolving the problems underlying the poor performance of most state-owned electricity utilities. Privatization is not easy to implement either, however, and if it seems unavailable as a policy option in the short term, the implementation of options such as those discussed here appears worthwhile.

ANNEX 1: COMISIÓN FEDERAL DE ELECTRICIDAD, MEXICO

Mexico is an example of country whose electricity sector has an independent regulator but is dominated by a single state-owned utility. Although the utility discloses detailed financial information in its financial reports, the case is useful mainly because it offers an example of a relatively traditional approach to electricity policy and the governance of state-owned electricity utilities and a contrast with the other cases examined here.¹

Background

Market structure and ownership

The largest public utility in Mexico, the Comisión Federal de Electricidad (CFE), owns most of Mexico's installed electric generating capacity and generates about 90 percent of the country's electricity. Another state-owned electric utility, Luz y Fuerza del Centro (LFC), generates a small percentage of electricity mainly around Mexico City, as does Petróleos de México SA (Pemex), a state-owned petroleum company. Various private IPPs and cogeneration facilities also produce some electricity, selling it to CFE.

The constitution mandates that the Mexican government have "direct, permanent, and non-transferable dominion over electricity distribution and transmission to public users." As such, the transmission and distribution of electricity is operated solely by public sector. CFE is in charge of transmission. LFC is in charge of distributing electricity in the Mexico City and surrounding areas, and CFE is in charge of distributing electricity in the rest of the country.

Regulation

The Ministry of Treasury and Public Credit is in charge of setting tariffs and policies regarding the subsidies. The Energy Regulatory Commission (CRE) awards and rejects permits for those activities that are carried out by private entities, such as IPPs. CRE is also in charge of supervising the performance of contracts between permit grantees and CFE. According to the Energy Regulatory Commission Act, CRE is "an administrative

¹ Much of information in this annex is taken from www.cfe.gob.mx and www.cre.gob.mx.

agency of the Ministry of Energy” with “technical and operational autonomy.” It consists of five members, including the Chairman. Members of the CRE are nominated by the Minister of Energy and appointed by the President.

Governance

Legal identity

The Electric Energy Public Services Law makes CFE a decentralized public organization with its own legal identity and assets. As a decentralized public organization, the CFE is not subject to general corporate laws that govern private companies in Mexico.

Responsibility for government shareholding

The Mexican government does not hold shares in CFE, as CFE is not considered a company but a decentralized public organization. The Ministry of Energy acts as the sector coordinator as established in the Federal Public Administration Organization Law. The Federal Law of Parastatal Entities mandates the Secretary of Energy to act as the chairman of the Board, in his capacity of sector coordinator. In addition, four cabinet secretaries and one state-owned enterprise are represented on the Board.

Objectives

The Public Services on Electricity Services Act makes CFE responsible for the public service of electricity, which includes planning of national electricity system, generation, transmission, distribution, and sale of electricity, and other acts related to planning, execution, operation, and maintenance of national electricity system (Article 4). No law requires CFE is to be profitable.

The UN Economic Commission for Latin America and Caribbean (CEPAL) argues that CFE is in practice mandated to achieve conflicting objectives—one is to provide electricity, and the other is to help the government develop the country. Historically, it argues, the government has given priority to using CFE as instrument to pursue its social and economic development strategy.

The problem is also faced by the other public electricity utility, LFC. The chairman of the lower house’s energy committee in Congress was quoted in the press (*The*

Wall Street Journal, December 3, 1999) as saying that LFC has served as the medium by which power subsidies had been delivered to urban voters, as it must purchase electricity from CFE and sell it at a lower price. LFC has lost money since 1975 and needed a \$1 billion operational subsidy to remain viable in 1999.

The Board

CFE is governed by a board of governors, made up entirely of non-executive governors. In accordance with the CFE Charter, the Board consists of the Secretary of Energy as the chairman and additional eight governors. Five members represent the public sector, including the Secretary of Commercial and Industrial Promotion; the Secretary of Treasury and Public Credit; the Secretary of Social Development; the Secretary of Environment and Natural Resources, and the Director General of Pemex. The remaining three governors are representatives of the Sole Union for Electrical Workers of the Mexican Republic.

Legal duties of the Board of Governors include, among others, approving the budget and submitting it for authorization to the Secretary of Energy and the Secretary of Treasury and Public Credit.

Neither the CFE Charter, the Federal Law of Parastatal Entities, nor CFE’s annual reports specifies that the Board of Governors has any sub-committees.

By comparison, Telemex, a private telephone company in Mexico, has a board of 17 directors, 10 of whom are non-executive, independent directors. All non-executive directors have substantial business backgrounds, typically holding such positions as chief executive officer, president, and chairman of the board in a variety of industries ranging from telecoms, media, and textiles to chemicals and real estate. The Telemex board has both auditing and remuneration committees.

Accounting and auditing

CFE follows generally accepted accounting principles in Mexico. PricewaterhouseCoopers audited its 2001 financial statement. CFE’s financial reports are quite detailed compared to those of some other state-owned electricity utilities, including Napocor’s.

Borrowing

CFE borrows from private lenders, both domestically and internationally. According to the company's website, as of 31 December 2002, about 75 percent of the CFE's debts were foreign (Table 2). In accordance with Federal Law of Parastatal Entities, the Secretary of Treasury and Public Credit authorizes CFE's borrowing. The Treasury Department registers loans from foreign financial institutions to its Public Debt books and offers implicit guarantee.

Table 2. CFE's liabilities

TYPE	AMOUNT (\$ MILLION)
Lease	1,461
PIDIREGAS ²	3,206
Debt	2,372
Domestic	623
Long term	610
Short term	13
Foreign	1,749
Long term	1,399
Short term	351
Total liabilities	7,039
Note: total assets	56,443

Source: CFE website.

Currently, Standard and Poor's rates CFE's foreign-currency debt BBB-, the same as for the Mexican government, suggesting the debt has an explicit or implicit government guarantee. (But note that the foreign-currency debt of Telemex, a private company, is also rated BBB-.) CFE's local-currency debt is rated BBB+, one notch below the sovereign rating.

Profitability, tax, and subsidies

CFE's net income was \$6.0 billion pesos in 2000 and 6.2 billion pesos in 2001, or about 1.2 percent of total assets.

The Electric Energy Public Services Law requires CFE to pay a fee to the government for using assets to supply electricity (Article 46). This capital charge, or "duty" in the language of the Law, is determined by the Secretary of Treasury. It is calculated from a profitability rate established for state-owned entities each fiscal year. For 2001 and 2000, the rate was 9 percent.

CFE receives non-cash subsidies from the federal government to supplement deficient tariffs. The capital charge owed to the government and subsidies owed to CFE often largely cancel each other out. Up to 1999, the capital charge turned out to be larger, while in 2000 and 2001, the subsidies owed to the CFE became larger. IPD Latin America estimates that net subsidies to CFE (less taxes paid by CFE) have been equal to \$6 to \$7 billion pesos a year (www.infrastrategy.com).

The World Energy Council estimates that the residential sector enjoys a subsidy of nearly 50 percent. During the last few years, residential tariffs have fallen by over 20 percent in real terms, affecting the CFE's ability to finance investments in building generation or transmission capacity (www.worldenergy.org).

Comments

The government of Mexico seems to influence the CFE's operation and profitability, sometimes negatively, perhaps in part because it acts both as the "sector coordinator" and as CFE's owner. Even with legislation that mandates the CFE to supply electricity, the government requires it to pursue other objectives, for instance, by setting tariffs to achieve social policy goals, rather than to allow CFE to recover its full costs. In April 2003, for example, the senate approved a bill to cut electricity prices for households (this is to be passed by the Chamber of Deputies), which may cost CFE and the energy department some \$11 billion pesos in revenue (*Business News Americas*, 11 April 2003). The government's approach is also reflected in the composition of the board, which largely consists of government officials and includes the Secretary of Treasury and Public Credit, whose Ministry is in charge of setting electricity tariffs and subsidies.

² Los Proyectos de Impacto Diferido en el Registro del Gasto Público (PIDIREGAS) is a scheme to finance strategic projects, such as electricity generation, with private funding. Following PIDIREGAS recording guidelines, CFE records only the obligation due in current and subsequent few years. As the remaining obligation is not accounted for, remaining an off-balance sheet liability, obligations due in future are underrepresented. See Annex 3 for a contrasting accounting treatment in the Philippines.

Industrial users have expressed concerns over the reliability and affordability of electricity supply. Many plants are old and have exceeded their planned life spans (FAC/Corporate Mexico, 2 June, 2003). To address these concerns, the government has proposed an electricity sector reform in August 2002 (FAC/EFE News Service, 21 October, 2002), which will involve more private-sector participation, competition, and will grant autonomy to CFE and LFC. The reform process has been stalled in the Congress, however, and analysts doubt whether the utilities will be allowed to be truly antonymous, even if the reform goes through (Reuters News 30 April 2003).

ANNEX 2: STATE-OWNED ELECTRICITY COMPANIES IN NEWZEALAND

The case of New Zealand is interesting because it represents an ambitious attempt to make state-owned electricity firms operate like privately owned firms. The major reforms date back to 1986, so enough time has passed to form an impression of their effects and whether the ambitions have been achieved.

Background

Market structure

Three types of company make up most of the electricity industry in New Zealand:

- Generator–retailers, which generate electricity and sell it to final consumers over other companies' wires
- One transmission company, Transpower
- About twenty-eight network distribution companies that transport but do not sell electricity.

The generator–retailers and other companies wanting to buy or sell electricity trade in a wholesale market. Retailers can sell electricity to end-consumers without also being generators, but in practice retailing is dominated by companies that also generate power.³

There are no restrictions on entry into and exit from the electricity industry, except that companies that buy or sell electricity may not own wires businesses (transmission or

distribution companies). No company has any legal monopoly, but Transpower has a *de facto* near monopoly on transmission over the whole country and each distribution company has a *de facto* near monopoly in its area.

Ownership of the electricity industry

The central government owns three large generator–retailers—Genesis, Meridian, and Mighty River Power—that own about two thirds of the country's generation capacity and supply about half the customers (see www.m-co.co.nz). Although they have a common owner, they compete with each other, as well as with private generator–retailers.

The central government also owns Transpower, the transmission company. Most of the distribution network companies are owned by community trusts, but two—Delta and Orion—are owned by local governments, and one (Powerco) is partly privately owned.

Regulation

Regulation does not legally distinguish among companies according to their ownership, and, although regulators might make distinctions in practice, we are not aware of evidence that they have done so. All generator–retailers, including those owned by the central government, are subject to competition law and various rules governing the operation of the wholesale and retail electricity markets. But they are subject neither to formal price regulation nor to the electricity information-disclosure regulations.

Transpower and the distribution companies are regulated by the Commerce Commission, an independent utility-regulation agency that also administers the competition law that applies to generator–retailers. The Commission is in the process of introducing what it calls “targeted price regulation”, which may operate somewhat like CPI – X price regulation (companies can avoid formal price-control if they reduce their prices by CPI – X each year). Transpower and the distribution companies (but not the generator–retailers) must also publicly disclose information on their performance under the electricity-industry information-disclosure regulations.

³ Part of the reason is that retail prices tend to be sticky (although they are not regulated, retailers appear to believe customers prefer stable prices), whereas wholesale prices fluctuate widely. So companies that sell more electricity than they produce are exposed to considerable risk arising from volatility in the spread between wholesale and retail prices.

Governance

The governance of the generator–retailers is similar to governance of large privately owned companies in New Zealand.

Legal identity

The generator–retailers are all limited-liability companies, having legal identities separate from the government's. Laws that apply to privately owned companies apply also to the state-owned generator–retailers and other state-owned enterprises, including those relating to taxation, employment conditions, the organization and operation of companies (the Companies Act 1993), and financial reporting (Financial Reporting Act 1993).

State-owned companies are also subject, however, to some laws that don't apply to privately owned companies, including the State-Owned Enterprise Act 1986, the Public Audit Act 2001, the Official Information Act 1982, and the Ombudsmen Act 1975. The Official Information Act 1982 is designed "to make official information more freely available" and gives the public rights to certain information about state-owned companies that they don't have in relation to privately owned companies. Government-owned companies can, however, withhold certain commercially sensitive information as defined by the Act. Under the Ombudsmen Act 1975, ombudsmen can investigate any administrative decisions of government-owned companies that affect individuals (such as a refusal to release information on grounds of commercial secrecy under the Official Information Act). Some of the main implications of the State-Owned Enterprises and Public Audits acts are discussed below.

Responsibility for government shareholding and accountability framework

The central government owns all the shares of the generator–retailers. When the major reform of policy toward state-owned enterprises was ushered in by the State-Owned Enterprises Act 1986, companies were legally required to have at least two shareholders (Brumby and Hyndman (1998: 35)) and, accordingly, two ministers—the Minister for State-Owned Enterprises and the Minister of Finance—each hold half the government's shares in the generator–retailers. The Minister of Energy has responsibility for electricity policy, but not for the

exercise of the government's role as a shareholder in its electricity companies.

The Minister of State-Owned Enterprises receives advice from an agency called the Crown Company Monitory and Advisory Unit, or CCMAU. CCMAU is owned by the Treasury operates independently of it. The Minister of Finance receives advice from the Treasury. Major decisions are typically made, or endorsed, by the Cabinet, and all ministers would see advice from both agencies relating to such decisions.

Overall, the board of the companies is accountable to the shareholding ministers, who in turn are accountable to the Parliament (State-Owned Enterprises Act 1986, Section 6).

Objectives

Under the State-Owned Enterprises Act 1986, the "principal objective of every State enterprise [including the generator–retailers] shall be to operate as a successful business and, to this end, to be:

- As profitable and efficient as comparable businesses not owned by the Crown
- A good employer
- An organization that exhibits a sense of social responsibility having regard to the interests of the communities in which it operates and by endeavouring to accommodate or encourage those interests when able to do so (Section 4)".

Disputes have arisen about whether this important provision requires state-owned enterprises essentially to act as profit-motivated private-sector-like businesses (which may also want, as secondary objectives, to be good employers and good members of their communities) or whether it requires them to place more emphasize than other firms on the latter two objectives. Until 1994, New Zealand courts interpreted the State-Owned Enterprises Act to imply that the requirement to be profitable was paramount (CCMAU 2002a: 43). In 1994, however, the Privy Council, which act as the supreme court for New Zealand, overturned this interpretation, allowing "a broader scope for social-policy objectives to be reflected in" the companies' statements of corporate intent.

BOX 5. The statement of corporate intent for New Zealand state-owned enterprises

The State-Owned Enterprises Act requires (Section 14) the following:

1. The board of every State enterprise shall deliver to the shareholding Ministers a draft statement of corporate intent not later than 1 month after the commencement of each financial year of the State enterprise.
2. Each statement of corporate intent shall specify for the group comprising the State enterprise and its subsidiaries (if any), and in respect of the financial year in which it is delivered and each of the immediately following 2 financial years, the following information:
 - (a) The objectives of the group.
 - (b) The nature and scope of the activities to be undertaken.
 - (c) The ratio of consolidated shareholders' funds to total assets, and definitions of those terms.
 - (d) The accounting policies.
 - (e) The performance targets and other measures by which the performance of the group may be judged in relation to its objectives.
 - (f) An estimate of the amount or proportion of accumulated profits and capital reserves that is intended to be distributed to the Crown.
 - (g) The kind of information to be provided to the shareholding Ministers by the State enterprise during the course of those financial years, including the information to be included in each half-yearly report.
 - (h) The procedures to be followed before any member of the group subscribes for, purchases, or otherwise acquires shares in any company or other organization.
 - (i) Any activities for which the board seeks compensation from the Crown (whether or not the Crown has agreed to provide such compensation).
 - (j) The board's estimate of the commercial value of the Crown's investment in the group and the manner in which, and the times at which, this value is to be reassessed.
 - (k) Such other matters as are agreed by the shareholding Ministers and the board.
3. The board shall consider any comments on the draft statement of corporate intent that are made to it within 2 months of the commencement of the financial year by the shareholding Ministers, and shall deliver the completed statement of corporate intent to the shareholding Ministers within 3 months of the commencement of the financial year.
4. A statement of corporate intent for a State enterprise may be modified at any time by written notice from the board to the shareholding Ministers, so long as the board has first given written notice to the shareholding Ministers of the proposed modification and considered any comments made thereon by the shareholding Ministers within 1 month of the date on which that notice was given.

Original numbering has been retained.

Statements of corporate intent are documents in which the companies set out their objectives (see Box 5).

As an example, Mighty River Power's statement of corporate intent sets out the "financial and commercial performance targets" for the 2002 financial year presented in Table 3.

Mighty River Power's statement of corporate intent also sets out dividend-payout targets, contemplating the payment to the government of a dividend of 25 percent

of net profit after tax in 2001/2002 and of 70 percent thereafter—reflecting a plan to lower the company's leverage over the next year.

In practice, the companies also provide shareholding ministers with their business plans, which set out the companies' objectives and strategies in more detail (CCMAU 2002).

The companies must also give the shareholding ministers annual and semi-annual reports, including

financial statements, which the shareholding ministers must provide to Parliament. In practice, the companies also provide quarterly reports to their shareholding ministers (CCMAU 2002). The companies typically post the annual and semi-annual, but not the quarterly, reports on their websites.

Table 3: Performance targets from Mighty River Power’s statement of corporate intent

INDICATOR	TARGET 2003/2004
(a) Financial	
Return on shareholders’ funds as a percentage	8.8
Equity as a percentage of total assets	53.5
Free funds from operation as a percentage of interest expense	474
(b) Nonfinancial	
Lost-time accidents per 100,000 hours worked	<1.25
Hours lost per 1,000 hours worked	<0.25
Number of regulatory enforcement actions arising from breach of environmental controls and standards	0
Percentage of requests to switch customers achieved within 48 hours	100
Number of telephone calls to call centers per customer per year	2.5
Percentage of time hydro generation plant is available for use	93
Percentage of time hydro generation plant is unavailable due to unplanned outages	0.9

The Board

Directors and their duties

The Companies Act sets out the legal duties of all directors, including those of the government-owned generator–retailers. According to the Act, boards (not shareholders) are responsible for managing the company.

The principal duty of directors under the law is to act in good faith and in what the director believes to be the best interests of the company.

Among directors’ other duties are the following:

- to avoid reckless trading, defined as “carrying on of the business of the company in a manner likely to create a substantial risk of serious loss to the company’s creditors” (Beck and Borrowdale 2002: 66),
- to avoid the company’s trading while it is insolvent, and
- to exercise the care, diligence, and skill of a reasonable director.

People can be deemed to be directors, even if not officially so appointed, if they exercise “de facto control of the company even in respect of a single issue” (CCMAU 2002). As a result, such shadow directors can be held “personally accountable for the liabilities of the company incurred as a result of their actions”. CCMAU (2002:10) notes in its briefing to the Minister of State-Owned Enterprises that “Shareholding ministers and their advisers (including CCMAU) must take care to avoid conduct that could result in them being deemed directors of a [government-owned] company or if such conduct is considered to be required and appropriate, it should be undertaken in a fully informed manner.”

The appointment of directors

The shareholding ministers appoint the directors and decide who will be the chairman and the “deputy chair”. They appoint them for three-year terms with the expectation that the appointments will be renewed once, but not twice (CCMAU 2002). Although the two ministers have the authority and the responsibility to make appointments themselves, they often ask the Cabinet to review and endorse their proposals (CCMAU 2002: 21).

Criteria for appointment

According to the State-Owned Enterprises Act 1986, “The directors of a State enterprise shall be persons who, in the opinion of those appointing them, will assist the State enterprise to achieve its principal objective (Section 5).” According to CCMAU 2002, “Whilst appointments are on skills-based merits, CCMAU and Ministers devote considerable energy to ensuring, as far as possible, appointments reflect the demographic diversity of our community.”

The mix of executive and non-executive directors

The boards of the government's electricity companies contain only non-executive directors (see Table 4). Some boards of listed private-sector companies in New Zealand are also entirely non-executive, but most also include the chief executive and sometimes other executive directors. The chairman is typically a non-executive director. The boards typically meet a dozen times a year.

Table 4: Composition of boards of generator-retailers in New Zealand, February 2003

	NUMBER OF EXECUTIVE DIRECTORS	NUMBER OF NON-EXECUTIVE DIRECTORS	TOTAL
Privately owned companies			
Contact	1	5	6
Trustpower	0	6	6
State-owned companies			
Genesis	0	8	8
Meridian	0	7	7
Mighty River Power	0	7	7

Experience of non-executive directors

The directors of the state-owned generator-retailers typically have business experience and are often also directors of large privately owned companies. None are from government departments. Consistent with the government's concerns about "demographic diversity", some of the generator-retailers' board members appear to have less business experience than, say, those of their privately owned counterpart, Contact.

Remuneration

The shareholding ministers determine the total remuneration of the board; the board determines the allocation of the remuneration among board members. Annual reports disclose the amount each director is paid.

Committees

All the boards of the state-owned generator-retailers have committees responsible for audit and remuneration.

Accounting and auditing

The companies prepare financial statements that comply with the Financial Reporting Act 1993, which applies also to private companies, and requires reporting according to generally accepted accounting practice in New Zealand. New Zealand GAAP is intended to converge with International Accounting Standards over the next three or four years.

The government audit body, the Auditor-General, has responsibility for auditing the government-owned generator-retailers' accounts (as a result of a provision in the State-Owned Enterprises Act), but can delegate the audit task to private audit firms. The accounts of Genesis and Meridian for 2002 were audited by Deloitte Touche, while Mighty River Power's were audited by Ernst & Young—in each case on behalf of the Auditor-General.

Borrowing

According to the State-Owned Enterprises Act, the companies may issue what the Act calls "state enterprise equity bonds", which are like equity except they don't give the holder any voting rights. No company, so far as we know, has done so.

The companies can also borrow from banks and issue ordinary bonds. All have credit ratings (see Table 5). Their borrowings carry no legal guarantee from the New Zealand government. Although the willingness of the government to allow large state-owned companies to go bankrupt has been questioned, state-owned electricity companies have credit ratings lower than that of the government and their credit ratings vary; the generator-retailers, which operate in a competitive market have lower ratings than Transpower, which has a near monopoly in transmission, and among the generator-retailers the one with the highest debt-equity ratio has the lowest credit rating.

Table 5: Credit ratings by Standard and Poor's of generator-retailers and others

	RATING ON LONG-TERM FOREIGN-CURRENCY DEBT FEBRUARY 2003	RATIO OF EQUITY TO TOTAL ASSETS AT BOOK VALUES FROM MOST-RECENT ANNUAL REPORT
Privately owned companies		
Contact	BBB	0.75
Trustpower	Not rated	0.66
State-owned companies		
Genesis	BBB+	0.79
Meridian	BBB+	0.64
Mighty River Power	BBB	0.51
Others		
Transpower	AA	0.44
New Zealand Government	AA+	0.25 ⁴

In addition, the government has let one small government-owned business fail, without bailing out its creditors. The business, called Terralink, used to be part of the Department of Lands and Survey Information and provided maps and similar information. According to newspaper reports, "Terralink was placed in Receivership on 15 January 2001. The Receivership was successfully completed on 28 March 2002 and the company is now in Liquidation, pending final wind-up."⁵ Secured creditors, including the government (which apparently had lent the company about US\$0.5 million), appear to have been paid in full, while unsecured creditors "could get up to 38 cents for every dollar they are owed."⁶ Although the government would face stronger pressure to bail out a large electricity company, lenders to these companies may take seriously the prospect of their loans not being repaid.

Profitability, tax, and subsidies

The state-owned electricity companies pay corporate income tax and generally have no financial privileges of a legal nature compared with private-sector firms. All the

Table 6: Recent accounting profitability of New Zealand electricity generator-retailers

	ACCOUNTING RETURN ON EQUITY (%)
Privately owned companies	
Contact	6.4
Trustpower	0.2
State-owned companies	
Genesis	5.7
Meridian	5.2
Mighty River Power	6.6

Note: The accounting return on equity is measured as net profit after tax as percentage of equity at book value at the beginning of the year.

government-owned generator-retailers were profitable in an accounting sense in 2002 (see Table 6), though some made profits that may not cover their cost of equity capital.

According to the State-Owned Enterprises Act 1986,

Where the Crown wishes a State enterprise to provide goods or services to any persons, the Crown and the State enterprise shall enter into an agreement under which the State enterprise will provide the goods or services in return for the payment by the Crown of the whole or part of the price thereof.

Thus the Act establishes a procedure by which the government can cause state-owned electricity companies to provide noncommercial services in return for an explicit subsidy. In practice, this provision has been little used.

Comments

Overall, the reforms ushered in by the State-Owned Enterprises Act 1986 of the governance of generator-retailers and other state-owned businesses appear to have depoliticized the management of the business. After reform, the generator-retailers acted much more like privately owned businesses than their predecessors did (Spicer and others 2001 and Duncan and Bollard 1992).

⁴ Calculated as the difference between the value of the government's assets and its debts, as recorded on its balance sheet, and called the "crown balance". Of course, the government's credit rating does not depend on its balance sheet in same way as those of companies.

⁵ See <<http://www.ccm.au.govt.nz/soe/profiles/terralink.asp>>.

⁶ Adam Gifford, "Terralink creditors wait on EDS claim." New Zealand Herald, 7 August 2001.

Concerns are often expressed, however, that the benefits of corporatization are somewhat fragile and that reforms have not brought all the benefits that privatization would.

In a review of the performance of other state-owned enterprises and the now privately owned New Zealand rail company, the New Zealand Institute for the Study of Competition and Regulation (2000) argues as follows

In its period of public ownership, New Zealand railways underwent five corporate-like restructuring episodes that attempted to place business at arms-length from political control of operations, and to establish sharper business objectives: the first commencing in 1888. From historical gross revenue and operating expense data, it seems that there was a financial improvement around the beginning of each of these episodes and deterioration toward the end. This suggests the hypothesis that corporate forms of governance in public ownership yield only short-lived improvements in productivity.

CCMAU (2002:46) also notes in its briefing to the new government in 2002 that state-owned enterprises are “exposed” to problems because:

- They face no threat of takeover.
- They do not have to compete for their equity capital.
- Lenders monitor their performance less vigorously than they do the performance of private companies, where the likelihood of government bailout is remote.

Various aspects of the legal framework reduce the commercial focus of the government-owned generator–retailers, including non-commercial statutory objectives (such as being a good employer) and the application of public-sector legislation, such as the Official Information Act. The biggest issue, however, is probably the extent to which the actual pressures exerted by government, as shareholder, are commercial or not. There is a risk of course of “behind-the-scenes”, “nontransparent” pressure on the companies to achieve non-commercial objectives and absence of pressure to achieve commercial objectives. The legal framework probably reduces, without eliminating, these effects.

Despite these weaknesses, however, there does not appear to be strong evidence of actual declines in performance. And after noting the problems above, CCMAU (2002:47) goes on to state that actual performance has nevertheless been good.

ANNEX 3: THE NATIONAL POWER CORPORATION, PHILIPPINES

The Philippines provides an example of a large government-owned electricity utility that competes to some extent with private companies and is regulated by an independent government agency.⁷ For the moment, however, most aspects of corporate governance remain similar to the traditional model for public-sector businesses.

Background

Market structure and ownership

Both public utilities and private companies generate electricity and sell it to distributors and large industrial users. In 1993, the Electric Power Crisis Act (Republic Act 7648) opened generation to private participation, and reform was further reinforced by the Electric Power Industry Reform Act (Republic Act 9136) of 2001, which mandates that “generation of electric power, a business affected with public interest, shall be competitive and open”. In 1998, National Power Corporation (Napocor) owned and operated about 50 percent of total installed generating capacity, and IPPs contracted by Napocor owned and operated about 45 percent of the total capacity. The remaining power was produced by privately owned generation facilities that served distributors or acted as self-generation. The government owns Napocor but is in the process of privatizing it.

The National Transmission Corporation (Transco) was carved out of the Napocor by the Electric Power Industry Reform Act and is the only company involved in transmission. The government owns Transco, but is in the process of privatizing it.

Several larger private distributors and many rural cooperatives distribute electricity. Napocor does not.

Regulation

The Electricity Regulation Commission (ERC) regulates prices in the industry. The Energy Industry Administration Bureau within the Department of Energy is responsible for nonprice regulation of generators and distribution utilities.

⁷ Much of information in this annex is taken from www.napocor.com.ph, www.coa.gov.ph, and www.erc.gov.ph.

Governance

Legal identity

Napocor is legally separate from the government, being a wholly government-owned stock corporation (Republic Act No. 2641.)

The board

Directors and their duties

Before the passage of the Electric Power Industry Reform Act, Napocor's Board had seven members—a chairman, vice chairman, and five other directors. All directors were appointed by the President of the Philippines, except for the vice chairman, which was the General Manager *ex officio*. Every member of the Board had to be a professional of recognized competence in engineering, business management and finance, or law, with at least ten years' actual and distinguished experience. Three directors were to represent three main islands—Luzon, Visayas, and Mindanao—one was to represent labor, and one was to represent the business sector. Duties of the Board included:

- Formulating and adopting policies and measures for the management and operation;
- Adopting budget of receipts and expenditures;
- Appointing and removing General Manager and fixing his or her compensation, subject to the approval of the President of the Philippines; and
- Adopting guidelines for the employment of personnel.

The Electric Power Industry Reform Act organized a new Board, composed of the Secretary of Finance as chairman, with the following eight other members: the Secretary of Energy, the Secretary of Budget and Management, the Secretary of Agriculture, the Director-General of the National Economic and Development Authority, the Secretary of Environment and Natural Resources, the Secretary of Interior and Local Government, the Secretary of the Department of Trade and Industry, and the President of the Napocor.

As a comparison, Meralco, a private distribution company operating in metro Manila, has a 12-member board of directors. The chief executive officer of Meralco serves as the chairman of the board, and the chief operations officer is also a member of the board. The remaining 10 directors are non-executive, all with business backgrounds.

Remuneration

Napocor's annual report does not disclose how much remuneration board members received. However, the revised Napocor Charter states that the members of the board receive a per diem of no more than 300 pesos for each regular meeting of the Board and 100 pesos for each special meeting actually attended by them, provided such per diem does not exceed 1500 pesos per month, and that no allowances are paid other than actual expense of traveling to attend these meetings.

Committees

Napocor's annual report does not mention committees of the Board.

Accounting and auditing

Napocor follows generally accepted accounting principles in the Philippines.

The government's Commission on Audit audited Napocor's financial statements for 2001. The auditor rendered a qualified opinion on the fairness of the presentation of the statements. Moreover, according to a report by the Commission, of the nine prior years' audit recommendations on financial and compliance audit embodied in the 2000 Annual Audit Report, only six were fully implemented. Napocor's annual report is not very detailed compared with those discussed in the other annexes.

Borrowing

Napocor borrows from private lenders. Currently, Standard Poor's rates Napocor's foreign-currency denominated debt as BB+, the same as the sovereign rating, possibly suggesting that the government provides an explicit or implicit guarantee of Napocor's debt. Napocor's local-currency debt is rated BBB, one notch below the sovereign rating.

Profitability, tax, and subsidies

While Napocor's net income averaged 5 billion pesos a year between 1994 and 1997, it has been negative for the following four years. In 2001, the loss amounted to 10.4 billion pesos (Table 7), or about 1 percent of Napocor's total assets of 1 trillion pesos.

Table 7: Napocor’s net income in billion pesos

YEAR	NET INCOME
1997	3.0
1998	-3.6
1999	-6.0
2000	-13.0
2001	-10.4

Background

Market structure and ownership

Eskom generates approximately 96 percent of South Africa's electricity. Eight municipalities generate the remaining 4 percent for their own distribution companies. Eskom is the only transmission company. In distribution subsector, Eskom and several hundred municipalities separately operate the country's electricity distribution networks. Eskom distributes electricity to a geographically dispersed customer base, while municipal distributors generally supply consumers within their geographic areas. Municipal distributors serve about 60 percent of the customers and 40 percent of electricity by sales volume.

Regulation

The National Electricity Regulator (NER) regulates the electricity sector. Although the Department of Minerals and Energy appoints the board members of NER, the NER acts independently and reports directly to parliament.

No person is allowed to undertake the generation of electricity without a license, except for a local authority that does not sell more than five gigawatt hours of electricity a year (the Electricity Act 41, 1987). Every license contains a schedule of the approved tariffs to be charged by the licensee for the supply, provision, or distribution of electricity to different classes of consumers.

Governance

Legal identity

Eskom is legally separate from the government. It was converted from a statutory body to a public company, Eskom Holdings Limited, on 1 July 2001 (Eskom Conversion Act 2001).

Responsibility for government shareholding

The South African government, represented by the Department of Public Enterprises, is the sole shareholder of Eskom. Eskom and the Minister of Public Enterprises sign a shareholder compact every year (according to Treasury Regulations issued under the Public Finance Management Act of 1999).

According to the Report by the Commission on Audit, the net losses incurred for 2000 and 2001 were mainly due to the high cost of long-term power-purchase contracts with IPPs, some of whom are receiving payment for capacity that Napocor does not currently require (Oxford Analytica, May 2002). In 2001, Napocor paid IPPs 30 billion pesos in capacity fees. Note that, in contrast to the case of Mexico described in Annex 1, Napocor’s balance sheet reflects the full cost of its obligations to IPPs under long-term power purchase contracts.

Napocor is exempt from paying corporate income tax (BIR Ruling #018-2000, Section 32(B)(7)(b).)

Comments

Napocor’s corporate governance structure is fairly traditional. For example, government officials have dominated its board, and its financial reporting does not disclose as much information as in the other cases examined here.

The company has faced financial difficulties, particularly in recent years, and the government has decided that privatization, rather than further reforms of corporate governance under public ownership, offers the best solution to address the company’s problems.

ANNEX 4: ESKOM, SOUTH AFRICA

Like Mexico, South Africa offers an example of an electricity industry with an independent regulator that is dominated by a state-owned electricity utility. In contrast with Mexico, however, the company’s corporate governance is modeled closely on that of private South African companies.⁸

⁸ Much of information in this annex is taken from www.eskom.co.za

The shareholder compact sets out key performance objectives and key performance indicators for Eskom and provides a framework to guide the relationship between Eskom and its shareholder. The performance indicators cover financial indicators such as profit, revenue growth, and price increases, as well as social targets such as equal opportunities, gender equity, disability targets, electrification targets, and black economic empowerment.

Reporting

The Public Finance Management Act requires public entities such as Eskom to keep full and proper records of the financial affairs and prepare financial statement for each fiscal year in accordance with generally accepted accounting practice. These financial statements are to be audited and submitted to the Minister of Public Enterprises within two months after the end of the financial year (Public Finance Management Act Chapter 6 Part 2 Subsection 55-1).

The board

Directors and their duties

Eskom complies with the requirement of Public Finance Management Act, and the Companies Act 1973 as amended. It is also in the process of implementing the recommendations of the King Report on Corporate Governance for South Africa 2002 (the King II Report). The King II Report includes the Code of Corporate Practices and Conduct, as well as the Protocol on Corporate Governance in the Public Sector.⁹

The Board has identified its role as follows:¹⁰

- Provision of strategic direction and leadership;
- Approval of key policies including investment policy and strategy, risk management policies and strategy;
- Approval and monitoring compliance with corporate plans, financial plans and budgets (including setting objectives and targets);
- Ensuring good corporate governance and ethics;
- Monitoring and reviewing performance and effectiveness of controls;

- Monitoring and ensuring triple bottom line performance in the context of integrated sustainable economic, social and environmental performance, and issuing the Board's assessment of the company's ability to continue as a going concern in respect thereof;
- Succession planning;
- Guiding restructuring and transformation;
- Ensuring effective communication with relevant stakeholders (transparency);
- Liaising with and reporting to the shareholders;
- Guiding key initiatives, for example, AIDS/HIV strategy; and
- Approval of transactions beyond the authority of management.

The Board meets quarterly and monitors management's compliance with policy and its achievement against objectives.

The appointment of directors

The Minister of Public Enterprises appoints the directors. The term of office of the non-executive directors that were appointed on the conversion of Eskom is three years, while the term of office of the non-executive directors that were previously members of the Electricity Council is two years.

The mix of executive and non-executive directors

In keeping with the recommendations of the King II Report, Eskom board consists of a majority of non-executive directors. Specifically, 13 out of the 15 directors are non-executive, including the chairman of the board. The two executive directors hold, respectively, the positions of chairman and finance director.

Experience of non-executive directors

Typical non-executive directors have substantial business experience, and 8 out of 13 Eskom non-executive directors serve as directors of other companies. The background of Eskom board's non-executive directors seems to be more diverse than for typical private companies in South Africa. The board includes one director who serves as a full time employee of the Department of Public Enterprise, one director who holds a lecturing position in a university, and one director with union background.

⁹ The original King Report has established an initial framework for corporate governance practices for the South African companies and has been used as a benchmark of good practice. The King II Report updates the original report.

¹⁰ See Eskom's Board Charter and the Annual Report.

Remuneration

Non-executive directors receive fees for their contribution to the Board and the committees on which they serve. The Minister of Public Enterprises determines the remuneration of the directors, with the concurrence of the Minister of Finance. The Board committee on Human Resources, Remuneration, and Ethics makes recommendations to the shareholder on the remuneration policy for executive and non-executive directors.

Committees

The Eskom Board has several committees including an executive-management committee, a sustainability committee, a risk-management committee, investment-and-finance committee, a tender committee, an audit committee, and a human resource, remuneration, and ethics committees.

The audit committee reviews the activities of the corporate audit department, and is responsible for the review of accounting and auditing concerns identified by internal and external audit. The audit committee comprises five non-executive directors, including an independent non-executive director as the chairman.

The Human Resource, Remuneration, and Ethics Committee makes recommendations to the shareholder on the remuneration policy for Board directors, and makes recommendations to the Board on the appointment and removal of directors. The committee is made up of four non-executive directors and the chief executive, including an independent non-executive director as the chairman.

Accounting and auditing

Eskom’s financial reports comply with International Accounting Standards. The Public Finance Management Act mandates that the annual financial statements of a public entity be audited by an external auditor who is registered as an accountant and auditor under the Public Accountants’ and Auditors’ Act 1991, and engaged in public practice as such. KPMG Inc, SizweNtsaluba VSP, and Deloitte& Touche audited Eskom’s financial statements for the financial year 2002.

Borrowing

Eskom is allowed to borrow from private lenders. The South African Government does not guarantee all Eskom

bonds, but does guarantee some foreign bonds. Standard Poor’s rates Eskom’s foreign-currency debt BBB, the same as the sovereign rating. Eskom’s local-currency denominated debt is rated A-, one notch below the sovereign rating.

Profitability, tax, and subsidies

In recent years, Eskom has been profitable in an accounting sense, but its real (that is, inflation-adjusted) rate of return on total assets has been relatively low and declining (Table 8.) The government does not provide explicit subsidies.

Table 8: Eskom’s real rate of return on total assets

YEAR	RETURN
1994	4.33
1995	3.82
1996	3.89
1997	3.62
1998	2.49
1999	1.42
2000	2.45
2001	1.16
2002	1.69

Source: Annual Reports

Eskom is responsible for paying corporate income tax.

The company intends to pay dividends to the government, although this did not happen in the fiscal year 2002.

Comments

Eskom’s corporate governance structure is closer to that of private sector, compared to utilities such as CFE and Napocor. For example, a majority of the board members are non-executive, non-governmental directors with business backgrounds, while financial reporting is detailed and complies with international accounting standards.

By most reports, Eskom operates reasonably well and its customers are generally satisfied with the service quality and reliability. Nonetheless, the government has announced plans to reform it. It has said it will sell 10 percent stake in Eskom’s power stations to the private sector in 2003, and additional 20 percent in 2004 (PANA 11 March 2003.) There are also plans to introduce competition in generation (NER 2002).

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