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Corporate Governance of Public Enterprises in Transitional Economies

Edited by Dominique Pannier

The World Bank
Washington, D.C.
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The reform of the public enterprise sector is at the heart of structural transformation in transitional economies. While the basic direction of reform is to divest the state of enterprise ownership, a number of enterprises are likely to remain in the public sector for an indefinite period or while awaiting privatization. With the disappearance of the former system of direct control from the center and the lack of adequate alternative systems suited to a market environment, the management and control of enterprise assets — corporate governance — has emerged as a key issue. A comprehensive strategy for public enterprise reform should include the five "external" reform elements of divestiture, hard budgets, competition, distancing of the enterprise from the government, and financial sector restructuring. Corporate governance is an important complementary element, particularly in the transitional economies where other checks on the behavior of enterprise managers are not yet adequately developed. If properly administered, corporate governance can help to implement financial discipline and improve performance. As a monitoring and controlling device it can help introduce transparency and accountability.

This volume is an outcome of an international workshop on Corporate Governance of Public Enterprises, attended by policy makers from transitional economies and experts from developed market economies, organized in October 1994 in Prague by the Public Sector Management Team of this Department. The volume highlights the corporate governance options available to governments and the conditions for success in establishing the balance between shareholders' control and managerial autonomy. It compares and draws lessons from the varied experience of transitional economies, includes examples from developed market economies and aims to provide practical policy recommendations to policy makers and enterprise reform practitioners.

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Abstract

Privatization has been the basic direction of reform in transitional economies. In implementing this process, however, policy makers overlooked the problems of the remaining public enterprises, mainly public utilities and natural resource-based industries which often include declining industries. This volume draws lessons from the contrasting experience of five large transitional economies (Hungary, Poland, Romania, Russia, Ukraine) in corporate governance of public enterprises, i.e. their management and oversight. Relevant experiences of developed market economies are included.

The volume's first chapter provides an overview of the main dimensions of corporate governance of public enterprises, with reference to actual experience in transitional economies: the process of corporatization; the choice of governance structure; improving management; the role of boards of directors; and the advantages and limitations of performance and management contracts. Chapter II describes the corporate governance regime in the five countries of the sample: the extent and content of the residual public sector; the legal and institutional framework for corporate governance; and illustrations from the power, railways, coal, telecommunications and postal sectors. Chapter III contains relevant corporate governance experiences from developed market economies: state asset management in Austria and New Zealand; railways in Canada and Germany; energy, coal and telecommunications sectors in France; and steel in Britain.
Acknowledgments

The editor is grateful for valuable comments provided by Wafik Grais, Russell Muir and John Nellis, and for the constant support of Salvatore Schiavo-Campo. I would like to thank Arshad Sayed and P.K. Subramanian for their editorial assistance.

The country studies have been prepared under the editor's direct supervision. Assistance was provided for Hungary, by Krisztina Kiss, Tamas Markus, Ilham Zurayk; for Poland, by Rachid Bennessaoud, Christian Duvigneau, Yves Duvivier, Mario Reyes-Vidal, Enn Vasur (World Bank); for Romania, by Ileana Ionescu (Alternate Executive Director), Patrick Tardy, Maziar Minovi, Akin Oduolowu (World Bank); for Russia, by Elvira Nabiulina (Ministry of Economy of the Russian Federation); for Ukraine, by Véronique Bishop, Bernard Drum, Ana Goshko, Peter Kyle, Lazlo Lovei, Thomas Till, Jonathan Pavluk (World Bank).

Several of the papers were presented in preliminary form to the World Bank Seminar on Corporate Governance of Public Enterprises in Transitional Economies, Prague, October 1994, organized by the Public Sector Management Team of the Technical Department for Europe and Central Asia. All these papers were revised, partly benefitting from the discussions at the seminar, and updated as necessary to November 1995.

Geoffrey Lamb supported the preparation of the 1994 seminar, Anil Sood chaired the seminar, and Lynette Alemar, Muriel Darlington, and Josephine Onwuemene assisted in organizing it. Lynette Alemar, Celestine Collins and Brigitte Franklin processed the various drafts of the volume.
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I. OVERVIEW
Corporate Governance of Public Enterprises: The Comparative Experience

Dominique Pannier and Salvatore Schiavo-Campo

This volume reviews the general issue of corporate governance of public enterprises (PEs), i.e., the framework for management and control, with particular reference to transitional economies in Eastern Europe and the former USSR. In these economies, where the former structure of direct state controls on PEs collapsed but where indirect and market-based mechanisms are nascent, improving corporate governance is essential.

In these economies, the basic direction of reform has been to privatize quickly and broadly. In doing so, policy makers overlooked the problems of the PEs that would remain in government hands, for four reasons. First, there was an expectation that most enterprises would be privatized quickly. Second, the importance of improved PE performance for the implementation of the reform process was not well understood. Third, when it was recognized that PEs would continue to remain a substantial and important part of the economy, the state lacked the capacity to foster better performance by PEs. Finally, it was often considered that attention to better management of public enterprises would weaken the privatization effort. A comprehensive governance policy for PEs has rarely been adopted.

A number of enterprises will remain in public hands in the long run (the "residual" public sector). The actual content of the residual public sector varies between countries, and is expected in any case to shrink over time. (Currently, the residual public sector includes some utilities, so-called strategic industries and some natural resource-based industries.) Other enterprises, although slated for privatization, will still be in the public domain for years to come, because of the complexity of the process. Typical cases are the coal and metal producers which underpin the economy of entire towns or regions. This volume covers the corporate governance of PEs which will remain in public hands for the foreseeable future. Public enterprises which are to be privatized in short order, those in the financial sector and the issues of state minority shareholding are not covered here. Minority private shareholding in PEs is rare in the transitional economies.

In order to provide a summary useful to readers unfamiliar with the issues, this first chapter compares across countries the
key elements of corporate governance and includes some fairly basic considerations, well known to specialists in this area. The second chapter consists of five case studies: Hungary, Poland, Romania, Russia and Ukraine. (It must be noted that the situation is continuously evolving in many countries; by and large, the material presented in this volume was current as of November 1995.) The final chapter provides illustrations from the experience of developed market economies, especially in the utilities and declining sectors.

Public Enterprise Reform: The Context of Corporate Governance

PE reform comprises both "internal" and "external" measures. While corporate governance consists of "internal" reforms that directly affect the management and control of assets, for the sake of completeness, we summarize below very briefly the role of the "external" measures. The key consideration here is that improvements in corporate governance are an essential complement to external reform measures, and a part of PE reform rather than a substitute for it.

Privatization

By privatizing public enterprises, economies can gain in many ways: reduced political influence on the management of the enterprise, transfer of risk to the private owners providing powerful incentives for efficiency gains, reduced wastage, etc.¹

Competition

Competition not only compels better performance but also enables an assessment of the enterprise's efficiency relative to competitors.

Hard Budgets

This has been one of the most difficult issues to tackle in the transitional economies. Enterprise restructuring programs have often stalled because PEs have had access to subsidies and privileges, have been permitted to accumulate tax arrears, or have obtained other soft financing that enabled them to survive without improving efficiency. Recent successful reforms in this area have aimed at eliminating, or at least lowering, subsidies and transfers, particularly operating subsidies. The Central European countries in particular have taken important steps toward the imposition of hard budget constraints. For example, budgetary subsidies to SOEs were sharply reduced in Poland after 1990 and in the Czech Republic after 1991, and both countries (as well as Russia) have moved to curb access to soft credits.

Financial Sector Reforms

Hard budget constraints cannot be implemented unless banks stop providing subsidized credit or automatic rollovers.

¹ See the bibliography for references to divestiture and the other external measures.
Financial sector reforms in the transitional economies have included improving supervision and regulation, reducing directed-credit programs and direct government control over financial intermediaries, reducing interest rate controls, and similar measures designed to strengthen the capacity of the financial system to allocate capital on an economic basis.

Restructuring

Downsizing loss-making enterprises and restoring their viability is an important part of any sound PE reform program. This is a complex task, particularly concerning the need to partition the social assets from the commercial assets. Generally, the following measures have helped:

- hiving off competitive businesses from the public goods core;
- privatizing and spinning off functions not central to operations (such as construction and equipment subsidiaries);
- separating the policy and regulatory functions from operational functions; and
- breaking up monopolies into smaller competing units.

Elements of Corporate Governance of PEs

As noted, "internal" improvements in corporate governance are an essential part of the PE reform process and an adjunct to the "external" reform measures. The principal dimensions of corporate governance reform, discussed below, are the process of corporatization; selection of an agent to represent the state; management improvements; the role of board of directors; and performance and management contracts. Each section contains a list of concrete conclusions. Many of these conclusions rest on various considerations and experiences additional to those summarized in the section in question.

Corporate governance is an enabling condition that can reinforce the external reform measures summarized above. It helps enforce financial discipline; enables the injection of transparent rules and procedures instead of direct and personal interventions; and protects public assets from undue "appropriation" by insiders. Spontaneous "appropriations" of state assets by groups often dominated by the former nomenklatura generate resentment which reduces the credibility of the entire reform process. Improved corporate governance is particularly important in the transitional economies because other measures that provide checks on the behavior of managers, such as rating companies, brokers, financial investors that assess the performance of enterprises, and the capital market are yet to develop.

Better corporate governance involves strengthening or developing institutions, enacting regulations, building administrative and monitoring capacity, and political support. All of these actions require efforts and direct costs. Good sense and the overwhelming weight of evidence indicate that these costs are justified.
Corporatization

The General Issue

In transitional economies, the state has inherited a situation where the distinction between the roles of owner (principal) and manager (agent) was blurred, and this has contributed in large measure to the poor performance of PEs. Therefore, separating the identity of the owner from the agent — corporatization — is the first step in improving corporate governance arrangements.

"Corporatization" is the setting up of an independent legal entity for the enterprise, separate from the identity of the state as owner. Corporatization usually involves commercialization of activities so that public enterprise operations are governed by commercial law like private enterprises. (Nevertheless, in many transitional economies, PEs are exempted from commercial law.) Generally in transition economies, "joint-stock companies" have emerged as a common form of corporate organization.

Both developed and transitional economy experience show that corporatization carries important benefits. In virtually all cases, the net result of the corporatization is an increase — sometimes very large — in the efficiency of allocation and utilization of the country's economic resources. In the developed market-economy countries, corporatization of public enterprises has been a major step in improving corporate governance, as shown in the cases of the Canadian Railways, British Steel and New Zealand described in Chapter III. In Germany, for example, the railways which were historically managed by a federal authority were transformed by Government in 1994 into a company, Deutsche Bahn AG, which operates under normal corporation law (although the state remains the only shareholder). The change has reduced the financial burden of the railways on the federal budget. In France, telecommunications were run by the General Directorate of Telecommunications in the Ministry of Post and Telecommunications (PTT). The directorate was transformed in July 1990 from an administrative department within a ministry into a public, corporatized quasi-company functioning in a competitive environment — France Telecom — with the financial autonomy essential to adjust to changing economic conditions.

For the transitional economies, where the corporation as an ownership and management structure is quite new, corporatization of state enterprises offers even greater benefits. First, it can help clarify the ownership of enterprises, establish clear title, and sort out the web of relationships among enterprises, their subsidiaries and ministries — a necessary first step toward hardening the budget constraints. Clear title also gives the owner power to dispose of assets, and initiate partial or full privatization. As such, corporatization has often been used as a first step toward privatization.

Furthermore, corporatization provides different sets of opportunities in different countries. In countries like Hungary, where during the socialist period the state ceded many of its rights over the enterprises to insiders, corporatization is being used to regain control from enterprise managers, while in the former Czechoslovakia, where the state managed during the socialist period to retain direct control, corporatization is being used to provide enhanced autonomy and to define responsibilities for the management of enterprises.
Country Experiences

As noted, and to be discussed in detail in Chapter II, the first step in transitional economies was to quickly corporatize public enterprises. This, in turn, was supposed to encourage privatization and the participation of foreign investors. In most cases, corporatization has involved the creation of incorporated companies. Exceptions include the creation of bifurcated systems of incorporated companies and non-commercial entities, called régies autonomes (autonomous holdings) in Romania and kazenny in Russia.

In Poland, in late 1990, the Government embarked on a comprehensive corporatization and privatization program. The Privatization Law of July 1990 created the Ministry of Privatization (MOP) to represent the state treasury in exercising ownership. The MOP was responsible for transforming state enterprises into commercialized enterprises. In the newly established joint-stock companies, all shares were taken over by the state treasury. This method, called capital privatization, was aimed at large and viable enterprises, henceforth submitted to commercial law, for which the Commercial Code of 1934 was revived. Corporatization in Poland was essentially viewed as a means for improving corporate governance before privatization and to address the problem of "spontaneous privatization." The virtual veto power given by the law to the employees was overcome by tax savings and other incentives offered by the government. And so, despite its other benefits, corporatization in Poland resulted in practice in softening the budget constraint of the PEs.

Hungarian PEs operate within a fairly comprehensive, market-oriented legal framework, including the Insolvency Act and the 1988 Business Enterprises Act that regulate the formation and operation of most business entities. In Hungary, the passage of the 1988 law resulted in a wave of manager-initiated restructuring of enterprise assets. That law gave managers the right to reorganize all or part of their enterprise into a limited liability company. As a result, managers often transferred the best of the enterprise assets into commercial companies and proceeded to distribute shares in these companies. State officials lost control of the process and were unable to keep track of the ownership structures put in place by the managers. In March 1990, the Hungarian government created the State Property Agency (AVU) to put a stop to this chaotic period of company creation and share shuffling. AVU took control of about 1,900 of the roughly 2,000 medium and large PEs; the rest remained with the sector ministries and municipalities. By end 1995, almost all enterprises in which the state retains a share have been corporatized.

In Romania, the process of enterprise reform started in 1990, soon after the revolution. By mid-1991, the corporatization of state-owned enterprises was complete, resulting in two types of enterprises: the régies autonomes (RAs), which are natural monopolies or public services deemed essential for national security and welfare, and the commercial companies, which were supposed to be privatized. While the new Company Law provides a regulatory framework for the establishment, management and liquidation of commercial companies, it is not applicable to the RAs. As of August 1994, there were about 400 RAs. Of these, it is expected that 44 RAs of national importance will remain under direct central state supervision, while supervision over the remaining RAs is being devolved to local authorities. While all RAs are assumed to remain in the public
sector, their commercial activities are being spun off into commercial companies. Some 6,300 commercial companies were incorporated in 1990-91 and are now slated for privatization.

In Russia, enterprises in which the state retains a stake fall into two main categories: corporatized and non-corporatized. The former consists of joint-stock companies wholly-owned by the state, as well as corporations in which the state retains majority shareholding or a controlling right (golden share). In the latter, enterprises are mostly controlled by line ministries. In addition, a new legal form, the kazenny, or "governmental plant," has been introduced for a restricted range of the non-corporatized sector. The kazenny maintains the old governance pattern of multiple principals and thus provides openings for management to resist privatization, sidestep supervision and avoid a hard budget constraint.

**Overcoming Resistance**

It is often thought that resistance to corporatization, particularly by workers, is a major stumbling block. In practice, experience from developed market-economy countries suggests that internal resistance to corporatization can be overcome by appropriate "change management." The New Zealand case, for example, shows the importance of direct and open communication with workers. Prior to every corporatization, company management invariably warned the government of anticipated resistance from unions. The resistance, however, never materialized because the government effectively communicated to workers the reasons and benefits of the corporatization process. In the case of the corporatization of the New Zealand railways, the Minister of State-Owned Enterprises wrote directly to every railway worker. In addition, the Railways offered generous redundancy payments to surplus workers — 90% of whom accepted voluntary redundancy. These high redundancy payments overcame the resistance of workers' councils; and once the workers themselves favored corporatization, the union's opposition ended. In fact, in every single case, it was opposition by senior management which proved to be the biggest barrier to corporatization.

Similarly, the changes in the French telecommunication industry were at first perceived as a veritable cultural revolution. In view of the very close links between the French postal service and France Telecom, it appeared impossible to change the status of France Telecom without affecting the postal service. Reform of this sector, therefore, included not only the 150,000 employees in telecommunications but a total of 500,000 civil servants. Thus, it was necessary to bring the public, customers and employees together to discuss the problems of the sector as a whole and to consider future directions. A wide-ranging internal and external debate took place within France Telecom and society at large regarding the future of the postal and telecommunications services. Negotiations took place with the unions, an intensive public information campaign was implemented, and corporatization plans were modified to incorporate the ideas expressed. Ultimately, the process resulted in the creation of a state-owned quasi-corporation, and the modification of the regulatory framework.

In the case of the transitional economies, another major difficulty has been the reluctance of the sector ministries. Since the enterprises were considered as an appendage of the ministry, it has been difficult to make the ministries accept corporatization, with an indirect accountability relationship and protection
from interference, because of loss of power and influence over the enterprises. The adoption of hybrid approaches to corporatization such as the kazenny or the régies autonomes, is a manifestation of that resistance. To ensure smooth implementation of the corporatization process, sector ministries with a vested interest in blocking corporatization have either been removed from the process (as in Ukraine), or the process has been managed by an independent body (as in Hungary). In Ukraine, at first, corporatization was top-down and initiated by the sector ministries. Since the ministries were also the founders of the joint-stock companies, they could easily block or delay the process. Recognizing this problem, a November 1994 decree abolished the Ministry of Economy's corporatization program and entirely removed sector ministries from the corporatization process.

Conclusions

The experience reviewed in Chapters II and III suggests, among other things, that the following measures can help ensure the benefits of corporatization:

- submit the enterprise to commercial law. Submission to commercial law will underline the business orientation of PEs. Commercial law should include provisions on bankruptcy where possible. The threat of bankruptcy will send the right signal to PEs, implying that the government will not automatically bail them out;

- establish one corporate form. Governments should avoid hybrid solutions such as the kazenny, which undermine the key objective of corporatization of distancing the enterprise from political influence.

Also, governments should avoid sector-specific schemes; corporatize all enterprises or commercial undertakings that remain in state hand; and set mandatory guidelines for the way corporatization is prepared by the enterprises; and

- ensure open communication and credibility. Disseminate information about corporatization and its benefits, particularly to the employees. Monitor closely reluctant enterprise managers, forcing them to join the process or to resign.

Selection of an Agent to Represent the State

Establishing appropriate oversight has been difficult for four reasons: (i) the end result of corporatization was meant to be quick privatization; (ii) the credibility and authority of the state was low; (iii) former branch ministries have sought to keep their influence over the enterprises; (iv) lack of experience in corporate legislation. These are the main reasons for the hesitancy observed in the transitional countries, and explain the unclear mandate and overlapping responsibilities of the agencies in charge of state property.

The General Issue

The state has basically two roles with regard to PE, as "sovereign" and as "owner." In its "sovereign" role the state has the same rights and obligations with respect to PEs as it has vis-a-vis private enterprises. For example, monetary and tax policies are equally applicable to public and private enterprises. However, as "owner," the government also has to ensure that society's welfare is maximized from the investment and operations of the PEs. When the PE
Corporate Governance of Public Enterprises: The Comparative Experience

takes the legal form of a corporation, the functions of the state as owner are similar to those exercised by shareholders acting collectively. The main choice that governments have faced in exercising their ownership rights has been between a public organization and a private arrangement such as a management contract.

Country Experiences

Most transitional economies have opted for a public semi-autonomous agency to represent the state.

Until 1995, Hungary experienced the coexistence of two organizations, a public agency and a holding company. The rationale was to have one organization to hold the shares of companies to be privatized, and a separate organization to manage the enterprises in which the state wanted to retain full or partial ownership. This division of responsibility failed, due largely to the successive expansion of the overbroad definition of residual public sector ("enterprises with economic-strategic, national economy or other important interest"). The privatization law of May 1995 reduced the minimum public participation from 50% to 25%, and merged the two organizations. Accordingly, the focus of the unified agency has shifted towards privatization, and the divestiture of assets now takes priority over conservation of assets.

In the case of Romania, due to the fact that two types of public enterprises have been created (commercial companies and régies autonomes), a proliferation of institutions with oversight responsibilities has emerged. Régies autonomes of "national interest" are directly overseen by the relevant sector ministry, but other ministries are also involved, in particular the ministry of finance, blurring lines of accountability. Commercial companies still in public hands are 70% owned by the State Ownership Fund, established as a public body in 1992. This fund is required to divest itself of its holdings over seven years. To prevent a concentration of ownership and encourage privatization, the remaining 30% has been divided among five private ownership funds established as private organizations.

Some similarities are noticeable in the Russian case, where non-corporatized enterprises, including kazennys, are placed under the authority of the relevant sector ministry. By contrast, the Russian Federal State Property Committee (GKI) holds the enterprise shares, both those which are to be sold and those which are to remain in public hands. Although the GKI has a pivotal role in privatization as well as in managing public enterprise assets, its powers are limited in the latter case by the competing responsibilities of sector ministries. For example, GKI approves the standard charter of state-owned enterprises and the model contract with enterprise managers. However, specific charters and managerial contracts are approved by sector ministries which are also responsible for appointment and dismissal of managers. In the case of minority state shareholding, another agency, the State Property Fund, acts as the owner. If a federal state-owned enterprise is considered insolvent, state representation is transferred to the Federal Bankruptcy Agency.

The most significant innovation in this field occurred in 1995. Through a September decree, a loan-equity swap undertaken to reduce the Russian federal budget deficit authorized banks and local and foreign investors to manage state shares in certain enterprises in exchange for major loans to the state. This measure allows the state to retain ownership of the shares. However, ownership of the shares will be
transferred to the banks and the investors if the state defaults on the loans. The right to manage the shares is to be allocated by tender and the amount of the loans and the conditions and guarantees are to be determined by the successful bidders.

In Poland, a centralized unified scheme was created in 1990, when the newly established Ministry of Privatization took over the representation of the State Treasury (the legal owner). Since then, the Ministry has experienced difficulties in asserting authority over enterprise managers who have taken advantage of the persistent involvement of numerous government departments. Thus, in 1994, the Ministry of Privatization proposed a draft law creating a new agency, the Treasury, in order to distinguish regulatory functions from "operational" ownership functions. The Ministry would retain its regulatory and policy role. The Treasury would implement government policy concerning management of public enterprise assets, as well as the transfer of ownership to private investors. The operational arm of the Treasury would be the specialized regional agencies which would manage assets on behalf of the State Treasury, and directly supervise state owned enterprises. These regional agencies would have a board and a supervisory council.

Experiences in Romania, Russia, Ukraine and elsewhere have proven that the main reason for opposing a uniform organizational arrangement has been the attempt to maintain old patterns of personal relationships with sector ministries. Among market-economy countries, New Zealand tried giving the exercise of ownership rights to ministries. However, this was a failure for two main reasons. First, the enterprises in effect captured the monitoring agency. For example, the Ministry of Civil Aviation routinely supported Air New Zealand's expansion plans. Second, there was a shortage of business skills in the government and thus effective control was diluted. In response, the government set up a single asset-management agency that was close to, but separate from, the Treasury. The agency concentrated on the shareholders' role, and hired staff with business skills who learned to identify early signs of failure. Because the agency monitors many enterprises, it is able to take a national overview of all the corporations, and has so far been very successful.

The Holding Company Alternative: Small Benefits and Large Drawbacks

Although envisaged by some countries like Ukraine, Russia and Kazakhstan (see below), the transitional economies have so far avoided the holding company scheme. The model of Austria in the 1970s is the reference for the holding company. It consists of creating a corporation to hold the state's shares in public enterprises and manage the enterprises. The goals of the Austrian government were to:

- distance state-owned enterprises from politics and increase continuity;
- establish a financial rationale;
- insure greater professionalism, and
- improve the controlling system.

Among transitional economies, Kazakhstan has followed the holding company route on a large scale. On the basis of June 1992 legislation, the government created 83 state holding companies between September 1993 and June 1994. These holding companies in turn controlled 1,573 enterprises, most of them sector-based and created from existing structures such as branch ministries.
The holding companies were intended to address two major governance problems. First, they were intended to control perceived abuses by directors of state enterprises, who in 1991 had been given the right to sell, lease and transfer assets of their companies. Second, they were intended to be an intermediate layer between the government and the state enterprises, thus reducing operational interface with ministries. However, in practice, the holding companies themselves were not subject to effective governance by the state, resulting in lack of accountability.

Supervisory boards did exist in most cases, but were composed of employees from governmental agencies and had little impact on the management. Ministerial interference in enterprises continued, as the holding companies executives were mostly former ministry officials, and the line ministries used their allies on the boards of enterprises to interfere with operations. The holding companies did not govern the subsidiary companies on the basis of market criteria. Rather, their activities centered on controlling competition, and obtaining capital and production inputs. Holding companies were often used for providing cross-subsidies to enterprises that would otherwise fail. The law has stipulated, that state holding companies are to be transitional structures (indeed, the privatization in 1994 included many subsidiaries of holding companies). However, there are pressures from various stakeholders to prolong their existence.

In a variant of the holding company model, in the Russian coal sector, a state-owned company (ROSUGOL) has been established to manage state shares in coal mines and former production associations. But ROSUGOL also carries out various other activities such as consulting, diversifying in other economic sectors and distributing subsidies. It is doubtful whether combining the governance function, financial and commercial activities within the same entity will promote efficient downsizing.

The holding company does not generally appear to be a satisfactory model for the organization of state assets management, and certainly not in transitional economies, where those responsible for protecting the autonomy of the enterprises are closely related to the sector ministries that used to own the enterprises. Furthermore, once created, holding companies become very difficult to disband. International experience points to the longevity of both the holding companies and their subsidiary enterprises, due to their capacity to bargain and sustain the flow of government subsidies. The best known example is the Italian state holding company, IRI. IRI had the statutory obligation to dismantle itself within five years of its start in 1948. This statutory obligation did not prevent it from becoming one of the largest industrial conglomerates in Italy over the next 40 years.

**Conclusions**

The following conclusions emerge from transitional economy experiences and the practice in developed market economies. Governments should "invest" in a central public agency mandated to manage state's residual ownership. This agency would serve as the government's operational arm and specifically would:

- be responsible for the oversight of every public enterprise;
- not take the form of a holding company. However, it may be feasible to create holding structures for managing decline in specific sectors for a limited time with appropriate
accountability safeguards and an irrevocable sunset clause (following the German example of the Treuhandstalt);

- delegate as many operational tasks as feasible to private contractors or specialized entities;

- not be in charge of regulatory activities in order to avoid conflicts of interest. The regulatory function should be vested in separate agencies;

- preferably be separate from the department which decides upon financial transfers to public enterprises (e.g. Treasury or Ministry of Finance), although it must develop a close relationship with that department.

**Improving Management of PEs**

**The General Issue**

For PEs, survival in the transition and success in an emerging market economy will largely be determined by how well and fast the enterprises adapt to changing conditions. In turn, how well they adapt will depend greatly on the skills of top managers. While some managers are indeed making the changes required to pursue new business opportunities, many others are content to hold on to their positions.

The increased autonomy acquired by managers of former socialist public enterprises, coupled with lack of market indicators or enforced accounting standards to measure enterprise outcomes, makes it extremely difficult to judge their performance.

There are essentially four non-exclusive ways in which to improve the management of PEs: (i) retrain existing managers; (ii) increase the stock of managers; (iii) improve selection from existing managers; (iv) evaluate and reward or penalize accordingly. Human resource development and training issues are outside the scope of this volume. We focus below on the latter two issues: selection and performance evaluation.

**Selection of Managers**

In selecting managers there are three common problems: (i) entrenched relationships leading to bias in selection; (ii) lack of objective performance measurement; and (iii) opaque selection processes. It is essential to note that in all countries governments exert substantial influence in the appointment or removal of managers of PEs. In the UK, for example, the Minister of Industry was directly responsible for appointing the chief executive and executive directors of British Steel, before its privatization. In France, the government "de facto" appoints the chief executives of Gas of France and Electricity of France, by requiring Board members to vote for a particular chief executive officer. While the governments should and will have some say in the selection process, it is clear that the more transparent and objective the process, the better are the chances of matching managers with the requirements of the enterprise.

One way to distance the government from the enterprise and thereby "loosen" the links between governments and managers is to create boards of directors and have the boards select the managers (the role of boards of directors is discussed next). Arrangements vary. For example, in Austria, the minister nominates the supervisory board and participates in the selection of the state holding company
management. In Canada, the supervisory boards of the Federal State Holding Company are nominated by the ministries or by Parliament, and participate in the selection of the holding company management which is appointed by the cabinet. A better example of distancing the government from the enterprise is Germany, where the management of most public enterprises is selected by the board, which is appointed by the government; the government has the final say only in the case of disputes over appointments or dismissals.

The selection process of managers in PEs has never been fully transparent in Eastern Europe and the former USSR. Governments have recently begun to adopt more "open" procedures. For example, in Hungary, the board of directors is appointed by the Privatization Minister, but the appointments are screened by a Parliamentary Committee, and six out of the eight board members are nominated by Parliamentary groups. Among the ingenious ways to ensure a more open process is the introduction of competition, as has been done in Romania and Poland. In Romania, a law of October 1993 stipulates that, rather than automatically renegotiating contracts with existing managers, contests are to be held to select managers of commercial companies in which the State holds over 50% of share capital. Invitation for applications and the selection criteria are published in leading newspapers. The rules and eligibility criteria have been well defined. Nevertheless, many incumbent managers have found ways to maintain their positions due to their personal connections. In the case of the régies autonomes, the so-called management contracts are more similar to performance contracts: incumbent managers are favored and no formal bidding process occurs in the selection, negotiation and signing of the contract. A good practice is followed in Poland where the managers are selected through a bidding process for commercialized enterprises in sectors open to privatization. Once chosen, managers are required to restructure the enterprise to prepare for privatization, and to add value to the firm. They receive fees and a percentage of the value added to the enterprise. This ensures that only capable managers are chosen, who can take on the role of restructuring enterprises with a view to foster privatization.

**Performance Evaluation and Incentives**

In tackling the issue of performance of managers three areas need to be addressed: (i) performance evaluation; (ii) performance information; and (iii) performance incentive systems.

Until recently, performance evaluation systems were largely non-existent in transitional economies. The lack of objective measures of management performance meant, obviously, that many non-performing managers were overlooked and outstanding ones were unrewarded.

Performance information is standard in most developed countries, and reduces the information asymmetry that exists between insiders and outsiders. Without information performance measurement is baseless. Managers are informed of the criteria by which they will be evaluated at periodic intervals, either explicitly or implicitly. Sometimes norms dictate what kind of performance is expected without explicit agreement. Performance evaluation systems are now beginning to add to the quantitative aspects some qualitative aspects of performance such as employee satisfaction, customer satisfaction, delivery time, etc. In the transitional economies, both the qualitative and quantitative aspects of performance evaluation have yet to be
Box 1: Performance Contracts in China

China was the first transitional economy to introduce performance contracts. Beginning in 1987, a variety of contracts were introduced under the "Contract Responsibility System," all of which gave managers of industrial public enterprises greater control over enterprise operations in return for meeting profit remittance targets. Many contracts also gave the public enterprises greater autonomy over sales and permitted managers to grant employee bonuses and hire contract workers. In 1992 a government directive stipulated that contracts could grant managers additional autonomy, including the rights to make production decisions, determine prices for outputs and inputs, purchase goods and materials, make investment decisions, hire workers, and determine wages and bonuses.

Assessing the extent to which these contracts have improved performance is difficult. In general, enterprise performance improved, but increasing competition from the non-state sector may have been the essential factor. Performance contracts in China, moreover, while providing incentives for good performance failed to penalize bad performance.

Included in the information systems and procedures need to be developed that will allow the flow of information throughout the organization and to outsiders.

In performance setting exercises, the targets and who sets the targets are both important. If targets are "soft" they will defeat the purpose of an evaluation system. Similarly, if the targets are set by sector ministries with a paternalistic approach, they are unlikely to be optimal. In Russia, where until 1994 relations between the heads of non-corporatized PEs and the sectoral governing agencies were regulated by labor contracts, bonuses were given on the basis of performance indicators almost identical to those used under the socialist system. A presidential decree of July 1994 improved the situation by recognizing the relations with managers under civil law, with contracts allowing directors to share in the enterprise's profits and, conversely, possible replacement of the manager in the event of losses. Similarly, the so-called management contracts being developed in Romania include performance criteria such as turnover, profit, import-export balance, investment, and productivity based on the previous year's financial performance. Although outside the region, the experience of China (see box) is relevant to the transitional economies of Eastern Europe and the former USSR.

In devising an incentive scheme for PE management, the main issues are criteria for enterprise eligibility for the incentive scheme; the categories of personnel that should be covered by the scheme; the nature of incentives to be provided; and the sources of funds. In Pakistan, the enterprises are graded on the basis of the performance agreement, ranging from excellent to poor. Those assessed as "excellent" are entitled to a bonus of three months' wages, progressively decreasing to zero as performance falls to poor. Use should also be made of non-monetary incentives such as recognition by the government, individual upgrading to board level, integration of management in decisions regarding remuneration and publicizing both successes and failures.

In summary, performance improvement will require:

- specifying clear rules and enforcement mechanisms for enterprise performance, through explicit performance or management contracts; developing
transparent and publicized performance evaluation systems; conducting and publicizing regular external comprehensive audits; and acting decisively in the case of failure;

- *contracting public managers on a fixed term*, as has been done recently in Russia, and evaluating their results before renewing their contracts; and

- *improving reporting procedures* by making them part of the objectives set for managers and boards or as part of the performance evaluation. A good example is Romania, where under the management contract the manager has to report quarterly to the shareholders the financial statement and the statement of investments.

**Removal of Non-Performing Managers**

Transitional economies have generally been unable to make significant changes in key management positions until recently. As will be discussed in Chapter II, in Poland, the supervisory boards are too weak; in Russia, many managers of enterprise have functioned as if they were the private owners; in Ukraine, the balance of power between the sector ministries and the management is tilted in favor of the latter; in Hungary, the incumbent managers have taken advantage of the confusion in property rights, to appropriate enterprise assets or strengthen their own positions.

In addition to the obvious need for information on performance, it is important to hold managers accountable for their actions. Once it has been established that managers are not performing, and appropriate cautions (or, where useful, training) have been given, the responsible authority should act decisively. In order to overcome the problem of collusion, three measures can be adopted in transitional economies:

- *Locate the authority for removal in one institution*, preferably the Board of Directors;

- *Distance the government from the managers*, to ensure that the managers are unable to seek support from their "patrons" in the ministries; thus, ministerial officials should not form the majority of the Board;

- *Improve the status of the removal authority* by enhancing the pay and prestige of the positions. In Ukraine, there was an attempt to ensure this situation but in the wrong direction. Resolution no. 47 of January 1993, prohibits salaries of managers from exceeding those of board members, whereas the right approach would be to raise the pay of board members towards that of the managers.

**The Role of Boards of Directors**

**The General Issue**

In both public and private enterprises of market economies, the board of directors (BOD) functions as the intermediary between owners and managers. It is responsible for protecting shareholder investments by ensuring management performance and accountability.

The state as owner is faced with a basic choice. It can delegate the control function to the board, or, if it considers that boards are an imperfect control of full-time managers, it can establish formal control through performance contracts. Combining boards and performance contracts is possible; however, the latter will decrease the authority of the board since the owner
Corporate boards of directors are new institutions in transitional countries. It is important therefore to see how boards have been used as governance instruments in the PE sector.

Country Experiences

Countries such as Germany, Hungary, the Netherlands, Poland and the Ukraine have a two-tiered board structure. In contrast, France, Italy, UK and the régie autonomes in Romania have unitary board structures. In the two-tier system, the supervisory board is typically made up of non-executive members appointed by the owner, while the management board is an executive entity nominated by the supervisory board itself or jointly with the owner. In the unitary system the board comprises both executive and non-executive members. An advantage of the unitary system is its simplicity and clarity, and avoiding conflicts between the two boards, which places managers (or owners) in a position of arbitration. The choice between a unitary or a two-tiered board structure depends on the characteristics of the country and government preferences.

To exercise their functions effectively, all boards have to balance conflicting demands: exercise their legal responsibility without stifling the initiative of the executive; and represent the interests of shareholders, without being intimately involved in the affairs of the company or the internal allocation of responsibilities. The effectiveness of company boards in practice depends not only on their structure, but also on other factors such as the authority given by the owner, personalities of the board members, size of the boards, frequency of meetings, and flow of information between the board and the management. There are no generally valid prescriptions concerning these factors, and practices vary.

A number of different models of board structure and composition have emerged or are still emerging in the region. The widespread adoption of the German model in Eastern Europe is explained largely by the desire to involve workers in company governance because the supervisory board includes members selected by the workers. In Russia, instead, PEs are either noncorporatized and directly overseen by the sector ministry, or joint-stock companies in which the state owns a majority or controlling share. In the latter case, a board of directors is established via a standard joint-stock company charter, and includes the director general of the enterprise, the representatives of the GKI (State Property Management Agency) and the workers' collective and local authorities. The federal government is prohibited from having a majority on the board even when it owns a controlling share.

Under the Polish scheme, most PEs have been corporatized as limited liability joint-stock companies with a two-tiered board. For each, the Ministry of Privatization (MOP) appoints a supervisory board, two-thirds of whom are nominated by the Ministry and one-third by the workers. Board members must pass an oral exam given by the MOP and have a higher education degree. This is an interesting feature of the Polish system which is worth considering in other countries. Reports suggest that these supervisory boards are
still too weak to exercise real control over management, as indicated among other things by the fact that few enterprise directors have been replaced.

Hungary and Ukraine have also adopted two-tiered board systems. In Hungary, corporatized PEs have a board of directors with the traditional responsibilities of a management board, and a supervisory board whose role is primarily advisory. Members of the board are appointed by the shareholders, APV Rt., or the sector ministry in the case of enterprises entirely state-owned. The supervisory board members are appointed by the shareholders and the workers. In Ukraine, enterprises which are at least 75% state-owned must form a supervisory council and a board of directors. The council's membership is jointly approved by the Ministries of Economy and Finance, and may include representatives of these ministries, the State Property Fund, founding agencies, banks serving the company, and employees. The manager of the enterprise is the chairperson of the board of directors. Other members are approved by the supervisory council on the basis of the chairperson's recommendations, and are generally drawn from former State Property Fund executives.

Romania has established two different governance structures for commercial companies and régies autonomes (RAs). Commercial companies have two-tiered board structures, along German lines; whereas RAs have a single board consisting of 7-15 directors appointed by sector ministries and consisting of representatives of the sector ministry, the Ministry of Finance, other sector ministries with an interest in the enterprise, and on occasion, individuals with relevant expertise. The Romanian government has begun to experiment with real management contracts for both commercial companies and RAs in order to increase managerial responsiveness. In commercial companies boards are abolished once management contracts are signed; in RAs the boards continue to function even after the signing of a management contract.

A cursory examination of the way boards function in transitional economies reveals a number of common problems, many of which are typical also of PEs in other parts of the world. The most general issue concerns the difficulty of establishing effective control over enterprise managers.

Other factors contribute to the weakness of board control in transitional countries. First, governance structures are evolving (with the rules in many cases yet to be defined), and capacity is limited. Consequently, managers retain a great deal of leeway within the existing rules, and the need to establish boards for thousands of PEs has taxed the capacity of governments. In Romania, for example, only about 1,100 out of the more than 6,000 public commercial companies had boards of directors almost two years after launching the corporatization program.

Second, there is a lack of experienced board members. The legal framework does little more than provide a board with legitimacy to govern. Its real power depends on the knowledge that directors possess and their ability to work as a team. Many countries in the transitional economies appear to draw PE board members from among current and former government employees. This can be problematic: public employees do not always have the business expertise required and may rely on the PE for political patronage and/or a source of future employment.

Third, in many cases, the public owner does not provide sufficient incentives for
Examples of Board Empowerment in the U.S.

<table>
<thead>
<tr>
<th>Company</th>
<th>Innovation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dayton Hudson Corporation</td>
<td>Requires the outside directors to conduct an annual evaluation of the CEO.</td>
</tr>
<tr>
<td>Medtronic</td>
<td>Solicits opinions on board procedures by requiring all directors to complete a questionnaire; then the full board reviews the results at an annual meeting and tries to make improvements.</td>
</tr>
<tr>
<td>Stanhome</td>
<td>Developed a formal document that specifies the board’s purpose, size, proportion of outside directors, annual calendar, and expectations of directors and management.</td>
</tr>
<tr>
<td>Mallinckrodt</td>
<td>Separated the roles of chair of the board and CEO.</td>
</tr>
<tr>
<td>Lukens</td>
<td>Formed a committee of outside directors to study a major acquisition proposal, hold discussions with management, and recommend action to the full board.</td>
</tr>
<tr>
<td>Campbell Soup Company</td>
<td>Designated a lead director with the title of vice chairman.</td>
</tr>
<tr>
<td>Monsanto</td>
<td>Increased the proportion of the board’s time that would be focused on strategic direction and considered specific capital proposals within that framework.</td>
</tr>
<tr>
<td>General Motors</td>
<td>Developed an explicit set of guidelines that outline how the board will function and be structured.</td>
</tr>
</tbody>
</table>

**Note:** The companies are listed in the chronological order in which they made significant moves toward empowerment. The innovation listed is only one of several changes each board has made. From J. W. Lorsch, "Empowering The Board," Harvard Business Review, January-February 1995.

board members to encourage good performance. In Russia until 1994, for example, there were no provisions to compensate board members for travel and other expenses. Moreover, the State Property Management Agency tried to dictate board members' positions on most issues, which made serving on PE boards very unattractive.

**Conclusions**

The key objective of creating a board of directors is to ensure an arm's-length relationship between the PE and the government. There is no single best way to structure a board. In practice, the situation in many transitional economies suggests that a unitary board is probably preferable. In any event, the following is needed:

- **first, evaluate whether a board is preferable to the alternatives of performance or management contracts, based on three criteria:** (i) the capacity of the government to set up boards with real power and accountability; (ii) the availability of good potential board members and; (iii) the size and nature of the enterprises in question;
• **clarify board objectives.** The by-laws should establish mandatory responsibilities for boards, without any opportunity to delegate. These mandatory responsibilities should include among others: reporting on PE performance, approving budgets, investments, corporate plans, accounts, selecting or firing managers and deciding on compensation for top management. In order to be effective board members must have full access to information about the enterprises.

• **give the board adequate authority;**

• **ensure credibility of the board by paying a great deal of attention to the selection process of board members.** The selection process should produce independent, competent board members representing different constituencies, predominantly from the private sector. In the special case of PEs belonging to declining sectors, bank's or creditor's representatives should form the majority of boards;

• **help boards organize themselves and provide training where lacking.** Effective board-functioning depends also on proper internal division of labor. This may include the creation of committees such as an audit committee, salary review committee (for top management), capital investment committee. Board members may need special training in order to not only understand the company's financial results, but also outside benchmarks;

• **provide adequate incentives and accountability systems.** Board members' remuneration must be competitive with that of enterprises' management. In addition, procedures must be established to review board members' performance.

**Performance and Management Contracts**

Although they are both referred to as "contracts," performance and management contracts respond to different needs and have distinct requirements.

**Performance Contracts**

**The General Issue**

*Performance contracts* are agreements between governments and public managers, whereby the government sets strategic objectives and the managers decide on operational strategy to achieve those objectives. (Performance contract is used here in the generic sense, which includes contract plans, program contracts, performance agreements, memoranda of understanding, signalling systems, statements of intent and public utility licenses.)

The process of developing performance contracts is beneficial in itself: it leads to a dialogue on facts and figures; forces use of a common ground to view the problems of the enterprise; and helps both parties to become familiar with the problems of the enterprises. A performance contract is only an opportunity: it is the proper design of the contract, an incentive system, improvement of information and enforceability which make it an instrument for improving enterprise performance. Since most contracts are indicative rather than prescriptive, the probability of success depends more on the importance both sides attach to delivering on major commitments than on the degree of detail with which their relationship is spelled out in advance.
Country Experiences

In Romania, performance contracts have been prepared in 1993 in collaboration with the World Bank for the régies autonomes. The first 50 of these contracts require all public enterprises to design a system of accountability, and clearly specify the objectives of the state enterprise and the corresponding responsibilities of the government as owner. It is too early to assess their success.

In France, performance contracts introduced in 1970, first with the French National Railway (SNCF) and electricity utility (EDF) have been successful in clarifying responsibilities and establishing a rational framework for the dialogue between owners and management. The contract determines the broad financial goals for productivity, tariffs, debt, profit, and dividends; the main objectives for commercial development and quality policy, international action, investment, and social policy; and provides for a mechanism of contract implementation.

New Zealand has been using a variation of performance contracting since 1986, with much success. The system includes a "statement of corporate intent" for each state-owned corporation, which is redrafted each year to define the goals, targets, and subsidies for any non-commercial goals. Improvements in productivity, profits, customer service and lower prices were dramatic.

South Korea has had perhaps the most successful experience to date with performance contracts. As part of the 1983 reform of public enterprises, contracts were instituted to permit comparative evaluation of the short and long-term performance of all PE's managers. Rewards were linked to performance, as evaluated by independent auditors. Performance indicators are used to measure results against the trend as well as agreed upon targets. Set annually, 70% of the indicators are quantitative, and include profitability and productivity, as well as sector-specific indicators. Qualitative indicators include corporate strategy, research and development, improvements in management information, and internal control systems. Indicators are combined into a single "public profitability measure" using a weighted average of performance with respect to each indicator.

Conclusions

Performance contracts are not a panacea for the problems of the public sector, and the experience of countries that have successfully executed performance contracts shows that:

- performance contracts should be used selectively, and only when there is a clear commitment on the part of government to redefine the relationship with the firm through a multi-year contract;

- when designing the contract, it is crucial that the information upon which the performance targets of the enterprise are set is made available to both parties;

- a permanent, credible, independent and small oversight body should be established, to act as an arbiter and conflict-resolution mechanism. Its assessments should be public;

- the contract should specify as objective a set of measures of enterprise performance as possible;
Box 2: **Drafting Performance Contracts with State Enterprises: An Illustration**

At the beginning of the year the enterprise signs a performance agreement stipulating the following targets:

<table>
<thead>
<tr>
<th><strong>Performance Agreement Targets</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Criterion</td>
</tr>
<tr>
<td>-----------</td>
</tr>
<tr>
<td>1. Gross Profit</td>
</tr>
<tr>
<td>2. Exports</td>
</tr>
<tr>
<td>3. Project Implementation</td>
</tr>
</tbody>
</table>

At the end of the year the achievements of this enterprise are as follows:

- Gross Profit: 385 million
- Exports: 65 million
- Project Implementation: 6 months

Accordingly, the weighted score is 2.10, as shown below. (Excellent performance would be indicated by a score of 1.0 and poor performance by a score of 5.0.) The weighted result is the key concept of all performance contracts, for it measures the ability of the enterprise to meet its commitments and allows the evaluation of management.

**Calculation of Composite Score**

<table>
<thead>
<tr>
<th><strong>Criterion</strong></th>
<th><strong>Units</strong></th>
<th><strong>Achievement</strong></th>
<th><strong>Raw Score</strong></th>
<th><strong>Weight</strong></th>
<th><strong>Weighted Raw Score</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Profit</td>
<td>million</td>
<td>385</td>
<td>2</td>
<td>.50</td>
<td>1</td>
</tr>
<tr>
<td>Exports</td>
<td>million</td>
<td>65</td>
<td>3</td>
<td>.30</td>
<td>.90</td>
</tr>
<tr>
<td>Project Implementation</td>
<td>months</td>
<td>5</td>
<td>1</td>
<td>.20</td>
<td>.20</td>
</tr>
<tr>
<td><strong>Composite Score</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td><strong>2.10</strong></td>
</tr>
</tbody>
</table>

*Adapted from an actual agreement prepared by Prajapati Trivedi of the World Bank for Thailand.*
• performance indicators should be derived from an agreed 3-5 year plan. These indicators should be made part of the management information system, which will help ensure timely issuance of financial results and audits;

• performance targets should only be adjusted when major factors outside the control of managers change;

• once performance targets have been set, managers should be left free to manage, subject only to general government policies and contractual guidelines. However, the government must be prepared to face the case of failure and act decisively to replace the manager, where needed;

• to the extent possible, employees of PEs should receive a bonus or reward linked to their actual performance, so that personal goals become congruent with organizational goals as defined in the performance contract;

• a small bureau should be created at a central location, responsible for managing the performance contracting system. Preparatory work on strategic planning and contracting should be done by an interministerial task force for which the bureau would serve as a technical secretariat;

• if government capacity is not sufficient or if enforceability of performance contracts is doubtful, governments should consider empowering company boards or using management contracts.

management contracts (MCs) are contractual arrangements between the government and private managers. Consequently, MCs are closer to "external" reform measures and to privatization. The relationship between the government and the private manager can also take the form of a lease (where the government receives a fixed rent), concessions (where the government is responsible for fixed investments) and joint-ventures (where the private manager owns a share). The use of MCs is dependent on their suitability for particular sectors. They are most often used when governments find it particularly costly to manage the enterprise directly; when enterprise technology is not changing rapidly; when output is a homogenous product; or when the supplier has an international reputation to protect and quality is easily compared, as with hotels. Generally, management contracts are most effective in restructuring operations, when an enterprise faces severe managerial difficulties, seeks to regain profitability, wants to rehabilitate a major part of its operations, or when a government wishes to improve the financial performance of a state-owned enterprise before privatizing it.

Country Experiences

A comparative review shows that no government has systematically adopted MCs as an important instrument of public enterprise reform, despite its potential advantages. Some countries, such as
Poland, Romania, Sri Lanka, as well as several African countries, have implemented a number of MCs, but nowhere do MCs cover a large proportion of public enterprises. Two illustrations of management contracts are described for Poland and Romania in Box 3 below.

**Box 3: Management Contracting in Poland and Romania**

In Poland, MCs are used under the Privatization Through Restructuring (PTR) program, which seeks to find a privatization path for those enterprises that appear difficult to sell in their present state or that require some restructuring. The program calls for restructuring and privatization to be carried out by highly qualified management groups. These management groups were invited to bid for one or more of the 27 companies involved in the pilot project of PTR, as well as to submit business plans that outlined the changes needed to prepare a company for privatization. A tender was organized for each company participating in the program, and the management group that submitted the highest bid, along with a viable restructuring plan, was awarded a mandate to negotiate a Management Contract (MC) for the company with the Ministry of Privatization. Each bid reflected the management group's estimate of the value of the company. Under PTR, the contractor's compensation takes three forms: a fixed fee, a success fee (percentage of the cumulative net profit), and an equity fee (percentage of the capital gain upon the sale of at least 51% of the company share).

A key attraction of this program is the relatively low initial capital outlay (as compared with other privatization tracks). Upon signing the MC, each management group is required to pay into the company a sum equivalent to 5% of its bid value. This money is then made available to the company to finance restructuring. As of early 1995, of the 27 enterprises in the PTR, 15 management groups had been selected and four contracts signed.

Like performance contracts, management contracts can be complex and time-consuming to design due to the broad range of issues that must be addressed relating to the precise scope of the manager's role and responsibilities and allocation of authority and control between the owner and manager. The manager is often given powers of hiring and firing, promotion and lay-off; planning and design of capital investments; control of production schedules; procurement and maintenance; and preparation of annual work programs and corresponding budgets. The MC should clearly indicate how in practice the owner's authority is to be exercised (by the board of
directors or by a governmental agency) and enforced. Provision should also be made for compensation, duration of the MC, liability of the manager, personnel issues, and remuneration of technology transfer.

Designing MCs as well as performance contracts requires increasing the availability of information about the enterprise. Such information can be obtained through competitive bidding. In order to maximize the information, the call for tenders should be on a periodic basis. This information system should be part of the reward system for managers.

Conclusions

Successful MCs will require:

- a correct choice of incentives including the use of success fees instead of or alongside fixed fees; minority share in equity for the contracted manager, and tight links between incentives and profit;
- full managerial autonomy;
- emphasis on profit generation;
- an independent, permanent, credible oversight body which can supervise the execution of MCs.
II.

COUNTRY STUDIES

These papers were written by World Bank staff specifically for the World Bank Seminar on Corporate Governance of Public Enterprises in Transitional Economies, held in Prague in October 1994; they were updated as of November 1995. While every effort has been made to ensure their accuracy, the World Bank cannot guarantee that the papers do not contain factual or other inaccuracies.
Summary

Hungary has sought to improve the corporate governance of its state enterprises through the twin strategy of gradual privatization and the reassertion of ownership rights in the residual state sector. Over half of all medium size and large state enterprises have now been privatized. By 1993 the private sector was estimated to be producing about 50% of total GDP, a figure that has risen to 60% in 1994.

Recently, through the Privatization Act of May 9, 1995, the Government has decided to increase private equity participation in the residual public enterprise sector. Logically, it has decided to merge the State Property Agency AVU with the State Holding Company AV Rt to create the State Privatization and Property Management Agency, APV Rt. The new body will be responsible for privatizing firms in its control as soon as possible. Before this, the State Property Agency, AVU, owned more enterprises than the State Holding Company, AV Rt, and the line ministries. The paper focuses on those enterprises in which the state has kept an equity stake. MATAV Rt, the telecommunications company, and MVM Rt, the power company, were owned by AV Rt, while MAV Rt, the railway company, and Magyar Posta Rt, the post office, are (partly or wholly) owned and operated by a ministry.

Most residual state-owned enterprises have been corporatized, although the state's stake in each enterprise varies. Each enterprise has a board of directors and supervisory board. However, responsibility for appointing board members and the chief executive officer varies across enterprises.

In keeping with the thrust of privatization, Hungary is moving towards greater private participation and increasing foreign share ownership in its public enterprises. MATAV Rt was recently partially privatized through the sale of a 30% stake to a foreign consortium, in the largest such sale in Eastern Europe to date. MVM Rt (Electricity Company) is also slated for privatization. Two major loss-making industries, Railways and Coal are being restructured, with a view to improving their management. Many aspects of the Hungarian experience are worth considering, and first of all to increase private equity participation in the residual public enterprise sector. The sophisticated combination of pressure from competition,
sector or enterprise reorganization and creation of corporate governance mechanisms to distanciate public enterprises from politics are of great interest.

Ownership and Management Structure of Public Enterprises

The State Property Agency (known in Hungarian as AVU), was created in March 1990 to assume ownership of most medium-size and large state enterprises. The objective was to transform them into commercial companies and to prepare the privatization process. This agency took over more than 1900 of the roughly 2000 medium-size and large state enterprises and the rest remained with the line ministries and municipalities. The privatization process continued to experience problems and delays during the early part of the agency's existence, although many of these problems have been resolved.

In August 1992, in accordance with the Law on the Management of Enterprise Property, 172 enterprises in which the state wished to retain full or partial ownership were transferred from AVU to the newly created state holding company, AV Rt (originally called the State Asset Management Company). The rest reverted to the line ministries and a few other small state assets to management agencies. Following the August 1992 reallocation of state enterprises portfolio, AV Rt had 46% of the book value of the state portfolio, AVU had 31%, and the line ministries 23%. Enterprises that had to remain state-owned, as a matter of law, were designated in the 1992 Law on the Management and Utilization of Entrepreneurial Assets Permanently Remaining in State Ownership. To be included under the law an enterprise would have to be of "economic-strategic, national economy, or other important interests;" serve "national public service purposes," or be capable of economic operation "only in a unified system." An enterprise may also be included if "preparation of the property ... for sale takes a particularly long time."

However, this structure has changed with the adoption of the Privatization bill of May 1995. The new state agency APV Rt, holds over 90% of total state shareholdings in enterprises. It has the responsibility of divesting at least 50% of the current State equity holdings of AVU and AVRt over the 1995-1997 period. To facilitate this, the new law sharply reduces the previously mandated minimum shareholdings in enterprises.

The new act stipulates that for companies, mainly public services, the state will retain control in the following three ways: (i) ownership share not to be lower than 50+1%, (ii) in exceptional cases, the lowest share that the state can hold to guarantee its ownership will not be less than 25+1% and/or (iii) a share akin to the "golden share," that will guarantee the state's voting priority.

Organization of APV Rt

The Privatization Act of May 1995 merges the AV Rt and the State Property Agency (AVU), into a single State Property Agency, the APV Rt. The shareholder's rights in APV Rt are exercised by the Minister in charge of Privatization. The company is governed by eleven members of the Board of Directors, appointed for a period of not more than three years. The Board of Directors will be appointed and relieved by the Government. The Privatization Minister, in consultation with the Finance Minister, shall make recommendations for appointing the Directors, whose appointments will be screened by a Parliamentary Committee.
Box 4: AV Rt's Structure and Function

With the passage of the Privatization bill in June 1995, AV Rt will cease to exist, its name will be transformed to APV Rt and will be merged with AVU. Until this transformation, AV Rt was the agency primarily responsible for monitoring the enterprises in which the state retained a majority stake. AV Rt's stated objectives were to privatize the companies it holds to the fullest extent allowed by law; to maximize the value of the assets in order to preserve certain (undefined) strategic activities; and to pay a dividend to its owner, the Hungarian state. AV Rt's income was derived partly from the privatization of companies in its portfolio and partly from borrowing internationally. AV Rt's goal was not to maximize its short-term revenue, but to improve the long-run prospects of the companies in its portfolio and thus of the state budget. It owned between 95 and 100% of the shares of about two-thirds of the enterprises in its portfolio, although this proportion was to decrease over time. Foreign investors owned about 5.7% of AV Rt's total assets. Domestic investors were being encouraged through a number of plans, such as employee share ownership plans and the small investor share purchase plan.

AV Rt was managed by an eleven-member board that was recommended by the privatization minister and appointed by the prime minister. Members served for four years and a minimum of three members would also be on the staff of AV Rt. The chairman of the board was also the Chief Executive Officer. Five larger directorates had been established for asset-management, sales, financial affairs, legal affairs, and administration. AV Rt employed about 170 people.

According to AV Rt, primary responsibility for the day-to-day management of enterprises in its portfolio rested with the boards of the constituent corporations. The extent of AV Rt's involvement in a company was defined by its share in the company and by the company's importance. For critically important companies, AV Rt was represented on the company's board. In addition, AV Rt nominated other board members, usually in proportion to its ownership share. There were plans to create review boards to identify suitable candidates for company boards. Each review board would include a recognized industry authority, local representatives, and the AV Rt portfolio manager. Their nominations would be subject to approval by the AV Rt board.

In addition, AV Rt monitored these enterprises' activities by reviewing acquisitions and divestitures and requiring feasibility studies for all major investments. It used risk-analysis to assess investment decisions. AV Rt's Controller's Department analyzed financial reports and market indicators on a monthly basis. The system of accounting control covered AV Rt's entire portfolio and was intended to assist in making management decisions, including asset management and privatization strategy. AV Rt also offered management training to its enterprises.

The operation of APV Rt will be supervised by a Supervisory Board consisting of eleven members. The Chairman and the members of the Supervisory Board are appointed for at least three years. The chairman of the Supervisory Board will be appointed and or recalled in accordance with the recommendation of the State Audit Office. Six of the supervisory board members will be nominated by Parliamentary groups. One member of the Supervisory Board will be appointed by the employers, and one by the workers.

The day-to-day working of the organization will be the responsibility of the director general, acting as an employee of the Company.

Corporatization and Deregulation

Short of outright sale, Hungary has experimented with a number of other ways
to involve the private sector in the operation and management of its infrastructure. Almost all enterprises in which the state retains a share, including those previously owned by AV Rt, have been corporatized. Corporations in Hungary operate within a fairly comprehensive, market-oriented legal framework. This includes the 1988 Business Enterprises Act that together with subsequent legislation, stipulates and regulates the formation, organization, and operation of most business entities; the 1988 Foreign Investment Act (as amended); the 1991 Accounting Law; the 1992 Labor Code; the 1992 Insolvency Act; and comprehensive tax legislation. Several of these laws, including the Insolvency Act, also apply to noncorporatized state enterprises.

Most corporatized state enterprises take the form of public limited companies. The Business Enterprises Act requires that public limited companies, designated by the Hungarian abbreviation, Rt, appoint a board of directors of three to eleven members, a supervisory board of at least three members, and a financial auditor. One-third of the supervisory board’s members must be appointed by the workers. The supervisory board has the purely advisory, non-executive role reviewing the company’s budget and ensuring that the company’s activities conform to the legal and regulatory framework. In general, the period of appointment of the supervisory board is determined by the company’s general meeting.

Hungary is also attempting to introduce market discipline into the state sector by deregulating activities such as road transport, contracting out road construction, or proposing the establishment of private, independent power generation projects. In some cases, such as cellular telephone communications, responsibility for competitive activities was given to a joint-venture company formed by a state enterprise and a private investor. Hungary has also employed build-operate-transfer arrangements (or concessions), particularly in transport (road construction) and mining. However, it has rarely used affermage (leasing) or management contracts.

Involving the private sector in the management and operation of state enterprises has brought much-needed pricing discipline to these enterprises, which have traditionally priced their services substantially below economic cost. It has also generated competitive discipline and increased the enterprises’ access to expertise and much-needed finance. MATAV Rt, the Hungarian telecommunications company, is a prime example. In cases where competitive pressures have been considered insufficient to generate a dynamic industry, for example in the energy sector, Hungary has established regulatory systems. These regulatory systems closely resemble those of Germany in that ministries influence regulatory decisions, albeit indirectly, through a regulatory agency under the ministry’s authority.

With the passage of the new privatization bill into law, the government seeks to involve the private sector further in the ownership of state-owned enterprises.

Ownership and Management of Telecommunications, Energy, and Railways

MATAV Rt, the Hungarian Telecommunications Company, and MVM Rt, the Hungarian Power Company, are owned by APV Rt. However, with the new privatization bill, the majority shareholding of MATAV Rt is to be in private hands.

Within the energy sector, there are a number of enterprises that are part-owned
by APV Rt, directly and part-owned by MVM Rt, which is owned by APV Rt. These include seven power plant companies, six distribution companies and a national grid operating company. In each case, MVM Rt owns 50%, APV Rt owns about 48% and the municipalities the balance. Coal mines, which were previously owned by the Ministry of Trade and Industry, are now owned by power stations, which are, in turn, owned by APV Rt, MVM, and the municipalities. Two enterprises are still owned by ministries: MAV Rt, the Hungarian Railway Company and Magyar Posta Rt, the Hungarian Post Company, both of which are owned by the Ministry of Transport, Communications, and Water Management.

Telecommunications and Postal Service

Until 1990, postal services, broadcasting and telecommunications were provided by Hungarian Post. Then in January 1990, Hungarian Post was split into three enterprises including the telecommunications company MATAV and Magyar Post.

Telecommunications

In December 1991, MATAV was converted into a (one-member) joint-stock company. In December 1993, a 30% stake in MATAV Rt was sold to Magyar Com, a Deutsche Telekom-Ameritech consortium. A small number of shares are also owned by the European Bank for Reconstruction and Development and the International Finance Corporation. The Board of Directors has eleven members: seven are appointed by APV Rt and four by Ameritech and Deutsche Telekom. The chairman of the board is elected by the board members and is also the CEO. The board is responsible for approving the annual business plan. MATAV Rt also has a nine-member supervisory board: four appointed by APV Rt, three by MATAV Rt workers, and two by Ameritech and Deutsche Telekom.

The Hungarian government has retained a special "category B" ("golden") preferential share in MATAV Rt, which gives it the right to be represented on the board, to cast the deciding vote at the general meeting, and to veto certain decisions. These include whether to increase or decrease share capital, to change the corporate mission, to appoint and remunerate board members, to accept new international loans, and to decide on mergers and acquisitions. Meanwhile, the government is now keen to divest the remaining state equity in MATAV to about 35% or less.

Although APV Rt retains shareholder control of MATAV Rt, the strategic investors have substantial management control through their pre-eminent position on the operating committee, which manages the day-to-day operations of the company and implements the annual business plan. Two of the four committee members are nominated by APV Rt and two by the investors. In the event of a tie, the casting vote rests with the investors.

The 1992 Telecommunications Law allows for several services, including public telephone service and public mobile radio telephone service, to be granted by concession to a private company or to a state-established agency. The law sets out certain provisions to which the concession must conform. The state's role in the telecommunications sector includes: development of a national policy, regulation of the concession market, economic and technical regulation, and supervision of the
telecommunication networks. Although the regulatory regime includes a special communications authority, the discretion to review price caps (as is the case with power) is vested in a government ministry.

Postal Services

Magyar Posta Rt became a joint stock company on December 31, 1993. It is wholly state-owned. The Ministry of Transport, Communications and Water Management represents the state's interests. It appoints the seven members of the board of directors and six of the nine members of the supervisory board. The remaining three are appointed by the postal workers. The chief executive officer, who was elected chairman by the board of directors, is also appointed by the same minister. Management is appointed by the CEO. Recently, cost-profit centers were established and an annual performance review system was introduced.

Electricity & Gas

In 1992, the state-owned power sector was re-organized into eight generating companies, a national transmission company, and six regional distribution companies, all under the umbrella of MVM Rt. The MVM Rt group has about 39,000 employees: 58% of them in distribution, 40% in power generation, and 2% in administration.

The 1992 restructuring and corporatization of the electricity sector was intended to decentralize the operational decision-making process, by replacing the central planning mechanism with contractual relationships between the generation and distribution subsidiaries, and to improve the efficiency of operations. For example, commercial arrangements for purchases and sales between the generating companies, MVM Rt, and the distribution companies are formalized in annual contracts, replacing the previous system of arbitrary internal pricing.

MVM Rt's new organization and management structure are defined in its articles of association, which were approved by AVU as a founder of MVM Rt. Its board of directors includes representatives from the state (four directors), MVM Rt (one director, the CEO) outside companies (two directors), banks (one director), academic institutions (one director) and Parliament (one director). MVM Rt's supervisory board has six members, two of them appointed by the employees and four by the owner. Supervisory board members serve for a maximum of five years.

Responsibility for preparing price schedules was given to a newly established Energy Office in the Ministry of Industry and Trade in accordance with the April 1994 Act on the Production, Transport and Supply of Electric Energy. Final responsibility for prices, however, rests with the Minister of Industry and Trade. The Energy Office was also given the task of issuing licenses for the production, transmission and distribution of electricity; monitoring standards; and investigating consumer complaints.

As long as it wholly owns the nuclear power station and the transmission system, the government would have the currently mandated minimum share in the electricity sector as a whole. In addition, the government plans to enlist private participation in the power generation sector by allowing independent power generation to proceed and by selling stakes in existing non nuclear plants.

Coal

In 1990 there were about 60,000 people working in the Hungarian coal industry and
all mines were owned by the Ministry of Industry and Trade. Today there are about 18,000 workers, employed primarily in six mines that have come under the control of regional power generating companies owned by MVM Rt. Between 1991 and the year 2000, the share of coal in energy consumption is expected to fall from 22% to 14%, while the shares of oil and gas are expected to rise. Demand for coal is likely to fall because old coal-fired power stations are being replaced by gas-fired units and households are substituting gas for coal. Production of coal is projected to fall by 42% over this period.

Downsizing the Hungarian coal industry was the responsibility of the Coal Mining Restructuring Center, a government body with a staff of five, reporting directly to the Minister of Industry and Trade. The Center was responsible for liquidating coal mines, which at the time belonged to the Ministry of Industry and Trade, and ensuring that landscaping and recultivation were carried out. The Center received funds directly from the government's central budget for these purposes.

All six remaining mines have been corporatized: four have become joint-stock companies and two, limited liability companies. About 25% of the mines’ assets are owned by their creditors, while the rest are shared by MVM Rt (about 37%), APV Rt (about 37%) and local governments (about 1%). APV Rt is effectively the owner and controller of the residual coal sector and is responsible for any privatization.

According to the 1993 Mining Act, regulation of the industry is the primary responsibility of the Minister of Industry and Trade. The Act allows concessions to be granted for periods of up to thirty five years (renewable once) if a concession fee is paid.

**Railways**

MAV Rt is one of the largest loss-makers among Hungary’s state enterprises. To offset these losses, tariffs and government subsidies have been increasing. Moreover, the 1993 Act permits the establishment of private railways. Various subsidiary activities have been partially or majority privatized, including catering services, of which private investors own 85%. Despite this, and despite staff layoffs, MAV Rt’s financial position continues to deteriorate.

MAV Rt was established as a public limited liability company under the July 1993 Railway Act. The government retains complete ownership in MAV Rt, as is legally required (although this requirement may soon change). The Ministry of Transport, Communications, and Water exercises ownership and its duties include overseeing the following:

- Changes in capital structure, mergers and acquisitions, introduction of MAV Rt components into the stock markets, long-term debt contracts, asset sales, and significant financial participation in other companies.
- Appointment, dismissal, and compensation of the CEO, members of the board of directors, and members of the supervisory board.
- Appointment of the financial auditor.

The board of directors has from five to nine members. The first appointment was for two and a half years. The CEO and deputy CEO are automatically members. Other members include a senior official of the Ministry of Transport, two CEOs of other transportation companies, and a university professor. The board of directors controls operations; makes one-year and
long-term plans and investment decisions; handles long-term debt contracts, asset sales, and small-scale financial participation in other companies; prepares balance sheets, profit and loss statements, and an annual company report; and handles international relations.

In addition to the board of directors, MAV Rt has a supervisory board. The supervisory board also has from five to nine members, two-thirds of whom are appointed by the Ministry of Transport, and the rest are elected by the employees. Its members include two Ministry of Transport officials, one Ministry of Finance official, three trade union officials, one senior official from a Hungarian bank, and one business executive. The supervisory board supervises policymaking and other important management decisions, acts as an advisor to the Ministry of Transport on important proposals made by the board of directors, and validates and approves annual financial statements. The CEO is responsible for the management and control of MAV Rt's day-to-day operations, the execution of decisions made by the owner and the board of directors.

Currently there seems to be no active board of directors. Instead the Ministry of Transport has appointed a commissioner to run MAV Rt. A president answers to the commissioner and the CEO answers to the latter.

In addition to the above bodies, a "creditor's committee" advises MAV Rt on financial matters such as loans, investment plans, and liabilities. This ad hoc committee was founded in September 1993 and its members include senior members of major Hungarian banks that lend to MAV Rt.

Lessons and Prospects

Hungary's approach to corporate governance of the residual state sector was shaped initially by the need for the state to regain control of its assets from enterprise managers. To this end AVU, later AV and now APV Rt were established as a means of centralizing the management and privatization of state assets.

Corporatization, the enactment of market-oriented legislation, the existence of a dynamic private sector, together with recent measures deregulating telecommunications, power, and other areas of the infrastructure, have subjected state-owned enterprises to the discipline of market competition. In addition, during its existence AV Rt monitored the performance of the enterprises in its portfolio and played an active role in improving their management, performance and subsequent privatization.
Corporate Governance of Public Enterprises in Transitional Economies

Poland

Marion Leblanc-Wohrer

Summary

From 1989 to 1993, the Polish government emphasized privatization and neglected to address corporate governance in the public sector. Commercialization was viewed as a means to improve enterprise governance while waiting for privatization. Few special ownership control mechanisms were created. Several projects sought to clarify the assignment of responsibilities among government agencies for the ownership of public enterprises were continuously delayed.

Recently, the government has become concerned about the prospect of having to oversee a vastly increased number of commercialized enterprises. The slow rate of privatization has required the Ministry of Privatization to develop workable arrangements to prevent enterprises awaiting privatization from failing. Commercialization is beginning to be viewed not only as a first step to privatization, but also as a means of clarifying management responsibilities for the firms that will remain in the public sector at least for the medium term. To this end, the Ministry of Privatization is pushing for the creation of an independent State Treasury Ministry.

Organization of State-Owned Enterprises

Before 1989, Polish enterprises were organized into socialized and nonsocialized units. Broadly speaking, socialized units included state-owned enterprises, cooperatives, and social organizations (unions, and religious or political groups). Nonsocialized units mainly comprised individual businesses and joint ventures with foreign investors. After 1989 the introduction of new legal organizational structures and new types of mixed ownership blurred this classification. In response, the authorities developed a new classification system based on public or private ownership. This system has been in force since January 1, 1991.

During the 1980s power over state enterprises shifted from the state administration to employees. The demise of communism further reduced the state's powers, making workers councils and general workers assemblies the dominant stakeholders and supervisors of the
enterprises' activities. The rights of these bodies resembled those typically held by the board of directors and the general shareholders meeting in a Western joint stock company. These rights include approval of the enterprise's statutes, long term plans and objectives; annual review of the activities of the enterprise and of the managing director; the power to determine the proportion of profits to be distributed to workers and to review appointments and dismissals of the managing director and other managerial personnel; approval of mergers, transformations and assets.

State enterprises had no effective owner and workers, represented by a workers' council, had the power to oppose personnel changes and restructuring activities. There were no effective incentives to maximize the value of the firm. In short, there was no advocate for capital formation, which led to dissipation of the firm's capital base and wait-and-see attitudes rather than decisive restructuring.

Institutional Framework for Privatization

As part of the Economic Transformation Program, and, to address the issues of "spontaneous governance and spontaneous privatization," the Government embarked in late 1990 on a comprehensive corporatization and privatization program. Following enactment of the Law on privatization of state enterprises in July 1990, the government developed a multitrack approach to privatization that includes: (i) privatization through the dissolution of state enterprises, or "liquidation" (productive assets were sold or leased to new private companies); (ii) capital privatization, under which shares were sold to private investors. Later, mass privatization was envisaged as a one-time transfer of the ownership of selected enterprises to National Investment Funds (NIFs), whose shares would be distributed to private citizens through a voucher scheme.

As a transitional step toward privatization, the government program envisioned a large scale commercialization of state enterprises. Commercialization was viewed as a means to improve enterprise governance before privatization (commercialized enterprises were supposed to be privatized within two years). According to the Privatization Law, a state enterprise can be transformed into a joint-stock or limited liability company fully owned by the state Treasury. When this takes place the state enterprise comes to be governed by the 1934 commercial Code rather than by the 1981 State Owned Enterprises Act. A company created by the transformation of a state enterprise remains wholly owned by the state treasury until its shares are distributed to third parties.

As of December 1993 the public sector included about 5,924 state enterprises and about 527 commercialized state enterprises. The bulk of public enterprises were in industry (about 2,752), and construction (about 988). The remainder operated in the trade and service sectors (about 641). By the end of December 1993, public enterprises accounted for an estimated 60 to 70% of all enterprises' gross sales and 1999 enterprises had been privatized (602 in industry, 624 in construction and 130 in transportation).

Corporate Governance of State-Owned Enterprises

The Privatization Law of July 1990 created the Ministry of Privatization (MOP) to represent the state treasury in exercising ownership over commercialized enterprises. Under this law the Ministry, which defines the company statute on behalf of the state treasury, is responsible for transforming
state enterprises into commercialized enterprises. The enterprise's funds become the company's capital at the time of transition. In the newly established joint-stock company, all shares are taken over by the state treasury represented by the Ministry of Privatization.

The initiative for commercialization may come from a joint motion of the enterprise's managing director and the workers council, from the enterprise's founding body with the support of the enterprise, or from the Council of Ministers with the support of the enterprise. In the last case, the consent of both the managing director and the workers council is still required. In most cases, the Privatization Law ceded the power over the corporatization decision to the enterprise employees. Enterprise commercialization is conditional on enterprises having clarified the legal status of their assets. The ministry has refused commercialization in one quarter of cases. At the end of 1993 there were 527 commercialized enterprises (less than 10%). Most commercialized enterprises are in the industry sector (83%) and are large.

Corporate Governance of Commercialized Enterprises

Commercialization aims to change a firm's corporate governance. When an enterprise's legal status changes, the workers' council is abolished and the MOP appoints a supervisory board. By law, two-thirds of the supervisory board must be nominated by the Minister of Privatization, and one-third must be composed of workers' representatives. The MOP appoints members of supervisory boards on the basis of clearly specified eligibility criteria and represents the state treasury at the annual general meeting. In addition, the ministry can take over a part or all of the company's debt and issue new shares to increase the share capital. The minister is also formally in charge of preparing the firm for privatization.

Supervisory boards usually consist of six persons in the case of a joint-stock company and three in the case of a limited liability company. The MOP appoints two-thirds of the seats. Eligible individuals must be over 25 years old, must have received higher education and pass an exam set by the MOP. In 1993, 3,000 people passed the exam, and 2,000 of them were appointed to board positions. The ministry also provides an intensive 100-hours training program for those wishing to take the exam. The supervisory board convenes once a month to: examine company accounts and reports; suspend, if necessary, Board members; prepare report for the annual general meeting and select and remunerate the Board.

Beyond the training and the stipulations of the commercial code, the MOP does not provide any guidelines about how the supervisory boards should perform their duties. The performance of supervisory boards and the board of directors is assessed annually at the general meeting. Supervisory board members do not participate in these meetings.

Supervisory boards are generally too weak to exercise real control over management, as revealed by the relatively small number of enterprise directors that have been replaced. Furthermore, once board members have been trained and tested, their involvement in managing enterprises is largely unregulated.
Box 5: Commercialization

The notion of commercialization is usually interpreted as simply a change in the legal status of an economic entity from a state-owned enterprise to a company incorporated under commercial law. But commercialization primarily involves the rehabilitation of enterprise's business. This process affects all facets of the enterprise's operations.

The change of legal status should strengthen the owners' supervision over state enterprises; change the organizational and legal structure of the enterprise to adjust to the new market economy; create transparent decision making; generate pressure for market-oriented restructuring and facilitate reorganization or liquidation of enterprises under the commercial law; and force enterprises to settle legal questions, especially regarding ownership of land and buildings.

The Polish commercialization program has been heavily criticized by the press. One criticism concerns the rapid pace of the program. Some doubt that it will be possible to incorporate so many enterprises under commercial law, and for them to begin overnight to operate according to commercial rules. These critics hold that simply granting a new legal status changes very little. Companies that have been commercialized and are still completely owned by the treasury experience considerable problems. Critics are also afraid that commercialization will delay privatization, claiming that, without any clear prospect of privatization political pressures will mount to retain the status quo.

Evidence indicates that insiders, especially management, have maintained their privileged status in many enterprises. As a rule, no significant changes are made in the key management positions of the new companies. Although workers' councils are eliminated when a company is corporatized, workers' representatives on supervisory boards often continue to play an important decision making role. Other informal reports indicate that the supervisory boards are either passive or ignored by insiders.

Management contracts were introduced in an attempt to strengthen the governance of commercialized enterprises. Potential enterprises managers are selected through a bidding process. Once chosen, managers are required to restructure the enterprise to prepare for privatization, and to add value to the firm. They receive fees and a percentage of the value added to the enterprise. About 25 enterprises have signed management contracts.

The MOP intends to commercialize about 1,000 medium-size state firms by 1995. By making the managers of these firms directly accountable to the state treasury, the government is hoping to tip the balance of power away from workers' councils and towards management. The government is also trying to pass legislation that would allow commercialization to take place without the consent of workers' councils.
Box 6: Proposal by the Ministry of Privatization to Create a Ministry of Treasury

The current governance system has been criticized because it combines regulatory and property management functions within the same ministry. This leads to joint formulation in the state budget of proceeds from managing property with proceeds obtained through fiscal policy instruments. In this way state property often finances immediate budget needs. As a result, short-term goals take priority over long-term economic restructuring. The government must create an homogeneous institution to represent the state treasury and perform all the functions concerning its properties. However, such an institution should be created when the state sector is no longer predominant in the economy, and when the economy is relatively stable. Meanwhile, this institution must not be involved with the budget; process which is the task of the MOF.

This analysis led the MOP to propose creating an agency that would differentiate the regulatory and ownership functions, both of which are currently executed by the MOP. The law would create a Ministry of Treasury, as well as Agencies for State Treasury Assets.

Commercialized firms would be directly responsible to the Treasury rather than the ministries or regional authorities. The Treasury would not have to seek approval from firms' management or workers' councils in deciding how firms should develop. The Ministry hopes that clarifying the lines of managerial authority will create an attractive business climate. It also hopes that a clearer ownership structure would strengthen managers' determination to resist demand for excessive wage.

The tasks of the Ministry of Treasury would include implementing state policy concerning managing public assets, transforming property, privatizing state firms, making stipulations for foreign investments and supporting capital market development. The execution of the Ministry's ownership rights would be entrusted to specialized regional agencies, the Agencies for State Treasury Assets (ASTAs). The state treasury would be responsible for establishing the ASTAs; organizing and supervising them. Supervision would include approving purchase and sale of equity; establishing companies; increasing or reducing equity in companies, transferring additional capital to companies; and merging, transforming or liquidating companies.

ASTAs would manage assets and revenues on behalf of the state treasury, supervise state enterprises, execute contracts for the use of assets and the sale of enterprises.

According to the first proposal, an Agency would consist of a three- or five-member Board, a council and an auditing Committee. The Minister of Treasury would appoint the president of the Board. The remaining members would be appointed by the Ministry at the request of the president of the Agency. The council would consist of 5 members appointed by the Ministry, two of the candidates being recommended by the Ministry of Finance and one by the Ministry of Industry and Trade.

The draft law has not yet been enacted as the Polish President opposed in July 1995 his veto to the adopted legislation on commercialization and privatization of state owned firms. Both the law and the veto have been deferred to the Constitutional Court. The decision of the Court did not take place before the November 1995 presidential elections. It is not certain that the final version will resemble the one described here.

Corporate Governance in Specific Sectors

The government identified the sectors over which it wanted to retain some control (majority or golden share) in the medium term. These are the energy, mining, steel, and defense sectors, which include about 300 enterprises and account for about 20% of industrial output. In all other sectors, enterprises are eligible for privatization.
Corporate Governance in the Energy Sector

The energy sector is one of the largest sectors in the Polish economy. It consists of two energy producing subsectors (hard coal and lignite and oil and gas), two energy conversion subsectors (electric power and district heating), and one energy processing subsector (oil refining). Together, they accounted for about 11% of the country's total investments in 1990-92. In 1993 the energy sector accounted for about 8% of GDP and directly employed 4% of the working population.

The energy sector was substantially restructured in October 1987. An act of the Parliament dissolved the Ministry of Mines and Energy and sector responsibility was transferred to a reorganized and downsized Ministry of Industry and Trade (MOIT). At the same time, the hard coal and power sector also were reorganized and further centralized in an effort to reduce administrative overhead. All hard coal mining enterprises were brought under the control of a new state monopoly, the Hard Coal Board. The lignite mines were transferred from the coal to the power sector and were merged into the newly created Power and Lignite Board. The gas sector was not affected since the Polish Oil and Gas Company had already been vertically integrated in 1983. All three centralized entities had a 25-member supervisory council, representing government, employees and consumers. MOIT appointed the general managers.

As part of the World Bank's sector assistance strategy and with the Energy Sector Adjustment loan - Heat Supply Restructuring and Conservation Project, the government set out to implement a comprehensive energy sector restructuring program.

Hard Coal. MOIT was the founding agency in charge of the hard coal state enterprises. In accordance with the February 1993 Law on Privatization of Strategic Industry (coal, power, defense) MOIT became solely responsible for the commercialization of these enterprises in recognition of its experience with the mining industry. But it was not an ideal solution since the Ministry sets policies in the energy sector, and represents the owner (the treasury) of the newly formed joint stock companies. The regulating function will be transferred to an independent agency once the energy law is adopted by the legislature. Among its other duties, this agency would regulate network energy prices.

In 1989, as part of its strategy to improve the performance of the mining industry, reduce cost and improve competition among the mines, the government abolished the Hard Coal Board and created individual mining state-owned companies that were established as legal entities. Sixty coal mines were grouped into seven multi-mine companies, each managing between 7 and 12 mines; seven single-mine companies were also created. The new multi-mine and single-mine companies were established as joint stock companies. Each company has a supervisory board, consisting of three members designated by MOIT, three members chosen by the workers, and three members from outside institutions. The role of the supervisory board, though still evolving, will need to be further defined and reinforced as the companies develop commercial practices. The multi-mine companies also have a board of management, appointed by MOIT and a supervisory board.

In conjunction with the Economic Transformation Program and a major review of the economy, the government placed seven mines on a Government...
closure program in 1990. Subsequent analyses concluded that about 15 mines would have to be closed or merged. However action on this matter progressed slowly. The outline of a full-fledged restructuring program was not prepared until early 1993. The first phase consisted mainly of the reorganization of the sector, and the commercialization and introduction of cost-cutting measures were carried out in 1993. The crucial measures for mine closures and mergers are expected to take place in the second phase during 1994-1995.

The State Hard Coal Agency was created when the Hard Coal Board was dissolved in 1989. Initially, it provided technical assistance to the mines and advised MOIT, the industry, and the unions. It currently oversees the industry’s closure and merger program and provides technical assistance on a competitive basis.

Natural Gas. Natural gas is produced by the Polish Oil and Gas Company (PGNiG), the last remaining monopoly. PGNiG is expected to be broken up into mainstream and downstream operation and service companies. The divestiture of service companies has already begun and the separation of exploration and distribution companies is scheduled to start in the spring of 1995.

Electricity. The power sector underwent substantial demonopolization and divestiture. Until September 1990 it consisted of 106 enterprises consolidated under the former Power and Lignite Board. When this Board was dissolved, all service enterprises were spun off into joint-stock companies. The sector now consists of 68 autonomous enterprises specialized in the generation, transmission and distribution of electricity. The transmission company, the Polish Power Grid Company (PPGC), and the 33 distribution companies have been commercialized. The 34 generation enterprises will be commercialized after they are merged into a smaller number of separate generating companies.

PPGC was created as a joint-stock company in August 1990, just before Power and Lignite Board monopoly was dissolved. All company shares are held by the Treasury, represented by the MOIT. PPGC has a supervisory council of 11 people appointed for three years. The council is chaired by the Vice-Minister of Industry and Trade. PPGC has a two-tier structure, consisting of a four-member board of directors which is appointed by MOIT, and the management, consisting of the departments heads.

Corporate Governance in the Telecommunications Sector

At the time of the historic political changes in Poland in the early 1990s, the nation's telecommunications infrastructure was among the most rudimentary in Europe. The Government was well aware that the development of a telecommunications network was critical to economic growth and national development. To rehabilitate the sector the Government introduced a series of reform measures.

Before 1990, the organization of the telecommunications sector was simple. A limited range of services — telephone, telex, and telegraph — was provided by the Polish Post, Telephone, and Communication (PPTT), which was a state enterprise under the direct control of the Ministry for Post and Telecommunications (MPT). The enterprise was operated as a government agency, with profits from telecommunications returned to the national treasury.
The Post and Telecommunication Act of November 1990 aimed at demonopolizing the telecommunications sector and substantially restructuring it. The Ministry of Posts and Telecommunications was reorganized and assigned responsibilities for: (i) issuing and rescinding licenses for service providers; (ii) issuing of homologation certificates; (iii) defining the policy for national frequency management for radio communications. The PPTT was transformed into a joint-stock company, TPSA, which had MPT as its founding body and had all 100% of its shares held by the state. Telecommunications services were separated from postal services, and the postal responsibilities were assigned to the Polish Post Office. TPSA was given an exclusive monopoly power over international telecommunications services.

The Polish telecommunications sector now consists of three segments:

- the MPT, which is both owner and regulator. The Ministry is formally responsible for regulating and supervising the sector. In addition, since the state treasury has full ownership of TPSA, the Ministry is indirectly responsible for operating most telecommunications services;
- telecommunications services providers, of which Telekomunikacja Polska (TPSA) is the primary company, under the Ministry for Posts and Telecommunications;
- the telecommunications manufacturing industry, under the jurisdiction of the Ministry of industry, which is gradually being privatized.

The Post and Telecommunications Act also introduced private sector participation in telecommunications services, and lifted restrictions on foreign ownership of local networks. Deregulation has led to the creation of a cellular radio network in a joint venture with France Telecom and Ameritech.

The Post and Telecommunications Act does not give the MPT enough legal authority to effectively regulate the telecommunications sector and to respond to the tremendous changes taking place. To resolve some of these issues, the government is now drafting a new telecommunications law. This law is intended to bring Poland's telecommunications in line with the telecommunications sector in the European Union.

**Corporate Governance in the Railways Sector**

Polish Railways (PKP) is a state-owned enterprise. The government appoints the general director who appoints the deputy general directors and chief accountant with the approval of the Minister of Transport and Maritime Economy. PKP is being restructured to reduce its excessive number of employees and to spin off some of its activities as separate supplementary entities. PKP is reorganizing its monolithic railroad system along its principal lines of business: commercial freight, intercity passenger, and international passenger. Eventually, it is expected to have an infrastructure department servicing institutionally distinct lines of business, with each paying suitable, nondiscriminatory compensation for track use. Suburban passenger activities will be spun off to local agencies or provided under "contracts" with national and local governments. PKP will transfer its liabilities and nonrail assets (mainly urban real assets) to a new authority. It will also seek to transfer its nonrail activities to the private sector. This reorganization will separate commercial services from public services.
Summary

The process of enterprise reform started in 1990, early after the revolution. By mid-1991, the commercialization of State-Owned Enterprises was complete, resulting in two types of enterprises:

(i) The "Régies Autonomes" ("autonomous holdings"). These are either national monopolies or public services deemed essential for national security and welfare. As of August 1994, there were about 400 "régies autonomes" (RAS). Of these, it is expected that 44 of national importance will remain under direct State supervision, while the remaining ones are being devolved to local authorities. The "régies autonomes" are slated to remain in the public sector. However, many activities of a commercial nature are being spun off and transformed into commercial companies.

(ii) The Commercial Companies. Some 6,300 commercial companies were incorporated in 1990-91. These commercial companies are slated for privatization. After a slow start, the privatization program was sharply accelerated in 1993-94. As of September 1994, about 800 commercial companies had been privatized. The Government is presently launching a very ambitious mass privatization program aiming at privatizing 3,000 commercial companies in the coming months.

While the ownership and governance of the commercial companies have been shared among a State Ownership Fund and five Private Ownership Funds, the "régies autonomes" have remained under direct control of either branch ministries (for "régies autonomes" of national importance) or local authorities. The Government is strengthening the governance mechanisms of the first group through the nomination of representatives on their board of directors and through management contracts. A subset of five major "régies autonomes" have been placed in a special isolation program to force their management to cut down payment arrears and, in some cases, their losses.

Legal Framework

Most of the essential legal and regulatory framework for the enterprise sector is in place. Law No. 15 on State-
Box 7: Special Supervisory Mechanisms

The Romanian government in Decision 301 of July 1993 instituted a special isolation program for a group of thirty commercial companies whose financial situation was critical. These commercial companies were denied access to bank credits until they had produced acceptable financial recovery plans (FRP).

The supervision was exercised by monitoring commissions set up in each of the commercial companies, which included expert representatives from the Ministry of Finance (MOF), the Ministry of Industry (MOI), the State Ownership Fund and the National Bank of Romania (NBR). These commissions were established and managed by a restructuring committee (RC) that voted the FRPs. The SOF implemented the program.

The monitoring commission censured the strict implementation of the FRPs and reported every month to the RC. Several options were available:

- replace the management of the commercial company;
- withdraw further financial support;
- declare a state of insolvency and propose liquidation.

The restructuring committee (RC) consisted of representatives from MOI, SOF, POF, MOF, NBR, creditors and state-owned banks. The SOF representative served as committee president and the MOF representative served as the secretariat. Each member of the committee had one vote, although the representative of the state-owned creditor commercial banks could only vote in matters that concern their debtor commercial companies. Likewise, representatives of POFs could only vote on matters related to the commercial companies they hold shares in.

FRPs were actually established with the assistance of World Bank's consultants and subsequently approved by the Government. The SOF was then instructed to monitor their implementation.

As of August 1994:

- four commercial companies are in the process of liquidation; 12 have "graduated" and, having regained their financial health, have left the program;
- three have been privatized; and
- the remaining 11 are still being restructured.

Following this rather successful exercise, a new group of 32 commercial companies and eight "régies autonomes," including the largest loss makers, will be included in a similar program under the supervision of a newly created Agency for Restructuring and the SOF.

Owned Enterprise Restructuring (August 1990) converted all state-owned enterprises into Commercial Companies or "régies autonomes." Company Law No. 31 (November 1990) provided a regulatory framework for the establishment, management and liquidation of commercial companies. Law No. 58 (August 1991) on privatization of commercial companies provided the legal and institutional framework for the privatization program. In June 1994 Parliament approved a law for the establishment and operation of the stock exchange and the National Securities Commission.

Organization of the State-Owned Enterprise Sector

In 1989 Romania had about 6,000 state enterprises. By mid-1991 their commercialization had largely been completed, creating "régies autonomes" and commercial companies.

(i) "Régies autonomes" are legal entities in which the capital is entirely state owned. The government has established clear policies limiting the range of activities appropriate to "régies
autonomes," as codified in Decision 266 of June 10, 1993. This status is restricted to state enterprises that are "natural monopolies of public interest or essential for national defense and security." The government limited the sphere of "régie autonomes" activity by forcing many of them to reincorporate as commercial companies or to spin off ancillary operations as commercial companies. As of June 1994, there were about 400 "régies autonomes," down from the nearly 900 that had been incorporated in 1990-91. Of these, 346 have regional importance (mainly in water distribution, public transportation and road maintenance). Ultimately, only forty four that have national importance will remain in the public sector, at least in the near future. Branch ministries are responsible for the governance of "régies autonomes" of national importance while local authorities govern regional "régies autonomes."

(ii) Commercial Companies are the 6,300 joint-stock companies that were corporatized in 1990-91. Their capital has been split between the State Ownership Fund (SOF), which owns 70%, and five Private Ownership Funds (POFs) under a scheme whereby each POF holds the remaining 30% in about one-fifth of the commercial companies.

Institutional Framework for Privatization

(i) The National Agency for Privatization (NAP) was established in early 1991 as a public body to develop a privatization strategy and to monitor and control its implementation. Initially, the agency played an active role in launching the privatization process. It initiated the first pilot privatization and organized the first auctioning of small assets. During the years 1992-93, it built up a well-qualified management team and a comprehensive network of regional branches to ensure full coverage of the country. However, recently the role of the agency has been greatly reduced because its regional network and direct privatization activities have been transferred to the SOF. Its president left in September 1993 and had not been replaced by February 1994. Further, most of the agency's best staff have left. The agency is now limited to its policy-making, monitoring and control functions.

(ii) The State Ownership Fund (SOF) was established as a public body in June 1992 and began operating in October 1992. It is the majority shareholder of all commercial companies, having a 70% stake in each. According to Law No. 58, this fund is required to divest itself of its holdings over seven years at a rate of at least 10 percent of its original shareholding each year. Its board of directors is composed of members appointed by the Romanian president (5), Parliament (6), Cabinet of Ministries (5) and the president of the NAP. The board plays a major role in policy design as well as in day-to-day decision making. The SOF has operated independently of the government. However, it has been plagued by constant management changes (four general directors within one year) and various organizational problems and has not successfully implemented its own privatization program.

(iii) Five Private Ownership Funds (POFs) were established in 1992 as private organizations. Each fund was allocated
30% of the commercial companies' shares, either on a sectoral or on a regional basis, on behalf of the population. These funds essentially perform like closed-end stock funds and, at the end of five years, are expected to be converted into mutual funds. Headquarters for each fund have been established in five different cities. Even though the members of their boards of directors are nominated by the government and approved by the Parliament, the POFs have behaved independently and consider themselves truly private organizations. Presently these are the most dynamic organizations in the privatization framework.

Organization of Corporate Governance

Corporate Governance of Commercial Companies

The Law No. 31 on Corporations provided a regulatory framework for the establishment and management of commercial companies. It established a two-tier governance structure comprised of:

- the general assembly of shareholders of each commercial company, which is a Council of State Representatives as long as the state is the only shareholder;
- the board of directors, elected by the General Assembly of Shareholders; and
- the management board, appointed by the board of directors for operational management of a company.

The general assembly of shareholders is composed of two representatives from the SOF and one from the POF for medium- and large-scale enterprises and one from either fund for small firms. These representatives elect directors to the board of commercial companies. Each board must have at least seven directors (the general manager of the firm is the chairman of the board) and there must be at least three members in the General Assembly of Shareholders (two for the SOF and one for the POFs). The SOF has tended to choose people from the public sector. The POFs tend to choose people from the private sector, or academics. Enterprise boards also include representatives of local authorities and other parties with limited experience in corporate guidance. Apart from large enterprises where they are directly represented, SOF and POFs choose their representatives from among local officials, such as prefects or mayors. In some regions, board members receive a large flat fee plus a commission on profits netted by commercial companies beyond their business plan target. These fees make these Directors' positions quite attractive. Moreover, since the business plan targets are proposed by the general manager and approved by the directors, both members of the board of directors, there is a risk of their colluding to maximize commissions.

The corporate governance framework, set out in Law No. 31 was introduced rather quickly, but effective governance continued to be hampered by the lack of experience among board members. In practice, the majority of the commercial companies are self-managed and enterprise managers act with considerable independence. Moreover, not every enterprise has a board of directors. In 1992, only 1,080 had a board of directors of more than 6,000 enterprises. The management and governance of enterprises are also affected by powerful Trade Unions.

Governing such a large number of commercial companies is a problem. Both the POFs and the SOF must rely on outside representatives. Even if the pace of
Box 8: Are "Régies Autonomes" Necessary?

Separating "régies autonomes" and commercial companies in Romania and establishing enterprises that will not be subjected to privatization in strategic sectors is criticized.

Critics emphasize that:

Firms have not been chosen to be "régies autonomes" according to well-defined criteria, raising doubts as to whether many "régies autonomes" are engaged in activities that could be better handled by commercial companies and eventually the private sector. Neither legislation nor the constitution clearly specify what enterprises should be "régies autonomes." On the other hand, economic criteria, such as if the enterprise is a natural monopoly, provides a public good, or if there is a low demand elasticity for the product, are not always followed. The importance of "régies autonomes" in the Romanian economy creates doubts among domestic entrepreneurs and foreign investors about the sincerity of Romania's commitment to a market economy. They continue to exert power over resource allocation hence frustrating the transition to reliance on market forces.

In addition, the legal foundations and provisions for the governance and accountability of "régies autonomes" set out in Law No 15 seems very weak, especially concerning local "régies autonomes." Since a "régie autonome" income benefits the authority that created it, there is a danger that local governments will exploit "régies autonomes" purely as revenue sources rather than allowing private businesses to develop and then taxing them.

Because they are insulated from competitive forces, the "régie autonome" may be, or may become, inefficient. In fact, some inefficient firms were made "régies autonomes" precisely to shield them from the market consequences of inefficiency.

Corporate Governance of "Régies Autonomes"

The governance of national "régies autonomes" is the direct responsibility of the relevant branch ministries, although other ministries are involved, including the Ministry of Finance (MOF). The directors of "Régies autonomes" are appointed by relevant branch ministries and by MOF. "Régies autonomes" of national interest have a board of directors including between 7 to 15 Directors representing the sector branch ministry, the MOF, other branch ministries with an interest in the activity of the "régie autonome." Some individuals would be appointed for their special expertise.

Branch ministries carefully supervise national "régies autonomes," commonly interfering in their activities. It raises the concern that branch ministries may not be conferring the operational autonomy that the management of the "régies autonomes" requires to strengthen managerial responsibility and accountability. Law No. 15 stipulated that the "régies autonomes" board of directors should comprise: management board members (full-time employees of the company), ministerial board members (employed by a ministry, mainly in Ministry of Industry (MOI) and
MOF), and outside board members (appointed by MOI and MOF). Recent experience has shown that the inclusion of government members on the board is clouding the issue of corporate governance: (i) these members have not been able to exercise judgment independent of their ministries; and (ii) all decisions are indirectly being left to the ministries, sometimes to the detriment of the company.

Local governments are directly governing local "régies autonomes." Public service enterprises provide most public services (water supply, solid waste collection and disposal, urban heating, urban transport and road maintenance). These enterprises were created following the break up of the state-run district services departments mandated by the Law on the Restructuring of State Economic Units. The local "régies autonomes" have a considerable advantage over administrative bodies in delivering services, as they can more easily apply the principle of direct cost recovery through user charges.

The ownership of public service enterprises was transferred to local governments and was then supposed to be assigned to either districts or municipalities depending on the nature of the service. However, most enterprises are in financial disarray. Tariff and other income is, in many cases, insufficient to cover minimal operating expenses. Investment is low or inexistent and, as a result, the capital stock is depreciating rapidly. These enterprises used to depend on government subsidies. By transferring their ownership to local governments, the state hoped to end their dependence. However, local governments are reluctant to assume this responsibility because they lack the resources to do so. The ownership situation is thus very unclear. In fact no one is actually controlling local "régies autonomes."

Management Contract for Commercial Companies and "Régies Autonomes"

To strengthen the governance mechanism, Parliament enacted Law No. 66 on Management Contracts in October 1993. It establishes a framework for management contracts for all commercial companies and "régies autonomes" in 1994.

The basic problem of state enterprises is that they are controlled by many players with multiple conflicting objectives. For example, "régies autonomes" must deal with the branch ministry, which feels that it has the mandate to control them, with the MOF and the Parliament, which may have other goals. To resolve this problem, the Management Contract clearly specifies the objectives of the state enterprise and the corresponding responsibilities of the government as owner. Commercial companies have less of a conflict because in most cases their ties with the ministries are not as strong and they answer only to the SOF.

According to article 1 of the Law No. 66, "The management contract is an agreement by which a legal person who carries out an economic activity, in the capacity of owner, entrusts a manager to organize and manage its activity, on the basis of some measurable targets and performance criteria, for a payment." The Romanians call contracts for the commercial companies and the "régies autonomes" management contracts. But the government's behavior suggests that the contracts are more like performance contracts, at least for the "régies autonomes." The major difference between the two types of contracts is the contractor: government employed managers in the case of performance contracts and private contractors selected through a bidding process in the case of management contract.
**Management Contract**

**for Commercial Companies:**

**Real Management Contract**

The SOF and the POF to which the commercial company is allocated, and the other shareholders' representatives, after consulting the branch ministries, draw up the management contract. The management contract is binding for a period of four years. The objectives and performance criteria include: turnover; profit or an other synthetic financial indicator; import-export balance; investment volume; and productivity. The terms of reference are based on the previous years' financial performance. Every quarter the manager must present to the shareholders a statement of the enterprise's economic and financial situation, and the state of the investments.

The parties to the contracts are the commercial company through the representative appointed by the General Assembly of Shareholders, and the manager.

Law No. 66 stipulates that there should be a bidding process to select the manager rather than automatically negotiating with the existing state enterprise manager. The Law establishes rules for selecting managers through contests for commercial companies in which the SOF holds over 50% of share capital. Such managers' competitions must be held within six months of the law's date of effectiveness. The manager is appointed by the unanimous vote of a commission appointed by the shareholders. Invitation for bids and selection criteria are published in national and local newspapers.

The rules for and the eligibility criteria for selection have been well defined for the manager contest. A prospective manager must possess good professional references "from the latest job or from managers or administrators of commercial companies." The selection criteria include: demonstrated decision-making skills; attending courses given by the management institutions; having management experience in a commercial company or "régie autonome;" and making proposals for the commercial company's rehabilitation, recovery and privatization.

Though Romania has started to use tests in selecting managers, incumbent managers usually retain their position, even after testing. Because the representatives of the SOF and POF are often local personalities, they are likely to have personal connections with the incumbent manager.

The role of the manager is of importance. According to article 25 of Law 66, "as soon as the management contract is concluded, the administrator or the board of directors in office at that time will step down." Thus, the only remaining body to supervise the manager will be the General Meeting of Shareholders.

**Management Contract**

**for "Régies Autonomes":**

**Performance Contract**

The provisions of Law No. 66 also apply to the "régies autonomes." Management contracts for "régies autonomes" are closer to performance contracts: incumbent managers are favored and no formal bidding process occurs in the selection, negotiation and contract signing. Other features are similar to those for the commercial companies. The plan to abolish the board of directors was a major bone of contention between the "régies autonomes" and the government, and it has apparently been decided to retain the board after the signature of the management contract.
Management contracts have been prepared in collaboration with the World Bank, especially with "régies autonomes," and are currently being signed.

**Corporate Governance in the Energy Sector**

The energy sector accounted for 46% of industrial investment in 1990, and nearly 100% of public industrial investment in 1992 because of the nuclear power development program. Following the 1989 revolution, the State Planning Agency was abolished and responsibility for energy development was entrusted to the Ministry of Industry (MOI). The "centrals," enterprise holding groups that coordinated and implemented annual plan decisions, were replaced by "régies autonomes" for the production and supply of energy products, and by commercial companies for support services and activities. This enabled the government to separate policy and regulation from operational functions.

The Ministry of Industry sets policies and regulates the energy sector. The ministry is divided into 11 departments each headed by a secretary of state. The Secretary of State for Energy has the principal role in setting energy policies, though other departments are also involved at times (the Secretaries of State for Restructuring, Strategy and Reform; and the Secretary of State for Management, Legislation, Human Resources and Administration). The Secretary of State for Energy has several divisions under him, each headed by a director general. Other ministries involved in policy formulation functions, sector regulation, and ownership functions are the Ministry of Economy and Finance which sets prices, and is represented on the board of directors of the "régies autonomes;" the Ministry of Commerce and Tourism which is also represented on this board; and the Ministry of Environment.

To establish an effective transparent regulatory framework that will reconcile policy objectives (meeting oil and gas demand at lower costs) with ownership objectives (maximizing profits), the Romanian government created an independent regulatory authority: the National Agency for Mineral Resources (NAMR). NAMR was established (decree No 417) in August 1993 as an independent agency reporting directly to the cabinet. The Agency represents the State in all relations with central and local government and foreign entities. NAMR's main functions include managing Romania's mineral resources, establishing fees for geological exploration, and issuing regulations concerning exploration, production and protection of the useful deposits of mineral resources.

NAMR is to be managed by a president who will have the rank of secretary of State, and is appointed by the Prime Minister. The agency's president will be supported by a board of administration whose seven members are appointed by the Prime Minister and will include experienced representatives from the Ministry of Finance, Ministry of Justice, Ministry of Industry, and Ministry of Environment. As a first step in making the agency operational, the government has appointed the President of NAMR.

Five "régies autonomes" have been established in the sector: (a) RENEL, responsible for power generation, transmission and distribution; (b) PETROM, responsible for the production of oil and associated gas; (c) ROMGAZ, responsible for the production, transmission and distribution of non-associated gas; (d) RAL, responsible for the mining and distribution
of lignite; and (e) RAH, responsible for the mining and distribution of hard coal. Complementing the work of the "régies autonomes" are 45 commercial companies, including CONPET which transports and stores all domestic and imported gas.

These agencies seem to suffer from common systemic problems including: (i) government micro-management ranging from control over prices and profits to interference in day-to-day affairs; (ii) lack of commercial orientation; (iii) lack of financial accountability and the absence of sound investment decision-making procedures; (iv) overlapping responsibilities of agencies and departments within agencies; (v) overemployment; and (vi) the absence of a competitive environment that would foster operational efficiency and flexibility. The sector needs to be restructured in order to achieve efficiency, improve management capabilities, and promote private sector investments essential to the efficient development of the sector. In pursuit of these objectives, the Government, with the assistance of the World Bank, has developed an overall strategy for the energy sector.

**Electricity Sector**

RENEL is a "régie autonome" responsible for electricity and heat generation, transmission, and distribution. It was created in 1990 from the former Ministry of Electrical Energy (MEE), which had been responsible for the electricity production and supply, detailed engineering, design and construction, foreign trade, research and development, and nuclear power development. Some of the construction and foreign trade departments were spun off into independent commercial companies. The staff of RENEL was reduced from 200,000 in 1990 to 105,000 in 1993. RENEL was reorganized in late 1992 and given a corporate form. Corporate policy-making is vested in a nine-member board of directors, which is chaired by the president of RENEL. In addition, the board of directors comprises representatives of the government, financial institutions, fuel suppliers, and consumers. RENEL's management, which includes the President and five Vice-Presidents (one each for: generation; transmission and distribution; nuclear power group; strategy and development, finance and human resources), handles day-to-day affairs.

The reorganization was intended to separate the corporate policy-making from company management operations. However, there is little separation in practice since several vice-presidents are also members of the board of directors.

**Gas Sector**

ROMGAZ is a vertically integrated "régie autonome" responsible for gas exploration, production, transmission and distribution. It is managed by a general manager, who reports to the board of directors. Both the general manager and all members of the Board are appointed by the Ministry of Industry. The board consists of seven members, including the General Manager and one representative each from the Ministries of Industry, Finance and Commerce. The board of directors has the power to approve budgets prepared by ROMGAZ's management and to approve work and investment programs within the guidelines set by the Ministry of Industry.

The 1994 World Bank financed Petroleum Sector Rehabilitation project includes a component for restructuring ROMGAZ. This restructuring is designed to correct the anomalies and inefficiencies
created by its involvement in service and maintenance-oriented activities and to improve its accounting and management information systems. Since ROMGAZ is a vertically integrated group, its exploration, production, gas transmission and distribution activities are the responsibility of a single headquarters management group. The Corporate Development Program would convert ROMGAZ into a holding company with four subsidiaries. The program would include:

• restructuring ROMGAZ as a company that would coordinate the activities of four Strategic Business Units (SBUs): one for exploration/production, one for transmission, and two for distribution of gas;

• reorganizing the functions of the SBUs and the headquarters group along lines more closely related to their respective activities and upgrading their departments for accounting, financial management, corporate planning, and human resources;

• establishing financial performance criteria for each SBU; and

• developing options for privatizing the SBUs.

**Coal and Lignite Sector**

Two "régies autonomes" are operating in this sector. RAL which manages all lignite mining operations, and RAH which manages all hard coal mining operations. In terms of output, profitability and future development prospects, RAL is the more important of the two.

RAL operates about 35 surface mines and 50 underground mines. RAH operates only underground mines. Consolidating the country's geographically dispersed coal mining activities into two companies allowed each company to control an unusually large number of mines. While the creation of two companies was a logical, practical and probably useful organizational step at the beginning of the economic transformation, particularly given the need to dissolve the ministerial lines of responsibility, there is now a need to review the sector's organizational structure to find ways to create viable economic producers. The options considered by the government and the World Bank would include:

(i) breaking-up the existing "régies autonomes" into smaller companies;

(ii) spinning off unprofitable mines by placing them under new ownership and management or phasing out their operation; and

(iii) transferring mines that supply a single power plant to the power plant.

Management in both RAL and RAH has very good technical qualifications. However, its ability to act is inhibited by strong union and worker pressure and it lacks financial and commercial expertise, as well as institutionalized procedures for cost accounting, auditing, and capital budgeting.

**Railways Sector**

The situation of the Railways sector (SNCFR) has worsened dramatically since the loss of the major part of the freight traffic in 1989. A thorough reorganization is required to equip SNCFR to cope with the changed economic and political environment. In 1990 SNCFR was reorganized and is now a "régie autonome." It is divided into eight regions and the area of the port of Constanza. Each region has three to five
A draft law was written by foreign consultants at the request of the SNCFR to define it as a "régie autonome" operating on commercial principles (consultants proposed to transform SNCFR into a commercial company, but the government refused). SNCFR would be a "régie autonome" with a fifteen-member board of directors: the chairman, appointed by the government and recommended by the Minister of Transport; representatives of the Ministries of Transport, Finance, Employment and Social Protection, Industry and Public Works; experts and economists. The chairman would serve as the president of SNCFR. A "Holding Board" would be established to advise the president on corporate policy, controlling and guiding activities, and coordinating. Performance contracts are also being written.

**Telecommunications Sector**

The Ministry of Communications is responsible for the telecommunications sector. It sets national telecommunications policy and performs regulatory functions including allocating frequencies, setting tariff and establishing technical standards. In 1990, as a first step in the restructuring process, Rom-Post-Telecom was established to provide telecommunications, postal, radio and television services. As part of the Ministry of Communications' efforts to commercialize the Communications sector, Rom-Post-Telecom was split in January 1991 into the separate "régies autonomes." Rom-telecom (universal telecommunications), Post Régie Autonome (postal services), Radio Régie Autonome (radio), General Inspectorate (mobile telecommunication), and Bank Post (financial services).

Each of these "régies autonomes" is a separate legal entity with its own profit and loss statements. These enterprises are not expected to be privatized, because the government considers the functions they perform to be strategically important. The government has indicated, however, that it would consider changing the status of Rom-Telecom and General Inspectorate to facilitate their commercialization.

A board of directors in the Ministry of Communications provides guidance and oversight to Rom-Telecom's management. This board of directors has 15 members. Five directors are representatives of the Ministries of Industry and Finance, the districts units, the association of customer protection, and educational institutions.

The organizational structure of Rom-Telecom is hierarchical and rigid. It is headed by a general director selected and appointed by the board of directors, subject to approval by the Ministry of Telecommunications. The senior management team is accountable to the Ministry of Communications for Rom-Telecom's technical, financial and management performance.
Summary

Developing a corporate governance system for state-owned enterprises has not been a focus of reforms in Russia, which has instead emphasized their rapid privatization. Before the beginning of mass privatization all the state property was divided into four categories: exclusive federal property, federal property which might be transferred to the subjects of the federation, property of the subjects of the federation, and municipal property. By the middle of 1994, public sector enterprises (i.e., those wholly owned by the state) employed about 48% of the total labor force and produced about 35% of the nation's industrial output. However, the regulatory basis for public sector control is embryonic. Sectors and types of enterprises to be totally owned by the state are defined on a "residual" basis, e.g., as entities prohibited for privatization under the State Privatization Program which is periodically updated. This same document identifies sectors where the state retains control over strategic decision-making, as well as the forms of such a control.

During 1994, a number of legal acts have been enacted which are designed to improve the corporate governance of the residual state sector: representation of the state ownership rights has been distributed in a more clear way between the central government, the State Property Committee (GKI) and sectoral agencies; rights and responsibilities of the managers of state-owned enterprise have been clarified and the procedure for making contracts with state-owned enterprise managers established; the general principles of state representation in the governing bodies of joint-stock companies partly owned by the state have been described; the rules on how to deal with insolvent state-owned enterprises have been established; and the legal basis for governmental (kazenny) plant establishment and operation has been formed. The reform of state-owned enterprises is aimed primarily at overcoming the negative consequences of past policies granting the state-owned enterprise directors the "full right of economic management," which has led to numerous cases of abuse and misuse.

In practice, noncorporatized sectors are mainly governed under sector-specific schemes whose principles are outlined in special presidential and governmental resolutions for that sector. Joint-stock companies, in which the state has a
controlling interest ("Golden Share") are subject to the general regulations for joint stock company operation, with due regard for sectoral peculiarities normally reflected in presidential decrees. To manage the blocks of shares held by the state, the GKI uses different sector-specific schemes: there is no standard solution. This paper will present the corporate governance structure of the main residual public enterprises. For example, in the power sector, the state holds a controlling interest in a joint stock company, RAO EES Rossii, whereas in the coal sector, a state-owned enterprise, Rosugol, has been established and contracts with GKI for the commercial management of public shares. In contrast, in the telecommunications sector there is no intermediary management structure; the public interest is represented by the staff of the Ministry of Communications under agreement with GKI.

Background

In Russia, developing a corporate governance system for state-owned enterprises has not been a focus of reforms, which have instead emphasized their rapid privatization. By the middle of 1994, public sector enterprises (enterprises completely owned by the state) employed about 48% of the total labor force (down from 60% in the first quarter of 1993) and produced about 35% of the nation's industrial output (almost 75% in the first quarter of 1993).

The table below summarizes the progress of corporatization.

Since early 1994, more attention has been given to the issue of corporate governance in the public sector. A number of government resolutions and presidential decrees have been adopted that: allocate public property management/responsibilities among the Russian government, the State Property Committee (GKI) and sector governing agencies; specify the duties of the director of a state-owned enterprise; regulate contracts with state-owned enterprise managers; and establish ways to represent state interests in the enterprises' decision-making bodies.

The reform of the corporate governance of state-owned enterprises is primarily intended to change the responsibilities and

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<td>Number of privatized enterprises</td>
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<td>Enterprises whose controlling share is held by the state as a percent of all corporatized enterprises</td>
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Source: Goskomstat
incentives of their directors. While workers never took a very active part in enterprise management in Russia, the scope of authority of state-owned enterprise directors even in the pre-reform period was comparable to that of private owners. Legally, directors were granted the full right of economic management, essentially giving them a free hand in enterprise property management and creating the opportunity for numerous cases of misuse. Decisions taken in 1994 have significantly restricted the rights of state-owned enterprise managers, forcing them to manage enterprise property in strict compliance with its purpose as defined in the transfer documents or enterprise charter, and prohibiting them from making real estate transactions without the GKI's approval. For example, state-owned enterprise managers do not have the right to lease assets, or create subsidiaries without GKI's consent.

However, mechanisms of manager's responsibility to the state as an owner are not yet adequately enforced. Many of the instruments and methods of governance typical of the former state planning system and many of personal relations established then (the so-called "telephone right") still play a significant role in governance today. At the same time, organizations meant to represent the state's interests often act as representatives of the enterprises and lobby for them. This behavior is especially characteristic of line ministries or bodies which grew out of former ministries. These bodies still hold on to their old patterns of dealing with their former subordinate enterprises, despite the fact that their ownership may have changed radically.

### Representation of the State's Ownership Interests

The redistribution of public property among the federal, regional, and municipal governments took place in December 1991, in preparation for mass privatization. A resolution of the Supreme Soviet of the Russian Federation identified three types of public property: exclusive federal property, federal property that might be transferred to private citizens, and municipal property. Property that did not fall under any of the three categories was considered to be owned by private citizens. According to the above classification, federal property included mining enterprises (except for the production of local raw materials); fuel and energy enterprises; railway, air, pipeline, inland water and marine transport; communications; most power and gas distribution enterprises; television and radio transmission facilities; and federal highways and their respective servicing entities.

Public property division does not imply that owners at different levels act independently. The managers of large federal property facilities take the interests of regional authorities into account, notably when appointing directors. When a fundamental decision is made on the corporate governance of federal state-owned enterprises, the Federal government usually recommends that regional authorities implement a similar policy with respect to their own enterprises.

The distribution of responsibility for federal property management has not been addressed for a long time and is characterized by some uncertainties. At
present, the following bodies are in a position to implement the powers of ownership: the GKI, the Russian Federal Property Fund, the Federal Bankruptcy Agency under the GKI, and sectoral governing agencies.

With respect to enterprises owned exclusively by the state, the powers are distributed as follows. The GKI is in charge of transferring public property to legal entities for economic and operational management, for lease or use under agreements, and to monitor targeted utilization. In addition, the GKI approves a standard charter of a state-owned enterprise and a model contract with a manager. However, the approval of specific charters, conclusion of managerial contracts, and appointment and dismissal of managers are the responsibility of sector governing agencies. Sector agencies can also make decisions on the establishment, reorganization, and liquidation of their respective subordinate enterprises if the decisions can be implemented given available budgetary allocations and labor requirements. All other decisions are the responsibility of the Russian government and the GKI.

The GKI supervises the utilization of state property and realty transactions made by federal state-owned enterprises, federal state organizations and federal governing agencies. There are very few exceptions: the Ministry of Railways, for instance, has the right to sell the rolling stock at its own discretion. The GKI monitors other federal transactions.

With respect to partially state-owned enterprises, on one hand the GKI acts as a representative of the state if the state owns the controlling share. On the other hand, if an enterprise is subject to unrestricted privatization, and its shares are still partly held by the state, these shares are managed by the Federal Property Fund. To manage the shares held by the state, the GKI uses different sector-specific schemes, rather than a standard solution. However, according to governmental resolution No. 96 of February 10, 1994, the Russian government must decide which of the entities (GKI or Property Fund) shall act as a founder on behalf of the state.

If a federal state-owned enterprise or a partially owned enterprise is considered insolvent (according to insolvency criteria legalized by governmental resolution No. 498 of May 20, 1994), state representation is transferred to the Federal Agency of Bankruptcy. This agency thus acquires extensive powers with respect to director replacement, enterprise restructuring, ownership change, and a number of other operational issues.

Under presidential decree No. 2296 of December 24, 1993, on trust property, blocks of state shares (fixed as state property after privatization) can be transferred to a trust, with the state budget being its exclusive beneficiary. However, this mechanism was not widely used until the issuance of the decree of September 1995 on loan equity swaps, which represents a major innovation.

Through the September 1, 1995 decree, the Russian loan-equity swap undertaken to reduce the federal budget deficit has authorized banks and local and foreign investors to manage state shares in certain enterprises in exchange for major loans to the state. The measure allows the state to retain ownership of the shares. However, the shares will be transferred to the banks and investors if the state defaults on the loans. The right to manage the shares would be allocated by tender and the amount of the loans and the conditions and
guarantees would be determined by the successful bidders.

**Corporatized and Noncorporatized Sectors: Types of State-Owned Enterprises and Forms of State Participation in Ownership**

Legal forms for the operation of a state-owned enterprise have not yet been finalized. The privatization program adopted in December 1993 recognized only two types of state-owned enterprises: state organizations and joint-stock companies that are entirely publicly-owned. Presidential decree No. 1003 of May 23, 1994, introduced a third type, a kazenny or governmental plant (factory or farm). This new legal form has yet to be tried in practice. A number of draft laws describe other types of state-owned enterprises, such as noncorporatized enterprises. Those enterprises that have not been corporatized are mainly governed under sector-specific schemes whose principles are outlined in special presidential and governmental resolutions. Examples of noncorporatized enterprises are mentioned later in the sector descriptions.

**Joint-stock Companies**

Joint-stock companies in which the state has a controlling interest are subject to the general regulations for joint-stock company operation, and presidential decrees that account for sectoral exceptions. In practice, joint-stock companies that are owned exclusively by the state are uncommon and a special mechanism for their governance has not been developed.

For a number of sectors, the Federation can retain controlling shares, including: communications; fuel and energy; water and transport; production and processing of precious metals and stones, and radioactive and rare earth elements; nuclear engineering; military; production and utilization of virulent, toxic, and explosive materials; research institutions; wholesale trade enterprises engaged in public procurement and export/import operations under international agreements; and foreign trade enterprises. A decision to retain the controlling share can be made for a three-year term, which can be renewed once. At the same time, the Russian government or the GKI can sell the controlling shares before the end of the three-year period.

The level of participation associated with the controlling share is 51%, 36% (in the case where non-voting shares are present) or 25.5%, of the capital base. Alternatively, the state can decide to retain a "golden share." With a golden share, the state reserves the right to veto the following decisions made by a shareholder meeting:

- to amend a joint-stock company charter;
- to reorganize or liquidate a joint-stock company;
- to participate in other enterprises and enterprise associations; and
- to manage the enterprise's property.

When 25.5% of the shares are held as state property, the range of decisions left to the discretion of public bodies is close to that associated with a golden share. These include decisions which must be agreed with the holders of the remaining 75% of the votes, as defined by the standard joint-stock company charter.

A controlling share equal to 51% or 25.5% of the voting stock allows the state to influence any decision that could be made by the shareholders meeting. Under the post-voucher privatization program, the Russian government will decide on a case-by-case basis whether to retain a controlling
share. Reserving controlling shares of privatized enterprises as state property has not been widely implemented (see Table page 58).

Before the first shareholders' meeting, which must be held within twelve months of the registration of a joint-stock company, the board of directors, including those of joint-stock companies partially owned by the state, shall be determined by the standard joint-stock company charter. According to the charter, the board of directors consists of the general director; a representative of the GKI or a trust owner; a representative of the working collective; and a representative of local authorities. Even when the Federation owns controlling share, representatives of federal authorities cannot have a majority on the board. Theoretically, should a conflict arise, they will be forced to convene a general shareholders meeting to exercise their ownership rights. Nevertheless, in practice, public bodies are preserving the above membership structure of boards even after the first shareholders' meeting. The director of a joint-stock company in which the controlling share is owned by the state is appointed by the sector governing agency or another body representing the state.

Before June 1994, representation of state interests in joint-stock companies partially owned by the state was based on presidential decree No. 1392 of November 16, 1992. This decree stipulated that the state's interest could be represented at the board of directors on a contractual basis by people identified by the Russian government or the GKI, including officials from state-owned enterprise administrations or public-management bodies. Civil servants engaging in this activity were not subject to the restrictions set out in the presidential decree on the Prevention of Corruption in the Civil Service System, and were to be remunerated for their service. In practice, however, there were no real incentives for taking part in this work. The Decree did not clearly specify how representatives were to be remunerated for their services. Moreover, the issue of compensation for travel and other business expenses of people responsible for public representation was not addressed.

Presidential decree No. 1200 on Measures to Ensure State Control of the Economy, signed on June 10th, 1994, specifies the mechanism for representing state interests in joint-stock companies. The decree envisages that representatives can include civil servants or other Russian citizens, except members of the Parliament and local bodies. State representatives are to reach a written agreement with bodies on whose behalf they act on draft decisions that they will submit and support and on their position on draft decisions proposed by other members of the joint-stock company management. The issues covered include changing and amending the company's statutory documents; changing the company's authorized capital; appointing (electing) members to joint-stock company management and supervisory bodies; loans exceeding 10% of the company's net assets; realty transactions; and participation of the company in establishing other enterprises and financial and industrial groups. Representatives of the state are to also submit to their respective governmental bodies reports on the performance of the joint-stock company at least twice a year. This decree includes promising provisions, but the mechanism it foresees for decision making is cumbersome.

This decree gives a more detailed description of the legal rights and duties of representatives who are not civil servants. It establishes that the GKI or the Property Fund are to enter into contracts with these individuals to represent the interests of the
state. The contract is to be registered by judicial bodies and specify:

- the duration of the contract and the procedure for its early termination;
- the rights and responsibilities of a state representative;
- remuneration; and
- the penalty for the violation of contractual terms and conditions.

For civil servants, the decree only states that if their voting is at variance with the agreed decisions of governmental bodies, they are to be subject to disciplinary sanctions and, at most, to dismissal from the civil service. The other issues related to the mechanism of public interest representation by civil servants have not yet been formally established.

These decrees do not clearly specify which bodies can choose public representatives (especially in the case of civil servants) and on behalf of which bodies the representatives can act, although the most frequently mentioned bodies are the Russian Federation government, the GKI, the Property Fund, and federal executive authorities (which usually include sectoral agencies). However, it is established that if the management body of a joint-stock company includes state representatives selected by several governmental agencies, they are to agree on their common position prior to discussions.

In practice, modifying relations between ministries and their once subordinate enterprises when ownership changes is a complicated process. The ministries retain a desire to exercise control as reflected, for instance, in the appointment of federal ministerial staff only to represent public interests in the management of joint-stock companies. As a result, ministerial officials have to travel all over the country to take part in the management of a large number of enterprises, which might be considered a waste of time and money. The Ministry of Communications, for example, is trying to use the controlling share held by the state to maintain control over its former subordinate enterprises (now joint-stock companies). To alleviate this problem, the GKI has proposed retaining ministries to represent public interests only in the most important communications enterprises. For the other enterprises, the ministry can contract with a local official to represent the interests of the state or transfer the state's share to a trust.

**Noncorporatized Sector**

A number of sectors and enterprise categories cannot be privatized under the State Privatization Program: they can be generally equated with the notion of a "noncorporatized public sector." This sector includes inter alia: organizations more than 50% funded directly from the Russian Federation's federal budget; railways; mints; nuclear and toxic waste disposal enterprises; nuclear power plants; enterprises producing nuclear and radioactive materials and nuclear weapons; postal enterprises; precious stone grading factories, gold and silver refineries; radio and television transmission facilities and radio centers; and a number of research institutions, etc.

The idea of establishing entities in the form of kazenny-government plants (factories or farms), as a way of primarily reorganizing a part of the noncorporatized public sector has recently been proposed. In compliance with presidential decree No. 1003, these entities would be established from primarily noncorporatized state-owned enterprises intended to be liquidated. However, it is still unclear how widespread this type of entity can become and what role
it would play. (The postal services since their reorganization in 1992 bear some resemblance to the kazenny concept. The problems that have arisen in that sector are discussed at the end of this report.)

Under the decree, kazenny can be established from federal, industrial or agricultural state-owned enterprises that meet at least one of the following requirements:

- they carry out activities restricted to state-owned enterprises;
- the state consumes at least 50% of their product; or
- their privatization is prohibited by the state program.

This type of organization is a reaction to the misuse of budgetary appropriations or real property by enterprise managers and/or to the lack of profits from activities carried out over the last two years. The reform is thus perceived as a way of punishing enterprise managers.

Regulations for operating a kazenny are set out in presidential decree No. 1003, Standard Charter and Procedure for Planning and Financing the Activities of Government Plants (Factories or Farms) Established on the Basis of Liquidated Federal State-Owned Enterprises. A kazenny operates in compliance with an annual plan order and a development plan, and has the rights of an independent economic activity, as permitted by a state agency authorized to govern the plant (this agency has not yet been identified). The plan order shall establish basic indices of production and sales, including setting and establishing conditions for changing prices and wages, setting the employment limit, and determining the procedure and timing for obtaining funds. A kazenny plant manager is responsible for the plant’s performance. The manager’s salary is paid out of the plant’s wage bill, according to the rules established for civil servants.

The activities of kazenny are to be financed by product sales and revenues from other authorized activities. If a plant lacks resources, it can obtain public funds to implement its development plan, maintain social infrastructure facilities, and cover losses from the execution of the plan order. The amount of funding is determined annually as part of the process of plan order and development plan approval. The Ministry of Finance (MOF) provides budgetary allocations only after receiving information on the expenditures and general economic performance of the plant in the preceding period.

Property is transferred to a kazenny based on the right of operational management. As a rule, a plant sells its products independently. However, without the approval of the Russian government or its authorized agency, a kazenny is not in a position to establish subsidiaries, act as a founder of enterprises and organizations, or make realty transactions and use real estate as collateral. A kazenny can only obtain credits under guarantees from the Russian government.

Apart from kazenny, two other legal forms of noncorporatized enterprises are anticipated in the Civil Code: "unitarian" enterprises that would be state or municipal enterprises. Accountability and governance mechanisms for the operation of unitarian enterprises have not yet been fully developed.

System of Relations with Directors of State-Owned Enterprises

As in joint-stock companies, the director of a noncorporatized state-owned enterprise
is appointed by the sector governing agency or by another body that represents the state, in consultation with the local government. In some cases, special regulatory acts have established rules for appointing heads of noncorporatized state-owned enterprises. For example, the Russian government has passed resolutions covering the appointment of heads of individual regional railways. In other cases, appointment is regulated by informal mechanisms. For example, a moratorium on director replacement was temporarily instituted during the corporatization and privatization of the volatile coal sector to avoid destabilizing this sector.

Until 1994, relations between the state and the heads of noncorporatized state-owned enterprises were regulated by labor contracts with sector governing agencies. However, the incentive system was often determined by other factors. In a number of cases, directors received bonuses on the basis of performance indices practically identical to those used under the socialist system.

According to presidential decree No. 1200 (June 1994), the relations between governmental bodies and heads of federal state-owned enterprises are to be regulated under contracts (that may resemble management contracts) made according to the civil law. The decree sets out the following mandatory provisions:

- contract duration of at least three years;
- a guaranteed pay of no less than ten minimum monthly salaries;
- manager's share in enterprise's net profit;
- rights and responsibilities of the enterprise manager concerning enterprise management, including the right to hire and dismiss employees, delegate powers, and manage enterprise property;
- reporting procedures;
- procedures for and terms of an early termination of contracts;
- responsibility of the enterprise manager regarding the economic performance of the enterprise and safety and proper use of property, including liability for any damage to the enterprise integrity as a result of action or inaction; and
- size of compensation in special cases and social guarantees to an enterprise manager and the manager's family.

The decree specifies that contracts should be made with newly appointed managers of state-owned enterprises, as well as with managers whose labor contracts have expired. In addition, reviewing labor contracts with the managers of state-owned enterprises in accordance with the decree is a prerequisite for obtaining federal financial support (as stipulated in presidential decree No. 1484 of July 8, 1994). Existing labor contracts with the managers of federal state-owned enterprises will not be renewed or extended. Thus, managers are no longer viewed as any other employee. Instead, relations with managers are governed by civil law.

Implementation of the new regulatory system is expected to have a significant impact on the behavior of enterprise managers by eliminating or reducing the negative implications of the previous "full economic management system." The new system enhances the incentives for profitably operating an enterprise. Under the contract, a director shares the enterprise's profits. At the same time, if losses are incurred, an enterprise can be considered insolvent, leading to the intervention of the Bankruptcy Agency and possibly the replacement of the manager.
Managers are unlikely to be swayed by the threat of transforming enterprises into kazenny. For one, only a limited range of enterprises are eligible. For another, such a transformation is viewed positively in many cases. On the one hand, a manager's rights are severely restricted, but on the other, a manager is largely relieved of responsibility for the plant's financial performance and can benefit from the contradictions in the centralized governance mechanism. Some directors have tried to obtain the status of a kazenny; numerous applications of this type have been made for different ministries.

Despite these changes, it can be assumed that a manager's position will be secure for a long period of time. There is as yet no "market" for managers, making the search for a qualified replacement very difficult. Further, governing agencies often have a paternal attitude toward managers, which prevents an objective assessment of their performance.

Natural Monopolies and Crisis Sectors: Practical Experience with Public Regulation

The activities of natural monopolies represent one of the most urgent issues of the Russian economic reform. Low-quality service provision, overshooting of prices and tariffs, and lack of responsiveness to customers are typical of Russian natural monopolies. The first attempts to solve these problems are currently being made. In early 1994, a draft law on natural monopolies was prepared and submitted to the state Duma. The development of possible approaches to sector-specific reforms has been initiated with the help of foreign experts. However, the content of the draft law and the current situation in specific sectors do not suggest immediate reforms in this area. Most likely, these problems will be addressed over the middle-term.

According to the draft law, natural monopolies include pipeline transportation of oil and gas; railway transportation and a number of other segments and types of transportation services; power production and transmission; certain types of telecommunications and postal services; and local utilities. The law does not envisage any limitations on ownership of natural monopolies and applies as well to privatized facilities, even those without any public shares. It calls for the establishment of governing agencies to perform the following major functions:

- compiling a list of natural monopolies;
- regulating the activities of natural monopolies, including the identification of priority consumer groups and various methods for price regulation;
- monitoring diversification of natural monopolies' activities, their investments, and realty transactions on a preliminary basis;
- monitoring the movement of natural monopolies' stock; and
- imposing sanctions if a natural monopoly violates the law.

The draft law recognizes that reforming the natural monopoly governance system will be a lengthy and gradual process. Until the end of 1996, existing public governing agencies will take on the role of regulating natural monopolies. Each sector will have its own reform implementation rate and methodology.

Railways

The economic transition has not had much of an effect on the governance mechanism in the railway sector. The Ministry of Railways, which has retained its
independence from other transport-governing agencies, still combines the functions of governing agency, owner and economic agent. Only catering facilities in trains and at stations have been privatized, although, even there, the process has been tedious and slow.

A strictly vertical governance structure has been preserved: railways are subordinate to the Ministry of Railways, railway divisions to railways, and linear units (such as stations and depots) to divisions. Unlike the "premarket" period, the Ministry of Railways does not dictate the amount of railway transportation to provide, but coordinates transportation, redistributes financial resources, and influences railway tariffs. Radical reforms in the sector will be extremely difficult and are not likely to be initiated in the short term. The difficulty is largely a result of three major factors:

- the importance of Russian railway transport and impermissibility of any deviations from its normal operation, which, in the opinion of national leaders, can occur during the process of institutional changes;
- the lobbying capacity of the Ministry of Railways, which is interested in preserving the existing status; and
- large-scale cross-subsidization of various railways and freight and passenger transportation.

Electricity

A joint-stock company, RAO EES Rossii (RAO EES), was established in the power sector, with the state contributing to its charter capital (among other facilities) no less than 49% of the shares of every regional power joint stock company and 51 to 100% of the shares of large power plants. RAO EES also received state shares of construction industry enterprises working for power sector for commercial management (close to trust). The controlling share of RAO EES (no less than 50% according to presidential decree No. 1334) is held by the state, with 30% of the public votes belonging to regions. RAO's board of directors consists of 15 people, including ten representatives of the state. Three of the ten represent regions and the rest are high-level officials from core economic public bodies, such as the GKI, the Ministry of Economy, and the Ministry of Fuel and Energy.

The allocation of responsibilities in the sector is the responsibility of the Ministry of Fuel and Energy (MOE). The federal and regional energy commissions regulate tariffs. It is intended that the public control over RAO EES be executed through state representatives on the board of directors.

However, these mechanisms do not work efficiently enough. Experts believe that RAO EES, which is a giant monopoly holding company, cannot be effectively externally regulated because the state representatives are totally dependent on company managers for information on the company activities. In addition, company representatives were members of the Federal Energy Commission and largely controlled its decisions on prices and tariffs. The Commission, which consisted of less than 20 people who had other responsibilities and were not paid for their service, lacked the required capacity and resources for real control over tariffs.

Presently, a number of measures are being taken to change the situation. The status of the Federal Energy Commission has been enhanced and its rights expanded. It is now chaired by the First Deputy Chairman of the Russian government, A. Chubais. The Ministry of Economy (MOE)
is responsible for providing logistic support to the Commission. The Statute of the Federal Energy Commission, approved by Governmental Resolution No. 739 of June 19, 1994, has authorized the Commission to obtain information from enterprises to better justify tariffs, improve the pricing mechanism in the energy sector, and study the efficiency of public regulation and competitive market formation in the sector.

In principle, the revamped Federal Energy Commission could serve as a starting point for a body that would regulate the electric power sector as a natural monopoly, although its form is that of an interagency commission, consisting of producer, consumer and government representatives. However, the incorporating of consumers is a step forward, since there were practically no consumers in the former producer-dominated Commission. Further, many experts believe that the successful regulation and improvement of the sector's efficiency requires large-scale reforms aimed at the formation of a competitive power market.

Nuclear power stations remain 100% state owned; there are no plans for privatization. The bulk of these stations are part of the state concern RosEnergoAtom which is subordinated to the Ministry of Nuclear Energy.

**Coal**

Corporate governance mechanisms in the coal sector were developed in response to many factors, including a complicated social situation in many coal regions, a multilevel institutional structure, and allocation of large subsidies. They were not designed to promote efficient downsizing. In compliance with the Presidential Decree, there were two schemes for "privatization":

- Enterprises included in production associations were transformed into subsidiaries of joint-stock companies established from these associations.
- Enterprises included in voluntary associations were corporatized as independent joint-stock companies. Holding structures were also formed by consolidating shares of these enterprises.

In both cases, the controlling share of the joint-stock companies was held by the state, with a regional share included in the state block. Some mines were privatized following the national privatization scheme.

The following bodies are involved in coal-sector governance:

- Rosugol: a state-owned holding established by the GKI under a presidential decree. Rosugol has a contract with the GKI for the management of public shares of coal mines and associations (similar to a trust). Appointments of the general director and members of the company's management bodies must be approved by the government. In addition to managing public blocks of shares, Rosugol carries out various activities such as consulting, diversifying into other sectors, and distributing subsidies. Experts doubt that it is possible to combine the public governance of coal enterprises and commercial relations within the same body.
- The Ministry of Fuel and Energy is in charge of implementing state policy in this sector.
- Interagency Commission for the Socioeconomic Problems of Coal Production Regions: established to coordinate the interests of governmental bodies (the Ministry of Finance, the Ministry of Economy, the Ministry of
Social Protection, the Ministry of Fuel and Energy, and the Ministry of Environmental Protection and Natural Resources), trade unions, and administrations of coal producing regions, to address problems in the coal industry. The Commission is headed by the First Deputy Prime Minister. It was set up in response to increased social tension and intensified workers' movements and strikes in coal-producing regions.

The current governance structure does not promote the downsizing of inefficient enterprises; the coal industry has a complex multilevel structure, in which financial flows can hardly be regulated by the state. At the same time, the need for coal sector downsizing is widely recognized both within the government and by the general public. The World Bank's report on coal industry restructuring has played a significant role in attracting attention to the problem. There are two approaches to downsizing: Rosugol proposes to solve the problem by making a 10-year agreement with the government, and the Bank calls for the creation of independent coal companies in each region. The completion of the restructuring program has been entrusted to the Ministry of Economy, and its outcome is difficult to predict.

**Postal Services**

Based on Presidential Decree No. 1390 of November 16, 1992, the postal service formerly integrated in the Federal Post Service Department, was separated from the Ministry of Communications and its regional bodies were transformed into state organizations.

To obtain additional funds, postal service offices have diversified into secondary activities spheres, including trade and freight. These activities are encouraged by the Federal Post Service Department, and do not require public support. According to a high-level official in the Federal Post Service Department, the availability of such services is among the criteria used to assess the efficiency of postal service managers. Although the Russian postal services were reorganized prior to the emergence of the concept of the kazenny, the result bears some resemblance to the kazenny and points to problems that may emerge with this model.

**Lessons and Prospects**

During 1994, there have been a number of legislative reforms which appear to recognize the need for an effective system of monitoring and controlling state-owned enterprises, although Russia is still far from implementing such a system. These reforms include a more rational distribution of state property governing functions among different governmental agencies, as well as reforms to improve the state's control over the management staff of state-owned enterprises. In addition, a new legal form, the kazenny, has been proposed to facilitate the liquidation of certain noncorporatized state-owned enterprises.

It remains to be seen how these reforms will improve the public sector corporate governance system. In the case of the kazenny, the proposed reform has yet to be put into practice. The strengthening of the public corporate governance system is likely to require several improvements, including further development of the conceptual, legal and institutional basis, together with appropriate instruments for the corporate governance of state-owned enterprises; and improvement in the regulation of natural monopolies to underpin reforms in the corporate regime.
Summary

With the launching of the stabilization program of October 1994, the government is making a concerted effort towards privatization and reducing state intervention in the productive sector. Yet, much of the enterprise sector remains in state hands.

Despite the early establishment of a relatively progressive legal framework and ambitious privatization targets, complicated implementation procedures and retrograde leasing legislation blocked speedy progress on privatization. These obstacles reflect a weak overall commitment to privatization and the entrenched interests of the old Soviet structure-enterprise directors, workers' collectives and branch ministries.

According to the SPF (State Property Fund) about 2,200 small scale enterprises and 1,087 medium and large scale enterprises were privatized in the first half of 1995. Some of these were repeat auctions with an average of 15% of the shares being sold through closed subscriptions to workers and an additional 30% on average was retained for sale later. Additionally, the SPF states that from early 1992 to mid-1995 14,856, or about 15% of the total number of former state-owned small enterprises, and 3,781 or 20% of the total medium and large scale enterprises were privatized. The majority of these enterprises were privatized by worker or lease buy-outs.

In general, the corporate governance regime of state-owned enterprises is characterized by elements of the old system of socialist administrative control, without the basic mechanisms to implement this control. There is yet to be a consistent coordinated policy on corporate governance across the sectors and so while the sectors such as Telecom and Coal are being overhauled, corporate governance of their enterprises is still unclear. Similarly in the Rail sector, where a holding company is being set up, details are sketchy on who would control the company, what would be the relations between it and its subsidiaries and how its management would be held accountable. Although there is a growing awareness on the part of the government to tackle such issues, its direction and intention remain unclear.
Corporate Governance:
Institutional Arrangements

In the late 1980s, about 90% of Ukrainian large and medium-size enterprises reported directly to former Soviet branch ministries in Moscow. The collapse of the Soviet Union required a rapid reorganization of the government. A parliamentary decree on August 30, 1991 transferred control over the enterprises that were formerly Soviet property to the Ukrainian government.

Many government agencies were unprepared for the sudden increase in their work load. Understaffed, they were not able to effectively control the enterprises in their subsectors. At present too, ministries are still unable to maintain day-to-day control over enterprise activity, especially in the areas of income and asset disposal. Enterprise managers act autonomously in many areas, and they have developed efficient schemes to bypass government regulations. With the drastic reduction in subsidies, the old system of exercising government control over enterprises through budget transfers distributed by branch ministries is no longer possible. The spontaneous privatization that started following the Gorbachev reforms, has continued. The governance regime of most of the medium and large SOEs in Ukraine, has in practice, been in a state of limbo for several years.

Since the beginning of the privatization process in Ukraine, there has been a tendency to centralize authority in order to increase the effectiveness of the process. Two central privatization organs were initially created in 1991, the Ministry of Destatization and Demonopolization, which had responsibility for designing of the privatization program, and the SPF, which was to execute the sale of state property. In 1993, both functions were consolidated in the SPF and the Ministry of Destatization was abolished. City and oblast level property funds were created to sell off locally owned or "communal" property, (mainly small objects of retail trade, catering and services). Because many local administrations opposed the privatization goals and blocked the execution of policy, a President's Decree on the Unification of Privatization Organs was passed in early 1994. This decree mandates that all local property funds be placed under the authority of the SPF.

On the whole, branch ministries received more power with respect to corporate governance of state firms than did the State Property Fund and the Ministry of the Economy. The Ministry of Economy was only given the right to advise on the management of state property and to monitor the activities of branch ministries.

Historically, labor collectives never played an important role within the corporate governance structure. Although in the late 1980s, the Law on State Enterprises enabled labor collectives to elect managers of state-owned enterprises, this served to strengthen managers' independence from ministries rather than change the balance of power within enterprises. With respect to day-to-day management, state-owned enterprises continue to be management-controlled firms with sector ministries exerting influence over some strategic issues. The balance of power between management and ministries is, to a large extent, determined by the personalities of the parties involved, rather than by approved legislation.

Recent Resolutions concerning
Corporate Governance of SOEs

In 1994 the Ukrainian government initiated far reaching measures to transform
sectoral structures. These changes, as in the Telecom, Electricity or Coal sectors were intended to introduce competition between firms, private or state owned. However, a comprehensive, cross-sectoral legal framework for corporate governance of state owned firms has still not been developed. A standard corporate governance model has not been approved. Instead, a few individual decisions creating new industrial structures and governance mechanisms in separate sectors have been made. These decisions were approved on a case-by-case basis, and were typically initiated by the relevant branch ministry. The changes continue to reflect the influence of the old ministerial administrators.

The structure of corporate governance of state-owned enterprises was set out in the governmental decree of December 1, 1992 on the Administration of Property Owned by the State. According to this decree, branch ministries were required to perform most of the functions of state property management. Specifically, branch ministries were delegated power to:

- decide on the creation, reorganization, and liquidation of state-owned enterprises;
- adopt and enforce enterprise charters.
- conclude and cancel contracts with enterprise executives;
- grant permission to the State Property Fund to create joint ventures with state property; and
- prepare proposals to divide state property between the national and municipal levels.

At the same time, the ministries were not permitted to directly intervene in the enterprises' day-to-day economic activities. However, anecdotal evidence indicates that this provision is not being followed.

An example of the power that was given to branch ministries was in the appointment of chief executives of state-owned enterprises. According to government resolution 360 of December 14, 1991, the ministry hired the head of a state-owned enterprise by signing a contract. The contract would need to be signed even if a manager was elected to that position by a labor collective. This resolution thus further diminished the role of labor collectives in corporate governance. The contract would specify the enterprise's production and commercial goals; the rights, obligations, and responsibilities of both parties; wages and other terms of employment; the duration of the contract; and the grounds for terminating the contract. In keeping with the former socialist tradition, the contract was considered part of the common Labor Code, but not part of the Civil Code.

Resolution 47 of January 26, 1993 established the principles of salary control for state-owned enterprise managers. The resolution stipulated that the salary levels of different positions and bonus schemes had to be developed by the branch ministries in coordination with the Ministry of Labor. In general, managerial salaries were not to exceed the salary levels of the chiefs of the branch ministry that oversee the enterprise and would depend on the volume of gross sales. Bonuses were to be granted as a percentage of the firm's net profits.

Corporatization and Privatization

The Ukrainian privatization program included two processes for converting state owned enterprises to joint stock companies: corporatization and privatization. Privatization describes the bottom-up process initiated by buyer associations, mainly workers' collectives. Corporatization consisted of the top-to-bottom approach,
Recognizing this problem, the government in its November 1994 decree on the functions of branch ministries, abolished the Ministry of Economy's corporatization program and entirely removed branch ministries from the corporatization process for enterprises to be privatized, thus strengthening the SPF's authority over privatization.

**Governance of Majority State-Owned Enterprises**

The privatization program does not provide much information on the management of corporatized enterprises that remain majority state-owned. However, the program proposes that the State Property Fund shall:

- transfer the shares of state property to trustee administrations; and
- appoint representatives to participate in shareholder meetings and supervisory boards of joint-stock companies.

According to the presidential decree of June 15, 1993 and the Law on Economic Societies, mixed enterprises whose capital is at least 75% state-owned must form a supervisory council and a board of directors. The supervisory council's membership must be jointly approved by the Ministries of Economy and Finance. Representatives of both of these ministries, the State Property Fund, the company, the founders, banks serving the company, and employees may serve on the supervisory council. The salaries of supervisory council members are set according to special government regulations. The manager of a corporatized enterprise executes the duties of the board of directors' chairperson during the period immediately following corporatization. Other members of the board of directors must be approved by the supervisory council on the basis of the chairperson's
proposals. Generally, they must be chosen from the former State Property Fund executives.

In May 1994 the "Provisions on Holding Companies created in the Course of Corporatization and Privatization" were approved by a special presidential decree. The Provisions contain a general definition of holding companies that own a controlling block of shares in another company. The decree gives branch ministries many opportunities to form holding companies from the corporatized enterprises that previously reported to them. However, a holding company may only be created with the approval of the Antimonopoly Committee and the Ministry of the Economy, which must establish application procedures. Since May 1995, additional presidential decrees have approved the creation of large holding companies (in nonconsumer goods distribution, in the oil and gas sector, and most recently in the coal sectors), and in other sectors (in railways and telecom) such holding structures have been proposed.

The Railways Sector

There are six separate railways in Ukraine. Since 1992 they have operated under a consolidated administration that reports directly to the Council of Ministries. The railways' budget was set by the Ministries of Economy and Finance. The Ministry of Transport had a coordinating and advisory role, although the division of responsibilities between the Ministry and the Ukrainian Railways were not fully defined. Recent reforms have been adopted which charge the Ministry with providing regulatory functions, including tariff control, and the Ukrainian Railways with overseeing operations.

The drafts of a presidential and a governmental decree to transform the Ukrainian Railways into a national, joint-stock holding company were prepared early in spring of 1994. These decrees proposed that the Ukrainian Railways hold 51% of the shares of all major independent enterprises in the sector, including regional railroads, and 30% of the shares of auxiliary enterprises, such as those involved in trade, construction, and equipment repair. The regional railroads would also be transformed into regional holding companies and obtain 51% of the shares of all enterprises reporting to them, such as local transport enterprises, depots, railway stations, and warehouses. The corporatization of all enterprises included in this holding was to have been completed by December 1, 1994, under the general supervision of the Ministry of Transportation, but has apparently not been completed as yet. The railroad property that is not subject to privatization will be devoted to the long-term use of the Ukrainian Railways. All shares transferred to the Ukrainian Railways, as well as its own shares are to be in trust management by the managers of the holding company until its assets are privatized.

According to the drafts, the Ukrainian Railways would be required to approve the charters of enterprises in the holding and supervise their activities, sign and terminate contracts with enterprise heads (except with regional railroad heads, who will be appointed by the Cabinet of Ministries), and control enterprises use of state property. The Ukrainian Railways management must develop the draft of its own charter in cooperation with the Ministries of Transport and Economy, and the Antimonopoly Committee. The charter must then be approved by the government.
It is proposed that the Ukrainian Railways should have a two-tiered governance structure. The members of the supervisory council, the controlling body, will be appointed by the government. The board of directors will be the executive body. The chairperson and vice chairman of the board will also be appointed by the government, and the remaining four board members will be appointed by the supervisory council. The chairperson will have the same rank as the first deputy of the minister of transportation.

**Electricity**

During 1992-93, two line agencies operated in the electricity sector: the Ministry of Power and Electrification and Ukramenergoprom, the concern managing nuclear stations. These agencies reported to the deputy prime minister responsible for the energy sector. Both structures acted like monopolistic, vertically integrated concerns having the dual function of a government regulating agency and a holding company. In addition, they carried out most of the functions connected with planning, investment, and supply for individual enterprises. The presidential decree of May 21, 1994 called for an in-depth restructuring of this subsector, and implementation began in the late summer. The reforms are designed to separate the governance and regulatory functions and to improve electricity efficiency, service, and eventually lower relative electricity prices.

The government has reorganized Ukraine's power sector into a number of separate, state managed "businesses." Separate corporate entities have been created to handle electricity generation, transmission, and distribution in a process known as "unbundling."

Four types of companies have been created to effect this restructuring:

- The state enterprise, Energomarket, comprised of the central and regional dispatch centers.
- The national electric company, comprised of all high voltage networks.
- Seven joint-stock, electric-generation companies, which will unite all power stations with high capacity. They will compete with each other. These corporatized, state owned companies will generate electricity to be sold into a wholesale electricity "pool," or Energomarket managed by the National Dispatch Center of Ukraine.
- Regional electric distribution companies, which are to be privatized in the short run.

Local distribution companies (LDCs) will buy electricity in bulk from the Energomarket and sell the electricity on the retail market to local customers. The local companies will receive two licenses, one for distribution and one for supply. The two activities will have separate accounts and separate pricing arrangements, checked by the regulator. Later the two businesses may become two separate companies. And others will be allowed to start a supply business.

The National Electricity Regulatory Commission (NERC), an independent governmental regulatory agency funded from the state budget, will watch over this new system to protect the rights of consumers and to ensure that the power industry is profitable. Thus, each newly created entity in the power system has its own set of special responsibilities.

The Ukrainian government will play an important role in the new power sector, acting as a watchdog over the industry
(through the NERC) and as the owner of the new companies in the unbundled power sector. However, these corporatized companies will have their own board of directors and executives who will be responsible for the day-to-day management of these enterprises, removing the need for the government to run the power sector as in the past.

Since this reorganization is recent not all corporate governance mechanisms are yet in place. The selection and appointment of state representatives on companies' boards and their behavior in encouraging or impeding competition, will determine the effective functioning of this system. Sufficient care should therefore be devoted to this issue in order to unleash market forces.

**Telecommunications**

The former largely monopolistic sector has recently experienced a complete overhaul and has been restructured in the following manner. At present, there are:

- over 100 mainly local licensed telecom operators;
- licenses are non-exclusive;
- many operators have private participation including two 49% foreign-owned joint ventures which provide mobile service and long distance and international switching;
- a state-owned association, Ukrtelecom, holds the state's share in these operators; and
- the Ministry of communications performs the regulatory functions such as issuing licenses and advising the Ministry of Economy on tariffs.

The Ukrainian "Ukrtelecom" Association was formed by order of the Ministry of Communications in June 1993, and is controlled by it. The association comprises 34 "republican" and regional telecommunication enterprises among them "Ukrtech."

The aim of the association is to promote extension of Ukraine's telecommunication systems, to provide adherence to a uniform technical and technological policy in the subsector. Ukrtelecom is headed by a Director General appointed on a contract basis by the Minister of Communications and is approved by the Cabinet; Ukrtelecom's board of Directors consist of the Director General, deputy directors, appointed by the Director General, as well as managers of the republican, regional and municipal communication enterprises. Regulation on the board and its composition is approved by the Ministry of Communications of Ukraine.

An interesting addition to the Board of Directors is an "observation Board," which unlike the supervisory boards is not responsible for selection or firing of managers. This board which consists of 21 persons, includes representatives of communication enterprises nominated by the Ukrtelecom Board, consumer representatives nominated by state and public organizations, and representatives of state bodies nominated by the various ministries. The board is primarily expected to oversee decisions on the administration and use of telecom development funds. The board is expected to meet once every six months. The members are not paid a salary and do not have the right to interfere in Ukrtelecom board's operational activities.

Rather than privatizing existing telecom providers, the Ukrainian Ministry of communications has issued non-exclusive licenses to new operators, which compete with the existing providers and in some cases with each other. Concerns about
whether these companies operate on a "level playing field" with the existing providers are mitigated by the fact that: (i) the government-owned companies do not receive subsidies; (ii) in many cases the existing providers are unable to meet new demand — for example the wait for new lines exceeds ten years; (iii) Ukrtelecom or the regional operators often own shares in the competitors as well as in the existing providers.

Control over enterprises in this sector depends on the type of enterprise, which may be of the following three kinds:

- national joint ventures (JVs): three joint-stock companies for mobile communications, domestic and international switching and data network, are 51, 1% government owned and 49% by private interests. The state's share is held by Ukrtelecom. The private shares of the three companies are held by western telecom operators. The general managers of the JVs are representatives of these operators; therefore, the private foreign investor has the control over operations, under the oversight of the board. Boards include representatives of both Ukrtelecom and JV partners;
- local JVs: undertaken between state-owned regional phone companies and private partners often western, to provide new types of service such as high-quality local service; local JVs are similar to national JVs except that a representative of a regional phone company sits on the board (rather than Ukrtelecom); and
- SOEs: these are not corporations and as such they enjoy much less autonomy in management from Ukrtelecom.

In the future the sector is to be further transformed in the following way:

- Ukrtelecom is expected to be transformed to a holding company;
- the SOEs are to be corporatized;
- the Telecom Authority, established as per the communications law passed by the Parliament in March 1995, will function under the Cabinet of Ministers to assume with the required independence some of the regulatory responsibilities of the Ministry of Communications; and
- additional new operators offering new services on commercial terms are emerging.

**Coal**

The Ukrainian coal mining industry is suffering from a deep crisis. Between 1990 and 1995, coal output decreased by about 50%. Due to high material, energy and labor costs, the coal industry is unable to cover its production costs. In addition to producing coal, the mining companies also deliver social services adding further costs that reduce the competitiveness of the coal mines. With payment arrears piling up and the state unable to provide any further subsidies, it has become clear that large parts of the coal industry are not viable.

There are 383 enterprises in the coal industry. Out of these, 295 enterprises are organized into 40 associations, the rest are free-standing (or independent). Twenty-three associations are engaged in coal production, three in coal washing, and the rest are active in geological research, shaft design, mine construction, mine mechanization, and equipment repair. Concerning the legal status of the enterprises, only 28 are joint-stock companies mostly engaged in machine building and construction. Only one of the mines is a joint-stock company. The bulk of the enterprises in the sector have not been corporatized yet.
In early 1995, the Ministry of Coal Industry (MCI) decided that the survival of the viable core of coal mines required the closure of at least 39 mines. The remaining mines were placed into two categories: (i) 57 mines that have a secure future; and (ii) 160 mines that, if given additional support, can survive and become competitive.

Until 1995, coal prices used to be regulated by the Ministry of Economy. In early 1995, the regulatory function was turned over to the MCI, with the exception of coal prices for household consumers. The Ministry of Economy still plays an important role in the development of annual and long term production and investment programs and financing arrangements. In addition, it sets the margins the local retail outlets can charge to household consumers over the wholesale price of coal. The role of the Ministry of Finance is focused on the approval of subsidies in connection with the annual budget cycle. Local governments, depending on their budgetary resources, establish the amount of coal that can be sold to each household at subsidized prices.

The MCI, the key government agency for the coal sector, was established in late 1994, taking over the responsibilities of the former State Coal Committee. The MCI is responsible for the development of government policy in the coal sector, appointment and supervision of enterprise managers, approval of coal production and marketing plans, establishment of coal prices, advising the government on the allocation of subsidies (and directed credit), and decisions regarding the closure and development of mines. In summary, the MCI represents at the same time the policy maker, the owner and the regulator for the coal sector.

While officially only a small portion of the coal is distributed as "state order" with explicit payments from the state, more than 80% of domestic coal production is distributed through "Uglesbyt" a "Coal Trade Association." Earlier it used to have an exclusive right to purchase and sell coal to customers. In early 1995, coal mining enterprises were allowed to market 20% of their coal. For the remaining 80%, Uglesbyt is still responsible for purchasing and selling coal. Uglesbyt is also the only authorized agency to export coal. While Uglesbyt is now called a "Coal Trade Association," it also continues (de facto) to be the executor of "sector orders," based on a "sector plan."

The MCI has prepared a draft Presidential Decree on the corporatization of the coal industry. According to this draft, the 23 coal associations will be merged to form 15 geographically based coal production businesses that will be converted into joint-stock companies (JSCs). The target date for the completion of corporatization is April 1, 1996. According to the plan, the state will own 100% of the equity of the JSCs initially. However, the intention is to sell this equity over time so as to achieve the full privatization of the industry. These JSCs will contain only those activities that are directly related to the core business of coal production, including the local operational marketing activities of Uglesbyt. The central planning, coal distribution and revenue transfer functions of Uglesbyt will disappear. The management of the JSCs (and independent mines) will be free to negotiate and determine the prices of their production. The directors of the JSCs will be appointed by the Ministry of Coal, under
short-term contracts of a maximum duration of one year. The contracts will be based on performance-related pay.

In the future, the MCI will have a central role in and responsibility for the reform of the Ukrainian coal industry. In particular, the Ministry will be expected to:

(i) determine the composition of the new JSCs and manage the separation of non-core activities;

(ii) manage the transfer of social assets to local authorities;

(iii) represent the state as a shareholder in the JSCs, and arrange and manage performance-related contracts for senior management;

(iv) administer the fund that provides compensation for the cost of transferring workers from mines which are closed; and

(v) establish and supervise the activities of "Ukrainian Coal Enterprise," the company entrusted with managing mine closures.

Improving the competitiveness of the coal industry will also require the reduction of overemployment, transition to a market based system from the currently centrally planned system, and reform of the organizational and management structure of the industry. The main building blocks of such a restructuring being:

- liberalizing of coal markets;
- establishing of new corporatized entities by combining economically viable coal mines, washing plants and marketing organizations;
- rapidly closing uneconomic mines; and
- focusing budgetary support on the cost of mine closures, including social costs, and the divestiture of assets.

While the reorganization of this sector shows promise for improvement in management of this sector, the overhang of the control structure of the branch ministry and its marketing arm in corporate governance at every "level" (or in every enterprise), leaves much room for questioning the effectiveness of the changes.
III.

ILLUSTRATIONS FROM DEVELOPED MARKET ECONOMIES
A key lesson learned from the privatization experience in non-socialist countries such as Argentina, Mexico, Morocco, and those in Western Europe, is that privatization has been a complicated, intensely political process that almost always took longer to get going and to complete than anticipated by the designers of the program. For example, Mrs. Aquino, then President of the Philippines, announced the sale of Philippines airlines in 1987 and said that it would be completed within 90 days; sale was finally completed in 1992.

Privatization: A Slow Process in Transitional Economies

In Poland and the former Czechoslovakia, early in the transition, radical reforming governments passionately dedicated to free market economics in general, and to privatization of state owned enterprises in particular, came to power. They believed, as the World Bank does, that the ultimate solution for poorly performing public enterprises is to privatize them. However, despite worldwide experience revealing that privatization of even a few hundred enterprises can be a slow and complex process, these governments did not have a program for dealing with these public enterprises prior to their privatization. They thought that improving performance in the many enterprises, temporarily or indefinitely, which were likely to remain in the hands of the state, was not a problem, because:

- in a very short period of time there would not be any public enterprises to worry about, since the reformers intended to move very quickly on privatization; and
- even for those that would stay in state hands for a time, argued the reformers, it would be better to do nothing and simply wait until privatization came along, since they regarded bureaucrats as completely incapable of running enterprises in a competent manner.

Many of the first wave of radical reforming officials, at least in these two countries, thus rejected the idea that they should be devoting thought or resources to the problem of how to improve performance in remaining state firms. Equally, they rejected the notion that the World Bank or external agents could or should help them in any way with this question.
More than four years have passed since the transition started, and privatization has indeed been very slow in most post-communist countries.

- At present in Poland, of an estimated 8,440 enterprises in 1990, some 2,517, or about 30% have been privatized — but that leaves 70%, close to 6,000 companies unprivatized. As of mid-1994, 24 enterprises had been sold through public offerings, and another 60 or so had been sold to foreign investors in negotiated sales, a very small total number when compared to the plans to sell hundreds of firms by these means in 1990 alone. Most of the privatization in Poland that has occurred has been in medium-sized companies; it has come about through management and employee buyouts following the official liquidation of the company.

- In the Czech Republic and in neighboring Slovakia, out of some 7,000 medium and large firms in 1990, about 3,275, or 47%, have been privatized. This is an excellent record — but it still leaves a fair number of enterprises in state hands; and even in the Czech Republic, the state in many cases still retains a portion of the shares in enterprises that have been mainly privatized.

- In Russia, between 12 and 14,000 medium- and large-scale enterprises have been privatized through the voucher auction method in the last 20 months alone. This is rightly seen as a tremendous accomplishment — but there are another 10,000 or so enterprises remaining, and the voucher program, which was the means by which the first wave of privatization took place so quickly, has come to an end. It is reasonable to estimate that the second phase of privatization — selling the remaining enterprises for cash — will be a much slower process.

- In the countries that make up the former Yugoslavia, privatization really has not proceeded very far or very fast. And in Romania and Hungary privatization has at best been modest until mid-1994.

That privatization took place at all was a major accomplishment in these countries, or any other post-communist country, given the difficulty of the circumstances inherited and the many and major obstacles that block the path to privatization. To repeat, privatization is the best and ultimate answer to the problem of poorly performing public enterprises. Nonetheless, the fact has to be faced that a large number of enterprises have not yet been sold, and that they remain under the official ownership of the state. Even if the mass privatization program in Poland is successfully launched and completed; even after the completion of the second wave of voucher privatization in the Czech Republic and in Slovakia; even after the commencement of the second wave of sales for cash in Russia — there will still remain a substantial number of enterprises owned by the public sector in these and all other post-communist countries. So there is a need for reforms of the public enterprises (PEs).

**Improving Performance of PEs: The Case of China**

Experience in non-transition countries shows that there are many state owned enterprises which perform reasonably well, and some that perform very well, in terms of profitability, productivity and economic efficiency. There are a number of highly successful public enterprises in Western Europe — particularly in Austria, Germany
and France — in Canada, and in New Zealand. There are also a number of success stories from Asia — For example, a public sector fertilizer company in Indonesia, or the electricity generating authority of Thailand. Every region offers examples of well run public enterprises.

One very interesting and revealing example is the case of the Township and Village Enterprises (TVEs) in China. There are more than 1.3 million TVEs in China; they employ 90 million people. They produce more than 20% of China's industrial output; they now account for about 25% of China's manufactured exports, and are growing at roughly double the rate of the state-owned enterprises (SOEs). TVEs yield a return on capital two or three times that of the SOEs. They behave much like private companies, but they are not privately owned. As their name implies, they are owned by the sub-national governments of China, the regions and municipalities. Their performance contrasts very favorably with SOEs, of which at least a third (and probably many more) are unprofitable. They outperform SOEs because:

- TVEs are exposed to competition. They have to compete in markets with other producers of similar products in their region or elsewhere in the country. There is just about unrestricted entry into the ranks of TVEs, which means any local government can create them. There are few obstacles to exit, which means TVEs can and do fail and go out of business, and their local government owners do not rescue them when they persistently lose money.

- TVEs operate with fewer policy constraints. They have few if any requirements to provide social benefits (a major problem for the SOEs), they have few wage or bonus regulations, and few environmental restrictions. Commercial profitability is their main and over-riding goal, and non-commercial objectives are not allowed to take precedence over profits.

- They operate under a hard budget constraint, meaning that they receive no subsidies from government owners, and no subsidized credit from the state-owned banks; and they buy and sell at market-determined prices. (The result is that most of them finance their investments from retained earnings or from capital injected by private joint venture investors.)

- TVE managers have much greater autonomy than SOE managers; they can hire who they want and pay them according to their productivity, and they can — and they do — fire employees who do not perform. Managers can select what products to produce, and the markets in which to try to sell their products. They can price their products according to market principles; they make their own investment decisions and choose the technology they need. In sum, managers are allowed, indeed encouraged and even forced, to manage.

- Managers and workers have better incentives. Workers and, in particular, managers are paid according to how well the enterprise performs — and they are fired if they consistently perform poorly.

This sort of behavior is definitely not the norm in most state-owned enterprises. TVEs are a stunning example of how positive performance can be instilled in
enterprises which are not privately owned — but are made to act as if they were.

For the hundreds of thousands of state owned enterprises in China (not including TVEs) the question remains: why don't the Chinese authorities simply apply to SOEs the successful arrangements they use for TVEs? The answer to this question is very revealing about the problems of state-owned enterprises in China, and indeed, around the world.

In the first place, Chinese SOEs operate in different sectors than TVEs — they tend to be older, larger and working in the heavy industrial sectors such as steel, machine tools, etc. In contrast, TVEs generally produce consumer goods. Industrial SOEs dominate the heavy industrial sectors and use older technology; TVEs work in light industry, and their more recent creation means their technology is more up to date. SOEs report to central officials who are not personally touched by the good or bad performance of the enterprise.

Despite persistent performance improvement measures and campaigns over the past decade, SOE aggregate performance has not greatly improved. One of the main reasons for this is that SOEs fulfill many social, non-commercial objectives. TVEs, on the other hand, are supervised by local officials who are dependent on the profits of the TVEs to finance their political programs — and it has been argued that many local officials get direct financial benefits from well-performing TVEs. In these circumstances the local government "owners" of TVEs are more interested in making money than in protecting the jobs of incumbents or fulfilling other, non-commercial objectives. So, for reasons of market structure — that is, exposure to competition — for reasons of the sectors in which they work, for reasons of their general outmoded technology, for reasons of size, and especially for reasons related to incentives, Chinese SOEs tend to function more poorly than TVEs.

**SOE Reforms: Lessons from Other Countries**

The Chinese SOE case illustrates many of the causes of poor public enterprise performance. But, according to experts, there are some necessary steps to take to overcome and correct them, other than privatization.

A prime cause of poor performance is that state owned enterprises have multiple and conflicting objectives. They are told to make money, and at the same time to maintain existing levels of employment, or they are instructed to reduce costs to a rational minimum, but they must continue to buy their inputs from a particular supplier, or they are instructed to keep open a plant that is uneconomically situated, etc. The imposition by government owners of objectives other than commercial profitability is commonplace in SOEs, and the cost to profitability and productivity imposed by non-commercial objectives is one of the main reasons for deficient SOE performance.

To overcome this problem, governments have to take a series of measures. First, some governments attempt to provide clear and unambiguous objectives to their companies by means of performance agreements that specify the obligations of both the owner and enterprise management. There are many different types of such agreements; they are used in countries as widespread as France, Gambia, India, Bolivia, Pakistan and Korea.

Though they have been widely applied, there is little solid evidence that the signing of a performance agreement leads to
improved financial and economic performance. Indeed, a World Bank study on the subject of performance contracts found "little evidence" that they improved performance. There is some evidence to suggest they may have made performance worse. Where performance did improve, it was because the management's contracts gave credible signals that the rules had changed, and provided managers with concrete incentives to do better.

Another improvement mechanism often used is to reform an enterprise’s board of directors, staffing it with technical experts or people in the line of business of the enterprise, giving it the responsibility and the power to supervise the company and keep it aimed at the commercial objectives assigned by the owner. Board reform has been part of the SOE reform program in many countries, including New Zealand and Korea. Yet another method, used by itself or in conjunction with the previous approaches, has been to appoint strong and experienced leaders — sometimes with extensive private sector experience — and give them a free hand to run the business as Chief Executive Officer (CEO).

A second cause of poor performance is lack of incentives for managers. In many countries, SOE managers earn more than civil servants, but much less than CEOs of private sector companies of equivalent size or importance. If government owners want managers to take risks, make decisions — and make the right decisions — and suffer the consequences of mistakes, then they have to reward these managers; they have to provide a salary and other incentives sufficient to attract and retain high quality people.

A third cause of SOE problems is what is called the "soft budget constraint," meaning that many SOEs receive unjustified and persistent subsidies or capital injections from the state; or they get credit from the banking system at below market rates (while competitors, especially those in the private sector, pay full price); or they are excused from meeting their payments; or they receive exemptions from dividends, taxes, customs duties, overdue bills, etc. There are hundreds of ways for governments to subsidize or soften the financial requirements asked of SOEs, and governments have used them all.

Conclusion

Many governments attack this problem by removing all or most of the guarantees to banks and creditors they previously offered on enterprise debts and obligations, and they require that in future borrowing, their SOEs go to commercial capital markets, and that their loan applications be treated no differently from those of private sector applicants. Reforming governments try to create a "level playing field" for all enterprises, public and private, and eliminate the subsidies, bailouts and special treatments previously given to SOEs. Experience shows that resisting the temptation to provide financial assistance to troubled SOEs is one of the hardest steps for governments to take.

Many governments protect their SOEs from competition, even though it is absolutely clear that exposure to competition is one of the most powerful causes of improved performance. Most of the SOEs known for their efficiency and profitability are those forced to operate in highly competitive markets, in which their relative success or failure can be measured. Reforming governments around the world, tired of continuing losses and the inability to assess performance, are eliminating the
protected markets and regulatory barriers which guard their SOEs.

No government finds it painless and easy to enforce these reforms. The overriding problem of SOEs is that government owners want them to fulfill both commercial and non-commercial objectives. When these conflict, as, eventually, they inevitably do, politics tends to outweigh economics, and the non-commercial objectives win. States may be rich enough for a time to tolerate the losses and financial drain that are caused by the triumph of the non-commercial goals — but sooner or later the money runs out and fundamental reform is needed.
Relationship between Owners and Management: Commercial Utilities

Among all the vexatious issues in corporate governance, none is more troublesome than the defining of the relationship between the owner and the managers. The presentations in this section provide a small spectrum of choices to deal with owner-manager issues in the provision of commercial public services. Frank Matthias Ludwig presents the case of the Deutsche Bundesbahn (Germany’s railway company). The case highlights the importance of corporatization, accompanied by the separation of commercial goals and public service obligations and by the distinction between the infrastructure (in public hands) and its operation, to be privatized in future, so that the enterprise can face up to the competition.

Gérard Moine argues that the key transformation in the case of France Telecom came about with the change in the company’s relationship with the state, transforming it from a hierarchical authority to a contractual relationship (performance contract), enabling it to gain full autonomy in a partially competitive environment, with the gradual introduction of deregulation and separation of regulatory authority. Private sector corporate governance mechanisms have been adopted, but trade unions have blocked full privatization.

Next, Jean-Pierre Pery elucidates the key characteristics of the relationship between the owner and managers in the case of France’s Gas and Electricity companies. In so doing, he points out the usefulness of a strategic performance contract in clarifying the situation between several ministerial departments and the managers. The present situation, whereby the state is both shareholder and regulator, may not be sustainable.

Finally, Richard William Prebble outlines the principles and modalities of the corporatization of New Zealand’s public enterprises.
The Case of the German Railway
Frank Matthias Ludwig

Until 1994, the federal railways were managed as a federal administrative authority. The fundamental decision on the structural reform of the railways was made by the federal government on July 15, 1992. The first step was to create a new company, Deutsche Bahn AG (DB AG), which is based purely on corporation law. The state is still the only shareholder at the moment. Next, two new state authorities in charge of "public tasks" to be fulfilled by the Railways were created. To this date, "state" tasks and entrepreneurial tasks are clearly defined. The third step will take place three to five years from now. The DB AG will be turned into a holding company. Under its umbrella, there will be at least four independent corporations (public limited companies) that will be opened to private investments. One limitation to the full privatization of DB AG will remain, in that private shareholders will not be majority owners of infrastructure. According to the Constitution, at least 51% of the infrastructure ownership will remain in state hands.

Legal Situation before the Railway Reform of 1992

Principles of Management and Supervision

Until 1992, The Deutsche Bundesbahn was managed as a federal agency with administrative autonomy.

It was managed like an enterprise, with the general goal of a) providing optimum transport services in accordance with commercial principles, so that revenues covered expenditures including the liability reserves, and b) achieving an appropriate return on the equity capital invested. In this context, the Deutsche Bundesbahn fulfilled its public service obligations.

There was a broad allocation of rights to the Federal Minister of Transport who had the right to approve, inter alia:

- the business plan — and any significant alteration of said business plan — during the business year, and the annual financial statements. Approval also required the agreement of the Federal Minister of Finance;
- the construction of new lines, as well as implementation of basic upgrading or modification of technical installations;
- the permanent closure of a line, discontinuation of operations of a major station, the shutdown or relocation of a workshop or any other major facility;
- the establishment, relocation, or any fundamental reorganization of a regional head office or a central office of the Deutsche Bundesbahn as well as any alteration of its regional areas;
- the establishment or acquisition of other companies; and
- the approval of tariffs and proposals with respect to timetables to "be taken into consideration as far as possible."

The Ministry also had rights of approval with respect to personnel matters, such as decisions with respect to remuneration and promotion. Since staff members of the Deutsche Bundesbahn were public service employees, these decisions required the agreement of the Federal Ministers of Transport, of the Interior and of Finance. The Federal Minister of Transport
Corporate Governance of Public Enterprises in Transitional Economies

was also responsible for decisions regulated by public (service) law concerning personnel matters of the members and deputy members of the Board of Management.

Organization of Corporate Supervision under the Two Tier Model

The Administrative Board (comparable to a supervisory board) was composed of 20 members, including four groups consisting of five members each, nominated by the federal government. The proposed members of the Administrative Board came from (i) the Federal Council (Bundesrat); (ii) every sector of the economy; (iii) trade unions; and (iv) other members. The members of the federal government had the right to participate in or send a representative to all meetings of the Administrative Board. The members had to perform their duties to the benefit of the German people, the German economy and also to the Deutsche Bundesbahn, which was difficult to accomplish all at the same time.

The role of the Administrative Board included the approval of the business plan, staff plan, and annual financial statements; the right to propose the appointment/dismissal of members of the Board of Management and other executive employees of the Deutsche Bundesbahn. It also set the railway fares and other transport rates, which were vital to the financial situation of the Deutsche Bundesbahn.

The Board of Management was composed of one chairman and other members, the number of which was decided by the Federal Government. The official relationship between the board of management and the Federal Government was governed by public law. Appointments were made with the agreement of the Administrative Board, and if no agreement was reached, the decision was made by the Federal Government.

The Board of Management was bound by resolutions of the Administrative Board. It conducted business with the due diligence of a business-like and conscientious manager.

The Reform of 1992

Objectives of the Reform

The objectives of the reform were to reduce the overall financial burden of the railways as much as possible. Another objective was to put the railways in the position of playing a greater role on the future transport market, and to execute the EC Council Directive on the Development of the European Railways of July 29, 1991. This Directive demanded: (i) commercial autonomy of the railways; (ii) financial adjustment of the railways; (iii) separation of infrastructure and operations at least on accountancy basis; (iv) public service obligations performed on contractual basis with interested public bodies; and (v) free access of third parties (international groupings of national railways and international combined transport operators) to the national rail networks.

Prerequisites of Reform

The prerequisites were to place the railways on an equal footing with their competitors regarding their entrepreneurial scope for action — within the framework of an overall transport policy — and to release the railways of their legally imposed public service obligations.
Main Features of the Reform Regime

<table>
<thead>
<tr>
<th>Pre-Reform Public Authority</th>
<th>Post-Reform Company in AG Form (joint stock company)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Orientation in line with superior political objectives.</td>
<td>1. Entrepreneurial orientation.</td>
</tr>
<tr>
<td>2. Restricted by public civil service and budgetary law.</td>
<td>2. Integrated into general private and company law.</td>
</tr>
<tr>
<td>3. The actions of each individual are restricted by provisions and regulations.</td>
<td>3. The actions of each individual are oriented towards the bottom-line results.</td>
</tr>
</tbody>
</table>

Current Status of the DB AG

The goals of the enterprise are as follows: (a) to provide and market rail traffic services for the conveyance of goods and passengers; (b) to operate and market the railway infrastructure including, in particular, the planning, construction, maintenance and management of the operations control and safety systems; and (c) to support all business activities in areas related to rail traffic. Furthermore, the company is entitled to engage in any business activities required to achieve the above goals.

The company may establish or buy a share in undertakings of a similar or related nature at home and abroad. It may divide its operations totally or partially into such undertakings and restrict itself to management functions.

The New Corporate Governance Organization

The Board of Management is set up in accordance with the Company Act. The company management is responsible for the entire management policy. Board members are appointed by the Supervisory Board for a maximum of five years, and are liable for damages. Board members can be dismissed by the Supervisory Board, at the shareholders' meeting, for neglect of duties, or as a result of withdrawal of confidence.

The Board of Management needs the consent of the Supervisory Board for business activities including the following:

- initiation of new fundamental areas of activities within the scope of the articles of association or discontinuance of existing activities;
- fundamental alterations in the company organization;
- acquisition or formation of other companies, acquisition and disposal of shareholdings in other companies and participation in a capital increase with capital investments with the value of more than DM10 million;
- investments not already provided for in the budget planning, if the costs exceed DM20 million;
- acquisition and disposal of real estate unless provided for in the budget planning, if the value exceeds DM10 million; and
- taking up loans, debentures or other credits with a term of more than one year, if the amount exceeds DM500 million in each case.
Box 9: Necessary Steps to Turn the State Railways into a Public Limited Company

1st step
- Federal law

2nd step
- Change of constitution, especially Art 87 GG and federal law

3rd step
- Legally foreseen company act at the earliest 3 years, at the latest 5 years after start of DB AG

4th step
- Legally foreseen possibility to dissolve DB AG (Holding) to merge it with individual plc's or to split it up among other plc's

Note:  
- Special state property  
- Traditional authority  
- Public limited company
The Supervisory Board is composed of 20 members. Ten members are the shareholders' representatives appointed by the general assembly (of which three are delegated by the Federal German Government while still a shareholder), and the other ten members represent the staff, including three union representatives and one representative of management staff. In accordance with the Company Act, the role of the General Assembly includes legal changes introduced to clarify the duties of each category.

The reform has modified the financing of infrastructure. Capital costs of infrastructure investment will be taken over by the state. Infrastructure investment according to the National Master Plan has to be fully paid back by DB AG at the level of annual depreciations. In the event that certain infrastructure investment projects are not — or only partially — in the commercial and entrepreneurial interest of DB AG, it will pay back only part of the annual depreciations, or will receive direct construction cost grants. DB AG will present contracts to the Federal Republic on the details of infrastructure construction and financing. Maintenance and operating costs have to be borne by DB AG. Therefore, 100% of the infrastructure costs remaining with DB AG after reform have to be covered by the users of the infrastructure.

**Conclusion**

The first year of operating as a formally privatized company has shown that Deutsche Bundesbahn is able to run at a profit and increase turnover without raising prices. After decades of heavy losses, the board of management was able to present a net operating profit of DM 88 million for the year 1994. The German taxpayer had saved DM 3 billion in 1994, in comparison with continuing the status quo.
The Experience of France Telecom
Gérard Moine

Technological development, the evolution of ideas, globalization and the increase in competition that took place in the past fifteen years were all new and important challenges faced by the French telecommunications industry. Yet, the concept of public service which is in France intrinsically linked to the telecommunications sector had, at the same time, to be preserved. As a result, the telecommunications agency in France was transformed from an administrative department within a ministry into a public, corporatized quasi-company functioning in a competitive environment.

The Telecommunications Industry was run as a government agency until 1990

Until 1990, the telecommunications operations was run as a standard directorate within the Ministry of Post and Telecommunications (PTT), called the General Directorate for Telecommunications (Direction Générale des Télécommunications). The Minister was in fact the head of this directorate. This department had no real autonomy in terms of personnel, financial, procurement or pricing policies. The Ministry was mainly regulated by three bodies: the Parliament (which approved the budget of PTT), the Ministry of Finance — the Treasury (which owned the Cogecom holding company — see below), and the European Community. Ex-post control was, and still is, performed by the public Court of Audit.

This department was restricted in its technical and budget choices. The French telecommunications industry was in a very poor state for decades because, for many years, telecommunications services were considered to be a privilege and not a public service, i.e. it was not conceived to deliver its services to the public at large. At the beginning of the 1970s, however, the government realized the importance of telecommunications and decided to move toward a modern telecom network. During that time, some changes were suggested within the directorate. The department was modernized, with the implementation of a new organizational structure and a "management charter." However, a broader reform failed because telecommunications were still viewed as a source of income for the state budget. As of 1990, telecommunications were still an instrument of state industrial and budgetary policy, used to support the development of the electronics industry and to subsidize the general budget.

France Telecom became a public sector company with the 1990 reform

Reasons for Change

The last fifteen years have been marked by several profound changes that have compelled the telecommunications industry to adopt new structures. These include:

- New technologies. Technological development supported by the development of microprocessors brought telecommunications and data processing much closer. This technological convergence opened the
way to a real boom in the telecommunications-based services market. Obviously, monopolies were not the most appropriate structures for the rapid exploitation of these new markets.

- **Liberal ideology.** Since the beginning of the eighties, deregulation and privatization appeared to many to be the solution to all problems resulting from inefficiency.

- **Globalization of markets.** Large-scale customers and, more particularly, multinationals increased pressure on operators for international services. The telecommunications market was destined to break through national frontiers and become globalized.

These three factors have resulted in the opening of new markets to be capitalized. The decisive milestone in this development was the dismantling of AT&T in 1984 in the US. Another important factor was the move towards a single European market. The need to create an inter-European telecommunications market led to the publication of the EC Commission's Green Paper on the Development of the Common Market for Telecommunications and Services in 1987. The overall objective was to provide European users with the largest possible range of services under the most favorable conditions possible, while maintaining coherence and uniformity among the networks and services provided in member countries. The EC Green paper established a general framework which took into account the unquestionable specificity of telecommunications and, in a sense, brought it into the realm of the common law regulating the exchange of services, while also recognizing the globalization of the sector and putting an end to the protectionist context in which it had developed.

**Negotiating Change**

The proposed changes in the French telecommunication industry were perceived as a veritable cultural revolution. In view of the very close link between the French postal service and France Telecom, it appeared impossible to deal with changes in the status of France Telecom without considering that of the postal service. Reform of the sector, therefore, concerned not only 150,000 employees in telecommunications but in fact a total of 500,000 civil servants. Thus it was necessary to bring the public, the customers, and all the employees together to discuss the problems of the sector, and to engage in open discussions on possible future directions. There was a wide-ranging internal and external debate within France Telecom and within the civil society regarding the future of the postal and telecommunications services. Negotiations took place with the unions; and an intensive public information campaign was implemented. The project was adapted to reflect the ideas expressed; in fact, the telecommunication agency's transformation into a joint stock company with every labor contract governed by private law had to be postponed due to the opposition of the trade unions. Ultimately, the process resulted in the creation of state-owned quasi-company and the modification of the telecommunications regulatory framework.

**Adapting to Changes: The New Organizational Structure**

The new legislative and regulatory framework for telecommunications in France is based on two laws. One was approved on July 2, 1990, defining a new statutory framework for the French postal and telecommunications services, and modifying the status of France Telecom, granting it the means to become a competitive public service. A second law, approved on
December 29, 1990, defined the regulatory control over telecommunications in France by stipulating how networks and services could be established and operated. The new organizational form required substantive changes in the legal system. According to the new rules, France Telecom is no longer subject to administrative law, but rather, to commercial law. The operation has lost its monopolistic position and is now subject to regulated competition. France Telecom has retained its public service obligations; however these are specified and limited.

Under the law of July 1990, France Telecom severed its traditional ties with the French administration, and became an independently operating quasi-company established as a public corporation. France Telecom's charter is based on commercial law, and elects a chairman, a board, and directorates. The Ministry of Posts and Telecommunications is in charge of overseeing the public enterprise. The Parliament, acting through a committee, exercises a lighter control than before, and the European Union remains involved through general regulation and direct relations with the enterprises. The state is the owner of France Telecom. It has also become a regulator of the telecommunications industry, pursuing a policy intended to allow other actors to enter the market and to compete with France Telecom.

France Telecom must follow the guidelines set out by the Ministry of Posts and Telecommunications (PTT); however, it is no longer required to submit its budget for parliament approval. The management of France Telecom is responsible to its board of directors, president, and chief executive officer. Its status as a state-owned public corporation guarantees that its public service responsibilities will continue to be taken into account, and that concerns for defense, security and research are maintained. But France Telecom now has financial autonomy, which is essential to continue to progress in times of rapid technological development and to meet the increasingly complex needs of clients. France Telecom is now the direct owner of its assets and of its stakes in its subsidiaries.

The corporation's relationship with PTT also reflects a duality and a balance. In areas where it does not have exclusive rights, France Telecom is subject to the same regulations that the "General Directorate for Post and Telecommunications" (DGPT), within the PTT has established for all other telecommunications service providers. For areas open to competition, the corporation as a public operating company is subject to the same regulations as its competitors. The PTT ministry also has a supervisory role over the corporation which is characterized by proprietary functions (notably the approval of its strategy) and by the protection of specific state interests.

The New Relationship with the State

The key element of the change was the institution of a new relationship with the state, transforming it from a hierarchical authority to a contractual relationship. France Telecom and the Ministry now interact through a contract, known as a "contract-plan"; the Ministry of Finance is also partner in this contract. A multi-year contract is signed regularly between France Telecom and the state, which defines the strategic orientation for the company, its concrete objectives, and proposed financial indicators. France Telecom thus has gained the authority to define its own strategy.

The "contract-plan" describes the economic and financial guiding principles.
### Degree of Competition According to Services Provided

<table>
<thead>
<tr>
<th>System</th>
<th>Discipline</th>
<th>Objectives</th>
</tr>
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<tbody>
<tr>
<td>Monopoly</td>
<td>Public terrestrial infrastructure</td>
<td>Public Service</td>
</tr>
<tr>
<td></td>
<td>Voice Telephony</td>
<td>Strategic Resource</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Cost Organization</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Coherence of Basic Networks</td>
</tr>
<tr>
<td>Structured and Controlled</td>
<td>Messenger Services</td>
<td>To take advantage of a dynamic market</td>
</tr>
<tr>
<td>Competition</td>
<td>Radio Services</td>
<td>Not harm public provision</td>
</tr>
<tr>
<td></td>
<td>Independent Networks</td>
<td></td>
</tr>
<tr>
<td>Full Competition</td>
<td>Value-added Services</td>
<td>To create a dynamic force in multifarious markets</td>
</tr>
<tr>
<td></td>
<td>Terminals</td>
<td></td>
</tr>
</tbody>
</table>

The current agreement — the first — covers the period from 1991 to 1994. It stipulates that France Telecom prices can only increase by an amount which is 3% lower than the yearly general increase of GNP prices; its investment may reach an amount of FF150 billion. The level of its debt over the period must be significantly reduced, and personnel productivity should increase by at least 4.6% a year. The "contract-plan" also reflects the supervisory role of the state as the owner, recognizing its role in exercising the necessary control over France Telecom in all areas not regulated naturally by market forces. At the same time, the contract protects the company's management autonomy from the unavoidable and powerful temptations of the state to interfere in enterprise management, while ensuring that the company continues to take into account the public service requirements and specific interests of the state with respect to defense, civil security and research.

### Outlook

As a result of the reforms, France Telecom has become a powerful economic player. One of the specificities of the French experience is that France Telecom is a company with subsidiaries, regrouped under a holding company called Cogecom. Cogecom and its subsidiaries existed before the 1990-92 reform, when France Telecom was still part of the public administration. Cogecom's scope of activities includes networks for television and radio transmission and multi-media, mobile telecommunications with French and international subsidiaries, and software production. Cogecom represents 15% of the activities of the France Telecom group, 10% of the staff, and 15% of the turnover.

France Telecom nowadays faces three major challenges, to which it has to adapt very quickly. First, France Telecom faces a generalization of competition. It needs to adapt its strategy, corporate culture, tariff structure and organization to this new context. The European Union in particular, is planning to introduce general competition in all telecommunication services in 1998, eliminating all restrictions. Second, France Telecom has to become a full-fledged corporation with greater autonomy. The capital stock has to be opened to other partners, and, in order to compete, France Telecom has to define a strategic growth project. Finally, France Telecom is faced with the globalization of the telecommunication sector; telecommunication services
Box 10: France Telecom Group in 1994

<table>
<thead>
<tr>
<th>Key Figures</th>
<th>France Telecom</th>
<th>Cogecom</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues</td>
<td>$126.5 billion</td>
<td>$17.1 billion</td>
</tr>
<tr>
<td>Operating Income</td>
<td>$30 billion</td>
<td>$1.6 billion</td>
</tr>
<tr>
<td>Net Income</td>
<td>$4 billion</td>
<td>$285 million (France Telecom Group Share)</td>
</tr>
<tr>
<td>Investments</td>
<td>$37 billion</td>
<td>$5.2 billion</td>
</tr>
<tr>
<td>Employees</td>
<td>153,100 persons</td>
<td>13,700 persons</td>
</tr>
</tbody>
</table>

**Products and Services**
- 6.5 million Minitel terminals installed
- 400,000 mobile telephone subscribers
- 600,000 Numerus/ISDN basic rate accesses
- 106,000 Transpac data communications subscribers
- 196,000 public phones, 123,000 of them card-operated

are now operating on a worldwide basis. France Telecom needs to adapt its strategy, organization and financial structure to this new context, and to enter into partnerships. France Telecom has already taken steps in this direction by entering into partnership with the German company, Deutsch Telekom, and the American long-distance carrier, Sprint.

**Conclusion**

The success of the reform of the telecommunications sector in France is due first to the strong determination of the politicians in charge, including the personal involvement of Minister Paul Quiles and then Prime Minister Michel Rocard. It is also due to the method adopted, which consisted of negotiations with all the stakeholders, which was subsequently adapted to the actual situation of France at that time. Yet the evolution of telecom in the modern age is a continuous adaptation to technical innovations, economic rules and the needs of different consumer groups in society. These rapid changes will continue to affect the sector and will undoubtedly require further reform and adaptations.
Box 11: France Telecom Today: New Structures

Until 1990

European Community

Parliament → Ministry of PTT → Minister

Ministry of Finance

DGT

Regional Headquarters → Cogecom

Subsidiary → Subsidiary

After 1990

European Union

Parliamentary Committee → Ministry of PTT → France Telecom

Board

Chairman

Directorates

Regional Headquarters

Cogecom

Subsidiary

Partners
The Experience of France in Gas and Electricity

Jean-Pierre Pery

In France, the gas and electricity utilities, Gaz de France (GDF) and Electricité de France (EDF), belong to a "network sector" that is, a sector in which the service or the product is delivered through a grid.

The French experience on the relationship between owners and management, elucidates three characteristics: (i) the government role as both owner and regulator; (ii) the constitution of the performance contract, and (iii) the potential impact of increased competition.

The Role of the State

EDF and GDF being public companies, the government plays both roles, that is, of a shareholder and a public regulatory authority. In 1946, the electricity and gas sectors were nationalized during a period of transition characterized by lack of private initiative and capital, huge reconstruction needs and rapid development of the economy.

As a public authority, the state is responsible for energy policy and for other public interest policies (environmental regulations, regional planning) which can, in turn, influence the activities of EDF and GDF. The state is in charge of the development and implementation of the regulations. It is also the "conceding power" which grants transmission or gas pipe concessions to the operators, and which controls the distribution concessions granted by local authorities. Finally, the state is the regulator which ensures the optimal functioning of the market through tariffs, investment and competition control.

At the same time, however, the state is the sole owner of EDF and GDF which are, in turn, the dominant service providers in their sectors. As owner, the government appoints the president of the board of directors and the general director. One third of the board of directors is formed by representatives of ministries, another third by experts appointed by the government, and the remaining third is elected by the workers. The government, especially the Ministry of Economy, is in charge of the financial control of the utility through a "financial inspector." Budget and accounts, as well as the investment plan and financial capital investments of firms are subject to the owner's agreement. The Ministry of Industry appoints a "commissaire du gouvernement," a governmental representative, who attends the board of directors' meetings in an advisory capacity, and who is the administrative interlocutor of the utility with which he is very familiar, follows all its projects and activities, conveys the government's instructions, but can also represent the company's interest in government debates.

The confusion of two roles has advantages and disadvantages. The state is stronger in its relationship with very powerful utilities. It is not easy to control a company like EDF, which is the leading electricity company in the world, with a 20% share of the European market. As a result, the relationship sometimes looks like a power struggle. It also allows the state to mobilize the company in favor of general interest actions or orientations such as employment or environment, or regional planning.
On the other hand, the confusion of roles can be detrimental to the optimal management of the company. For example, the state is not a rich shareholder. It does not bring sufficient capital to the company, thus forcing the utility to borrow excessively. In the past, it also gave greater importance to the price index than to the rational evolution of tariffs.

The Function of the Program Contract

In order to clarify the relationship between owner and management, the government has signed program contracts, similar to performance contracts, with EDF and GDF. The basic philosophy of the program contract is that the public owner has to guide the enterprise, and not manage it. The company should be managed like any other private company, with the same methods and responsibility sharing. The contract determines the broad financial goals regarding productivity, tariffs, debt, profit, and dividends. Within this framework, it presents the main objectives for commercial development, international action, investment programs, social policy and quality policy, and it provides for a control of contract implementation.

The contract does not exhaust all dimensions of the relationship between the public owner and the company. Other contracts with various ministries have been signed in the fields of environment, regional planning and employment. However, this contract is a strategic one, signed by the three ministries in charge of the shareholders' control of the company (Ministries of Industry, Economy, Budget). Above all, it is a contract among these ministries in order to reconcile the general interests they represent, to coordinate the strategic control, and to avoid disagreement between them.

The core of the contract, the basis of all the other provisions, is an agreement between these three ministries and the company's management regarding the financial objectives and the method to distribute profits among the company itself for its investments; the consumer, through tariff programming — which must take into account the productivity gains and not increase at the same rate as inflation; the future consumer, through the debt reduction; and the public owner through dividends.

From this point of view, the contract represents a major step towards making the relationship between the government and the company more objective. In this context, it is interesting to note that, in the United Kingdom, the agency regulating the electricity industry (OFFER), has recently signed contractual tariff agreements with the public electric distribution utilities, which basically follow the same principle.

The Impact of Competition

Finally, it is important to consider how the relationship between the owner and the management will change in the future, as a result of increased competition, if new actors in the gas and electricity sectors are introduced. Some experts agree that France will have to distinguish more clearly between the different roles of the state: on the one hand the shareholder, and on the other, the regulator, in order to avoid a situation where the state would be both judge and interested party. This would certainly require the creation of an independent public regulator. However, the French Ministry of Economy and Finance does not agree with this view.

Another question remains unanswered: how will it be possible to keep such
powerful companies under control? For example, EDF, which employs 120,000 people, is controlled by a team of 25 civil servants in the Ministry of Industry, assisted by five or six people in the Ministries of Economy and Budget. How will it be possible to maintain a balanced relationship between such companies and the regulating agency? The British experience in this respect is not very encouraging, because the regulating agency has either accepted market domination of the most powerful companies, PG and NP, or has introduced artificial market sharing, as in the case of gas, reducing the market share of the dominating company, BG.
Corporatization of Public Enterprises in New Zealand
Richard William Prebble

Deciding on the scope of corporatization is of major importance. The New Zealand experience demonstrates that it is expensive if corporations have to be restructured repeatedly; it is, therefore, important to establish the scope correctly the first time.

Basic Principles Applied to Corporatization in New Zealand

- Corporations should not be their own regulators, consequently it is necessary to split off the regulatory functions and put them into a government department. For example, in New Zealand, the conservation forests were split from commercial forests, forestry mills were split from commercial forests.

- Corporations should have a single commercial focus because conglomerate corporations are not successful. New Zealand, for example, split the "post office" into Telecoms, New Zealand Post and Post Bank. Similarly, the set up of "Electrocorp" with the national power grid was not a success, whereas with the split of the power transportation (the grid) from the generators, both corporations performed better.

- Non-commercial functions should be identified and split off. In New Zealand, the National Engineering Company Works Corporation was also the inspector of lifts, cranes etc., a non-commercial function which had to be separated from the commercial one.

Help from independent consultants is necessary to assist in defining the scope of each corporation. In the New Zealand case, outside reports were done on each corporation as a basis for the government's decision.

Attitudes of Workers' Councils

In New Zealand, before every corporatization, management warned the government that transformation would be very difficult because of resistance from workers, councils, and unions. However, in every case, senior and middle management themselves became the biggest obstacle to corporatization; unions sometimes were an obstacle, but workers' councils were not.

The solution to the workers' opposition resided in communication. Communicating to workers through middle management, or unions, or workers' councils is fatal, because the message gets reinterpreted. Communication must be direct. For example, in the case of corporatization of the New Zealand railways, the Minister of State-Owned Enterprises wrote directly to every railway worker, setting out the facts. He wrote to workers' homes so their wives could learn the facts. In addition, the Railways offered generous redundancy payments to surplus workers - 90% of whom accepted voluntary redundancy despite the historically high unemployment. These high redundancy payments overcame the workers' councils' resistance.

The New Zealand experience shows that once direct, honest and open communication with the workers was
established, there were no serious obstacles to corporatization. When workers were given a choice between working in a badly-run business or a well-run business, they selected the well-run business every time. Once the workers favored corporatization, the unions and workers' councils' opposition to corporatization ended, provided that the unions and councils were reassured that they would still be recognized. The government withheld recognition to use as a bargaining chip. In the end unions bargained away everything in order to keep their power base as recognized bargaining agents.

**Attitude of Management towards Corporatization**

In many cases, management represented a much more difficult obstacle. The New Zealand government was forced to say to management that, unless they strongly and efficiently supported corporatization, they would be replaced with managers who did. Many senior managers had to be replaced. Middle management opposition is understandable because it is the most threatened by the reforms — but it still had to be dealt with. Just as modern corporations have realized that with computers they do not need an army of middle managers, so it is with state corporations. For example, in some state corporations, head offices were reduced from 600 to 60.

**Selecting the Agent as Owner's Representative**

New Zealand has tried a wide range of agents. The first choice was the logical one: the sectoral ministry. The Minister of Civil Aviation, for example, was the logical shareholding minister and the Civil Aviation Department the logical monitoring ministry for the airline industry, as were the ministry of Energy for the mines industry, the ministry of Forestry for forestry corporation, and the Treasury for banks.

However, this policy was a failure for two main reasons. First, the trading corporations captured the monitoring agency — for example, the Ministry of Civil Aviation liked aeroplanes and supported every one of Air New Zealand’s expansion plans. Second, there was a shortage of business skills in the government. By expanding the number of agencies, management skills were spread too thinly.

In response, the government moved in the opposite direction, setting up a single asset management agency that was close to, but separate from the Treasury, and thus able to have some independent financial analysts. The agency concentrated on the shareholders role, and hired a staff with business skills who learned to identify early signs of failure. They also have learned to identify good boards and good board members. Because the agency is monitoring so many businesses, it is able to take a national overview of all the corporations. To date, this agency has been very successful. The success of the agency depends in part on its ability to develop a special relationship with the finance department and, in turn, with the availability of an able and strong minister.

**Identification of the Owner**

New Zealand never spent much time considering the question of who acts as owner for the state, because it had a model in existence. For this past century, the state in New Zealand has owned some companies in the private sector. While the Minister of the Treasury normally used to hold the shares in Air New Zealand, the Minister of Civil Aviation appointed the directors. So
New Zealand adopted the model of Ministers as shareholders. The Minister of Finance holds half the shares in all corporations, and another minister, appointed by cabinet, holds the other 50%. As it happens, the other minister has been the Minister for State-Owned Enterprises, but legally it could be any minister.

Potentially, if the Minister of State Enterprises and the Finance Minister had a disagreement, corporatization would be paralysed. In reality, this has never happened; the system works in New Zealand because ministers have to cooperate and are accountable to Parliament; there is a special time put aside to debate the corporations' past performance, and for the statements of corporate intent. As the corporations work well, the debate is usually fairly low key.

Allowing agencies that are not accountable to Parliament to be owners of state-owned enterprises is questionable. Scrutiny would be very difficult, as demonstrated by the difficulties involved in examining subsidiary companies. If ministers are responsible for the corporations, then the ministers should exercise ownership.

Allocation of Responsibility Between Managers and Governmental Departments

Direct responsibility of managers seems to be more effective. It is important that managers have the power to make decisions, otherwise, they are not responsible, and cannot be held accountable. If they have direct responsibility for decisions concerning prices, wages, and capital expenditure, they then have direct responsibility for outcomes. Real performance is dependent on this direct responsibility. In New Zealand, boards and managers sign strategic plans.

The present government has, as a matter of policy, stated that some government businesses in areas such as state radio, electrical generation and national transmission, and New Zealand's postal service will not be sold. However, the government runs these businesses using the same model employed for businesses that are to be privatized. All permanently or temporarily public businesses are set up under the private sector Companies Act, with commercial balance sheets, commercial objects and non-government boards; social objectives are separate. In the case of the state radio, an agency funded by license fees, called New Zealand-On-Air, contracts directly and transparently to promote cultural and ethnic radio and other programming considered to be non-commercial.

Conclusion

Corporatization in New Zealand has been a successful policy. Nevertheless, in a fast evolving environment, businesses have to grow and adapt, or they die. State ownership is not always compatible with this principle. As an illustration, by owning a business like electrical generation the government becomes involved in plans for the new generation. There is a significant risk, because many power projects in New Zealand have had significant cost overruns. As the private sector is able and willing to finance electrical generation, it is not a good use of the tax-payers resources.

Appointing good boards, competent managers and insisting on performance can help improve state businesses — but the truth is that government is in the political game, and is not good at business.
Relationship between Owners and Management: Declining Industries

In this discussion of how PEs can overcome the challenges of operating in declining industries, Sir Ronald Halstead discusses how British Steel, a loss making public company, tackled the threats to its survival by rationalizing dramatically its production, downsizing its workforce, cancelling non-commercial objectives, and introducing performance-linked bonuses under a strict regime of financial oversight. The cost borne by the national and European budgets of this restructuring prior to privatization has been high. In contrast, the kind of commitment and the "authority" required by governments to enforce new corporate governance arrangements, as well as the financial means to implement the changes, is very thin in the transition economies.

In the next presentation, using the experience of the French coal industry, Jean-Pierre Pery argues that a public owner can rationally manage the decline of an industry, provided agreement is reached with local governments and trade unions, and that profitable activities are separated from loss making ones.

Evidence is presented to demonstrate that it is important that companies in declining industries not be managed as if the company were in decline. In the case of France, the lack of proper corporate organization in the form of one powerful organization in the coal sector, instead of separate entities that would be able to provide a long term orientation, has proven adverse.
Relationship between Owner and Management: Declining Industries

The Case of British Steel
Ronald Halstead

British Steel:
From Losses To Viability

By the mid-1970s the British Steel Corporation (BSC), like many producers worldwide, was facing a number of threats to survival: over-capacity in world steel; intense competition; and escalating costs as a result of the oil crisis. Labor-related costs reached a peak in 1978-79 of £1,100 million, equivalent to 35% of turnover.

Moreover, a particular feature of the effects on manpower productivity were dramatic. In 1979 it took over 14 man-hours to produce a tonne of steel. By 1989 that figure had been reduced to 4.4 man-hours per tonne and the proportion of labor costs to turnover had fallen from 35% in 1979 to below 20%.

Decentralization of Industrial Relations

Central wage negotiations were devolved and linked to incentives. Labor cost increases were largely met through self-financing deals from improved performance. Every three months, depending on the rate of progress toward locally agreed performance targets, a bonus was paid as a lump sum to all employees at a plant, from the plant manager to the laborer on the shopfloor. This has had the effect of dramatizing the link between pay and performance whilst emphasizing the interdependence of all those working at a plant, irrespective of status, union or occupation. This combination of policies allowed the company to give higher rewards to employees, an increase of 19% in real terms over 11 years, whilst reducing the labor costs per tonne of steel.
**Improving Communications**

Many of the policies and programs introduced would be unpalatable for the work forces of any corporation. Consequently, the third element of the strategy was designed to deal with this problem. Traditionally in the steel industry, many of the workers' managements had close relationships with their employees. There had always been elaborate consultative and participative systems, generally concentrated on representatives of employees. Under the pressure of the changes needed at the time, however, the system needed improvement; and many techniques were used to communicate the plans to the workforce, including direct letters to employees' homes (involvement of families), works newspapers and direct video messages to the workforce. The Corporation twice polled its entire workforce in order to test the strength of support for its policies when these were challenged. In both cases there was overwhelming support from the rank and file for the survival plans explained and proposed by the Corporation's management.

**Corporate Governance**

**before Privatization**

Before the 1988 privatization, supervision, reporting to government and funding of restructuring were arrangements already in place. The following elements were characteristic of its governance structure.

**Board of Directors**

The Board consisted of chairman, chief executive, non-executive directors and full-time executive directors who managed the business. The chairman and non-executive directors were appointed by the Minister for Industry for three-year terms which could be renewed. The chief executive and executive directors were appointed to the Board by the Minister for Industry on the recommendation of the chairman and non-executive members of the Board.

There were normally up to seven non-executive directors; and the executive directors consisted of divisional managing directors, finance director, personnel/industrial relations director, and the research and development director. The company secretary also attended all meetings of the Board and took the minutes.

The matters considered at the Board included the rolling corporate plan, annual budget, monthly trading results and chief executives report, major capital investments, divestments and plant closures. Many of these items were for submission to the government (see below). A senior civil servant from each of the Trade and Industry and the Treasury attended the Board meetings by invitation; they were the main links with the two government departments concerned.

There were two sub-committees of the Board — the Audit Committee and the Compensation Committee — both composed of non-executive directors. The Audit Committee was concerned with the financial controls of the Corporation; and the Compensation Committee dealt with directors' remuneration. The chairman of the Compensation Committee had direct access to the Minister for Industry and discussed with him the salaries of the chairman, chief executive and executive directors. The Minister for Industry then had to clear salary increases with the Treasury. Invariably salaries were kept at a low level so that there was an increasing disparity between nationalized industry salaries and those of equivalent executive jobs in the private sector. However, British
Steel obtained approval for a bonus system that allowed executives to earn up to an additional 30% of salary, depending on performance against budget. No other nationalized industry obtained this concession.

Relations with the Government

Information concerning the operating results and cash requirements of the British Steel Corporation (BSC) was supplied to the government on a regular basis in the 1980s. Normally, contact was made through BSC's sponsoring government department, the Department of Trade and Industry (DTI), although the Treasury also dealt directly with the Corporation. BSC was required to operate within the restraint of annual government cash limits (external financing limits), which were made after joint discussion and review. The regime of cash limits on nationalized industries was introduced by the government in 1976/77 as part of its measures to bring public expenditure under close control. Cash limits were in turn applied within the Corporation to its individual businesses, where they formed an essential element of management discipline and control. The Corporation was also required to operate within borrowing limits imposed by the appropriate Iron and Steel Act then currently in force, or relevant Borrowings Orders laid before parliament.

Beginning April 1978 cash advances to the Corporation were made under Section 180 of the Iron and Steel Acts of 1975. In principle, these advances were interest-free, although the Corporation was to be required to pay dividends once financial viability had been achieved. It was recognized in the early 1980s that a manifest crisis existed in the EC steel industry, with low steel demand, poor prices and a significant excess capacity. In order to proceed towards a viable steel industry throughout the Community, a quota system was applied to both production and sales, with target capacity reductions subscribed to by each member nation. In addition, it was agreed to phase out all state aids by December 1985. As far as BSC was concerned, all advances (made under Section 180) were regarded as state aid and before any payments could be released, formal approval was required from the EC.

If the Corporation required funds (within its external financial limits and its borrowing limits) that had not been released by the EC, then it was necessary to borrow short-term on the financial markets for which normal commercial rates of interest had to be paid.

Annual Submissions

The Corporation regularly submitted to the government detailed plans, both for the upcoming year and the medium-term. These plans were generally on a corporate basis, although the operating budgets also showed details for each of the operating divisions of the Corporation. The corporate plans were prepared to take into account the objectives set for BSC by the government, as well as internally set targets for performance improvements within BSC. Among other things, the plans contained projections of BSC funding needs for the following three calendar years. The plans were the subject of extended negotiations with government representatives, during which the plans were modified as appropriate.

Monthly Submissions

Cash Advances. In order to receive the funds from the government, a formal request was submitted to the DTI, generally on a monthly basis. This request detailed the actual application of funds for the previous month, and included forecasts for
the next three months ahead. DTI and the Treasury could seek justification of the cash requirement, and also review the previous month's actual expenditures. This was normally done at a regular monthly review meeting attended by all interested parties.

Monthly Results. The monthly results for the Corporation and businesses were reported to the BSC Board in the monthly management accounts. Copies were supplied to the DTI and the Treasury and the results were subsequently discussed at the joint monitoring review meeting. Not only was actual cash expenditure shown for the previous month, but comparisons were made against the budget for each constituent element of application. In addition to the formalized nature of the meetings noted above, it was always open to the government to request reviews and/or meetings on specific subjects at any time, which were held as required at a chairman/minister level and/or at a staff level. In particular, these meetings took place when it was necessary to review the Corporation's medium-term plans or strategies. The system of reporting and monitoring described above allowed the government to fully control the usage of funds and the rates of advance.

Social Plan to Accompany Plant Closures

The task of dealing with plant closures was not an easy one. Successful efforts required three characteristics, namely, collective action, committed action and rapid action to ensure effectiveness. In general, the steps taken were:

- Consultations with the trade unions and local government. These sometimes produced alternative solutions to full closure. In some cases there have been modifications to the original plan. Inevitably, given the business background, the planned redundancies were implemented in most cases.

- A target notice period of one year.

- Negotiation of severance payments with the trade unions for each closure. Payments were related to the employees' length of service; a typical severance payment would amount to 26 weeks' pay.

Steps taken with individual employees included:

- Peer counselling. Existing employees at different levels discuss various professional options for laid-off workers.

- Voluntary redundancy whenever possible, but not in the case of full plant closures.

- Early retirement at 55 years of age, 10 years before UK statutory retirement. Some employees chose to embark on a second career at this stage. During the period between 1977-84, 60,000 employees took early retirement.

- Retraining. The Corporation provided retraining benefits in terms of earnings protection and course fees to enable employees to receive proper training for an alternative career. These benefits would last for up to a year at 90% of previous earnings.

- Compensation. All employees who left the Corporation as redundant received a sizeable cash award. In addition to the severance payments already mentioned, employees received an enhanced redundancy payment of 90% of past earnings covering between 90 and 150 weeks. The corporation received some assistance from the UK government and the EC to meet the costs of redundancy.
Conclusion

British Steel was able to successfully manage the transformation from a loss making to a viable enterprise, by allowing it the autonomy to undertake managerial decisions, such as the designing of compensation policies to match performance and yet, at the same time extracting strict responsibility for performance, through the annual and monthly submissions. However, such dramatic changes would not have been possible without some required innovation, especially in the area of labor shedding; designing of redundancy packages that would make it attractive for labor to leave; providing counselling services to allay fears of the new situation; consulting with trade unions and employees about the plant closures; and ensuring that employees had opportunities for retraining and job placement outside. One such innovation, was the creation of BS(I), to help create jobs in areas affected by British Steel’s restructuring. Its main features are outlined below.

Box 12: British Steel (Industry) Ltd. BS(I)

The Organization BS(I) was set up in 1975 as a wholly-owned subsidiary of British Steel. Its sole mandate was to help to create jobs in geographic areas affected by the restructuring of the steel industry; currently, there are 19 target areas. This mandate has remained largely unchanged, except that today there is a greater emphasis on the durability of the jobs and the diversification of the local economy, and less on short-term job creation measures. The company operates very much at arm's length from the rest of British Steel. Over the years its board of directors has included business people from the private sector and national officers of the trade unions as well as executives from the British Steel group. It works in close collaboration with central government and regional and local authorities.

In 1981 the BS(I) Board proposed to invest most of the following three years of funding in job creation assets, primarily business loans and property. The main objective of this plan was to make BS(I) financially independent of British Steel after March 1984. The transformation was successful, and from April 1, 1984 BS(I)'s income has been derived from property rental and from the interest on loans to businesses, which created jobs in closure areas and, more recently, dividends from companies in which it has taken a shareholding. This income is now generally sufficient to cover its normal operating costs.

Activities. The company has always followed the principle of filling gaps in the supply of the resources and services which small, but growing businesses need. As the needs of small businesses have changed through time, so have BS(I) programs.

Finance. Despite the UK's well developed capital markets, small, growing businesses often have difficulty in raising relatively small amounts of risk capital often needed because they are usually unable to offer adequate security. BS(I) is one of the very few sources of risk capital to meet these needs; the company has invested between L10,000 and L150,000 in the form of loan or equity capital in such companies.

Premises. Small businesses, particularly new businesses, often have difficulty in finding suitable premises on affordable terms. BS(I) addressed this problem originally by converting redundant steelworks' ancillary buildings into self-contained units and, more recently, by building modern business centers.

Indirect Assistance. The indirect programs or assistance include several initiatives for encouraging entrepreneurial skills in young people and providing financial support for other local economic regeneration initiatives, including the Local Enterprise Agencies which provide business advice for new and existing businesses at the lower end of the size spectrum.

Results. Over 3,000 businesses have been directly and materially assisted by BS(I), mainly with finance or premises or both, with a three-year job creation potential of over 50,000 jobs. In addition, it has been estimated that at least a similar number of jobs have been created as a result of indirect British Steel (Industry) support.
The Experience of the French Coal Industry
Jean-Pierre Pery

The declining industries, such as steel or coal, pose specific problems, in addition to the other difficulties that transition economies face.

The French Situation in the Coal Sector

The Decline of Coal Mining in France

The coal industry in France has been in decline since the Second World War. Production has decreased from 50 million tons in 1947 to 9 million tons in 1994. The numbers of workers decreased from 360,000 in 1947 to 17,000 at present. Consumption of coal, currently at 25 million tons, is rapidly decreasing in all sectors (steel industry, cement, residential). In other industrial sectors the consumption remains steady because of low coal prices, but at a rather low level. In France, because of the importance of nuclear electricity generation, the use of coal in the energy sector is very limited; coal accounts for only 4.5% of the electricity generation (using 8 million tons of coal).

Coal prices in France are free and determined with reference to international prices, but production costs are much higher. For example, in 1992 the average production cost was FF543 while the price in the international market was FF242, that is to say less than half the production cost. This situation is due to bad geological conditions: French coal is of poor quality, and difficult to mine because deposits are coming to an end. Thus, companies engaged in coal production are faced with the difficult challenge of managing a situation where their production and markets continue to shrink along with a worsening financial position caused by their inability to compete in world markets.

Ownership of the Mines

Under common law, mineral rights belong to the owner of the surface land. However, this is not the case in the French mining code: the owner of the surface has no mining rights. Mining rights are given by the state to operators in the form of a mining concession, with a maximum duration of 25 years. The concession operator also needs a license from the Administration.

This system aims to be in conformity with different principles, including:

- the idea that mineral resources are of public interest and cannot be appropriated definitively by particular interests;
- the need for a legal framework that allows economically viable operations by the mining company; and
- the respect of public security and environmental obligations.

Ownership of the Coal Mining Companies

Coal mines were nationalized after World War I and their operation turned over to newly created companies. In 1946, France was in a situation not very different from that of countries currently in a transition: weakness of private entrepreneurship, lack of capital, and the necessity...
for rapid recovery. Today, coal mines in France are operated by three public companies owned by the French state. These include:

- two local operators: one in the coal basins of central and south of France, the other in the Lorraine basin in the northeast;
- a third operator, CDF (Charbonnage de France), which controls and coordinates the other two, managing some common services (especially financial services) and determining the global strategy. There is no capital link among the three operators, which is a problem.

The state is both the owner of the mining companies and the public regulatory authority. As owner, the state exerts its control through the Ministries of Industry and of Finance. The board of directors of each company is composed of 18 members, including five representatives of the state (Ministries of Industry, Economy, Budget and Social Affairs), seven experts appointed by the state and six union representatives elected by the workers. The president and the managing director are appointed by the government, upon proposal by the board of directors. A special representative of the government ("Commissaire du Gouvernement") attends the sessions of the board of directors in an advisory capacity. Generally, the representative is the director of gas, electricity and coal at the Ministry of Industry. He is in fact the administrative interlocutor of the company.

The public coal companies, like all public utilities and declining industries in France, are under the financial control of the Ministry of Finance which appoints a financial inspector ("Contrôleur d'Etat"). Budgets and financial statements have to be approved by the government. The annual investment plan is also approved by a specific body, the FDES.

**Box 13: The French Economics and Social Development Fund (FDES)**

During the expansion of the 1950s and 1960s, the Economics and Social Fund (FDES) proved to be a major instrument for channeling funds into long-term industrial investment. Created in 1955 as a special account within the French budget, FDES aimed at financing investment projects which followed Planer's guidelines or specific priorities pursued by the government such as industry conversion or decentralization. The FDES board of directors is composed of representatives of various technical Ministries (such as the Ministries of Transportation, Equipment, Industry, etc.), high level civil servants (Heads of central departments) and representatives of financial institutions (such as the Banque de France, the Caisse des Dépôts etc.). The Minister of Finance serves as the chairman and has the power of final decision on loans. Thus, FDES's board of directors is an essential institution of coordination for the government's financial policy, primarily towards public and secondarily, private enterprises. Its functions include: deciding on lending activities, scrutinizing public enterprises' investment policy; and approving agreements with intermediary financial institutions.

The fund is financed by budgetary appropriations, special resources affected to its operations and the reimbursement of former loans. The Ministry of Finance decides whether to subsidize interest rates on loans.

FDES has a fundamental role in financing large infrastructure and equipment investments. Originally, funds were slated to finance investment projects of large enterprises, public transportation, local governments and tourism. Special concern was given to enterprises whose activities were fundamental within a specific area. As the French financial system became more independent from the government in the early 1970s, FDES's role declined. Currently, FDES lending activity is now concentrated in troubled semi-public and public sectors, such as transportation, mining sector and public investment. Its main role remains in the reallocation of public investment within various sectors. In particular in the energy sector, the FDES board acts as a regulator of the investment programs.
Regulation of the Sector

However, the government is also the public regulatory authority, not just the shareholder. As regulatory authority, it is in charge of the broad energy policy and other public policies that can affect coal mining activity (such as environment, foreign trade, and social policies). For example, the choice of nuclear electricity generation has had great consequences on the coal sector.

In addition, the government establishes the mining code and all the administrative proceedings. For example, when mining activity comes to an end on a site, it is necessary to engage in a very long and complicated procedure of relinquishing the concessions that involves major problems of liability. The government also regulates competition in the energy sector, including the relationship between coal mines and the electricity generation company, quality and import control. Finally, the government's role is to assure the proper functioning of the coal market.

Specific Features: Role of the Owner in Declining Industries

The role of the owner in the case of declining industries is different from the role of the owner in the case of commercial sectors, especially when this owner is a public entity. The French experience demonstrates that a public owner can provide an opportunity to rationally manage the decline based on the following principles:

- Helping the declining sector and areas during this difficult phase in order to find new jobs for the miners who are too young to retire and to promote new economic activities for the former coal-producing areas.

- Maintaining a free market with free prices, based on the international coal price, as well as free relationships among collieries and electricity utilities. Indeed, the government refused to give any support to the coal sector market through artificially high prices.

- Promoting transparency. The decline of the coal industry requires subsidies so as to manage a socially acceptable phasing out and avoiding any sudden, mass redundancy. This requires time and costs a great deal, and must be transparent, which means that the subsidies are given through the public budget to the collieries to help finance the expenses inherited from the past — with no link with the present mining activity (such as the former miners' pensions) — as well as to finance the re-industrialization work of the coal areas and, finally, to finance collieries losses.

As long as it follows the above-mentioned principles, state ownership helps reconcile a market approach with a social approach to the problem of the coal industry's decline. In addition, the public owner has a global perspective on the problem of the declining industry and can implement other policies easing the phasing out of collieries, for example by programming educational investments. It can also maintain reindustrialization activity in the coal areas after the closure of the mine. In the north of France, where mines have been closed for two years, a reindustrialization subsidiary is still at work.
Limitations Imposed by the Nature of Ownership

Although such principles are attractive, in reality, the public owner faces several difficulties in rationally managing the decline of coal. It is not easy to be both the shareholder and the public authority subject to political choices under pressure from public opinion. Making decisions about the schedule of mine closures, for example, is difficult and subject to delay and backtracking. Closure decisions are difficult to implement because of the state's global approach as shareholder. As the government closes the mines in decreasing order of losses per ton and per miner, the difficulties it meets on a small site with heavy losses block the entire procedure and prevent it from taking adequate steps regarding other and larger sites.

Finally, it is also difficult for the public owner to solve some of the major problems posed by the end of mining activity, such as the responsibilities relating to the former mining operation or the future of real estate assets owned by the collieries. The state is sensitive to the complaints of local authorities regarding closures, and in recognizing that, the state encounters the risk of asset-stripping of the company.

To resolve these difficulties, the French government found that the following steps were critical:

- First, to make all actors (management, unions, local authorities) aware of their responsibilities and interests in the rational management decline. This means not covering entirely the operational losses in order to encourage the company's management to increase productivity and to enforce self-discipline, and letting the citizens know what the coals sector costs the nation.

The subsidies must be transparent and given through the public budget, not hidden in artificial market prices. It is worth noting that it would have been better to distribute these subsidies through regional budgets, as in Belgium, because otherwise it is in the interest of local authorities to maintain mining activities even at a loss, in order to receive as many national subsidies and infrastructure programs as possible.

- Second, to negotiate an agreement between the unions and the collieries on a global plan to manage the decline. In France, the mining company CDF and the unions have negotiated the "coal pacts," the main impact of which will be the creation of social guarantees for former miners and the acceptance of the year 2005 as the end of coal mining activity in France.

- Third, in order to maintain a rational economic discipline in the relationship between the public owner and the management, it is essential to create specific subsidiaries in order to separate the profitable activities (such as electricity generation) from the loss-making activities (such as coal mining) and to avoid compensating these losses. This separation helps the state to make appropriate investment and industrial strategy decisions.

Sectors in Decline versus Companies in Decline

Managing the Decline in the Coal Sector

Any company operating in a declining industry has to guard itself from the danger of being managed as a declining company. It can face this challenge by:
• managing the decline, closing sites, reducing production and at the same time becoming more competitive and productive on the sites that are still viable. It may not be easy to reconcile these objectives. How to keep experienced miners and executives on such sites, with a global policy leading to people reconversion? How to finance investments in a financially debased situation? The most productive investments that can be made lead to an earlier closing date;

• not letting viable activities be overshadowed by non-viable activities. For example, electricity generation by the collieries' power plants is profitable. In the case of CDF, its future lies in electricity generation, which now represents more than half of the turnover, with nine power plants totalling 2600 MW;

• considering the changes in the activities of the company. For example, the new responsibilities of CDF, which ensure the future of CDF as a company, are no longer in the field of coal extraction in France, but in the field of reconversion and reindustrialization, international mining engineering and electricity generation;

• reconverting and reindustrializing declining areas through job creation, and infrastructure development. CDF has created specific subsidiaries in this field of activity, which in turn require particular experience and skills. One of these subsidiaries, has helped the creation of more than 49,000 jobs since 1986;

• developing new engineering technologies as in the case of underground coal mines and coal-operated power plants outside of France. As CDF's mines in France are closing, one of the most interesting cases of implementation by CDF of modern mining techniques can be found in India; and

• recognizing that sectoral changes have implications for the organization of the company; a proper structuring of the group is of major importance to rationally manage the coal sector's decline and to ensure the development of viable new activities at the same time. The French experience shows that:

- the French industrial organization in this sector, with separate companies in the different coal basins, is not efficient. It is better to gather all mining activities into one company or group, with a central powerful organization and long-term strategic orientation, that can maintain guidance and negotiate with local authorities and unions;

- isolating viable activities into distinct subsidiaries to avoid any compensation of mining losses by profits from these activities would jeopardize their development.

**Privatization in Declining Sectors**

In France, the decline of the coal sector has been managed within the framework of a public company. The issue of whether privatization is possible in a declining sector
has not been addressed. Based on the European experience, three experiences can be distinguished:

- the market support to coal mining, through artificial internal prices, especially in the relationship between electricity utilities and coal mines, which can be private or public (Germany);

- the privatization of coal mines after separating the losses inherited from the past, which have not been passed on to the new operators (UK); and

- the management of decline by a public agency in charge of progressively closing the mines under socially acceptable conditions, and ensuring the future of the company by the development of viable activities, in partnership if necessary with other interests (France).

The first solution is very costly; in 1992, the subsidies per ton of coal amounted to 60 Ecu in Germany, 21.5 in the UK, and 19.9 in France. Moreover, it does not lead to the end of the activity, but rather prolongs it indefinitely, disturbing the energy market, undermining the competitiveness of the energy supply, and is in violation of European regulations. The second solution is efficient if the geological mining conditions allow it and if there remains a market for the coal. It requires that the new privatized operators not be obliged to support the costs incurred by other non-viable mines or closed mines, such as miners’ pensions. This strategy also requires a selection of the pits: only a few can be privatized. Finally, the third solution is adapted to the case of bad geological conditions and sufficient reserves. It is a good way to reconcile the free market and the social management of the coal decline for the population of coal-producing areas.

In conclusion, the French experience shows that the relationship between the owner and management has to be radically adapted in the case of declining industries. The management of a declining industry is costly and has major social dimensions. Every decision is subject to questioning because of local and national political interests. However, it is desirable to anticipate such problems and to put into place an adequate framework as soon as possible, based on the principles of transparency, responsibility, social solidarity and efficient structure of the company.
Establishing Effective Oversight over Public Enterprises

This section concludes the volume with two cases of managerial issues of PEs. The first, by Brian R.D. Smith, deals with the oversight responsibility of owners vis-a-vis the managers and describes the case of the Canadian Public Enterprises. Smith believes that the system of checks and balances for corporate governance embodied in a special legislation, has served Canada well so far, and may have its merits in applicability elsewhere. Establishing clearly the oversight responsibility of the Board and provisions of the Board's performance evaluation, were important measures taken to guide the development of the corporation on behalf of the shareholder. A proper division of responsibilities among the shareholders, the board of directors and the management is at the heart of establishing an appropriate governance structure, according to Smith.

The second paper, by Sir Ronald Halstead, provides the specifics of personnel management as undertaken at British Steel, in order to prepare the assumption of future management positions like the method for identification of high potential or rewards policy for performing individuals.
The Role of Boards:  
The Case of Canadian Railways  
Brian R.D. Smith

Introduction

Corporate governance has been defined as the process and structure used to direct and manage the business and affairs of the corporation with the objective of enhancing shareholder value. A key aspect of corporate governance is the manner in which powers and responsibilities are shared among shareholders, the board of directors, and management. The expression "oversight of management" sums up in a phrase the fundamental role of a corporation's board of directors as representative of the owner or shareholders. But the mechanisms by which this responsibility is carried out in a public enterprise necessarily differ from standard practice in the private sector.

Structures and processes have evolved in Canada to permit effective oversight of management in public enterprises. They may not always work as intended, but they are essential to the balancing and reconciliation of public policy and corporate objectives, which the shareholder and management respectively represent.

Selected statistics for Canadian PEs are shown below, along with the market share of public enterprises in different sectors. The Appendix summarizes the corporate governance regime in Canada.

Background:  
Public enterprises in Canada

Canada has used public enterprises as an instrument of nation-building fairly extensively, going back to the early years of this century. Entities called "Crown corporations" were established to achieve public policy goals in instances where it was deemed necessary to distance government from day-to-day management activities and where there was a need for the activity to be managed according to sound commercial practices. Today, there are close to 50 federal Crown corporations in Canada, with assets totalling more than $53 billion. Many more exist at the various provincial levels. Federal corporations today employ about 120,000 people, roughly as many as Canada's public service, excluding the armed forces and the Royal Canadian Mounted Police.

Canadian public enterprises may be divided into two groups: those that support infrastructure - Canadian National Railways (CNR), for example - and those that promote cultural identity, such as the Canadian Broadcasting Corporation.

Crown corporations also vary in terms of financial viability and dependence on government funding. Some, like Canadian National Railways, operate in a fully commercial environment. They compete on an equal footing with private sector firms and are subject to the same regulatory regime as their competitors. They are expected to be self-supporting and self-financing, to be profitable, and to contribute dividends to their shareholder. Others, because of the nature of their mandate, depend on state appropriations to fulfill the public policy goals for which they were established.
Corporate Governance of Public Enterprises in Transitional Economies

Canadian State-Owned Enterprises

(Canadian $)

<table>
<thead>
<tr>
<th></th>
<th>55 parent enterprises</th>
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<tbody>
<tr>
<td>SOE portfolio</td>
<td></td>
</tr>
<tr>
<td>Total SOE assets</td>
<td>$77 billion</td>
</tr>
<tr>
<td>Decrease in SOE assets</td>
<td>$6.1 billion (last 5 years)</td>
</tr>
<tr>
<td>Employment</td>
<td>121,148</td>
</tr>
<tr>
<td>Decline in employment</td>
<td>32% (last 5 years)</td>
</tr>
<tr>
<td>Net decline attributed to privatization</td>
<td>64% (last 5 years)</td>
</tr>
<tr>
<td>Efficiency gains</td>
<td>36% (last 5 years)</td>
</tr>
<tr>
<td>Decrease in loans, advances and investment</td>
<td>21% (last 5 years)</td>
</tr>
<tr>
<td>Reduction in indebtedness</td>
<td>12%, or $1.9 billion (last 6 years)</td>
</tr>
<tr>
<td>Dissolutions/transfers</td>
<td>37 transactions (last 6 years)</td>
</tr>
<tr>
<td>Privatization</td>
<td>23 transactions</td>
</tr>
<tr>
<td>Proceeds from privatization</td>
<td>$4.7 billion</td>
</tr>
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2. Market Share of Enterprises in the Public and Private Sectors

<table>
<thead>
<tr>
<th>Economic Sector</th>
<th>Federal SOEs</th>
<th>Provincial SOEs</th>
<th>Private Enterprises</th>
<th>Economic Sector</th>
<th>Federal SOEs</th>
<th>Provincial SOEs</th>
<th>Private Enterprises</th>
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<td>Energy</td>
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<td></td>
<td>Culture</td>
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<tr>
<td>Oil and gas</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>Television</td>
<td>X</td>
<td>X</td>
<td>X</td>
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<tr>
<td>Power</td>
<td>-</td>
<td>X</td>
<td>X</td>
<td>Film</td>
<td>X</td>
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<tr>
<td>Coal</td>
<td>X</td>
<td>-</td>
<td>X</td>
<td>Museums</td>
<td>X</td>
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<td>X</td>
</tr>
<tr>
<td>Uranium</td>
<td>-</td>
<td>X</td>
<td>X</td>
<td>Theatres</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Transportation</td>
<td></td>
<td></td>
<td></td>
<td>Banking/Financial</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Railways</td>
<td></td>
<td></td>
<td></td>
<td>Commercial banks</td>
<td>-</td>
<td>-</td>
<td>X</td>
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<tr>
<td>freight</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>Development ban</td>
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<td>passenger</td>
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<td>X</td>
<td>Venture capital</td>
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<tr>
<td>Marine freight</td>
<td>-</td>
<td>-</td>
<td>X</td>
<td></td>
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<tr>
<td>Ferries</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>Construction</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Canals</td>
<td>X</td>
<td>X</td>
<td>-</td>
<td></td>
<td></td>
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<td></td>
</tr>
<tr>
<td>Ports</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>Agriculture/Fisheries</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Trucking</td>
<td>-</td>
<td>-</td>
<td>X</td>
<td>Fish processing</td>
<td>X</td>
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<td>X</td>
</tr>
<tr>
<td>Airlines</td>
<td>-</td>
<td>-</td>
<td>X</td>
<td>Marketing boards</td>
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<td>-</td>
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<tr>
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<td></td>
<td></td>
<td>saltfish</td>
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<td>-</td>
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<tr>
<td>International</td>
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<td>-</td>
<td>X</td>
<td>fresh fish</td>
<td>X</td>
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<tr>
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<td>-</td>
<td>X</td>
<td>dairy products</td>
<td>X</td>
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<tr>
<td>Intra-provincial</td>
<td>-</td>
<td>X</td>
<td>X</td>
<td>livestock feed</td>
<td>X</td>
<td>-</td>
<td>X</td>
</tr>
<tr>
<td>Post and Courier</td>
<td>X</td>
<td>-</td>
<td>X</td>
<td>Manufacturing</td>
<td>-</td>
<td>-</td>
<td>X</td>
</tr>
</tbody>
</table>

Note: "x" = partial market share; "X" = dominant market share
Over the years, Canada has continually reviewed the status of its various Crown corporations: Are they still needed for policy reasons? Would they function better in the private sector? As a result, some corporations have been dissolved, others privatized. Recently, the Minister of Transport has formed a parliamentary task force to examine the future ownership and operation of Canadian National Railways, including possible privatization. Both the board and the management of CNR have welcomed this initiative as a timely and promising opportunity to review the enterprise's mandate in the light of current and future economic demands. This coincides with attempts by the two Canadian railways to rationalize and streamline their eastern Canadian operations. Canadian Pacific Railway (a private sector company) has recently offered to buy the entire eastern operations of CNR — so the Canadian rail industry is currently entering a period of major change and re-examination.

**Corporate Governance: Structures and Processes**

The general characteristics of the Canadian corporate governance system for SOEs are described in Annex 2. In addition, Canada has established specific structures and processes to facilitate oversight of public enterprise management by boards of directors and to ensure accountability.

**Role of the Board in Public versus Private Enterprises**

According to the conventional corporate model, a company is operated first and foremost for the benefit of its shareholders. The owners entrust to the board of directors the responsibility for monitoring management and ensuring that company activities contribute to shareholder benefit. Management's responsibility is to formulate and carry out strategies that achieve that objective. In the normal course of events, the interests of the shareholder and the interests of the corporation closely coincide. Shareholders are best served when the company is run primarily with a view to maximizing profitability. So it can be said that directors should act with the best interests of the corporation itself in mind because that will bring the greatest benefit to shareholders.

However, the role of the board in a public enterprise is more complex because the shareholder is not an investor seeking maximum return on his or her investment, but a democratic institution with important public policy goals to which the corporation is expected to contribute. This is not to say that the shareholder is not concerned with the commercial viability of the corporation. After all, good performance in financial terms is vitally important to management of the nation's accounts. But it does indicate the often difficult balancing act that the board, as representative of the shareholder and as the primary link between shareholder and management, must perform in attempting to reconcile the pursuit of profit and the pursuit of public policy objectives.

A recently published guide for Crown corporations directors summarizes their complex role this way: To "oversee the corporation on the Crown's behalf by holding management accountable for the company's performance, its long-term viability and the achievement of its objectives." The structures whereby the boards carry out this function are set out in legislation: the Financial Administration Act, which governs all Crown corporations, and the specific legislation, if any, under which the individual corporation was established. Ten years ago, in the wake of perceived accountability failures in a number of Crown
corporations, the Financial Administration Act was amended to improve and standardize the governance of these public enterprises. The changes have strengthened the ability of the board to oversee management and guide the development of the corporation on behalf of the shareholder.

**Instruments for Oversight of Management**

Crown corporations are required to present reporting and accountability documents on a regular basis. These documents include the corporate plan, capital and operating budgets, quarterly financial statements, and the annual report with audited financial statements. Each is prepared by management, with guidance from the board of directors. Each must be approved by the board before being submitted to the shareholder through the minister responsible for the corporation (in CNR's case, the Minister of Transport). Once approved by the shareholder, these documents become the basis of management accountability. They constitute the key element in the board's oversight of management performance.

Basic responsibilities of the board include:

- **Establishing the corporation's strategic direction.** The focus of this function is the formulation of the corporate plan, which originates with management. The board is intimately involved in the process and has a duty to ensure that the elements of the plan correspond with the objectives the shareholder has set for the corporation. The approved plan then serves as a basis for subsequent decisions as well as a yardstick against which management performance is measured.

- **Safeguarding the corporation's resources.** In this respect, the board acts as steward of the company's financial and physical assets. It must review and pass judgment on operating and capital budgets as well as new project proposals and borrowing requests. It has to decide on the sale of corporation assets and on the method of sale. For example, CNR management's proposal to spend $200 million on a new rail tunnel under the St. Clair river at the Canada-U.S. border, was subject to board approval, as was the external borrowing the project required. The board assessed whether the tunnel proposal was in line with CNR's planned strategic direction and represented a valid use of company resources. The conclusion was that it would indeed contribute in a major way to greater competitiveness in the marketplace and increased revenues over the long term, both of which are primary corporate objectives, and greatly enhance CNR's freight business between Chicago and Toronto.

- **Monitoring the performance of the corporation.** This is a continuous task and the framework for the board's oversight function. By studying reports on the company's performance, board members are able to assess the appropriateness of the strategic plan and the means management has adopted to achieve the objectives. Occasionally, this review results in changes both to strategy and tactics.

- **Reporting to the Crown.** It is the board's responsibility to convey to the shareholder a complete picture of the functioning of the corporation in relation to its established strategic direction. Obviously, this is possible
Establishing Effective Oversight over Public Enterprises

only if the board has exercised scrupulous oversight of management in the formulation and implementation of the corporate plan. Of course, reporting to the shareholder must go beyond the prescribed submission of board-approved plans, reports, and budgets. The board, through the chairperson, should bring to the attention of the minister any important matter that falls outside the regular reporting routine if the directors feel that shareholder involvement is warranted.

Structure of Canadian Railways' Oversight

The make-up of the board, the role of the directors and the conditions of office are spelled out in the governing legislation, the Canadian National Railways Act. CNR's board comprises a chairperson and 11 other directors, one of whom is the chief executive officer (CEO) and the only "inside" or executive board member. The chair is full time but independent of management. Apart from the chair and CEO, the directors serve on a part-time basis. They are appointed by the shareholders on the basis of their ability to contribute effectively to CNR's governance and collectively, they represent the various regions of the country where CNR has a presence. The majority of the directors have a background in business or law and are also usually politically connected.

The board uses committees extensively as a means of enhancing productivity and capitalizing on the individual skills of the various directors. Currently, there are six committees: audit, environmental and social policy, compensation, investment, real estate, and executive. Each committee has a role to play in the oversight of management. The audit committee oversees the preparation of financial statements, accounting policies, proposed capital expenditures, and the internal audit function. The environmental and social policy committee verifies compliance with legal requirements, monitors social issues, and ensures that the company has established appropriate policies in the social and environmental fields. The compensation committee monitors the quality of management by reviewing executive appointments, management compensation and benefit plans, and management succession, training and recruitment practices.

Issues

A number of important issues are associated with the setting up, staffing, and functioning of public enterprise boards. They may be grouped as having to do with the selection of directors, their development, evaluation of their performance, and constraints on their activities.

- Selection. In Canada, the Cabinet (Governor in Council), selects Crown corporation directors - altogether, about 600 positions. Finding receptive individuals with the right mix of skills and knowledge to match the needs of each corporation can be an enormous challenge and must be undertaken with great care.

- Development. Even with the ideal background, a new director has to undergo a rapid process of learning about the corporation and its business environment if he or she is to perform effectively. Both management and shareholder must provide comprehensive orientation materials to bring new directors up to speed as quickly as possible. Once that has been achieved, there should be an ongoing development process to form a career
path involving committee assignments of increasing complexity and responsibility so that each director contributes to the best of his or her ability.

- Evaluation. Another necessity is a mechanism for evaluating the performance of the board as a whole and that of individual directors. This is a function best performed by the board itself in collaboration with the shareholder — but it must be based on consistent and objective standards.

- Constraints. Directors of Crown corporations are subject to constraints not usually applicable in the private sector. These constraints stem from the need to maintain a distance between the essentially commercial nature of the political nature of the shareholder. One is to refrain from any partisan political activity that would reflect in a negative way on the impartiality of the corporation. Another is to avoid any potential conflict of interest by not getting involved in board deliberations on a matter in which the director has a personal interest.

Conclusion

Canada has had a long and largely successful experience with public enterprise. The accountability framework and the checks and balances established between owner and management — embodied by the board of directors have generally served Canadians well. But as national needs evolve, it must be ensured that the institutions, both public and private, remain flexible and open to new concepts.
Establishing Effective Oversight over Public Enterprises

Box 14: Corporate Governance of State-Owned Enterprises in Canada

Role of the Government

The Parliament, the Cabinet and its committees, the Finance or Treasury minister and the line ministries play an indirect role in the governance of SOEs. At the level of the enterprise, the board of directors and management of the enterprise are directly responsible for management and control. The specific responsibilities of each of the governmental bodies are described below (the role of the boards and management is covered in the preceding section).

The Parliament is responsible for approving all appropriations to SOEs. In addition, Parliament exercises control over the proliferation of enterprises, given that the creation of SOEs requires a special act, as well as over the liquidation of SOEs.

The Cabinet must approve the purchase or divestiture of wholly or partially-held subsidiaries of a parent SOE. The Cabinet also appoints the chairman and boards of directors of SOEs, usually upon recommendation of the prime minister or the line minister. In general, candidates for chair-man have experience at the highest level of the industry, or have been involved in public service with political affiliations. Board members are selected to ensure appropriate professional skills on the board, and/or regional, ethnic, gender and linguistic representation. The Cabinet also approves the appointment of CEOs as well as the salary scales and/or honoraria of the CEOs, chairmen, and boards of directors. The chairmen and directors serve at the pleasure of the Cabinet, but in practice are rarely dismissed for political reasons.

The Treasury Board must review and approve corporate plans, capital and operating budgets, annual reports and audited financial statements which are prepared by the management of the enterprise and approved by the Board of Directors. In addition, the Treasury Board must also approve interim borrowing requirements and major investments not included in the enterprise’s business plan. Finally, the Board establishes ceilings on lines of credit and borrowing from commercial banks and other financial institutions, both nationally and internationally.

The line minister is accountable to Parliament for all aspects of enterprise performance, and for integrating the strategies of individual enterprises into the plans for the sub-sector or sector as a whole. He may propose the restructuring, acquisition, sale or liquidation of enterprises.

The line minister negotiates with the management of the enterprise to establish enterprise goals, and monitors performance. Together with the Treasury, the minister negotiates dividends and may call for special dividends if the enterprise has surplus cash in hand, and receive those dividends which are contributed to the consolidated revenue fund of the Treasury. If necessary, the minister can issue "directives" to an enterprise, instructions that may be in the public interest but not necessarily in the commercial interest of the company.

A number of instruments are used to monitor and evaluate SOE performance. All enterprises must submit audited financial statements to the government; auditors are appointed by the Cabinet for a three year period. In addition, comprehensive audits of systems and practices are conducted every five years by an outside management consultant or by the auditor general.

Furthermore, enterprises are subject to legal restrictions, including laws that are specific to state owned enterprises, as well as laws that affect all corporations. SOEs, in the first instance, are bound by their articles of incorporation and the corporate by-laws. In addition, most SOEs are subject to federal laws concerning competition policy, unfair trading practices, environmental regulations, official languages, labor codes and property rights. SOEs, like private corporations, are accountable to the courts which enforce these laws.

The responsibility for commercial performance rests with the enterprise. The role of the government is limited to shareholder functions and to the usual functions of the state. The separation of the roles of chairman and president means that the CEO is accountable to the board of directors and the chairman is accountable to the shareholder. The clear legal framework for the mandate for boards diminishes political interference. The corporate business plan prepared by enterprise management and approved by the Board clarifies the enterprise’s goals and objectives in terms of profitability and efficiency, and the quarterly financial reporting system enables both enterprise and government officials to monitor performance, identifying deteriorating operating results and over-runs in capital investments promptly.
Selection and Removal of Managers: The Experience of British Steel
Ronald Halstead

Introduction
At the time British Steel was a public owned company, the Minister for Industry was responsible for the appointment of the chief executive and executive directors after consultation with the chairman and non-executive directors of the Board of the Corporation. They were appointed on three-year contracts and subject to all other conditions of employment of employees of the Corporation. Senior managers were appointed by the chief executive after consultation with the chairman and directors of the Corporation. The following are the basic procedures used throughout the Corporation with respect to the selection, appointment and removal of managers.

Recruitment
Recruitment into management ranks was and still is focused largely on young graduates leaving universities, of whom approximately 150 were recruited each year. Contacts with universities and the recruitment process are coordinated centrally, but initially graduates are appointed to particular works or businesses where they undertake basic training to fit them for first management posts and to meet the requirement of professional qualifications. There is relatively little recruitment of mature managers from other employers and those recruited tend to be specialists.

Basic Training
The provision of basic training, including professional qualifications is the responsibility of the particular works/business unit, each of which has appropriate training facilities. British Steel also has a residential management training college which provides a broad program of management training, designed to assist career progression from graduate entry level through to senior management. Some 1,400 managers receive training at the college each year.

Corporate Resource Development
British Steel has a company-wide system of development for its managers designed to meet individuals' aspirations for continuous career development and the company's need for high-quality managers with broad experience of a number of technologies, functions, markets, etc. Information about the development requirements of managers is derived from two key sources:

- A regular annual appraisal of performance of each manager, indicating the extent to which major objectives have been met, and development and training needs.
- For those seen as of high potential, the formal assessment of that potential, leading to the creation of an appropriate career development plan.
Those seen as being of high potential are formally recorded as being members of a corporate resource (currently totalling 250), which is seen as the seedstock for future senior management posts leading ultimately to director level. Members of the corporate resource are interviewed regularly by career panels consisting of executive directors who offer appropriate guidance on development and career opportunities.

**Accelerated Development**

Particular programs have been created to assist young managers who are members of the corporate resource in developing the broad range of skills needed for senior management/director posts. For younger managers, the accelerated management development program is run in conjunction with a business school on a modular basis and leads first to a certificate in management studies and thereafter through a three-year distance learning program to an MBA. For more experienced managers, the international management program, run in conjunction with international business schools, also on a modular basis, provides a particularly international perspective to management training. A significant number of senior appointments in recent years have been drawn from managers who have successfully completed these programs.

**Appointment**

In order to reinforce the objectives of the corporate resource concept, all senior management appointments are subject to the approval of an Appointments and Salaries Committee, a committee of executive directors chaired by the chief executive. An objective of the committee is to ensure that each appointment that is made draws effectively on the stock of high-potential managers that has been created and provides continuing career development to those appointed. Recommendations to the committee are made by appointment panels of directors following formal interview of those nominated from the corporate resource.

**Reward Structure**

In order to sustain the corporate resource approach, the terms and conditions of all British Steel senior managers are administered centrally in accordance with a common corporate pattern. The rewards objective of the company is to provide an opportunity of earnings at or above the appropriate market median where personal and business performance are good. Pay for performance is an important feature of the reward policy, with general reviews being entirely discretionary and reflecting the performance and contributions of the individual. Bonus is a significant feature of the package, providing up to 25% of earnings for senior managers and designed to reflect appropriate, successful business performance.

**Termination**

In order to create opportunities for younger managers with potential to move into more demanding jobs, attractive contributory pension arrangements exist, which provide an opportunity for senior managers to retire at age 60 at two-thirds of final salary with long service. Particularly during the decade of the 1980s, when British Steel was closing a large number of plants, it was not possible to retain the original management stock, although redeployment provisions were made to encourage those with higher skills to remain with the company. During this period it was necessary to declare a large number of managers redundant, with appropriate redundancy payments as provided under national and European
arrangements. Wherever possible, volunteers for redundancy were encouraged to take advantage of these terms, which were particularly attractive to those approaching retirement age. Managers could also be dismissed for the following reasons: breach of the code of conduct under the terms of their contract of employment; and inadequate performance.
ANNEXES
Corporate Governance of Public Enterprises in France

Marion Leblanc-Wohrer

The French public enterprise system is not based on a theoretical model, but was designed case by case. The state-owned sector came into existence after World War I and was rapidly expanded in 1936 (the period of the Popular Front), 1945-46 (as a reaction to World War II), and 1981-82 (following the election of the socialist government). As a result, the system of French state enterprises includes several corporate governance systems. In the competitive sector, the state usually acts like a private shareholder. In the noncompetitive sector, the state has greater control over the enterprises.

In 1981-82 the government tripled the public sector's share in the French GDP by nationalizing eleven industrial groups, two financial companies and thirty-six banks. In 1986, the conservative government began privatizing enterprises in the competitive sector. The reduction in the public sector's share in the French economy will accelerate with the implementation of the 1993 privatization program. This program is designed to privatize twenty-one of the major public enterprises, including insurance companies, four banks, and fourteen industrial groups, including the aerospace company Aerospatiale, Renault, and Air France. These groups employ one million people and their turnover is FF 1200 billion. This program does not include enterprises in the non-competitive sector, which require change of status before they can be privatized. Following implementation of the program, the public sector will be concentrated in the non-competitive sector (Electricité de France, Gaz de France, Charbonnages de France, SNCF, RATP, La Poste, and France Telecom for a short while).

In 1992 the public sector included 2,750 enterprises, employing 1.7 million people (9% of the employed population). The state controlled directly 105 enterprises (in which it owned more than half of the share capital), of which fifteen were large industrial groups. These groups represented 90% of the energy sector and 80% of the metallurgy sector. They controlled more than 50% of the capital of 492 enterprises.

In 1992, the public sector included enterprises in the energy sector (Electricity of France, Gas of France, French Coal), in the industrial sector, in the transportation sector (railways, underground company,
aerospace company) and in the financial sector (banks, and some insurance companies).

**Specificity of the French Model**

There is no definition of state enterprises in French law. The legislature has provided only partial definitions designed to govern specific legal situations rather than establishing a general definition. The distinctive nature of the public sector has historical roots and its legal basis falls within both public and private law.

State enterprises have two main legal forms, public "establishments" and commercial companies. Public "establishments" are enterprises whose activities are related to the general interest of the country and which have not been corporatized. They have an industrial and commercial nature, although some of them also perform regulatory activities. They are usually in the non-competitive sector. Public commercial companies (joint-stock companies) are usually in the competitive sector, and the state controls the majority of the share capital.

These two types of state enterprises differ in structure and management depending on their purpose, the extent to which the sector in which they operate is competitive, and the size of the state's share capital holdings.

State enterprises are also governed by two legal systems, public and private. Public law includes specific rules that apply to administrative activities undertaken by state enterprises, and disputes are settled by the administrative courts. Private law regulates industrial and commercial activity, and disputes are referred to the ordinary courts.

**Structures of State Enterprises**

Public "establishments" comprise industrial and commercial public "establishments" and mixed public "establishments" performing administrative and industrial or commercial activities, such as the Caisse Nationale de Crédit Agricole (a state-owned bank operating in the agricultural sector) or independent ports. Industrial and commercial public "establishments" (EPIC) undertake industrial and commercial activities, but their activities are related to the general interest of the country. Most of these are monopolies or oligopolies that provide public services, to which the Constitution guarantees the equality of access. Most large state enterprises with some monopoly power have this status, including Electricity of France, Gas of France, French Coal, and French Railways. Although certain aspects of their activities and operations remain subject to administrative law because of their public status, most of the acts they perform are subject to the rules of private law.

EPIC can create subsidiaries in the form of joint-stock companies as long as the parent enterprise retains at least 50% ownership. This allows these "establishments" to diversify their activities. The decision to create subsidiaries is subject to authorization by the line minister or by decree upon the advice of the Conseil d'État.

State enterprises in the competitive sector usually take the form of joint-stock companies, where the capital can be partially or entirely state-owned. The same applied to nationalized enterprises which remained commercial companies. It is rare to see the state creating commercial companies unless they were subsidiaries of public "establishments."
State enterprises can be established as commercial companies (société d'économie mixte) with both public and private capital. The capital composition of such companies and the objectives they pursue (such as urban development) give rise to some exemptions from general laws governing commercial companies.

**Legislation Governing Public Enterprises**

State enterprises are subject to public law with respect to their activities in connection with any public service, the use of prerogatives of state power, and their legal form as a public establishment. Regulatory decisions made by state enterprises providing an industrial and commercial public service or concerning special prerogatives outside the bounds of general law (such as the right of expropriation or the power to conclude contracts that require the occupation of public property) are administrative decisions; if challenged, they are referred to administrative courts. In certain circumstances, these privileges are concurrent with the submission of these activities to rules and regulations of public law.

Commercial law applies to all commercial activities, such as registration of the company, participation in professional elections, application of accrual-basis accounting rules, contracts entered into by state enterprises, and application of taxes. The distinctive nature of EPIC means that they are not bound to the general commercial law, including bankruptcy and judiciary settlement. Enforcement measures available under private law may not be used against such an enterprise.

State enterprises are also subject to European laws. The European Commission is keen to enforce fair competition between the public and the private sectors. For example, since 1980, a European directive compels the state to notify the Commission when it plans to grant capital contributions to public enterprises.

Finally, starting in 1983, specific laws modifying the status and governance of the public sector were enacted. These include laws on Democratization of the Public Sector (1983), which determine the governance structure of the enterprises, and laws on privatization and the opening of companies' capital to the private sector (1986). Decree No 91 (1991) allowed the private sector to acquire shares in the capital of major public enterprises. The opening of the capital to the private sector of public enterprises aims at facilitating the modernization of these enterprises by bringing in new capital but does not modify the status of the state as the major shareholder.

**Prior State Control over the Public Sector**

The power of the state as a shareholder depends on whether the enterprise is a public establishment or a commercial company. In the competitive sector, the state acts as a private shareholder: it appoints members of the board, approves the company's strategic plan, its accounts, and the distribution of benefits. It expresses its decisions through its representatives. In the noncompetitive sector, the state exercises its powers more directly. The following table shows the allocation of administrative powers and appointment of management bodies.
## Allocation of Administrative Powers

<table>
<thead>
<tr>
<th></th>
<th>Industrial and Commercial Public Establishment</th>
<th>Commercial companies state share &gt;90%</th>
<th>Commercial companies State share &lt; 90%</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>BOARD OF DIRECTORS</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- <strong>Members</strong></td>
<td>Parity between:</td>
<td>Parity between:</td>
<td>- state and private shareholders' representatives, (number of state representatives depends on the size of the state's share capital holdings); - employees' representatives (a third of members).</td>
</tr>
<tr>
<td></td>
<td>- state representatives;</td>
<td>- state's representatives;</td>
<td></td>
</tr>
<tr>
<td></td>
<td>- qualified personnel (experts);</td>
<td>- qualified personnel (experts);</td>
<td></td>
</tr>
<tr>
<td></td>
<td>- employees' representatives.</td>
<td>- employees' representatives.</td>
<td></td>
</tr>
<tr>
<td>- <strong>Powers</strong></td>
<td>Day-to-day activities. Need approval of line ministries for investments decisions, borrowing, tariff and wage policy.</td>
<td>According to Commercial law</td>
<td>According to Commercial law</td>
</tr>
<tr>
<td><strong>MANAGEMENT BODIES</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- <strong>Chairperson</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- <strong>General directors</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- <strong>GENERAL MEETING</strong></td>
<td>None</td>
<td>None if state-owned at 100%. A state representative acts at the general meeting.</td>
<td>General Meeting according to commercial law</td>
</tr>
</tbody>
</table>

## Appointment of Management Bodies

<table>
<thead>
<tr>
<th></th>
<th>Industrial and Commercial Public Establishment</th>
<th>Commercial companies state share &gt;90%</th>
<th>Commercial companies State share &lt; 90%</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>PRESIDENT OF THE STATE</strong></td>
<td>co-signs the appointment of the Chairperson</td>
<td>co-signs the appointment of the Chairperson</td>
<td>co-signs the appointment of the Chairperson</td>
</tr>
<tr>
<td>- appoints the Chairperson and managing directors - appoints state representatives and experts at the Board</td>
<td>- appoints the Chairperson and managing directors - appoints state representatives at the Board; - appoints experts, at the Board's suggestion.</td>
<td>- appoints the Chairperson. Managing director is appointed by the Chairperson. - appoints its representatives at the Board ( proportionally to its share capital). Private shareholders representatives are elected by the General Meeting.</td>
<td></td>
</tr>
<tr>
<td><strong>CABINET OF MINISTERS</strong></td>
<td>approves appointments by Cabinet of Ministers</td>
<td>approves appointments by Cabinet of Ministers</td>
<td>approves appointments by Cabinet of Ministers</td>
</tr>
</tbody>
</table>

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**Financial and Technical Supervision**

The Ministry of Economy and Finance exercises its controls through the Treasury, Budget, and Price departments. The coordination of these departments rests mainly with the minister's office.

The Treasury department acts as the enterprise's owner. It determines the amount of debt that the state enterprise may issue on financial markets, and the increase in share capital and approves capital investment decisions, mergers and acquisitions.

The Budget department handles the budgetary assistance paid by the state, and the Price department controls prices in the public sector in conjunction with the line ministries. In some industries it has only the power of approval, such as in the metro company (RATP).

The Economics and Social Fund (FDES) is a special account within the state budget designed to coordinate the government's financial policy toward public and private enterprises. Its functions include deciding on lending activities and scrutinizing public enterprises' investment policy. The Fund's board of directors is composed of representatives from various technical ministries (such as the Ministry of Transportation, the Ministry of Equipment, and the Ministry of Industry), high-level civil servants (heads of central departments), and representatives of financial institutions (such as the Bank of France and the Caisse des dépôts). The minister of finances serves as the chairperson.

A body of state inspectors exercises economic and financial supervision of public enterprises. They inform the minister of the enterprise's decisions and inform the enterprises of the minister's position. They sit on the board of directors and can exercise a suspensive veto but have no voting power.

Technical supervision is exercised by the line ministries, generally the ministry of Industry, Defence, or Transport. This supervision is exercised by representatives appointed by the line ministries to the board of directors. These government commissioners (commissaires du gouvernement) relate information regarding the enterprise's decisions and ensure that the ministerial instructions on the management of the enterprise are put into practice.

The Parliament must approve nationalization and privatization decisions and private capital contributions that would cause the state to lose its majority share holdings, since this would result in the transfer of an enterprise from the public sector to the private sector. Parliament also has to approve any increase in share capital.

**A Posteriori State Control over the Public Sector**

Despite attempts to take social needs into account, the control of state enterprises remains guided by the logic of profit and loss and financial equilibrium. Three bodies are responsible for controlling state enterprise: the Cour des Comptes (Court of Accounts), statutory auditors, and the Parliament.
The Court of Accounts audits accounts of all industrial and commercial public "establishments" and commercial companies in which the state owns the majority of the share capital and assess their performances.

The Commissaires aux Comptes (Statutory Auditors) play a legal role in state enterprises formed as corporations and in some public "establishments" (such as electricity, gas, and coal). They are appointed by the Ministry of Finance.

The government must provide the Parliament with an annual list of state enterprises and their balance sheets and operating accounts. Parliamentary control of the management of state enterprises may be exercised through investigative and controlling commissions, but this procedure has rarely been used.

**Strengths of the Governance System**

Public enterprises were designed on a case-by-case basis and, as a result, their governance status is very flexible. Furthermore, the responsibility for commercial performance rests with the enterprise. This autonomy has allowed enterprises to expand their activities and modernize.

One of the major success of the French system of public enterprises was the creation and implementation of "contracts plans" between the enterprises and the government. Contract plans ensure state control and respect of state objectives while allowing autonomous management. They are negotiated agreements between the government, acting as the owner of the state enterprise, and the enterprise itself, aimed at spelling out the rights and duties of both parties. Contract plans were signed with most of the largest EPIC and with commercial companies after 1981.

Several other factors have contributed to the relatively good performance of public enterprises in the noncompetitive sector. These include the depth of technical, financial and economic capabilities in the sectoral ministries. In addition, the continuity of personnel in the relevant ministries and stability of senior enterprise management have facilitated long-term planning, the relative transparency of operations and the minimal interference of politically-motivated decisions.

**Sectoral Study: Electricity of France (EDF)**

Enterprises in the electricity sector were nationalized in 1946, and Electricity of France (EDF) was created as an industrial and commercial public establishment. EDF acts as a monopoly in distribution and production. In 1992 it had a staff of 120,000, and its turnover was FF 171 billion (around US$34 billion). Its benefits amounted to FF 1.9 billion in 1991 (US$380 million).

The state controls EDF. It determines energy policy and regulates the sector in terms of security, health, and the environment. But it does not manage it.

The Cabinet of Ministers appoints a third of the board of directors (state representatives), and appoints the chairperson and the general directors.

The Ministry of Finance, through FDES, examines investment projects, controls the budget, and authorizes borrowing. It also determines wage policy in conjunction with the line ministry.

Financial supervision is exercised by the Mission of Financial and Economic Control, which consists of two state representatives placed within EDF.
The Ministry of Industry appoints one government commissioner (commissaire du Gouvernement) who relates information regarding enterprise decisions and ensures that the ministerial instructions on the management of the enterprise are put into practice.

The state does not manage EDF. To enforce this autonomy and delineate state and EDF responsibilities, the state signed a contract plan with EDF in 1970. This plan was the first signed in France and was considered to be the model contract plan. It spelled out a system of more flexible government supervision that reduced the powers of the government's representatives and the Ministries of Finance and Energy. Since the 1970s, EDF and the state have regularly signed new contracts. The objectives spelled out in the current contract are:

- to define economic and financial objectives, such as reducing the debt and increasing productivity;
- to assure coordination between the enterprise's medium-term objectives and the state's policy. The contract determines the conditions under which the EDF can diversify its activities without unfairly competing with the private sector; and
- to define social policy.

The state's supervision of the EDF is tight in terms of determining energy policy, but it gives the firm autonomy to manage its activities. There are no subventions from the state. As a result, EDF is an economic success. The firm makes profits, and electricity service is provided at a low cost (one of the lowest in Europe).
Organization of the Nationalized Sector in Austria

In Austria, nationalizations started after WWII. The First Nationalization Act (1946) comprised mining, heavy industry and banks and the Second Nationalization Act (1947) included electrical utilities. The motivations behind nationalization were a mixture: politics and ideology on one side, and very pragmatic considerations on the other. Years later, enterprises would be privatized in the context of a similar combination of ideological and practical considerations.

Main Characteristics of Nationalization in Austria

The success of nationalizations in the fifties and sixties depended on the following factors: the legal system remained unchanged; companies were nationalized, but not entire sectors like in the UK; an experienced management was kept at the head of the nationalized companies; the unions played a very positive role; the policy of social partnership secured industrial peace and strong position of the shop stewards led to a high degree of identification of the workers toward their company.

Development in the Organization of Nationalized Industries

<table>
<thead>
<tr>
<th>Time Period</th>
<th>Events</th>
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<tbody>
<tr>
<td>1945 - 50</td>
<td>Reconstruction</td>
</tr>
<tr>
<td>1950 - 60</td>
<td>Expansion &amp; Stabilization</td>
</tr>
<tr>
<td>1960 - 70</td>
<td>Discussion of Reorganization Issues of Mergers First Privatization Steps Structural Change</td>
</tr>
<tr>
<td>1970 - 85</td>
<td>Holding Structure Mergers Steel Crisis Decline of Heavy Industry &amp; Mining First Capital Infusions</td>
</tr>
<tr>
<td>1985 - 90</td>
<td>Major Reorganization &amp; State financial help New Strategy: Internationalization/Privatization</td>
</tr>
<tr>
<td>1993</td>
<td>Reorganization Majority Privatization</td>
</tr>
</tbody>
</table>
Initially the public enterprise sector was reorganized after every federal election. Various ministries were in charge of administering the ownership rights, which rendered the management of public assets unclear. Finally, in 1970, the holding company (ÖIAG) was established, representing the first real solution to the problem of ownership of public enterprises.

**The Austrian Holding Company**

In 1970, the Austrian government made the decision to establish a holding company for state-owned enterprises. The goals were to:

- distance state-owned enterprises from politics: state-owned industries are never entirely free from political influence, but a holding company structure allows the reduction of party influence;
- establish a financial rationale: a holding company is more profit-oriented than a government agency, because such a company has a balance sheet, and is interested in dividends. By contrast, in the context of the federal budget, a few millions of dividends do not make a big difference;
- improve the financial function: a holding company can have a central treasury function, and many other corporate functions that can not be performed in the Ministries;
- increase continuity: a holding company is better able to survive elections and changes of government;
- insure greater professionalism: there is more industrial experience among the staff of a holding company than in the ministries. Staff can be hired from the private sector to work in the holding company for a period of time, and later return to the private sector; and
- increase flexibility: It is much easier for a holding company to privatize their subsidiaries than for ministries which have more political responsibilities. For example, the Austrian holding company was very successful in handling several sales in 1993 and 1994, with the help of investment banks. This was made possible because the companies kept the negotiations secret.

**Corporate Governance in the Public Sector**

The minister of Public Economy and Transport currently controls 100% of the holding company, which in turn owns several industrial companies.

**The Role of the Minister**

The formal rules require that the minister report to Parliament, make decisions on state subsidies and guarantees, nominate the Supervisory Board of the holding company, and participate in the selection of the holding company management. He is also consulted on the appointment of the BOD. The strategy is also very often discussed with the minister. The minister offers recommendations on major reorganizations and mergers; in case of regional problems (such as plant closure), it is the minister who approaches the holding company. The chief executive and the president of the supervisory board are in permanent informal contact with the minister. Although major decisions are invariably made following consultation with the minister, his recommendations are not necessarily followed.
Role of the Holding Company

The holding company's functions include:

- nominating the supervisory board of subsidiary companies; management and staff of the holding company sit on the supervisory board of the subsidiary companies. In most cases, they occupy the functions of either chairman or vice-chairman;
- duties dealing with the annual general meeting such as approval of accounts, appointment of auditors; and
- duties dealing with the Extraordinary General Meetings, including approval of capital increases, change of articles of association and mergers.

Before the privatization program of 1993, the holding company in Austria also exercised additional functions that are not typical of all holding companies. These functions included preparation of guidelines for the subsidiary companies with the purpose of introducing a uniform controlling system, cost accounting system, consolidation guidelines, and treasury centralization. These guidelines also regulated management remuneration and introduced a system of investment projects evaluation. The holding company also approved acquisitions and divestitures, the annual budget, the mid-term plan (3 to 5 years) and the corporation's strategy.

Role of Operating Subsidiary Companies

Operating companies have always kept important functions and sole power and responsibility, in the following activities: purchase policy, personnel and wage policies (although Supervisory boards are involved in this function), investment decisions, financial policy (whether they borrow or not, and the choice of the bank) and production, sales and price policies. The holding company and the ministries did not interfere in these decisions.

Structure and Duties of Supervisory Boards on the Basis of Austrian & German Company Law (Two-tier System)

The Austrian and the German systems are very similar but both are quite different from the Anglo-American system of a one-tier board.

The responsibilities of the Supervisory Board are: to nominate executive management for a maximum period of five years (one to six members); to approve the acquisition and sale of companies, the closure of plants, the real estate transactions and capital expenditure, the borrowing policy (bonds, credits and loans), the start and closure of businesses and production lines, and the general principles of corporate policy. The board must hold a minimum of three meetings annually (usually four meetings). Two-thirds of the Supervisory Board are elected by shareholders for a period of four years and can be removed at any time; one third are nominated by the council of shop stewards.

Thus, the Supervisory Board is not just a supervisor. The Supervisory Board participates in, and must approve, important management decisions involving investment, acquisition and strategy. The Supervisory Board also gives advice and supports business. The Supervisory Boards of most major companies consist of managers of other companies, industrialists, experts in law and natural science, representatives of unions, and chambers of commerce, of customers, bankers and suppliers that give
them access to a very good network of contacts.

The Supervisory Board can have several committees, including the Presidential Committee, the Audit Committee, the Finance Committee and the Special Purpose Committee. These committees can either prepare a board resolution or be authorized to give final approval.

**Issues**

There are still a number of issues concerning the holding company structure and the relationship with the ministry which have to be decided on country-by-country and case-by-case basis: should public companies, for example, be regulated by special laws, or only common company laws? Austria used to have special laws, but most of them were abolished. One difficulty lies in the applicability of bankruptcy law. If a public share-holding in a company is over 51% in Austria, it will normally be bailed out, but not if it is less than 51%. To what extent should the Ministry get involved? This issue is linked to the difficult question of political responsibility and its limits: how can the minister be responsible for commercial activities, and what does that entail?

Furthermore, there are several types of holding companies, and the choice of appropriate form is difficult. The government must choose between a strategic holding or financial holding. A strategic holding is more involved in the strategic decisions than a financial holding. (A completely different type would be a management holding.)

Holding companies exert their function along vertical and horizontal lines. The choice is of major importance. However, there are limits to a horizontal holding. For example, the public holding company of a European country owned a refinery, and other companies such as a barber shop and a flower shop. This is too extreme: one holding company cannot care for 20 different industrial sectors. Three or four is absolutely the maximum.

There are also vertical limits. For example, the Austrian state-holding had a sectoral holding company which owned a German sub-holding company for some products; this German firm owned a Dutch sub-holding company, for some financing purposes, and the Dutch company had subsidiaries that really produced. Problems occur in communication, information and responsibility. When something goes wrong, the responsibility is blurred because of so many layers.

Other issues involved are the extent to which competition is allowed within the holding group, the degree of autonomy of subsidiaries and the need for overall coordination.

**Conclusion**

The holding model as a form of management of state assets has performed relatively well in Austria. However, the same necessary conditions might not be present in most transition economies; prevalence of the rule of law, transparency of public decisions, respect for the company's autonomy, management to be used in the corporate governance of subsidiaries and a competent bureaucracy. Recent changes in economic conditions have called for privatization, and the Austrian holding company has not resisted this change. Thus, the holding company model has been a transitional one for Austria.
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