# Privatisation in the 21st Century:

# Recent Experiences of OECD Countries

## *Report on Good Practices*

**January 2009**

After reaching all-time high levels in 1990s, privatisation in OECD countries remained at high levels in the beginning of the 21st century. State assets worth close to USD 500 billion were sold in the 8 years from 2000 to 2007. At the same time, it appears that we have entered a "new privatisation landscape". The block sales of individual enterprises already in competitive sectors are, in most countries, a thing of the past. Continued privatisation has taken place in more complex sectors such as the network industries, where companies are too large and too heavily regulated to be swiftly transferred. Gradual, or in many cases partial, privatisation via stock markets is now the most prevalent. These trends are analysed in this comprehensive report.

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## RECENT EXPERIENCE WITH PRIVATISATION IN OECD COUNTRIES

### *About this report*

The present report was prepared in response to a request by the Working Group on Privatisation and Corporate Governance of State Owned Assets, in its programme of work and Budget 2007-2008, that the Secretariat undertake a stocktaking of "good practices" in privatisation by member countries in recent years. The report is essentially intended as an update of the Working Group's major stocktaking of privatisation practices in member countries five years ago (OECD, 2003), taking into account the occurrence in the meantime of the OECD Guidelines on Corporate Governance of State-Owned Enterprises (henceforth "the SOE Guidelines") and the revision of the OECD Principles of Corporate Governance ("the Principles"). In consequence, the main new elements that have been added since OECD (2003) relate to corporate governance during the privatisation process as well as the governance of the privatisation process itself.

The factual information about recent privatisation practices – as well as individual privatisation transactions – derives mainly from a questionnaire sent to the members of the Working Group. The information in the questionnaires related to the period 2000 to 2007. Twenty-four countries have responded to the questionnaire, twenty-two of which with a full submission of privatisation practices and transactions: Austria, Australia, Belgium, Canada, Czech Republic, Denmark, Finland, France, Greece, Hungary, Ireland, Italy, Korea, Norway, Poland, Portugal, Slovak Republic, Spain, Sweden, Switzerland, Turkey and United Kingdom. Germany responded to the questions regarding privatisation practices, but did not submit data on individual transactions. The US Delegation notified the Secretariat that since 2000 the United States has no practices or transactions to report.

The purpose of the report is twofold. First, it provides government officials in OECD countries with an opportunity to synthesise and compare their recent experiences with privatisation. Second, it aims to provide a compendium of good – or generally accepted – practices that may serve as an inspiration to countries that have only recently embarked on a process of privatisation.

### *Structure of the report*

The remainder of the report is organised as follows. Section 1 proposes a definition of privatisation applied to the rest of the report. Section 2 provides a brief overview of privatisation trends in OECD countries since 2000, including with respect to the national and sectoral variations. Section 3 reviews the main issues that government officials normally have to address prior to privatisation. Section 4, the most comprehensive in the report, goes through all the main phases of the actual process of privatisation, starting with the decision to privatise and ending with post-privatisation audits and accountability. Section 5 addresses specific corporate governance issues that may arise during the privatisation process, including agency problems in the privatisation process and the post-privatisation concerns that may arise in the case of partial selloffs.

## 1. Defining privatisation

The definition of "privatisation" differs among the relevant authorities of OECD countries. Some agencies include only transactions effected subject to privatisation legislation – hence for instance disregarding asset disposals by partly privatised state-owned enterprises (SOEs). Others consider as privatisation not only any asset disposals but also transfer of individual activities from the public to the private domain.

This report does not intend to propose a common definition of privatisation. However, for the purpose of reproducing information submitted by member countries a relatively broad definition is applied throughout the text: *As privatisation may be considered any material transaction by which the state's ultimate ownership of corporate entities is reduced.* This definition includes direct divestment by the state, divestment of corporate assets by government-controlled investment vehicles as well as the dilution of state positions in SOEs by secondary share offerings to the non-state shareholders. It may also include divestment of subsidiaries by SOEs, though this is more of a gray area: if SOEs for example shed subsidiaries in consequence of government decisions then the resultant transactions would normally be considered as privatisation. However, if partly state-owned enterprises decide to divest based on commercial considerations then it makes little sense to speak of privatisation – lest any merger and acquisition of the said enterprises should be considered as "privatisation" and "nationalisation". (The following section includes data from the Privatisation Barometer which, as a general rule, includes divestment by partly owned SOEs.)

By the same definition the transfer of certain commercial activities from SOEs to private operators (e.g. through concessions, delegated management contracts, leasing or other forms of public-private partnership) is normally not considered as privatisation. Nor is the dilution of government control over incorporated entities through means other than share transfers (e.g. share class unifications; changes to the articles of association; cancellation of golden shares). In sum, the word privatisation is used to refer to a transfer of assets to the private sector rather than a transfer of activities. This distinction is particularly pertinent as an increasing share of privatisations takes place in public utilities and infrastructure, sectors which also have a high proportion of public-private partnerships that in some respects may be close substitutes to asset selloffs.

## 2. Reviewing the data: national and sectoral trends

The privatisation activities in OECD countries since 2000 have been buoyant by past standards. In the area as a whole privatisation proceeds are estimated to have amounted to at least US$ 487 billion over the eight year period from 2000 to 2007[1]. As shown by Figure 1 the figures

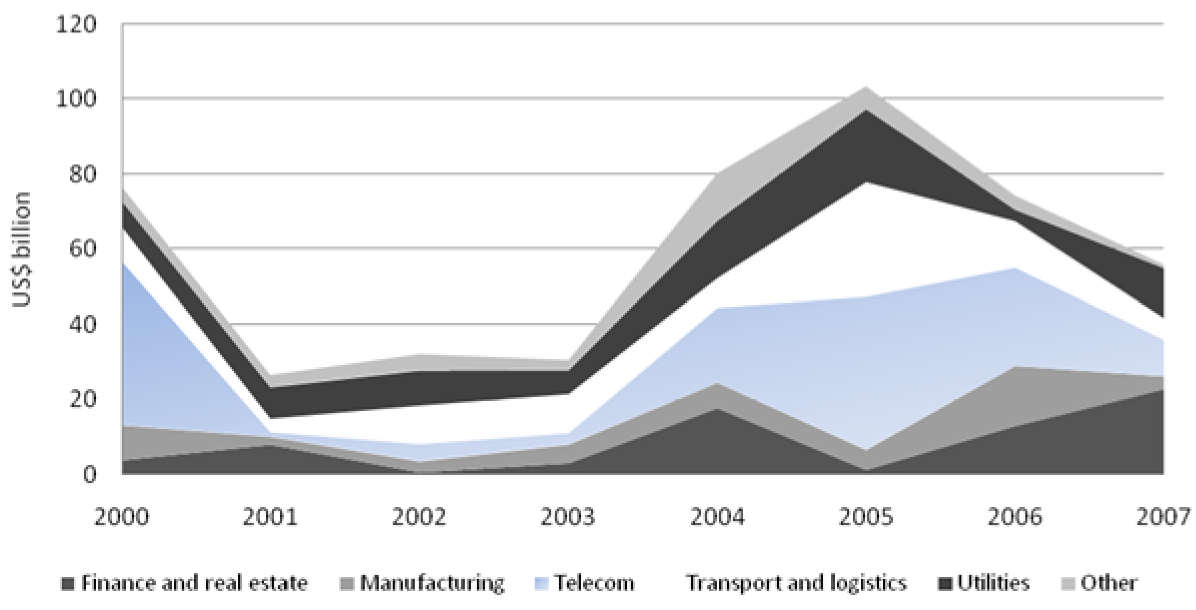
[1] This is a low-end estimate in the sense that it excludes data for two OECD countries as well as 2007 data for Mexico. On the other hand, it includes a wide range of "indirect privatisation" that not all member countries would consider as privatisation transactions.

activity reached its maximum in 2005 with total proceeds of US$ 103 billion – a figure that has historically been exceeded only in a couple of the "boom years" in the late 1990s. To some extent this is understandable against the background of stock market trends: since the 1990s privatisation activity has been correlated with equity valuation as many governments have timed at least their public offerings to coincide with favourable market conditions. The decline in privatisation transactions after the late 1990s to a trough around 2002 and the subsequent pickup in 2004 and 2005 are consistent with this explanation. What may seem less obvious is why the continued stock market boom into 2006 and 2007 coincided with a decline in privatisations.

Most active in privatising SOEs since 2000 have been the large economies of continental Europe (Table 1). With a combined US$ 233 billion of privatisation revenue, France, Italy and Germany accounted for almost half of the total proceeds in the OECD area. This, of course, to a large extent reflects the size of the underlying economies – plus the fact that unlike some other big OECD countries the governments in question still held a large portfolio of SOEs. A continuation of the privatisation programmes of Japan, Turkey and Australia also lifted these countries to high positions on the "Privatisation Top-10".

Relative to the size of the national economies the most active privatisers were the Slovak Republic and the Czech Republic where the privatisation proceeds over the period corresponded to 14 per cent and 9 per cent respectively of the countries' annual GDP. This reflects a continuation of these countries' post-transition efforts to transfer commercial activities from public to private ownership. In both countries the bulk of the activity was in the beginning of the period. Of an almost similar relative magnitude were privatisations in a couple of Nordic countries, namely Finland and Iceland. In Finland this reflects a piecemeal selloff of shares in a large number of commercially oriented SOEs, whereas the Icelandic figures are the effect of a couple of high-profile transactions (in telecom and banking) in a small national economy.

**Figure 1. Privatisation proceeds by sector, OECD total**




*Source*: Privatisation Barometer, where available; country questionnaire responses, World Bank data and press reports.

Note: For most of the countries the data include "indirect privatisation", i.e. the disposal of incorporated assets by wholly or partly state owned enterprises. Data for Korea, New Zealand and Norway are not included.

The sectoral distribution of privatisation in recent years also merits attention. As appears from Figure 1 the network industries have totally dominated the picture, albeit to a varying extent according to the levels of overall activity. For the period as a whole, no less than 31 per cent of total privatisation proceeds originated with the telecom sector. Nineteen per cent came from privatisations in the transport and logistics sector – mostly related to the selloff of railways, airlines and airports. An additional 17 per cent derived from divestment of state holdings in (other) utilities companies, mostly in the energy sector. The shares of privatisation in manufacturing (10 per cent of totals) and the financial sector (15 per cent) were low by historic standards.

The telecom sector appears to be by far the most pricing-dependent element of OECD countries' privatisation programmes. At the end of the high-tech bubble in 2000 telecom privatisations accounted for no less than 57 per cent of total proceeds, and in 2005-2006 the share rose again to between 35 and 40 per cent. Conversely, privatisations in the utilities sector (other than telecommunication and transportation) have been, if anything, counter cyclical; in the "weak" years of 2001 and 2002 they accounted for almost a third of total transactions. This does to some extent reflect the effect of indirect privatisations in the data: some state-owned energy groups were selling large corporate subsidiaries in these years.

**Table 1.Privatisation Top-10: OECD countries from 2000 to 2007**

| Largest absolute amounts | | Largest relative to size of domestic economy | |
|---|---|---|---|
| Country | Amount (US$ bn.) | Country | Per cent of 2006 GDP |
| France | 98.2 | Slovak Republic | 13.5 |
| Italy | 69.6 | Czech Republic | 9.2 |
| Germany | 65.0 | Finland | 8.7 |
| Japan | 33.2 | Iceland | 8.6 |
| Turkey | 25.0 | Hungary | 6.9 |
| Netherlands | 23.1 | Greece | 4.8 |
| Australia | 20.0 | Turkey | 4.7 |
| United Kingdom | 18.4 | Portugal | 4.4 |
| Finland | 18.3 | France | 4.4 |
| Sweden | 16.0 | Poland | 4.3 |
| Total OECD | 497.7 | Total OECD | 1.4 |

Sources: Privatization Barometer, where available; country questionnaire responses and, in the case of Iceland, press reports.

Note: For most of the countries the data include "indirect privatisation", i.e. the disposal of incorporated assets by wholly or partly state owned enterprises.

### *2.1 The new privatisation landscape*

Behind the overall trends in privatisation since 2000 there are several driving forces. One of these is the fact that the large privatisation programmes of the formerly communist countries in Central and Eastern Europe are either nearing completion or, at least, entering into a more mature phase. The privatisation data reviewed in OECD (2003) were dominated by the transition process of these economies (certainly in terms of the number of transactions, if not always in terms of amounts), but five years on these countries no longer figure prominently. In fact, among them only Hungary has undertaken large privatisation transactions since 2005[2]. Similarly, as alluded to in the previous section, privatisation in the more "traditional" sectors such as manufacturing and finance has also (except for a few, large stand-alone transactions in banking) tapered off across OECD countries.

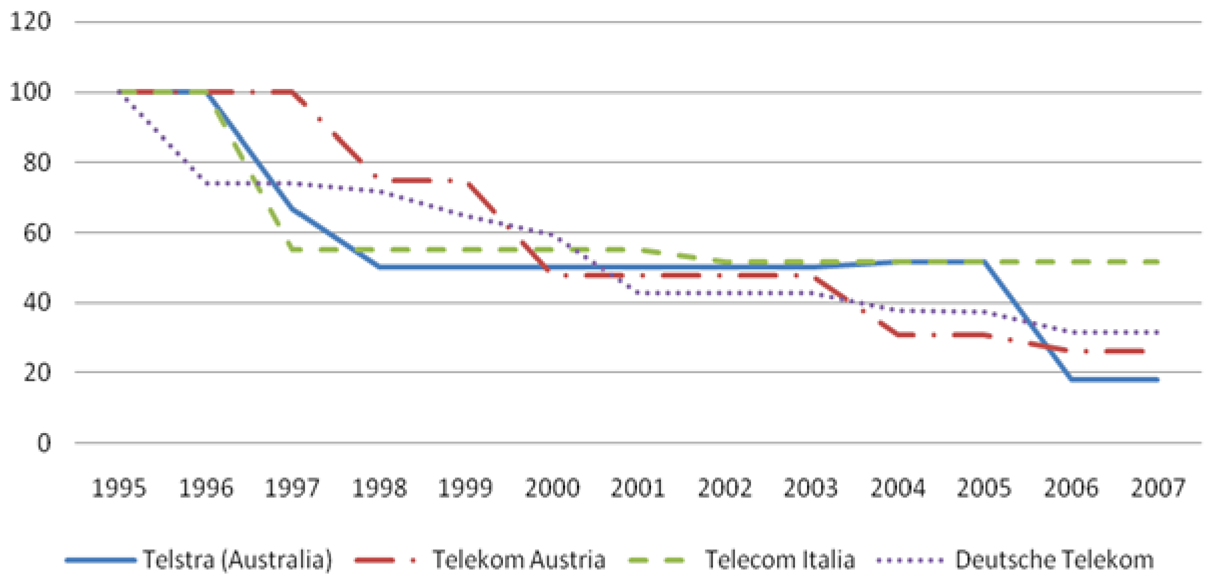
Recent years have, however, seen a number of "hard nut" privatisation cases, in which governments were caught between the fiscal burdens of subsidising financially unviable SOEs and, at the same time, strong public and employee resistance to either a restructuring or sell-off of the enterprise. Often the outcome was to let the SOE operate until it was essentially bankrupt. At this point, when the financial distress of the enterprise had become obvious to all involved, a strategic (in some cases foreign) investor was invited to buy a significant stake in the SOE for a limited sum and ensure the continued operation of the enterprise, or acquire some of the most valuable elements of its value chain. The efforts to privatise Alitalia and Olympic Airways in 2008 arguably fall in this category.

Since 2000 the privatisation league tables have been dominated by the partial or tranche-wise selloff of particularly large SOEs in the utilities and/or network industries. The sequential approach has been justified mostly by the size of the enterprises. Many of them could not have been sold in one transaction – or at least not without triggering a hefty price discount. In the case of particularly large companies the process of full privatisation has consequently taken many years – and in a number of OECD countries is still ongoing. A prime example is the Japanese government's sale of the telecom operator NT&T. It was completed in 2008, 21 years after the process began, and some of the individual tranches were among the largest secondary share offerings in newer history. A graphic illustration of the phased approach to privatisation in the telecom sectors in four OECD countries[3] is provided in Figure 2. (The figure shows the percentage state ownership of the incumbent telecom operator at each point in time.)

[2] The definition of "large" is the threshold applied in the Secretariat's questionnaire to member countries, namely transactions resulting in a revenue exceeding US$ 100 million.

[3] What appears to be a small "reversal" of Australia's Telstra privatisation in 2004 was in fact a share buy-back by the enterprise.

**Figure 2. Phased privatisation in the telecom sectors of selected OECD countries**




The share offerings in telecom and (other) utilities companies, whilst in most cases representing only small shares of the companies' total equity, were nevertheless very large. The top three privatisations in OECD countries since 2000 were all third tranche offerings in such companies (Table 2). The largest such transaction was the Australian government's sale of just over a third of Telstra's equity for US$ 13.7 billion in 2006. Of an almost equal magnitude was the US$ 12.8 billion that the German government raised in 2000 from selling a comparably limited stake of 6.6 per cent in Deutsche Telekom. In third place came the sale of 19.6 per cent of the Italian energy utility ENEL in 2004 for US$ 9.5 billion. Only two initial public offerings (IPOs) are among the largest individual transactions, namely France's Electricité de France (raising US$ 8.4 billion) in 2005 and Sweden's Telia AB (US$ 7.7 billion) in 2000. Governments generally (for reasons discussed in later sections) prefer to save their largest share tranches to secondary offerings at a time when markets have stabilised and the enterprises in question established a financial track record.

**Table 2. Largest ten individual privatisation transactions in the OECD area 2000-2007**

| Year | Country | Company | Sector | Share of company transferred | Proceeds (US$ billion) | Observations |
|---|---|---|---|---|---|---|
| 2006 | Australia | Telstra Corp. | Telecom | 33.6% | 13.7 | Third tranche |
| 2000 | Germany | Deutsche Telekom | Telecom | 6.6% | 12.8 | Third tranche |
| 2004 | Italy | ENEL | Utilities | 19.6% | 9.5 | Third tranche |
| 2000 | Japan | NT&T Corp. | Telecom | 6.4% | 8.7 | One of the last tranches |
| 2005 | France | Electricité de France | Utilities | 12.7% | 8.4 | IPO |
| 2000 | Sweden | Telia AB | Telecom | 29.4% | 7.7 | IPO |
| 2005 | France | Autoroutes du Sud de la France | Transportation | 50% | 6.8 | Second tranche, trade sale |
| 2005 | Turkey | Turkish Telecom | Telecom | 55% | 6.6 | Trade sale to a foreign investor |
| 2004 | France | France Telecom | Telecom | 10.9% | 6.2 | Third tranche |
| 2005 | France | Autoroutes Paris-Rhin-Rhone | Transportation | 70.2% | 5.8 | Second tranche, trade sale |

Source: Privatisation Barometer and national submissions to the Secretariat. Note: Indirect privatisation is not included[4].

It would appear from Figure 2 that privatisation of telecom companies is still work in progress and there are significant further transactions to come. However, this is not necessarily the case. Several of the recent sales of equity in public utilities by OECD governments have been characterised as "partial privatisation" (a bit imprecisely since by the definitions applied in this report a transaction needs not involve selling an entire enterprise to count as privatisation) because the respective governments made it clear that they do not intend to divest 100 per cent. In some countries the state is even required by law to retain holdings above certain thresholds in certain utilities companies.

In terms of corporate governance and control this represents an interesting departure from traditional thinking according to which privatisation implies a cessation of government influence over a given commercial activity. In "the new privatisation landscape" privatisation may increasingly imply a partial opening of SOEs' capital to outside investors with purposes such as

[4] This point is important because if indirect privatisation is included then the selloff of the mobile telephone operator Wind by ENEL of Italy would be one of the largest transactions in the league table. However, the Italian authorities do not consider this transaction as a privatisation.

raising the efficiency of an essentially government-controlled entity by subjecting it to the rigours of stock market listing and enhancing its financial flexibility by opening new alleys for raising fresh capital. A further illustration of this point may be the fact that, while the recovery in stock prices led to a jump in privatisation activity in the years up to 2005, the continued increases in 2006 and 2007 did mostly not lead to additional secondary offerings despite the fact that most of the governments concerned had "plenty left to sell".

An additional illustration comes from outside the OECD area. In emerging economies such as China and Russia privatisation picked up steam dramatically in the last couple of years (the largest transactions in 2007 are summarised in Box 1) and recently virtually dwarfed the activity in OECD countries. [5]There is no indication that a full selloff is planned for any of the SOEs that were recently listed on Chinese and Russian stock exchanges, and several of them are considered so closely linked with essential national interests that the respective governments are unlikely to have such plans.

**Box 1. The emergence of China and Russia as dominant players in privatisation**

In the first half of 2007 the honour of topping the world's privatization league tables belonged to the Russian government, which raised no less than US$ 18.3 billion from a mere three sales. In the second half of the year China had the world privatization stage (outside of Europe) much to itself, since other recently active countries such as Russia, India and South Africa were quiescent. China generated privatization revenues of US$ 37.1 billion in the second half of 2007, following an already very high US$ 17.6 in the first half of the year.

The largest individual transactions worldwide in 2007 also took place in China and Russia. Russia's largest savings bank Sberbank raised US$ 8.8 billion in a domestic rights offering that nation's second largest share issue ever (behind the 2006 Rosneft IPO)[6]. Three months later, Russia's second largest bank Vneshtorgbank executed an IPO of global depository receipts in London and ordinary shares in Moscow that raised US$ 8 billion.

China's privatization landscape in 2007 was dominated by a series of IPOs in large companies that was received by the general public with an enthusiasm reminiscent of the privatization frenzy that took hold in some European countries in the 1990s. PetroChina sold just over 2 per cent off its A-shares for US$ 8.9 billion in an initial public offering that saw the share price nearly triple during the first day's trading. Also in the energy sector, China Shenhua Energy Group executed an A-share IPO in Shanghai that raised US$ 8.8 billion in an offering that was more than 30 times subscribed. Within the financial sector, China Construction Bank became the fourth Chinese bank to execute an IPO, raising no less than US$ 7.7 billion. The amount is a sectoral record, as is the purchaser interest in the offering which went more than 40 times subscribed. Finally, Ping An Insurance, China's second largest insurer sold 15.7 per cent of its shares in a public offering for US$ 5.0 billion.

Source: Privatisation Barometer, *The PB Report 2007*.

[5] In the case of Russia, this is however somewhat tempered by the fact that the state has at the same time taken control over large previously private companies, so that by some measures the state's control over the productive sectors has actually grown.

[6] For comparison, the largest individual transaction in the OECD area in 2007 was a secondary share offering by the Swedish government of 8 per cent of the shares of the telecom company TeliaSonera, which raised US$ 2.7 billion.

## 3. The framework for privatisation

This chapter draws out some of the main characteristics of the (corporate governance) framework in which privatisation takes place. Obviously, the entire legal and regulatory framework for state-owned enterprises, as discussed in Chapter I of the SOE Guidelines, is relevant in this context, but the present section focuses more narrowly on the factors that bear directly on the process of privatisation. These are divided into three subtopics, namely the placement of administrative responsibility for privatisation in OECD countries; the legal requirements and approvals procedures involved; and the regulatory and competition frameworks for the privatised SOE. Again, the latter issue is dealt with in the specific context of the privatisation process. Here and in later sections it is implicitly assumed that the government owners of SOEs have established a sound general regulatory framework for the enterprises, consistent with the outcomes recommended by the SOE Guidelines.

### *3.1 Administrative responsibility*

The administrative responsibility for privatisation in most OECD member countries – at the national or federal levels of governments – tends to be rather centralised. In the Czech Republic, Italy, Korea and Poland privatisation is undertaken directly by the national ministries of finance and/or economics, and in Sweden and Switzerland by one other single government department (Table 3). Most other countries rely on a holding company or other state ownership function, or a privatisation agency. The SOEs of Austria, Belgium, Finland, Hungary, Portugal and Spain are mostly or entirely under the control of state ownership functions, which are also entrusted with their privatisation. The recently established Hungarian National State Holding Company (NSHC) is an example of a continued trend toward the reliance on one state ownership function for privatisation. It replaced another privatisation and state ownership company, but unlike this legacy company NSHC has a legal monopoly on undertaking privatisations subject to the national Act on State Owned Assets.

**Table 3. Administrative responsibility for privatisation**

| Responsibility for privatisation: | Branch of the state controlling SOEs: | |
|---|---|---|
| | Sectoral ministry | Central ownership function |
| **Ministry of finance or economics, or the equivalent** | Australia; Slovak Republic | Czech Republic; Italy; Korea; Poland; Sweden[7]; Switzerland[8] |
| **Privatisation agency** | | Greece; Turkey[9] |
| **State ownership agency or holding company** | | Austria; Belgium[10]; Finland[11]; France; Hungary; Portugal[12]; Spain; |
| **Sectoral ministry acting alone** | Canada; Ireland; Norway[13] | |
| **Sectoral ministry assisted by a coordinating agency** | Denmark; United Kingdom | |

Source: Submissions by OECD member countries.

In many cases the allocation of individual SOEs to such ownership agencies reflects, partly, the degree of corporatisation that they have already undergone and partly the fact that they are already considered as potential candidates for privatisation. Some of member states have indicated that insofar as an SOE is expected to continue to fulfil "specific societal tasks" (in the words of the Finnish delegation) then it is likely to remain under the direct control of a sectoral ministry.

Specialised privatisation agencies, again reflecting the fact that the era of frequent privatisations is coming to an end in most countries, have become rare in OECD countries. At present only Greece and Turkey appear to have such entities – and both cases involve high level government committees overseeing privatisation programmes as well as specific implementation expertise. In fact, a number of governments have discontinued privatisation agencies or related governmental functions in recent years. In Australia, Czech Republic, Poland and Slovak Republic privatisation agencies were discontinued since 2000 (or, privatisation ministry, in the Slovak case) and their previous functions incorporated in the respective finance or economics ministries. Canada previously also had a government department responsible for privatisation; its functions were taken over by the Department of Finance in the 1990s.

Four OECD countries included in the survey (Canada, Denmark, Ireland and United Kingdom) conduct privatisations at the level of sectoral ministries. Two of these, Denmark and United Kingdom, maintain a coordinating and/or advisory function whose services are offered to the privatising ministries (e.g. the UK Shareholder Executive). Another two countries, Australia

[7] The Ministry of Enterprise, Energy and Communications is responsible for privatisation, including of enterprises controlled by (other) sectoral ministries.

[8] Privatisation is the responsibility of the Swiss Federal Council, i.e. the highest executive level in the country.

[9] However, some forms of privatisation (e.g. airports) are carried out by the Ministry of Transport.

[10] This applies where the state's holding company owns the SOE. Otherwise privatisation is done directly under the auspices of the Minister for State-Owned Enterprises.

[11] Some SOEs with specific societal tasks remain under the administration of sectoral ministries.

[12] This applies where the state's holding company owns the SOE. Otherwise privatisation is done under the auspices of the Minister of Finance.

[13] However, an inter-ministerial working group is usually organised in which the Ministry of Finance is represented.

and the Slovak Republic, operate without a centralised state ownership function for SOEs but do allocate the responsibility for privatisation to one economic ministry. Some of the countries relying on decentralised models of privatisation or ownership have indicated that their "choice" basically reflects a small number of SOEs and privatisations rendering a centralised function uneconomic.

***Summing up: Administrative responsibility***

Consistent with the SOE Guidelines most countries have centralised the ownership function of all or most SOEs. Guideline II.D states that a clear identification of the exercise of ownership rights may be facilitated by "a co-ordinating agency or, more appropriately, by the centralisation of the ownership function". The annotations to the Guidelines further observe that "centralisation of the ownership function… is probably most relevant for SOEs in competitive sectors and is not necessarily applicable to SOEs that are mainly pursuing public policy objectives". Several member countries have made similar choices, transferring to their ownership agencies only fully corporatized SOEs considered as candidates for privatisation. One might conclude that the recommendation concerning a co-ordinated ownership function is particularly pertinent to SOEs being prepared for privatisation. As regulation is separated from ownership, competition introduced and a professional board of directors taking charge, the state has a strong incentive to ensure that its ownership function is exercised by a specialised unit (or units) of professionals with the relevant expertise.

A separate question is whether the reliance on a privatisation agency or a similar centralised unit should be considered as a good practice. The answer is not straightforward. Clearly, a government need to ensure that those entrusted with privatising SOEs are independent, competent, well resourced, and subject to high standards of accountability and transparency – and all of this can be effectively achieved by relying on a specialised agency. However, governments also need to safeguard efficiency – that is, ensuring that the benefits are obtained at the lowest cost – and this militates against specialised agencies unless the volume of privatisation is large. (This point is further borne out by the recent discontinuation of privatisation agencies in transition economies.) Good practice might be (1) where state-ownership units exist, take full recourse to the expertise in these agencies; (2) where ownership is dispersed among several government bodies, establish a coordinated approach to privatisation. The latter would either, where cost effective and politically feasible, be delegated to a specialised agency, or take the form of an enhanced collaboration between the relevant government departments which would have to be adequately resourced, reporting to one clearly identified part of the executive power, and be subject to the highest standards of transparency and accountability.

### *3.2 Legal considerations and approvals*

This section focuses on the legislative considerations that apply to the act of privatising itself. A host of other legislative and regulatory changes relating to the SOEs operating environment, competition, service obligations, etc. may have to be engendered, but this is assumed part of the general operating environment of fully corporatized SOEs and hence addressed separately.

The needs for, or discretionary decisions to invoke, legislative authorisation of privatisation vary greatly across OECD countries. Obviously in the case of statutory corporation and other SOEs that have been established by specific law, another piece of legislation is usually needed to change their status or ownership. Likewise, some SOEs may be subject to specific legislation (e.g.

in some countries laws are in place prohibiting a state ownership beneath 50% in certain enterprise) that would have to be repealed to allow full privatisation.

**Box 2. The framework legislation of France[14]**

Selling shares is strictly framed by the legislation. The article 34 of the Constitution states that: « The law defines the rules concerning …. Ownership transfers from the public to the private sector. To implement this, three laws define the general legal framework: Law n° 86-793 / 2nd July 1986, Law n° 86-912 / 6 August 1986 and Law n° 93-923 / 19 July 1993. The 1986 and 1993 Laws define the scope of different transactions and the Law of 1986 defines the process to be implemented. Some specific laws have also been adopted to adapt this general legal framework to some specific transactions (for example for the Air France privatisation in 2003).

The Law of August 1986 includes one title II applicable to firms directly and majority owned by the state (the so-called "first rank" participations) and the title III for other privatisations, mostly of subsidiaries of public sector enterprises (so called "breathing" operations) and of local enterprises with mixed ownership. The title II process has also to be applied for the selling of majority shares in first rank enterprises, and to the transfer to the private sector of shares of privatized companies under title II, as long as the state holds 20% of their capital. Under this, le Ministry of Economy is the only competent body, following the Laws of 1948 and 1949, and within the framework of the constitutional principles and rules.

Selling shares in "first rank" enterprises is done as follows:

- Privatisation of most important enterprises are first approved by the law, then decided on by decree. Other transfers are directly authorized by decree;

- The selling price is decided by the Ministry of Economy and shall not be inferior to the evaluation made by the Commission of Participations and Transfers (C.P.T.), an independent commission created by law. For selling shares outside of the markets, le Ministry of Economy decides on the buyer and on conditions according to the views of the C.P.T.;

- Physical persons and employees of the privatised enterprises benefit from specific advantages (free shares, reserved shares, payment delays and, for employees, price discounts).

- When it is necessary for the protection of strategic national interests, a « golden share » is given to the state in some privatised enterprises, with some specific rights.

Source : France's questionnaire response

Apart from this governments may derive their right to privatise according to framework laws, case-by-case legislation, parliamentary approval short of legislation, or the executive may be constitutionally empowered to dispose of state property on its own. Concretely, the reality in OECD member countries includes:

- *Executive powers.* In some countries the disposal of (and acquisition of) corporate assets is considered as part of the operations of governments, subject only to customary parliamentary oversights. This is the case in Australia and Ireland whose governments have, however, in some cases chosen to pass privatisation bills in individual cases to

[14] Original in French. Translation by the Secretariat.

facilitate the process[15]. In Korea, Spain and United Kingdom as well decisions to privatise are basically at the discretion of the executive powers.  In Germany, parliament is invited to approve of impending privatisation as part and parcel of the annual budget law.

- *Framework legislation*. A number of countries have framework laws authorising the executive to privatise SOEs subject to specific pre-defined conditions and observing agreed procedures. Examples include the Czech Republic, France (Box 2), Greece, Hungary, Italy (except for public utilities), Poland, Slovak Republic and Turkey. A variation of this theme is the reliance upon industrial holding companies to own indirectly SOEs. The transfer of enterprises to these holdings may necessitate legislation, but the subsequent disposal of companies or shares normally requires government approval only. In some cases, parliamentary approval is also be required to reduce state-ownership beneath 50% (one example of this is Finland).

- *Case-by-case laws*. Apart from the special cases already mentioned, relatively few countries require the passage of specific legislative initiatives in support of each privatisation project. In Austria, privatisations of “state owned enterprises” (in the Austrian phraseology, as opposed to enterprises held by the government holding company) require an authorisation by federal law. In Belgium, each SOE is governed by a law, which contains stipulations bearing on potential privatisation.

- *Parliamentary approval*. In several OECD countries governments are not expected to anchor privatisation in concrete legislation, but are nevertheless requested to seek parliamentary approval. In Canada this is the case whenever selling shares in an SOE or disposing of all, or substantially all, of an SOEs’ assets. In Denmark parliamentary approval is required, which can in practice mostly be obtained from the Finance Committee. Norwegian and Swedish law also requires parliamentary approval in the case of majority owned companies. In Italy, the privatisation of public authorities requires a government decree to be approved by parliament.

[15] For example, the privatisation of Telstra (Australia) and the Irish state banks ACC and ICC were approved by the respective parliaments by ways of specific bills.

***Summing up: Legal considerations and approvals***

It would appear that the legal and approvals frameworks for privatisation fall in two main categories: First, countries that (still) have large, active privatisation programmes mostly rely on framework authorisation acts – in part, presumably, because parliament does not have the time and inclination to monitor each transaction. Secondly, infrequent privatisors are mostly either required to seek parliamentary approval or chose on their own to involve legislators in order to gain acceptance around the privatisation efforts.

It is not clear that general "good practices" should be formulated concerning national legislative frameworks, which are firmly embedded in national political and constitutional realities. At the same time, it should be recognised that embedding privatisation in the legislative process can have important beneficial impacts on the transparency and predictability of the process. Even governments that are formally entitled to privatise state assets without specific legal authorisation, or which need only to seek the "approval" of parliament, have sometimes chosen to pass a sales act setting out the agreed modalities of privatisation. Where different parts of the political spectrum differ on privatisation – and not least in the current environment of large, sequenced privatisations – this may be useful in signalling a political commitment to investors and reassuring them concerning the likely future path of sell-offs.

### *3.3 Regulation and competition*

*"Privatization should not be looked at in isolation. Its success depends on appropriate deregulation and reregulation of privatized firms, as well as the creation of stable institutions that foster the development of financial resources needed by privatized firms to grow independently from the state."*

*Lopez-de-Silanes (2005)*

The consensus position among OECD countries is that a government should not privatise an SOE before an appropriate regulatory framework for the privatised entity has been established. Key organising principles for this framework are proposed by the Principles as well as the SOE Guidelines. The latter obviously apply only in the case of partial privatisation or corporatisation prior to privatisation, whereas observance of the Principles will be relevant to any post-privatisation situation[16]. The overarching text of Chapter I of the Principles posits that the framework should "promote transparency and efficient markets" and "clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities". The SOE Guidelines, Chapter 1 seconds that the framework should "ensure a level playing field in markets where SOEs compete". Individual guidelines further recommend a clear separation between the state's ownership and regulatory functions; full disclosure of obligations that an SOE is required to undertake in terms of public services; even-handed application of general law to SOEs; and an unsubsidised access to finance.

[16] Except for management and employee buyouts, where the privatised entity is usually privately held, plus the comparatively rare case where an SOE is trade-sold to a non-listed company.

In practical terms this implies that a privatising government needs to ensure itself that two separate, but related, regulatory frameworks are in place. An adequate competition, or anti-trust, regulation backed by effective enforcement mechanisms is needed. The consensus view is that privatised entities involved in any activity where competition on general market terms is feasible should be made subject to competitive pressures. This leaves a residual role for sectoral regulation (for instance, third party access regulation) of activities that will necessarily involve an element of monopoly subsequent to privatisation. A further consequence of the consensus is that safeguards must be taken to ensure the independence of the relevant regulatory agencies, in general, and *vis-à-vis* any remaining ownership function that the government may retain.

Whereas all OECD countries consider as good practice the establishment of such a framework prior to privatisation, some sequencing issues may occur in practice. Some of the post-transition economies appear to take the position that, since regulation is in many cases a learning process, privatising in a situation of an imperfectly implemented regulatory framework is broadly equivalent to having to privatise amid a rapidly changing legal environment. A few countries even alluded in their questionnaire responses to the possibility of using sequenced privatisation to safeguard continued government influence over the SOE whilst the final regulatory issues are being settled. From a purely regulatory perspective this may indeed represent a second-best solution, but it creates genuine conflicts for governments in the exercise of their ownership and regulatory functions and, in doing so, may imperil the interests of competitors, consumers and the minority shareholders in the partly privatised entity.

### *3.3.1 Establishing an adequate framework: sequencing and concrete steps*

If an SOE is operating in a fully competitive environment, then its privatisation should give rise to no regulatory issues. The only case where issues may arise is the trade sale to an existing private sector operator, in which case concerns about the combined entity's market share may have to be addressed by the already existing competition authorities. Similarly, if SOEs in regulated sectors are sold to a private sector incumbent then the transaction will be addressed through the frameworks already in place.

Where corporatisation of SOEs goes hand in hand with the introduction of competition and/or regulation then the first thing the government will normally want to do is to ensure the separation of the ownership from the (evolving) regulatory functions: in the absence of an independent regulator, most other concerns about regulatory quality are somewhat obscure. This issue has come to the forefront lately in OECD countries because of privatisation programmes' increasing focus on the network industries.[17] The solution chosen by most governments is to transfer the ownership and/or financial responsibility for an SOEs to a central ownership function or an economics ministry, while retaining the regulatory functions (in most cases, the previously self-regulatory functions) in the relevant sectoral ministry.

Alternative models include keeping both functions in a sectoral ministry, but shifting the regulatory function into an autonomous, specialised unit. Several OECD countries further take the

[17] This issue has also come up in the related context of OECD member countries increasing reliance on concession contracts and other public-private partnerships in the network industries. Good practices in this respect are discussed in a recently published OECD instrument dealing with private sector participation in infrastructure (OECD, 2006b).

position that the separation of functions can be buttressed by codifying the respective responsibilities in separate laws. In practice, though, the quality and credibility of the separation has more to do with public than corporate governance: when the ownership and regulatory function are part of the same state administration subject to the same political oversight, a potential for confusion exists. A degree of regulatory certainty is paramount to an effective sale process, particularly in the case of a partial privatisation. The best way of gaining credibility for regulatory independence is to demonstrate, over time, the *de facto* independence in concrete cases.

The next issue that needs to be resolved is the degree to which the SOE considered for privatisation – or parts of it – can be subjected to competition. In the network industries this brings up the question of "structural separation". (Some recent examples bearing on competition and separation in the case of Korea are provided in Table 4.) SOEs in this sector generally consist of many parts, some of which will remain monopolies. Through the process of structural separation the latter parts are separated from those that are capable of operating in a competitive environment. Governments may, of course, decide to privatise vertically integrated SOEs *en bloc*, but in practice this complicates the process of introducing competition and may be best suited if the privatised entity is intended to continue as a regulated monopoly. In individual cases policy makers may perceive a temptation to pursue this line of action because the monopoly elements can boost the privatisation revenues. However, in the longer term this conflicts with the ultimate goal of maximising economic efficiency through privatisation.

Particularly problematic cases have arisen in the past when, for instance, telecom and airport operators have been privatised in their original corporate form and demands for structural separation and related competition concerns raised by regulators only pursuant to the entry of private owners[18]. Such "late attempts" at remedying an initially unstable market structure are, for reasons alluded to in the previous paragraph, hardly ideal and can seriously jeopardise the credibility of a privatisation programme. Similar issues may sometimes pertain to the relationship between the privatisation process and general legislation. For instance, elements of Norway's Telenor (telecom) privatisation were postponed due to impending changes to the tax laws bearing on equity investors.

**Table 4.Examples of amending systems and laws & regulations in Korea**

| Company | Amendment | Privatization |
|---|---|---|
| POSCO | Ownership and management system got separated and the board of directors became solely in charge of management (articles of association). | Completed (Oct. 2000) |
| KT | The Electricity and Communications Law and the Law on Abolishing Korea Telecom were amended to create competition among fixed line communications service providers. | Completed (May 2002) |

[18] One example, which was resolved amicably, was the 2005 discussion about structural separation between the UK telecom operator BT and its regulator Ofcom: http://www.ofcom.org.uk/consult/condocs/bt_oss/summary.

| | | |
|---|---|---|
| | Necessary steps were taken to make sure that communications service continues to be provided to those who cannot afford communications services and people living in non-profit areas even after the company is privatized. | |
| KT & G | The Tobacco Business Law was amended.<br><br>→ KT&G's exclusive right to manufacture cigarettes and its legal obligation to subsidize tobacco farming was abolished. | Completed (Oct. 2002) |
| KEPCO | The 3rd law on Electrical power industrial restructuring was established and revised.<br><br>→ Power generating division was divided into 6 companies, and electricity trading centre was established to create competition in the power market. | Stopped |

Source: Korea's questionnaire response.

A course of action pursued by most countries is to separate "commercial" parts of a utility, typically including the retail side of business, as part of the corporatisation process. What then happens depends on national preferences. These units may be privatised subject to standard competition policy safeguards, or they may be retained as independent subsidiaries of the SOE whilst their competition with private entities is introduced. The latter approach has (admittedly, somewhat outside the scope of the present report) often given rise to practical problems since at the time of regime shift it involves putting in place Chinese walls between units of an entity that have previously worked closely together. Some such constructions have even been criticised for being little more than accounting separations, which may allow regulators to gauge whether cross-subsidisation takes place to the detriment of outside competitors, but hardly encourages competition within the "structurally separated" entity itself[19].

The final choice is whether the hard core monopoly elements of utilities SOEs should themselves be privatised. The retention of such "natural monopolies" under public control is widely supported by economic theory, and in practice the main argument for transferring them to private ownership is normally a need to address major operational inefficiencies that have accumulated due to the public ownership. Privatising such enterprises more than anything else highlights the need for independent and well-resourced regulation. A case in point is the so-called universal service obligations (USOs) that will normally follow this part of the enterprise. A means of treating USOs post privatisation will need to be established. If the SOE is corporatized, and perhaps sequentially privatised, then the SOE Guidelines imply that this will involve an identification process, a costing process, a funding process and, ultimately, a contractual process. In the case of *en bloc* privatisation the state may of course simply impose USOs on buyers and let the competitive sale process sort the costing and funding out.

[19] The Australian competition watchdog ACCC recently voiced such concerns for the Telstra telecommunications company: http://www.accc.gov.au/content/index.phtml/itemId/833570. The French railway track owner RFF has so far also been induced to continue sourcing all technical services from the service operator SNCF (CNT, 2005).

***Summing up: Regulation and competition***

Governments should not privatise SOEs before an appropriate regulatory framework has been established. This framework includes anti-trust regulation to ensure a healthy degree of competition wherever economically feasible and specialised regulation to oversee activities where an element of monopoly is likely to persist. Importantly, these regulatory functions need to be separated from the state's ownership role. A model chosen by most OECD governments is to transfer the ownership and financial responsibility for an SOE to a central ownership function or an economics ministry, while retaining the regulatory functions in the relevant sectoral ministry or agency.

Without prejudice to the ongoing discussion about structural separation in the SOEs of network industries, it should be noted that the mere conversion of a public to a private monopoly has often given rise to regulatory as well as political problems. Good practice normally call for exposing as much as possible of an SOE's value chain to competition no later than at the time of privatisation. Whether or not effective competition is feasible when competition-exposed elements of the value chain remain vertically integrated with monopolistic elements may vary between individual cases. However, if privatised SOEs with monopoly elements are allowed to remain vertically integrated then this further highlights the need for independent and well-resourced regulation.

## 4. The privatisation process

This chapter is the *de facto* centrepiece of the report: it addresses the procedures involved in the actual process of privatisation. It is organised largely chronologically, starting with the considerations and analysis underpinning the decision to privatise; moving on to governments' efforts to prepare SOEs for privatisation and their choice of privatisation methods, sequencing and timing; addressing briefly the role of external advisors in privatisation as well as governments' efforts to deal with employment conditions in the privatised entity. It ends with a discussion of the role of post-privatisation assessments and accountability.

### *4.1 The decision to privatise*

To policy makers the decision on whether or not to privatise has often had two vital elements namely, first, whether to corporatize the activity (or asset) in question and, secondly, whether to keep the corporatized asset wholly or partly under public ownership. The SOE Guidelines provide essential guidance for these considerations. Their recommendations on the corporate governance of state-owned enterprises may be taken to represent a consensus among OECD countries concerning the good practices governments will want to aim for in the corporatisation process.

The SOE Guidelines are aimed mostly at commercially operating SOEs, and for the same reason are relevant to SOEs that are considered as actual or potential candidates for privatisation. Some guidelines moreover espouse good practices of more general applicability. In particular, the framework conditions enumerated in Chapter I – which include the separation of ownership and regulation, a level playing field between SOEs and private sector companies, as well as transparency concerning non-commercial objectives of SOEs – are essential challenges for governments aiming to put their SOEs on a sound commercial footing in a competitive environment. In the remainder of this report the word "corporatisation" is used to describe the act of structuring an SOE with a board and management structure otherwise consistent with company law. The word "full corporatisation" denotes putting SOEs on a footing where they are not only corporatized but operate consistently with the SOE Guidelines.

The alternative to both corporatisation and public ownership is of course the direct sale of unreconstructed public assets, for example in the form of trade sales to existing enterprises or management buyouts. The prevailing views on this practice appear to have changed over time. Previously, a widely shared opinion was that governments should be expected to restructure fully SOEs prior to privatisation, in order to maximise the proceeds and minimise the disruption in connection with the transfer of ownership. More recently, practitioners and theoreticians alike have come around to the attitude that, at least in SOEs slated for trade sales, the state should limit itself to reconstructing those aspects of the company where it has demonstrated advantages (e.g. legacy pension issues; civil servant status of staff) and leave all commercial aspects of the corporatization to the new owners. This is discussed further in the following section.

#### *4.1.1 The decision to corporatize*

To most OECD governments the decision to corporatize hinges on the degree to which the activities in question are expected to exert policy or public interest functions – in other words, where they are placed in the continuum from general government to corporate entity. Citing the Finnish questionnaire response, "…state companies with specific societal tasks could be said to operate as parts of the State organisation, working in the form of limited liability companies. In most cases these companies are covered by special legislation and they enjoy a monopoly position. All other state-owned companies work under competitive market conditions…" The decision to reclassify SOEs from the first to the second group would basically depend on (1) changes in the commercial environment in which they operate, and (2) a rethinking of the extent of their societal tasks.

Where countries may differ more is in whether the changing commercial environment is a development to which they have to react, or brought about by their own policy actions. In a large number of countries the decision to corporatize/privatise goes hand in hand with policies toward deregulation and enhanced competition (as discussed in an earlier section). One illustration is the Canadian questionnaire response, decisions are based on "whether the market *could provide* the same services better and less expensively" (Secretariat's italics), which is taken to indicate a hypothetical situation rather than commercial operators already knocking on the door. Similarly, the United Kingdom, with its strong record of privatisation, said in its questionnaire response that privatisation is considered when the SOEs in question "are no longer required to meet the government's public service objectives". This would imply that authorities do not need a reason to pursue corporatisation/privatisation, but rather would pursue such practices in the absence of concrete reasons not to do so.

Some governments have actively sought out new public activities that could be corporatized and/or subjected to competition. To those, regulatory reform (including related to the competitive environment) became part and parcel of the larger body of privatisation efforts: the consensus view among OECD countries is that actual privatisation should not be embarked upon before the relevant regulatory frameworks are fully implemented – which again implies that the latter should be achieved in the process of corporatisation. This has been nowhere more visible than in the previous transition economies, where literally entire sectors of the economy have been corporatized.

Other governments have been somewhat more "reactive". In the EU area, for example, the evolving Directives bearing on competition, cross-border investment and state aids have effectively changed the corporate environment of many SOEs and stacked governmental owners' incentives in favour of corporatisation. In the words of the Belgian questionnaire response, "privatisation does not give rise to a need to review regulation. It's mostly the other way round: because of new regulations (liberalisation) it is decided to transfer SOEs to the private sector". Another interesting example is provided by the change in policy orientations in Spain in the late 1990s (Box 3). In effect, several members of the EU may not be entirely free to weigh the perceived public interest of SOE operations against commercial concerns, because realising the "public interest" would necessitate an excessive degree of subsidisation. This too militates toward corporatizing SOEs.

**Box 3. A paradigm shift in Spain**

[A] decision of the Council of Ministers in 1996 states that the composition and structure of the state-owned corporate sector in Spain did not conform to sound economic criteria. The role of the "state-as-entrepreneur" was exhausted, which had in the past acted as a main driver of industrial promotion: there were state-owned enterprises that competed with private ones and, in other cases, the state-owned enterprise had a monopoly. Since the goal was to establish the basis for a sound economic growth, reinforcing the market and trying to achieve convergence in real terms with the EU, the Government opted for an ambitious privatization programme, so that it should be the private sector which replaced the state in providing the corporate capital and technology, and which promoted the development of commercial networks and the internationalisation of companies. This happened in parallel with adapting the legal framework to the restrictions in European competition-related regulation directed at the intervention and control by the state in state-owned enterprises.

Source: Spain's questionnaire response

### *4.1.2 Selling off fully or partly corporatized SOEs*

Insofar as a given SOE has been "fully corporatized" as defined earlier, the economic impact of privatisation can be expected to be in most cases negligible. The rationale for privatising a well-run and wholly commercially viable SOE would normally hinge either on the assertion that there are limits to how perfectly governments can corporatize SOEs and, hence, additional efficiency gains can be obtained, or "political" reasons for dispose of state assets in search for gains other than purely economic ones. OECD countries committed to run their enterprises in accordance with the SOE Guidelines cite the following reasons for nevertheless deciding to privatise:

1. The full and successful corporatisation of SOEs is in practice not feasible for cost reasons, because of incentive problems between the public sector and the commercial entities, or reflecting the political economy of reform;

2. Successful corporatisation and regulatory reform have put SOEs on so competitive a footing that there is no remaining rationale for state ownership.

3. Public budgetary considerations and/or gross debt levels may militate toward the conversion of corporate into financial assets. A wave of privatisations in EU countries earlier in the decade to bring down debts to meet the Maastricht Criteria is as an example; the reliance on privatisation proceeds to finance government spending in the transition economies is another.

A number of OECD countries apparently feel that the full corporatisation of SOEs may be a "pie in the sky". For example, several studies of privatisation have concluded that one area where full corporatisation is rarely possible is the incentivisation of SOE management and, in some cases, other employees. Public opinion rarely allows publicly controlled companies to pay salaries and bonuses at par with the best performers in the private sector[20]. A related problem is the risk of

[20] See for example Megginson and Netter (2001).

a continued subsidisation by corporatized SOEs, including overstaffing or concessionary treatment of selected client groups, which may be difficult – as a matter of corporate image as much as politics – to abandon in the short run.

Another constraint that has in the past often been cited as a main reason for privatisation can be the access to finance. Unless the government owners are ready to inject capital in response to the needs perceived by the SOE board the access to finance may be more limited in an SOE than a privately owned company. Competition with other enterprises should eventually eliminate such drags on efficiency, but governments may be tempted to rid itself of the problem through swift privatisation. A particular issue was raised by the Danish authorities, namely the credibility of the separation of ownership and control (Box 4). According to this argument, the fact that the government opts for continued control over the corporatized entity casts doubt among private sector operators of whether the playing field between SOEs and others will be truly level.

Shortcomings of commercialisation raise important second order trade-offs for policy makers to consider. In particular, if an SOE cannot be made to work entirely like a private commercial entity, what are the pros and cons of the residual differences? The political economy of privatisation induces governments of different stripes to weigh the pros and cons of privatisation differently, *inter alia* reflecting how closely associated they are with the potential winners and losers. Put bluntly, if the remaining shortcomings in corporatisation of an SOE benefit the core constituents of a given government then that government will find it difficult to justify privatisation with the purpose of redressing the resultant economic inefficiencies.

Even governments confident that they have achieved a satisfactory degree of corporatisation of their SOEs take different views of the merits of privatisation. Countries that consider themselves as among the best-case owners of SOEs will, by the same token, consider that the economic difference between continuing as before and privatising as relatively limited. This argument cuts in both directions. Governments may use the economic equivalence as an argument for not wishing to retain state ownership, or they may argue that for the same reason there is nothing to be gained from privatising. Ultimately, the decision may often come down to ideological or pragmatic differences of the same kind that were discussed in the previous section[21].

Among individual OECD countries it would appear that the ones that are relatively more "agnostic" about the merits of state and public ownership of enterprises are those that either have gone a long way in corporatizing in accordance with agreed good standards, or have very few SOEs on their books (or, very few left) and hence tend to approach each privatisation on a case-by-case basis. In these cases politics or other non-economic considerations can play an important role. For instance, Australia said in its questionnaire response that the government "will consider whether there is a policy reason for the Commonwealth to continue to own, or be a part owner, of the company."

[21] For instance, Bortolotti and Pinotti (2003) conclude that one of the most reliable predictor of a pickup in privatisation activity in a given country is the replacement of a left-leaning with a right-leaning government.

**Box 4. The decision to privatise: overall and specific considerations in Denmark**

The overall consideration is whether it is possible to run the company in question according to the premises of private business and to manage it within the context of private business regulations. This is both an argument to privatise and a precondition. Two aspects are central to the overall consideration. First, are mechanisms in place to secure the fulfillment of any political considerations that relate to the particular SOE – such mechanisms being, for instance, a regulatory framework or an appropriate contractual framework for public service obligations. Second, the effectiveness of competition in relevant markets.

The main objective is to establish whether the company can function on the premises of private business. In this assessment the distinction is made between a) general considerations made in relation to privatisation; and b) characteristics of the specific company.

a) *Assessing the context of the privatisation.* Privatisations are often catalysed by similar objectives and the following general aspects considered. First, privatisation reduces state involvement in the market. Often state involvement stems from a public monopoly. Liberalising such a market with the introduction of competition and separation of commercial and political issues will usually result in better service, lower prices and stronger compliance with the demand from customers. Once competition has developed, the state-owned company will be only one out of several service providers within the market and the reason to preserve direct state ownership often becomes void.

   In a situation where a state-owned company is not privatised but functioning in a liberalised market it might be questioned if the market is fully liberalised. Hence, the presence of a company which does not function on the terms of the market can at times have the consequence that the separation of commercial and political interests is doubted. This can reduce the incentive for private companies to go into the market and consequently reduce the aforementioned benefits from liberalisation

   Second, privatisation can give the company better possibilities for adjusting to market changes. These changes can for example be caused by shifts in consumer demand or in supply, due to the entry of new companies in the market or an enlargement/reduction of the existing market. In general, both full and partial privatisation can strengthen the basis of making more flexible investments, procuring new capital and joining alliances. Further, a private company will often be able to accept greater risks that a public company, which can form the basis of higher-return investments.

b) *Assessing company specific characteristics.* The assessment of the company will typically focus on three main characteristics, which are crucial when analysing whether the conditions for privatisation are fulfilled. First, the revenue of the company must stem from the sale of products and services where both the cost of producing them and the willingness of the consumer to pay is reflected in the price. Second, it must be possible to flexibly adjust operational and investment costs so as to obtain the optimal balance between the produced products/services and the actual demand – based on market induced prices. Third, the company's objective must be to create the largest revenue and potential increase in value within the frames set by the relevant regulation.

Source: Denmark's questionnaire response

Sweden, with its large portfolio of SOEs that are commonly held to be well governed, responded that there will normally be a political element in a decision to transfer some of these to private ownership. In this respect, the position of Finland is both unusual and interesting. The government has corporatized the SOEs under the aegis of its ownership agency to the point where it considers them in all essentials as equivalent to private companies. Reflecting this it follows an opportunistic approach to divestment, involving the disposal of asset shares when the conditions are favourable, but rarely discretionary decisions involving the selloff of entire companies.

Other countries with large portfolios of SOEs, including the former transition economies, pursue somewhat different approaches. One example is Germany, whose privatisation choices as mentioned earlier are anchored in the annual fiscal budgeting procedure. Reflecting this, one of the key criteria that could influence a decision to privatise includes not only the public interest but also the contingent liabilities with which control over the SOEs could burden the public finances (Box 5). Another interesting characteristic of the German process is a statutory requirement to examine every two years whether the companies need to be retained by the state and the automatic commencement of privatisation procedures if this if found not to be the case. Such a requirement logically needs to be backed by standardised evaluation criteria and processes. These are described, for Germany as well as other countries, in the following sub-section.

### *4.1.3 Methods for assessing the pros and cons*

The degree to which countries employ formal and/or standardised evaluations of the pros and cons of privatisation depends on several factors. One of these is obviously the size of the task: other things equal countries with much to privatise have greater incentives to formalise the procedure. Another factor is the degree to which they choose to corporatize their SOEs. As mentioned earlier, if countries are convinced that they have achieved the highest feasible degree of corporatisation then the difference between the pre and post privatisation phases will be correspondingly smaller.

**Box 5. Conditions for state-ownership according to Germany's Budget Law**

In case of public enterprises, the Budget Law states preconditions for the formation of a company by the government, namely Section 65 BHO on *Participation in private law enterprises*:

"[T]he federal government should participate in the founding of a private law enterprise or in an existing enterprise with a legal form of this kind only if:

- There is an important interest on the part of the federal government and the purpose intended by the federal government cannot be achieved better or more economically in any other way;
- The federal government's contingent liability for calls is limited to a fixed amount;
- The federal government is granted suitable influence, particularly on the supervisory board or in an equivalent supervisory body;
- It is ensured that the annual statement of accounts and the annual report will be prepared and audited in accordance with the provisions of Part Three of the Commercial Code relating to large commercial law entities…"

Every two years the government of the Federal Republic of Germany examines whether the companies need to be retained by the state. If not, the Ministry of Finance and the owner-resort work out a concept for privatization.

Source: Germany's questionnaire response

Among those that rely on standardised evaluation methods such as cost-benefit analysis are Central European countries like the Czech Republic and Hungary. Hungary, moreover, engages in a battery of other quantitative assessment methods, according to its questionnaire response including "impact assessment, budgetary cashflow implications and the analysis of other factors like expected market trends, special requirements or commitments from the buyer…" This appears to be comparable to the oft-quoted Australian "scoping studies" that also result in a multi-faceted assessment of the consequences of proposed privatisation, including through cost-benefit analysis. Switzerland, like Australia an infrequent privatiser, also as a general rule applies cost-benefit analysis to its privatisation projects. So does Germany, which according to its Budget Law must carry out cost benefits analysis "for suitable measures of considerable financial importance". In addition, according to the same Law German private operators aspiring to take over government entities should "in suitable cases be given the opportunity to demonstrate whether and to what extent they are able to perform just as well or better business services…"

Comparably few countries have established other, less rigorous regular assessment criteria. Those that have are, unsurprisingly, found among the countries that still have a relatively large privatisation portfolio. One representative example is provided by Poland, where annual privatisation targets are agreed on the basis of a limited and quite general set of assessment criteria. Interestingly, the list includes political-economy criteria such as stakeholder and political pressures, and it takes into account as a factor behind privatisation the administrative capacities of the state ownership unit.

***Summing up: The decision to privatise***

Countries contemplating the privatisation of certain government activities face an important choice at the beginning of the process, between hiving these activities off the public balance sheets by selling them precipitously (typically through trade sales or management buy-outs), or to continue operating them as corporate entities through a period of sequenced, or partial, privatisation. In the first case, the scope for government intervention in the functioning of the privatised entity prior to sell-off is limited. The best course of action is for the government to limit pre-privatisation restructuring to such issues where it holds a demonstrated comparative advantage and for the rest to rely on the price mechanism to identify the private buyer best suited to undertake necessary changes after privatisation. Conversely, if the government chooses to operate these assets in a corporate fashion (for example, charging near market prices for services) prior to privatisation then it is well advised to restructure and "corporatize" them in accordance with the best practices laid down in the SOE Guidelines.

The work of corporatizing and privatising government assets may in most cases be best performed by one agency operating with a necessary degree of autonomy within the central administration. This function can be filled by a privatisation agency or by elements of the state-ownership (or co-ordination) unit that the SOE Guidelines recommend as part of the good corporate governance of SOEs. However, where governments have few SOEs to privatise the benefits of such an agency may not be sufficient to justify the costs.

The consensus view is that SOEs shall be considered for either privatisation or at least full corporatisation at the latest when they become subject to market competition. Many countries go beyond that, setting privatisation in a context of regulatory reform in which a transfer of ownership is contemplated if the introduction of competition is at all feasible. This is arguably a good practice. A full evaluation of the costs and benefits of privatisation should include the counterfactual scenarios of an alternative regulatory environment.

If full corporatisation of an SOE is achieved – including a fully competitive environment and a separation of ownership and regulatory functions – then the economic arguments for keeping it or selling it off may be equally balanced. However, the owning government should observe the highest standards of transparency and accountability, including its reasons for retaining ownership, to avoid misperceptions by competitors and the general public. Governments need to continually assess the pros and cons of privatising the SOE. This involves weighing the revenues to the public purse and the macroeconomic efficiency gains from privatisation against the net losses of public utility provided by the SOE in public as opposed to private ownership[22]. The political cost of privatisation should, as a general rule, not be considered.

Transparency and consistency in the methods used to assess the pros and cons of privatisation are important, and can help bestow public trust and credibility on the process. One way of obtaining this is to rely on a battery of increasing standardised evaluation tools, including cost-benefit analysis and regulatory impact assessments.

[22] The privatised entity may, of course, be compensated by the government for a continuation of certain public services, which will in that case have to enter the calculation of costs and benefits.

### *4.2 Preparing the company for privatisation*

The entire process of corporatisation (where embarked upon) of SOEs and adjustments to the regulatory framework discussed in earlier sections may of course be elements in the preparation of enterprises for privatisation. In the context of this section the word "restructuring" is used more narrowly to denote the act of adjusting internal corporate practices, management and capital structure as part of the preparation for privatisation. An evolving consensus in academic literature seems to be concluding that pre-privatisation restructuring should not be attempted or, at most, be kept to a minimum (e.g. Chong and Lopez-de-Silanes, 2002; Chong and Glado, 2002; Megginson, 2005).

However, this finding is based on the results of a large number of empirical estimates of the effect of privatisation with and without prior restructuring – most of which relied on data including a large number of trade sales in emerging and transition economies. In those cases, it is true, attempts to restructure enterprises immediately prior to privatisation often yielded little or even negative results as the incoming "strategic" investors were better placed to undertake the necessary changes. The expected cost of restructuring then simply shows up as a discount in the privatisation proceeds which is smaller than what would have been the cost of restructuring the SOE within the public sector. That said, this argument also hinges to some extent on trade sales being directed at one preferred – or a narrow group of potential – buyer(s). A degree of pre-privatisation restructuring could in some cases help widen the scope of potential investors (beyond those benefiting from comparative advantages in the kind of restructuring the SOE needs) and hence boost privatisation proceeds.

When an SOE is being prepared for IPO thoughts must be given to securing the viability of the enterprise after the transfer of ownership. Here, the challenge may be greater when the state plans to sell all or a substantial part of the SOE in the first transaction since, especially if the subsequent ownership is dispersed, then the well-known agency problems between owners and corporate insiders may influence subsequent restructuring. Conversely, if the state retains the majority owner then it would be in a position to pursue any further restructuring in the interest of all shareholders, but this strategy would likely come at a cost to the public purse in the form of a lower pricing of the IPO.

An interesting observation offered by the Polish authorities suggests that the question about whether or not a company should be restructured prior to privatisation is a bit "artificial" in the sense that privatisation involves a number of corporate changes, some of which occurring before, some after, and some during the privatisation (Box 6). Following this logic, rather than choosing whether or not to restructure, the government makes a pragmatic decision – on a case-by-case basis, based on an assessment of the relative capabilities of the public and the purchaser – about how to allocate the individual tasks between the parties.

Consistent with the Polish example it would occur that the decision to restructure, or not, even SOEs that have already been corporatized prior to selloff normally relates to three aspects of the enterprise: levels of employment; management, board and related governance arrangements; and capital structure. The consensus view of OECD countries is that the government owners have comparative advantages that may, dependent on the context, militate toward adjusting employment and capital structure even in the case of trade sales – with a view to optimising the net privatisation revenue. Conversely, last-minute changes to boards and management structures – which a trade-sale buyer will probably want to adjust anyway – make more sense in preparation of a public offering. A fourth, separate consideration that may sometimes occur is divesting an SOE of some of its assets or subsidiaries if these are deemed likely to complicate the privatisation process.

**Box 6. The Polish approach to pre-privatisation restructuring**

The problem whether state enterprises should be first privatised, with the new owners left to worry about their restructuring, or whether they should first be restructured and privatised only later appears artificial in Poland. As up-to-date experience shows restructuring of SOEs had to be pursued before, during and after privatisation. From the point of view of the area of operation of the enterprise, it is possible to identify:

- Organisational restructuring, which involves a modification of the organisational structure so as to make it possible to pursue the implementation of the strategy adopted by SOE;
- Assets restructuring, involving the management's actions affecting the enterprise's assets, e.g., the sale or lease of redundant assets with a view to raising cash, the establishment of ”daughter companies", which could be followed by the sale of shares in those companies;
- Financial restructuring, embracing the writing off and/or rescheduling of the repayment of obligations, conversion of debt into stocks or shares, issue of new stock or bonds, with the proceeds to be used for the repayment of obligations; financial restructuring as a rule signifies the reduction of an enterprise's debts at the expense of its creditors, so the consent of the latter is indispensable;
- Restructuring of employment, which involves a change of its structure and the retraining of part of the workers, replacement of management, laying off surplus workforce.

Source: Poland’s questionnaire response

### *4.2.1 Recent experiences and national practices*

The capital structure of SOEs is often reviewed prior to privatisation. Country experiences in this respect differ significantly across the OECD area according to national and sectoral contexts. On the one hand some SOEs, especially in the network industries and other low-competition environments, are reliant on government guarantees and tend to be overleveraged. On the other hand, governments might not want to leave excessive capital in an SOE to be privatised. Dependent on the exact nature of the privatisation process it could reduce the net privatisation proceeds, and where governments hope for a successful continued operation of the enterprise they may not want to attract investors mainly interested in “bidding for the cash”.

Illustrative of this dichotomy are some of the questionnaire responses. Hungary covered both sides of the argument, but comes down mainly in favour of a lean operation: “The main criteria are to ensure the normal operation of the companies… In case of a profitable operation and excess cash position a dividend payout is decided, which will be paid into the state budget. The state as an owner follows ‘conservative’ principles and does not intend to leverage the SOEs.” Finland opined that “balance sheets of all state-owned companies should be kept lean and effective so as to avoid the forming of any excess cash or other reserves". A couple of countries, Belgium and Italy, noted that rather than addressing the issue of capital structures prior to privatisation countries have sometimes been induced to privatise in consequence of an acute lack of capital. In the words of Italy, "capital structures have not been an issue: all privatisations so far have focused on capital stock and not on capital structure".

Spain took the position that shoring up the capital stock prior to privatisation is not materially different from maintaining government ownership, because "they would have been carried out in any case with the aim of guaranteeing the company's future"[23]. Similarly, Portugal reports having undertaken "restructuring measures to make the privatisation of a given SOE more attractive" including "capital injections and/or debt assumptions". One country, the Slovak Republic, took a neutral stance, reporting that "the capital structure of the privatised enterprises is proposed based on the existing state of affairs". This is consistent with the line of argument developed in the present section: since 2000, Slovakia has relied entirely on trade sales to existing enterprises.

Management and board changes should ideally be rare because companies whose shares are to be offered to the general public would normally be fully corporatized and operating in a competitive environment. However, if corporatisation has been less than perfect then board and management may at the time of privatisation reflect the old rather than the new reality and have to – particularly in the case of an IPO – be changed. Corporate governance also sometimes needs to change according to the listing rules of the respective stock exchanges. One recent example was the IPO of the Irish airline Aer Lingus where the Combined Code on Corporate Governance induced the government to restructure the board before going public.

Reducing the payroll in the case of overstaffed SOEs, or adjusting employment conditions, prior to privatisation is arguably one form of restructuring in which the government holds a comparative advantage. This is particularly the case where SOE employees hold special entitlements such as civil servant status, employment for life or privileged pension plans, which, unless discontinued, may deter potential buyers. The government has options such as engendering legal change to alter the status of SOE employees, offer them reassignments within the public sector or grandfathering their pension rights. Some OECD countries have moreover slimmed the payroll of SOEs in preparation of privatisation through voluntary redundancies and/or early retirement. Here, however, it is less obvious that the government is better placed to undertake such change than the future buyer, and anecdotal evidence suggests that the SOE employees who have volunteered to accept such offers were often the ones that the future buyer would have preferred to retain. The issue of employment conditions during privatisation is treated in more detail in the following section 4.6.

Regarding the need to divest SOEs of certain assets prior to privatisation, this question has for example arisen when the company had subsidiaries that were either incongruent with its own business plans and hence could complicate privatisation; when the subsidiaries were held jointly with enterprises other than the potential purchasers; and where the combined market share of the subsidiaries and the potential purchasers gave rise to anti-trust concerns. Recent examples of this include, in particular, privatised companies in the network industries. For instance, spinoffs and

[23] The questionnaire response further notes that the capital increases to compensate for losses are in fact provided for by the Spanish Public Limited Companies Act.

outsourcing of activities took place before the Hungarian government sold of the energy company MOL and Budapest Airport. Another interesting illustration (which was also one of the largest transactions in recent years in terms of revenue) occurred in 2005 when partly state owned ENEL of Italy spun off the mobile telephone operator Wind that it had held jointly with (other) European telecom companies. According to market comments at the time the move was motivated by a desire to simplify the further privatisation of the parent company. Finally, the state owners may not always have the choice: some SOE assets may be subject to security and related legislation and not transferrable to the private sector. This has for instance concerned the real estate holdings of certain recently privatised companies.

### *4.2.2 Valuation*

Beyond the act of "restructuring" a final act of preparing privatisation in most countries consists of establishing a proper valuation of the SOE to be privatised. While some might argue that privatisation based on competitive bidding will in itself establish the value of the enterprise there are several reasons why the state seller will want to establish (a) pricing benchmark(s). The choice of sales methods – or in the case of public offerings, sequencing – may depend on the valuation of the company in alternative scenarios, as may the ultimately decision whether to privatise now or postpone the transaction. Moreover, specific decisions in the privatisation process such as share allocations (in the case of public offerings), incentive fee structures to external advisors, *ex-post* evaluations of the outcome of privatisation as well as, ultimately, the propriety of the process itself may all hinge on a benchmark established up front.

Virtually all OECD countries undertake some form of pre-privatisation valuation. Even in the case of listed SOEs where a market valuation obviously exists many governments wish to consider the likely impact of further privatisation on corporate value. In a small number of countries (including France, Italy, Poland[24], Spain and Turkey) valuation prior to privatisation is even mandated by law. In some countries that have gone particularly far in corporatizing their SOEs regular valuation is demanded from the ownership agencies, and pre-privatisation valuation merely serves as an extension to this.

In a large majority of OECD countries valuation is undertaken by independent external advisors contracted from the private sector. (The role of such advisors is further discussed in section 4.5.) Country practices however differ regarding the part of the advisory mandate that is charged with this assignment. Some countries retain a specific "valuator" with no other role in the privatisation process. Others include valuation among the tasks assigned to strategic privatisation advisors or ask sales advisors for a valuation. The latter obviously calls for safeguards to guard against a conflict of interest insofar as the advisors have an interest in seeing the sale go ahead.

Conversely, a few countries have followed a different road, leaving the valuation task to a specialist commission within the government. This method, which is used *inter alia* in Korea and Turkey may help safeguard the integrity of the valuation against conflicts of interests in the private sector but can be rather resource intensive from the public perspective – especially if (as is the case in Turkey – Box 7) the commission is to apply similar methods, and represent similar

[24] In the case of Poland the law even specifies that at least two out of a specified set of valuation methods must be used.

expertise, as could be find in investment banks and financial service companies. This method may be helpful in avoiding conflicts of interest in a situation where corporate ownership is concentrated and, perhaps, close to the political process[25].

The specific valuation methods do not differ greatly across countries, albeit obviously with some differences according to whether the SOE is already listed. If this is the case then the valuation methods normally include (together, obviously, with the actual market capitalisation of the enterprise) discounted cash flows as well as multiples of comparable companies and transactions. In the case of non-listed companies other methods may include accounting for net assets as well as replacement and liquidation values.

[25] The corporate ownership and control structures in Turkey were further discussed in OECD (2006a).

**Box 7. Pre-privatisation valuation in Turkey**

According to the Law a value assessment, taken into account possible privatisation and tendering methods, must be made when a company enters the scope of privatisation. The Value Assessment Commission consists of five members; it is chaired by the Head of the Project Group responsible for privatisation proceedings and has as its members other members of the Project Group, namely the Head of the Department of Project Evaluation and Preparation, the Head of the Department of Capital Markets and the Head of the Project Group responsible for Property Affairs (or relevant experts from these units). The Commission carries out its duty under the authority of the President of the Administration and subject to the approval of the Prime Minister.

The Commission undertakes its valuation through the application of at least three of the internationally recognised methods: discounted cash flow; book value; net asset value; depreciated replacement value; break-up value; price/profit ratio; market capitalisation; market/book value; expertise value and price/cash flow ratio. The valuation and choice of tender method take into account the future service distinction; potential cash flow; sector and market specifications; industrial commercial and social features; machinery, vehicles and equipment; finished and unfinished product inventories; all moveable and immovable properties owned by the organisation; goodwill; and receivables and payables under existing contracts as well as other rights and obligations of the organisation considered for privatisation. The Administration makes public upon the approval the outcome of the tender and the value assessment results.

Source: Turkey's questionnaire response.

### *4.2.3 Environmental concerns*

Specific challenges may arise where SOEs are subject to particular environmental requirements, or where the government perceives a need to clear away environmental contingent liabilities in the context of the privatisation process. The first case in relatively rare within the OECD area where SOEs are generally subject to the same environmental requirements as other enterprises in like circumstances. One country (United Kingdom) in its questionnaire response remarked that sometimes government ministries may decide to include the SOEs they control into central government targets for sustainable development. In that case "any transfer would be considered on a case by case basis".

SOEs that are subject to standard environmental rules may, like any other company, carry heavy environmental liabilities due to polluting activities in the past. National privatisation practices in respect of these appear to differ, with a majority of countries transferring these liabilities together with the privatised entities, but a few (e.g. Austria, Slovak Republic and Sweden) may under some circumstances either assume the responsibility or compensate buyers accordingly. The national differences may to some extent reflect privatisation methods. In the case of the trade sale of an entire SOE, environmental liabilities would be the subject of buyer and seller due diligence and reflected in the ultimate sale price. Where SOEs are offered through IPOs to the general public it may be politically less easy for governments to "wash their hands" of long-standing environmental liabilities. However, in that case they need to ensure themselves that any compensation paid to the SOE in this regard does not rise to the level of unintended (or, in the case of EU countries, illegal) state aids.

***Summing up: Preparing the company for privatisation***

Restructuring an SOE prior to privatisation may help increase the net privatisation proceeds and enhance the company's long-term commercial viability. However, authorities need to be mindful of the fact that many aspects of restructuring can be more efficiently performed by the private sector buyers after privatisation. This suggests that governments should limit themselves to action in areas where the public sector has demonstrated advantages. As a general rule, the case for pre-privatisation corrective actions is stronger where (for instance in preparation of initial public offerings) there is unlikely to be one owner or dominant shareholder after privatisation.

The priority areas for government-initiated restructuring differ between countries and types of SOE. However, in the recent experience of OECD countries three priority areas stand out: adjusting the levels of employment; optimising the company's capital structure and, particularly in the case of IPOs, changing the management and board arrangements of the company. To facilitate the privatisation process itself it may also sometimes be necessary to divest the SOE of some of its subsidiaries or other corporate assets.

There is consensus that a thorough and independent valuation of SOEs should be undertaken prior to privatisation. There can be no one-size-fits-all when it comes to the appropriate valuation methods, but many countries seem to agree to rely on discounted cash flows and comparable analysis when SOEs operate in a reasonably commercial environment, and net assets and replacement values when they do not. A top priority is to safeguard the integrity of the valuation procedures, *inter alia* by taking steps to avoid conflicts of interest among the valuators.

### *4.3 Privatisation methods*

The privatisation methods employed by OECD countries over the last decade cover most of the spectrum of available options. Overall, a first dividing line concerns whether the privatisation is undertaken basically by the SOE itself or – as is far more often the case – by the state. A second main consideration is whether to transfer the SOE to private ownership (typically one individual, one company or a closely held structure) or list it on the stock markets. The following main methods offer themselves[26]:

- ***Trade sales***

    – *Private placement.* Negotiated sales of entire SOEs to a preferred bidder do take place, but are in most OECD countries not commonplace. Far more frequent is the practice of offering tranches of shares in already listed SOEs privately to groups of preferred investors – commonly referred to as "block trades".

[26] Not included in the list are some practices pursued earlier in transition economies including debt-for-equity swaps and mass privatisation through voucher schemes. Also, the liquidation of an SOE in the case of insolvency may, if material parts of its assets are picked up by private investors, be considered as a form of privatisation.

– *Trade sale auctions.* SOEs may be auctioned off *en bloc* to highest bidder. The purchasers are in this case usually either strategic investors or, by far the most usual, private companies involved in related or competing commercial activities.

- ***Share offerings***

  – *Initial public offering.* The listing of an SOE begins with an initial public offering (IPO) of all or, by far the most usual, a tranche of the enterprise's shares on a stock exchange. The procedures involved are, similarly to private companies in like circumstances, subject to securities law and stock market listing requirements. It is considered by far the most resource intensive form of privatisation.

  – *Secondary public offering.* Pursuant to the IPO additional tranches of SOE shares may be offered to the public through public offerings. Public offerings may, however, like IPOs be expensive and time consuming. Some countries mostly use them for targeting new investor segments. A special case is the offering of convertible bonds to the securities markets – a practice that some countries have resorted to when having to dispose of tranches of already listed SOEs amid stock market weaknesses.

  – *Accelerated book building*. Through a process of accelerated book building (ABB) the government charges a number of financial intermediaries (typically investment banks) with placing tranches of shares of already listed SOEs with institutional investors. The prices obtained may come at a discount relative to public offerings, but this is compensated by the relative cheapness and speediness of the method.

- ***Management or employee buy-out***. SOEs can be sold to legal entities controlled by the incumbent staff, management or combinations thereof. In principle, MEBOs can be considered as a form of trade sale through private placement. The pricing of such offers differs. In some West European countries governments have made concrete offers to management or staff to buy (part of) their enterprises at such-and-such a price; in some transition economies the corporate insiders have basically been offered the enterprise for whatever they were able to pay.

- ***Privatisation by SOE***

  – *Capital increases.* The government owners, or the SOEs themselves subject to instructions, may issue additional stock – including to the general public if the SOEs are already listed – thus diluting the government's ownership share. This method is of obvious usefulness if the decision to privatise is related to a need to shore up an SOE's capital base.

  – *Indirect privatisation.* The sale of material assets by SOEs may or may not count as privatisation. If a listed SOE does so in pursuit of commercial objectives then the word privatisation does not spring to mind, but *de facto* privatisation occurs when wholly state-owned enterprises under government instructions sell off their corporate assets, subsidiaries and/or commercial activities.

The preferred privatisation methods depend on two sets of considerations. One dimension spans the nature of the company to be privatised, the commercial reality into which it is to be transferred and the absorptive capacity of the relevant capital markets. Another dimension reflects the main objective(s) that public decision makers have set for the privatisation.

### *4.3.1 The nature of companies and markets*

It is important to separate further between the case of one-off privatisation of an entire enterprise and the process of gradual or partial privatisation. When a whole SOE is to be sold off within a relatively short time frame then the consensus view is that if the enterprise is too small to justify the cost of more sophisticated privatisation methods and/or deemed to be commercially non-viable on its own then the method of choice is a trade sale to an existing private company. In the category of "commercially unviable" SOEs come enterprises that are badly in need of industrial partners, technological upgrades or corporate restructuring that the public owners are not well placed to provide.

A variation over the trade sale theme is MEBOs, which have often been used (especially in transition economies) to dispose of particularly small enterprises with individual commercial prospects, such as shops, crafts and small industry. Larger enterprises may also be sold to their staff or management, but in that case usually pursuant to some form of competitive bidding vis-à-vis third parties interested in acquiring the SOE in a trade sale.

The two main factors that may militate against trade sales of an entire enterprise are (1) competition concerns related to the combined market share of the acquirer; and (2) the case where the SOE to be privatised is very large relative to the size of domestic (or, if the SOE operates internationally, relevant) markets and existing competitors. Either factor would normally induce the government as a first step to seek stock market listing through an IPO. The size of the IPO and the size and sequencing of subsequent share offers will depend on the size and absorptive capacity of the relevant stock exchanges.[27] An important secondary consideration is the fact that the pricing of subsequent offers can be boosted by allowing the partly privatised company sufficient time to establish a track record for its financial performance.

In a sequenced or partial privatisation of a listed company, the subsequent tranches were traditionally offered to the public through secondary public offerings. This method is still widely used; according to reporting by individual countries an estimated 32 per cent of the privatisation proceeds generated since 2000 came through this channel[28]. But, alternative methods are increasingly used. Secondary public offerings are, among other things, relatively costly and time consuming and an increasing number of transactions have – for this and other reasons – taken the form of accelerated bookbuilding. An estimated 12 per cent of the privatisation revenues since

[27] Previously, a large number of ISOs were often part of what OECD (2003) termed "mixed sales". In these, a tranche of shares was reserved for SOE staff and/or – especially in the case of network industry – small investors from the general public, typically at a discounted price. In recent years, reflecting the maturing state of privatisation in most countries, this method has become much rarer.

[28] However, this figure should be interpreted with caution. Derived from countries' questionnaire responses it includes neither Germany nor the Netherlands – which figure among the top-10 privatising countries.

2000 were generated by ABBs[29]. Additionally, a large number of countries have relied on negotiated trade sales to place shares of listed companies with preferred groups of institutional and other investors. To some extent this may be perceived as a way of “cutting out the middleman” from the ABB transactions by targeting interested investors directly. However, it may raise some additional concerns about fairness in pricing. Along the “progression” from public offerings, to ABB, to trade sales the cost of privatising decreases (and the state’s ability to handpick the investors grows – see below), whereas it becomes decreasingly obvious to the minority shareholders whether the company they co-own is being sold at market consistent prices.

As for privatisation through SOEs themselves, it is quite common for SOEs to spin off corporate assets but less clear whether such “indirect” privatisation reflects government privatisation objectives. Of a somewhat rarer nature is capital increases by SOEs themselves. As mentioned earlier such transactions are usually motivated by a perception that capital cover of the enterprise has become too thin and unwillingness – especially in the case of partly owned SOEs – on the part of the government to contribute fresh capital. Capital increases are also seen in combination with share offerings by the government itself, a method that may in practice be a close substitute to adjusting the capital structure of the SOE prior to privatisation.

### *4.3.2 Maximising proceeds – and other objectives*

Most privatising governments consider that (one of) their top objective(s) is maximising the net proceeds (after deductions of the cost of privatisation) to the public purse – and, according to national legislation, they may indeed be required to do so. But some countries have complementary, or sometimes conflicting, objectives that they may or may not choose to disclose fully. One example of multiple objectives communicated to the public is provided by Austria (Box 8), which alongside with maximising proceeds lists employment, the location of managerial and intellectual-property related activities and the position of national capital markets. Others such as the Commonwealth of Australia consider, alongside with the potential privatisation proceeds, “how the privatisation method may impact on the ongoing viability of the entity and/or industry” – which is certainly less intrusive than complex public interest criteria, but nevertheless represents a broader underlying strategic agenda. Korea likewise takes into account the “long-term development strategy of the privatized company” but to this adds a broader range of concerns such as the “prevention of hostile mergers and acquisitions and the protection of managerial rights”.

[29] This largely reflects the frequent use of ABBs in the privatisation programmes of the Scandinavian and a few other countries.

**Box 8. Privatisation objectives in Austria**

According to the ÖIAG Act (Austrian privatisation law), privatisations should lead to the maximum possible increase in the enterprise value of SOEs and to maximum proceeds for the owner. In addition, the following Austrian interests are to be protected:

- Creation and retention of safe employment in Austria;
- Wherever possible, the decision-making bodies of the companies to be privatised should continue to be located in Austria through the creation of Austrian core shareholder structures by means of syndicates with industrial partners, banks, insurance companies, pension funds, retirement funds, funds, etc.;
- The retention and expansion of existing research and development capacity;
- The taking into consideration of the Austrian capital market.

Source: Austria's questionnaire response.

Obviously one single competitive bidding process cannot target multiple objectives. Governments may exact a promise from would-be purchasers that they will respect limitations like the ones listed in the Box, but such declarations may not be legally binding and, at any rate, different bidders are likely to make different levels of commitment to the individual objectives listed by governments. The main options available to governments are relying on complex, multiple bidding processes; specifying non-pecuniary objectives beforehand and conducting the bidding with these as a sub-condition[30]; and relying on a formal or informal prequalification of bidders.

To some extent this points to a general conundrum that dogs the process of privatization. In most cases the SOE to be privatized was put in the public sphere for a reason – in pursuit of some concern to the public interest. In the case where some of these concerns are still valid, but privatization is nevertheless deemed necessary (e.g. because the SOE in question has become inefficient), the government will have incentives to privatise in a way that transfers the benign role previously assigned to the government unto the new owners. One frequent example of this is the assumed externalities to the general economy from retaining a domestic presence in "strategic industries". In this case (which also appears to underpin the Austrian example) the nationality of ownership *per se* may be less important, but the delocalisation of key parts of the value chain will appear to the government as a thing to be avoided. A closely related example is found in the airline sector where the national localisation of transport hubs is often deemed important to other parts of the business sector.

Such considerations have led to numerous cases of privatisation of dominant shareholdings – or at least blocking minorities – into the hands of national institutional investors or business

[30] A hybrid approach, for instance employed in Australia, is to invite to rounds of conforming and non-conforming bids to gauge the likely cost to the public purse of the non-fiscal objectives.

interests variably referred to as “strategic investors”, “hard core”, etc. While not casting in doubt the right of governments to act in the public interest, from a corporate governance perspective this particular model does give rise to concerns. In particular, the national interest may often not be fully aligned with the interests of minority shareholders, who, consistent also with the SOE Guidelines, at a minimum should have access to full information about other investors’ obligations in this respect at the time of purchasing their shares. More generally, transparent investment regulation and/or ownership and voting right limitations in the corporate articles of association might in many cases be more efficient ways of addressing ownership concerns than is tailoring the design of the privatisation process.

### *4.3.3 Proceeding in practice*

When the preferred privatisation method is trade sale subject to a bidding contest, the proceedings mostly fall in three main parts: (i) identifying a long-list of potential buyers; (ii) reducing the field to a short-list a potential bidders who are invited to acquaint themselves with company data and perform due diligence; (iii) the bidding and selection procedures. One example of the steps involved in the case of Finland is provided in Box 9. The Finnish case is illustrative but differences persist across countries. For example, the reliance on an external advisor to identify a long-list may, according to context, differ from several other countries that either invite an open expression of interest from potential buyers or combine such a process with the work of a specially appointed advisor[31].

The standard procedure in all cases seem to include a first phase in which long-listed buyers are made subject to a confidentiality agreement and, based on partial information (a “sales book” in the terminology of some), make an indicative offer on the basis of which the shortlist is drawn up. The shortlisted bidders gain access to a so-called data room where they can consult very detailed information about the company and, on the basis of this and other information, perform due diligence. Following this, binding offers are submitted to the ownership unit and, if this is mandated by national rules, shared with the higher levels of government. The trade sales process does in some countries involve setting a minimum price, the existence of which will in this case be communicated to the bidders beforehand. The main national differences are between the criteria for selecting the winning bid which, as follows from the previous sections, may include non-price elements. Also, some countries include as part of the pre-selection process negotiations with would-be bidders regarding the legacy commitments to the privatised company that they are prepared to undertake – including employment stability and remuneration, ownership structures, equity and investment plans.

Block sales of tranches of shares targeted at preferred investors and other forms of trade sales not involving competitive bidding obviously give rise to few procedural concerns. However, some important pricing issues may be involved. Other things equal the price will be lower than pursuant to a bidding process, a fact that will have to be dealt with in a transparent manner vis-à-vis minority shareholders and the general public. And, care will have to be taken to ensure that the pricing of trade sales is not so conservative as to raise concerns – especially where this is subject to specific laws or EU regulation – about state subsidisation of the buyers.

[31] Spain, and to a lesser extent Australia, Poland and the Slovak Republic, also provided detailed information about the nature of their trade sales procedures.

**Box 9. Trade sales in Finland**

If a trade sale is executed through a structured auctioning process it goes roughly as follows:

- An advisor is appointed through a normal bidding contest;
- Having acquainted itself with the company the advisor prepares an Information Memorandum;
- In cooperation with the company the advisor prepares the Data Room;
- The advisor prepares a wide list of potential buyer candidates which, together with the OSD [state ownership agency] is boiled down to a Long List;
- The advisor sends to candidates on the Long List an introductory letter together with a draft Confidentiality Agreement;
- Those who return a signed Confidentiality Agreement will receive the Information Memorandum and a request to give an indicative offer;
- On basis of the indicative offers a few candidates are selected on the Short List and these get access to the Data Room;
- Binding offers are requested and received;
- An MoU is signed on basis of the best offer;
- The bidder is given a possibility to execute a confirmatory due diligence;
- Final negotiations.

Source: Finland's questionnaire response.

In the case of public share offerings the sale offer structure, timing and marketing strategies will differ from case to case based on the government's sale objectives and the market conditions. The sale structure may also depend on timing of a public offering within a sequence of partial privatisations. In particular, when the tranche to be sold is large relative to the capital markets and pricing is a top priority then the sellers may choose to split the tranche in a subset of offerings targeting various market segments. Not all of these will necessarily take the form of public offerings. In recent Australian experience past offers have included combinations of "an institutional book-build involving between one and four tranches split across different geographical zones; a Japanese public offer without listing; a retail offer in the US and Canada; a firm offer to broker clients in Australia and New Zealand; a retail offer in Australia and New Zealand". In the case of secondary offers the list may also include specific offers to existing shareholders and in some cases to employees.

The practical steps involved in a public offering can be exemplified by the Spanish procedures shown in Box 10. The Spanish case is pretty representative of other OECD countries, although the need to seek ministerial approval in the design phase and seeking independent assessment of the appropriateness of the IPO process in the preparatory phase may not apply equally in some countries that delegate more of the responsibility to their specialised ownership agencies.

An important secondary objective in public share offerings is the development of share prices in the weeks and months following privatisation. In the words of the Hungarian authorities "[another] task is to ensure a long-term shareholder structure avoiding market price declines after the sale". This point reflects the political economy of privatisation: abrupt declines in the share price could jeopardise public support for the government's privatisation programmes more broadly, especially in the case where small investors have been actively invited to partake in the IPO. Governments may allow the use of over-allotment options ("green shoes") to help stabilise the share price post-privatisation and/or, depending on national securities regulation, charge the investment banks involved in the offering with market stabilisation operations.

**Box 10. Public share offerings in Spain**

Sales into the capital markets have in the past been the chosen procedure for a privatizing a number of companies belonging to such industries as telecommunications, steel, engineering, aeronautics, paper, tobacco, services, gas, petroleum, electricity and air transport. They are organised according to the following main phases:

***1. Phase for the design and administrative authorization for the public offering***

- Consecutive selection of the external Advisors: Financial Advisor, Legal Advisor and Global Coordinators for the public offering (Initial Public Offering) or of the public offering. These entities, in accordance with SEPI [state ownership agency], select the Entities which make up the Insurer and Placement Syndicate.
- SEPI's Board of Directors approves the main characteristics of the IPO/public offering: percentage for sale of the Company, distribution of the shares in tranches (retailer and employees, institutional-domestic and international), the incentives to be applied to retailers and employees and the process' detailed development. This public offering project is submitted to the Consultative Board for Privatizations, so that it can submit a report on it.
- SEPI submits the public offering project, on which the CCP has already submitted its report, to the Ministry of Economics and Finance, which submits it to the Council of Ministers.
- Agreement of the Council of Ministers, authorizing SEPI to carry out the public offering.
- Notices to the Comisión Nacional del Mercado de Valores (CNMV), the Spanish equivalent of the US Securities and Exchange Commission.

***2. Phase for preparing the sale.***

- Preparation of Prospectus and of the "Circular Offering" (international prospectus), and filing of this Prospectus with the CNMV for verification. Preparation of other documents needed in the relevant foreign markets.
- Signing of the Insurance and Placement Protocols with the Entities which make up the Insurer and Placement Syndicate.
- Contract for the advertisement campaign for the public offering, through a bid aimed at the specialized agencies (call, assessment of the bids according to rating system and award). Launch of the campaign:

press, TV and radio.

- IPO case is put to the Valuator and a valuation obtained.

3. ***Sale phase.***

- Start of the deadline for making the purchase orders for retail investors, to any of the Insurer and Placement Entities.

- During the sale period, SEPI and the company's managing team make presentations in the stock exchanges and before institutional investors (Road Shows).

- Book building with the institutional requests.

- Determination of the maximum retail price, which must be published in 2 newspapers and notified to the CNMV.

- Signing of the Insurance Contract for the Retail Tranche.

- Opening of the deadline for revoking the purchase orders for retailer investors and deadline for making final purchase requests.

- Determination of the Sale Price for the shares (which cannot exceed the maximum price set in the retailer tranche).

- Final distribution of the number of shares in each tranche.

- Signing of the institutional Insurance Contracts.

- Allocation of the shares: a) allocation in the retail tranche in case of oversubscription, according to an algorithm which guarantees a general minimum number of shares ; b) allocation of shares in the institutional tranche discriminating in accordance to the quality criteria of the requesting investors, which have been previously set; c) reallocation between tranches, when necessary.

- The shares begin to be traded on the Stock Exchange (in case of IPO).

- Liquidation of the transaction.

- Execution, when applicable, of the "green shoe" by the Insurer and Placement Entities.

Source: Spain's questionnaire response.

Finally, in a few cases trade sale and public offerings have been combined to a hybrid method. For instance, if the "letters of interest" from potential bidders in a trade sale auction are disappointing from a revenue-maximisation viewpoint the government may ask an investment bank to run a bookbuilding for an IPO in parallel and choose its privatisation method on the basis of the better price. Spain has been doing this on some occasions and so have sub-national levels of government in Australia.[32] At the same time, only relatively few SOEs are suitable for hybrid

[32] The Swedish authorities also consider hybrid approaches as part of their "arsenal", but have not made frequent recourse to them.

approaches: for starters, they must be small enough that they can be sold in one transaction and at the same time large enough (and independently viable) to be serious candidates for a flotation.

***Summing up: Privatisation methods***

The privatisation methods employed by OECD countries during the last decade are legion, conditional *inter alia* upon company characteristics, market structure, legal and administrative traditions and political context. Consequently, there can be no one-size-fits-all recommendations regarding good practices. However, as a general rule governments would want to aim (and have in practice done so) for maximum efficiency in their choice of methods. Governments have mostly opted for management and employee buyouts where the privatised entities were particularly small (in absolute terms, or relative to the size of the privatisation programme) and trade sales based on some form of competitive bidding where SOEs are on a largely commercial footing but not large enough to justify the cost of a public share offering. In recent years, IPOs and subsequent share offerings have gained grounds as very large utilities companies have been privatised at a pace set in accordance with capital markets' absorptive capacity.

There is a consensus behind relying to the greatest extent feasible on competitive bidding in privatisation. In trade sales of an entire enterprise this involves a form of auction, in which the bids of a wide range of potential buyers are invited, and a full disclosure of relevant information to the bidders (respectively, the short-listed bidders) enables them to optimise their bids. In public share offers the reliance on standard investment banking procedures of pricing and share allocations should normally be sufficient to ensure an adequate degree of competition. Governments may, however, on efficiency grounds opt for simpler and cheaper procedures such as accelerated bookbuilding. In this case, the role of external advisors as well as governments' efforts to maintain a level playing field gains additional weight. Privatisation by the SOE itself, by allowing it to adjust its capital structure, is supported by the SOE Guidelines. It may in practice highlight the need to have in place strong corporate governance mechanisms to ensure an alignment of interests between the enterprise and its owners.

A case has sometimes been made for targeting privatisation at certain preferred groups of buyers. However, authorities need to consider carefully alternative legal or regulatory measures that may be more appropriate to secure the hoped-for outcomes. If "targeted" strategies are pursued then it is often more efficient to work through pre-qualification following by bidding among the selected candidates than allowing the targeting to interfere with the selection of individual buyers. At any rate, full disclosure should be made, to minority shareholders as well as the general public, of the criteria according to which a preference for certain shareholders is developed and the objectives they are expected to pursue following privatisation.

### *4.4 Timing and sequencing*

In previous decades a crucial question for authorities pursuing policies of privatisation was in what order to privatise individual SOEs. As mentioned in the previous section they generally chose to begin either with "easy case" companies already operating in a competitive environment or with companies that combined the virtues of being otherwise easy to sell and likely to raise large revenues to the public purse. However, in the "new landscape of privatisation" there are fewer companies to sell and those remaining are typically very large compared to the domestic capital markets (or other relevant markets) and the absorptive capacity of potential investors. Authorities may have little choice but to embark on a process of sequential privatisation of these enterprises. In consequence, questions concerning the optimal strategies for timing and sequencing arise. Some of the overall considerations in this respect of the Italian government are listed in Box 11.

A closely related issue is whether or not to opt for full or partial privatisation. The cases of partial and sequential privatisation may in practice appear observationally equivalent: a government may in practice opt for selling off a minority share without a clear commitment – or indeed a clear plan – concerning future steps. Moreover, in some countries and sectors privatising governments make clear from the outset that only a limited share of SOE stock will eventually be offered to the public. This is for example the case in Switzerland where federal law stipulates that the public ownership in Swiss Telecom may not drop beneath 50% plus one share. The Finnish authorities have made clear that, while its state ownership agency approaches the question of tranche-wise privatisation in a pragmatic manner, the state has no plans to let its ownership shares fall beneath a sizeable minority shareholding in most of the companies concerned.

**Box 11. Timing and sequencing in Italy**

If the SOEs to be privatised have already been identified, the most important criteria to determining the order of privatisation are:

- Time needed to fulfil the chosen privatisations, regarding to the relative situation (economical, legal issues: e.g. already listed corporations, no need of shake-outs; existing regulation by law, concessions and/or sector Authorities etc.);
- Profitability of SOEs for retail investors, institutional investors and/or other industrial competitors.

In general, the choice between full, partial and sequential privatisation is guided by the following considerations:

- Full privatisation is considered as the proper choice when the target objective is the placement of the newly privatised firm within an industrial sector, even with creation of synergies and managerial efficiency (ETI);
- Partial privatisation does take place for privatisations within strategic sectors, when the public ownership wants to retain a relevant share (even not the majority) of the corporate stock (ENI, Enel);
- Sequenced privatisation is considered as the right choice when it’s unlikely that the operations end with the full placement of shares offered in just one time (ENI, Enel).

Source: Italy’s questionnaire response.

The main reason governments cite for opting for a partial privatisation is that it allows them to reap (most of) the efficiency gains from a private operation without having to relinquish control. This argument is most frequently voiced in those industries (e.g. utilities, finance) where a continued public interest in the operations of the SOE is assumed. The “control” may consist of a continued majority ownership in which case the state remains free to dispose over the SOE subject only to the protections of minority shareholders laid down in the relevant legislation and listing requirements. Or, it may imply a minority share large enough to prevent unsolicited bids or, through super-majority provisions, changes to the corporate articles of association. Another reason for partial privatisation has to do with the political economy of the process. Political opponents of privatisation – and often entrenched interest groups as well – generally take more kindly to a partial asset sale accompanied by some form of assurance that it is not a precursor to full privatisation[33].

### *4.4.1 Sequencing in practice*

Whereas governments may choose a strategy of IPO followed by tranches of secondary offers because of the size of the SOE to be privatised, it is rarely strictly true to say that a one-off sale of the company – whether through a trade sale or a huge IPO – would not have been at all feasible. The issue of pricing, as discussed in earlier sections, normally plays a considerable role. First, if public share sales are the preferred method then an IPO that exceeds what markets can easily absorb would have to be priced at a sizeable discount.

Secondly, and importantly in the recent strategies of many OECD countries, sequencing may in itself help boost the long-term revenues. The listing of an SOE does, as discussed elsewhere, help improve corporate governance and efficiency. Consequently, several governments have preferred a first, limited-sized IPO followed by more sizeable secondary and tertiary offers once the company's improved performance and prospects have become reflected in its share price. In the words of Greece's questionnaire response the decision on sequenced privatisation takes into account "the potential value uplift for the company as well as the necessity of a grace period for trying out co-operation with a strategic partner[34] (if that is the case), but also to further implement structural corporate changes if needed". Spain observed that "in the case of listed companies the sale has been carried out in a number of subsequent public offerings, so that pent-up demand raises the share value".

Insofar as the government has supplementary or conflicting privatisation objectives to maximising proceeds these normally influence the sequencing decision as well. Most basically, if for "strategic" or industrial policy reasons the state wants to ensure the viability of the SOE as an independent entity following privatisation (an objective that would also have militated for IPO and against a trade sale) then it will want to tailor the sequencing of the offerings to the absorptive of those investor groups that are consistent with the strategy.

Another consideration cited by several OECD countries (and alluded to in the previous section 3) is a desire to move gradually while the regulatory and competition frameworks are still evolving. In the words of Denmark "usually it takes time for competition to develop in a former monopolised market and the liberalisation process often needs adjustments as the first experiences have been gained. In this case, sequential privatisation represents a cautious approach where the state [retains] some measure of control through ownership". This strategy may in practice compel governments to walk a tightrope: the SOE Guidelines recommend a separation of regulation and ownership function that is difficult to reconcile with the use of majority shareholdings to remedy regulatory failures, and doing so may also jeopardise the interests of minority shareholders in the partially privatised SOE.

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[33] However, such assurances need to be seen as credible. In several OECD countries there has been increasing reluctance by opponents of privatisation to contemplate even the corporatisation of SOEs, based on past experiences with stepwise privatisation.

[34] Utilities privatisation in Greece sometimes involves inviting an international strategic partner who will take a minority stake in the privatised company. A recent example is the telecom operator OTE which in 2008 accepted the strategic partnership of Deutsche Telekom.

Another couple of rationales for sequenced privatisation were offered by individual respondents. Some West European OECD countries which offer specific employment conditions to civil servants impart these conditions on certain categories of SOE employees. In case of privatisation, a partial approach provides leeway to let such staff retain their employment status at least during a transition period. Another example, provided by Poland, relates to the occasional need for the SOE to raise fresh capital during the privatisation process: insofar as the government authorises it to tap the capital markets on its own, this in itself leads to a process of sequential privatisation.

***Summing up: Timing and sequencing***

Sequenced or partial privatisation has become the rule rather than the exception in recent years. This is understandable in the context of the current focus on the network industries in many countries' privatisation programmes, since the sell-off of particularly large SOEs that have not previously operated in a commercial environment, does militate toward a partial or gradual approach. The partial privatisation option will typically be chosen where an SOE is expected to fulfil well-defined objectives in the public interest following privatisation, and governments are uncertain as to their ability to impose these through legislation and regulation on a fully privatised entity. Where full privatisation of this category of SOE is the option of choice, a proper sequencing will in most cases be key to maximising the privatisation revenues to the public purse.

Partial privatisation "in the public interest" as well as the use of sequencing to pursue other objectives than revenue maximisation carry inherent risks. The first consideration is transparency in order to inform fully the investors in the first tranches of the state's subsequent intentions. This applies even as policy makers might perceive political reasons for maintaining a degree of ambiguity. In particular, if the government plans to retain a majority or blocking minority shareholding in order to depart from what would be considered in the financial interest of other shareholders (e.g. use the company to fill a residual regulatory function; deter hostile bids or foreign ownership) then this should ideally be made clear from the outset.

### *4.5 The role of external advisors*

The role of external advisors in privatisation varies greatly among countries, *inter alia* reflecting their preferred methods of privatisation and the size and scope of their privatisation programmes. As for the first point, market sales – in particular IPOs – call for much more specialised expertise than for example trade sales, raising the likelihood that governments will need to draw on external resources. Secondly, governments with many SOEs and large privatisation programmes normally have better resourced privatisation or government ownership agencies than others and have the opportunity to amass greater experience in the relevant areas of expertise. In addition to resource considerations, governments may chose to rely on independent service providers for functions that could, if carried out by the state administration itself, cast doubt on the integrity of the privatisation process. In any case, a government with a privatisation programme needs to decide where to position itself within a trade-off between providing expert services in-house and factoring them from the private sector.

The main challenges in selecting external advisors are ensuring that (1) they are free of conflicts of interest with other interested parties; and (2) they are properly incentivised so that even their self-interested actions are likely to produce a socially optimal outcome. The different types of external advice involved in privatisation were extensively covered by OECD (2003). That publication argued that a crucial distinction needs to be drawn between, on the one hand, initial strategic advice to help governments decide whether and how to privatise (the “advisory mandate”) and, on the other, specialised advisory functions of a financial, legal or technical nature (the “sale mandate”) during the privatisation process. The publication further argued that the same external advisor is not allowed to serve in both capacities – or, at least, that candidates for the two mandates be selected through separate, independent procedures. A key conflict of interest inherent in allowing the same external advisor to act in both capacities he/she may have incentives to under-value the assets as a means of facilitating the sales.

OECD countries rely on strategic advise prior to privatisation to a varying agree. Frankly speaking, privatisation of an individual SOE is often decided either politically or in consequence of a broader economic reform agenda, which limits the need to evaluate the pros and cons in each case. Among the OECD countries that generally contract strategic advice are Australia, whose externally contracted “scoping studies” mark the start shot of the privatisation process, and Poland and Spain where pre-privatisation analysis of companies to be privatised through an external advisor are mandated by law. The Polish experience with initial strategic advice is presented in Box 12.

It should be noted that certain potential conflicts of interest arise when external advisors are involved in (or hope to be involved in) business relationships with either the potential buyers of the SOEs to be privatised or the management of the SOEs themselves. The most obvious such problem arises if the external advisors are retained in an advisory capacity by several of the interested parties in a privatisation. Ex ante, if the privatising government becomes aware of such conflicts of interest it will in almost any case lead to the exclusion of the relevant advisors from the process. In terms of post safeguards, OECD countries have guarded themselves against this in different ways reflecting their national legal frameworks. In some countries operating amid conflicts of interest would in itself be illegal for the external advisors. In others, the state usually makes its advisors disclose any actual or potential conflict of interest, subject to legal or civil penalties in the case of erroneous disclosure. Governments as a general rule forbid their advisors from at the same time advising the management of the SOEs. The latter sometimes choose to retain separate legal and financial advice in the case of share issue privatisation, whereas in trade sales, etc there is usually no separate advisory role at the SOE level.

**Box 12. Initial strategic advice in Poland**

According to applicable law, prior to each privatisation an external advisor shall be selected. His main task is to prepare pre-privatisation analysis for company planned for sale. The scope of such analysis comprises four elements:

- An assessment of the legal status of a company's property (method of establishment, ownership rights towards assets, material rights of the company toward third parties' assets, material rights of third parties on company's assets, debts and liabilities, legal status resulting from labour code, environment protection law and anti-monopoly law, third parties' claims, analysis of concessions and permits granted, and other elements specific for a company, e.g. specification of military tasks, geological analyses);

- An assessment of company's standing and prospects for growth (based on company's economic outlook, marketing stance, technological position, review of managerial system for the last three years);

- An assessment of obligations resulted from environmental law as well as law on monuments (full report on technological processes, methods of protection etc. including identification of financial and other risks linked to environmental violation);

- A valuation of the company based on the above points.

Pre-privatisation analysis should end with conclusions and recommendations.

Source: Poland's questionnaire response.

What may be less easily dealt with are conflicts that can arise from the external advisors' ongoing business relationship with other players in the national business environment. The classic advice would be to bring in complete "outsiders" for the advisory functions, but this is often not feasible in the smaller OECD economies. One solution picked by some governments is to appoint a separate (and, one supposes, unscrupulously independent) probity advisor, whose job is to monitor the integrity of each step of the privatisation procedure. It will be this advisor's job to scrutinise the roles of (other) advisors and assess their appropriateness on a case-by-case basis.

A related issue is the selection process for external advisors – one role of which is to guard against a fourth type of "conflict of interest" that arises if the state itself operates with preferred partners. Virtually all OECD countries select external advisors through a competitive tendering process, consistent with national – and in the case of European countries, EU – laws on public procurement. However, since the appointment of an advisor for a specific task concerning a specific company usually involves the disclosure of business secrets it is often not possible to run the bidding contest in public. One way of dealing with this is to operate a registry of pre-qualified bidders, which is open to any potential external advisor able to comply with the qualification requirements. The experience of Finland with the selection of advisors is described in Box 13.

**Box 13. The use of external advice in Finland**

The OSD [ownership agency] takes relatively often advantage of services of external financial advisors as well as legal advisors and, in special cases, auditors. In any privatisation transaction, the external financial advisor, and as the case may be the legal advisor, has an essential role as a) the provider of the most recent expertise and b) as the impartial, neutral, external operator. The actual role and task of the advisor depends on the extent and nature of the transaction in question, be it an IPO, an ABB, a trade sale, negotiations with a single prospective buyer, an MBO or a structured auction process.

Under the present Finnish and EU legislation appointing advisors against remuneration is of course public procurement and the relevant regulations are to be followed. Advisors are in all cases appointed following a bidding contest. However, since the appointment of an advisor for a specific task concerning a specific Company always includes business secrets, at least those of the State and in most cases also those of the Company, it is not possible to run the bidding contest in public. To overcome this problem the OSD has established a public Register of Contractors, which provides a possibility for anyone to offer his advisory services to the Finnish Government. In a concrete case the OSD will pick from the Register 5 – 6 suitable candidates, depending of the object, nature and extent of the planned transaction, between whom the bidding contest will be undertaken following all appropriate formalities but under strict confidentiality.

The remuneration of the advisors will depend on the nature and extent of the advisory task. A fixed fee is commonplace as well as a percentage of the value of the shares sold. International banks sometimes propose a discretionary fee, to be added in case the client is satisfied with the service received. This is somewhat awkward since the Bank naturally assumes that the client will be satisfied and that the additional fee will be paid and if this is not the case, a debate will ensue. Success fees are sometimes used to incentivise the advisor.

Source: Finland's questionnaire response.

In addition to the already mentioned Australia, Poland and Spain, the countries relying on external advisors for at least parts of an initial, strategic assessments include among others Canada (regarding "the timing and method of privatisation"); Hungary ("the climate for the privatisation and research of potential buyers")[35]; Italy (among others "industrial advisors" and "independent appraisers") and the Slovak Republic (where "international tendering" was involved). With a sweeping generalisation one might conclude that the need for initial assessments is generally greater when the privatisation portfolio includes companies that operate in already highly contested sectors, and when there's a real choice between alternative privatisation methods.

The use of external advisors during the actual privatisation process has differed sharply across OECD countries over the last decade. Size is an issue. In small (trade) sales external advice will not be called for in most countries, and in the presence of a specialised ownership or privatisation agencies all except the biggest transactions may be handled in-house. The latter point was made by the UK authorities with respect to the Shareholder Executive. Switzerland, with its very limited privatisation portfolio, also prefers to keep almost all of the work inside the state administration. That said, virtually all governments involve financial advisors such as investment banks in share issue privatisation, *inter alia* reflecting the strong role these actors nevertheless have as part of the bookbuilding process. Other expert functions that most OECD area

[35] The point about potential buyers is related to trade sales. The Czech Republic also often relies on external advisors for this function.

governments factor from the private sector include legal advice and, in a smaller number of cases, auditing services. A small number of countries also rely on more specialised outside advise, such as vendor due diligence and in some cases even public relations services.

The remuneration of external advisors is obviously determined by the bidding process. However, there are national differences between the way it may be structured – in particular with regards to the balance between fixed fees and performance related bonuses. As a general rule, success bonuses are paid to financial advisors if the privatisation proceeds exceed certain pre-defined minima. This underscores the importance of a reliable valuation of the SOE to be privatised, because if the fee structure is designed to reward a "successful" sale even at a comparably low price then the financial advisor's incentives may become misaligned with those of the government. It also raises specific challenges regarding the structuring in incentives in the case where the government's privatisation objectives are not only maximising the proceeds. Other advisors such as legal and auditing firms are normally paid either their standard fees or a specially negotiated one-off remuneration for their services.

***Summing up: The role of external advisors***

For a government, a decision to use external advisers rests on the trade-off between external and internal capabilities, set in the larger context of whether to maintain a central, specialised state ownership unit. The outcome needs to target the most efficient use of public resources. In many cases, the externally sourced services will concern issues that private sector operators are genuinely best placed to address, though the choices made may also reflect the inadvisability of building public sector expertise in states with limited privatisation and state ownership. Governments should neither shy away from contracting external expertise for reasons of short-term savings, nor should they rely on private sector expertise simply as a way of safeguarding themselves from responsibility.

The three main operational challenges are the avoidance of conflicts of interest, the selection of the best and most cost efficient advisors, and the incentivisation of the latter. In most cases, sound general contractual and legal practices should be sufficient to ensure this. A competitive tendering procedure is vital, as are strong ex ante and ex post mechanisms to stamp out conflicting engagements by the external advisors. However, some additional safeguards may be needed. Good practice calls for advisory functions in different but related parts of the privatisation process to be administered by different advisors. And, the incentives scheme for advisors must be carefully designed to ensure that bonuses and "success fees" are payable if and only if the outcome of the privatisation at least conforms with what could and should have been expected.

### *4.6 Changing conditions of employment*

The changing labour conditions in SOEs are in practice often one of the main stumbling blocks of the privatisation process (for a discussion of the politics see OECD, 2003). Public employees may or may not be better paid than their private sector counterparts, but as a general rule they enjoy better-than-average job security and pension schemes. To this comes the fact that SOEs tend to be overstaffed. Empirical studies of privatisation generally identify the downsizing of a bloated payroll in SOEs among the main sources of efficiency gains – although, it should be added, the long-term employment changes in privatised SOEs can be either positive or negative depending on the degree to which the company's post-privatisation prospects are enhanced. A key question to be dealt with in the privatisation process is therefore what legal and contractual rights SOE employees have, and how these are affected by the transfer from the public to the private domain.

Again in this context the question of whether or not the government chooses to corporatize the assets prior to privatisation imposes itself. Un-corporatized activities are typically staffed with civil servants or comparable categories public employees, subject to an employment regime established by specific laws. A fully corporatized SOE is subject to a similar legal regime, including concerning staff relations, as that applying to private incorporated entities. In consequence, the privatisation of corporatized entities should be relatively less complex in terms of employment conditions, because the state will already have settled the staff issues as part of the process of corporatisation. Conversely, the decision to dispose of an unincorporated entity will normally involve considerations about whether or not to reassign staff, offer them a compensation for transferring to the private sector, or reaching an agreement with the purchaser concerning the future employment conditions. In both cases, special problems may arise when the employees invited to accompany the SOE during privatisation enjoy a legally guaranteed civil servant status. This issue has been highlighted in recent years as more countries have proceeded to privatise utilities companies, the SOEs in which civil servant status was generally most common.

The OECD countries in which SOE employees may have civil servant status are located in Europe (Table 5). Of these, employees in Austria and Belgium are legally entitled to retain their civil servant status as employees of the privatised company. Conversely, in Denmark and Turkey SOE employees have to rescind civil servant protections as part of the privatisation process. They are in both cases offered reassignment within the government administration or alternatively a cash compensation for termination of employment. In Sweden, public employees are asked to agree to a change in their employment conditions in negotiations with unions that predate corporatisation. The government retains the option of discontinuing the employment of individuals who refuse to shift to the new regime.

Several more countries grandfather certain rights such as preferential pension schemes post privatisation, including Finland, Portugal and in some cases Ireland. The countries where – mostly in the case of trade sales – the new owners are expected to guarantee salaries and job security in a transitory period following privatisation include Hungary, Italy, Spain and (subject to negotiations) Poland. Finally, the legal framework of some countries (including Canada and the United Kingdom) includes "successor rights" in labour contracts, which apply equally to the purchasers of a privatised company.

**Table 5. Employment conditions during and after privatisation**

| | Civil servant status protected? | Pension and other rights maintained? | Temporary job or income security imposed on buyer? | Generic protect-tions applying to privatisation? | Comments |
|---|---|---|---|---|---|
| Australia | | No[36] | | | |
| Austria | Yes | Yes. | | | Civil servants are employed in telecom and post |
| Belgium | Yes | Yes | | | |
| Canada | | | | Yes. Successor rights | |
| Czech Rep. | | | | Yes. Employee rights are assumed by purchaser | |
| Denmark | Yes/No. Offer of redeployment or compensation for rescinding status | | | | |
| Finland | | Yes | | | SOE pension schemes used to be more generous |
| France | Yes | Yes | | | The status of staff depends on sectoral legislation |
| Germany | Yes | Yes | | | Civil servants are employed in the telecom, railway and postal sectors |
| Greece | Yes/No. No civil servant status, but similar employment protections | Yes | Temporary "protective measures" are sometimes, but not always, agreed among the parties | | The transferability of pensions will be aided by ongoing pension reforms |
| Hungary | | | Yes. Collective agreements and employment may be safeguarded for 2-5 years | | Does not apply to market sales |
| Ireland | | Yes/No. Depends on legislation establishing the company | | | Management and staff generally reach an agree-ment on this prior to privatisation |
| Italy | | | Yes. Employment and salaries may be protected for 3 years | | |
| Korea | | | | | |
| Norway | | Normally not[37] | | | |
| Poland | | | Yes/No. Subject to negotiations. 80% of priv. agreements include wage and employment guarantees | | |
| Portugal | | Yes | | | |
| Slovak Rep. | | | | Yes. Employee rights are assumed by purchaser | |
| Spain | | | Yes. Work conditions and employment may be guaranteed for up to 5 years | | Applies to non-listed companies |

[36] However, Superannuation rights already earned by Commonwealth employees are transferrable.

[37] Pensions are transferrable but the state has sometimes had to intervene to safeguard the sustainability of the new pension regime.

| | | | | | |
|---|---|---|---|---|---|
| Sweden | | No [38] | | | Corporatisation is subject to negotiations with existing staff |
| Switzerland | | | | | |
| Turkey | Yes/No. Transfer to other public institutions with a limited loss of benefits | Yes/No. SOE staff is offered early retirement with 30% bonuses | | | Redundant SOE staff is moreover offered extraordinary severance payments. |
| U.K. | | No[39] | | Yes. Successor rights | |

Note: Excluding employees' legal right of participation in the privatisation itself.

***Summing up: Changing conditions of employment***

Privatisation entails both opportunities and risks for SOE employees. Where the transfer of ownership puts at risk job security, wages and benefits of incumbent staff, the general rule applies that existing contractual rights should continue to be honoured. However, the automatic or uncritical grandfathering the rights of civil servants and other public employees cannot be considered as a good practice. A corporatized SOE, in particular, will find it difficult to compete with private sector operators if it is weighed down by heavier obligations than these. In the case of direct transfers of corporate entities such as trade sales the buyers are of course free to discount the price they offer in case of obligations toward incumbent staff. However, the continuing company will be staffed by "class A and B employees", which is rarely an efficient outcome.

The moment of corporatisation is the best time to agree with SOE employees their future employment conditions, wages and benefits – in a manner compatible with prevailing conditions in the private sector, so that the terms are easily transferrable in the case of privatisation. The question is how to manage the transfer and, in many cases, loss benefits. Insofar as benefits are legislated (as is the case with civil servants in some countries) then the state can in principle simply change the relevant laws, but, in view of the political economy of reform, they may in practice have to compensate those who stand to lose. In the case of specific contractual entitlements such as pension rights, rescinding these up front in return for a compensation corresponding to their market value is arguably preferable to a continuation in some form within the corporatized entity.

In the case of the direct purchase of a non-corporatized SOE by a private company existing contracts must as a general rule be honoured by the buyer, for instance in the form of successor rights. However, this does not necessarily extend to salaries and benefits – in particular where these are covered by collective agreements. The practice of demanding that the buyer guarantees wages, employment or benefits for a transitory period, whilst hardly optimal from an economic efficiency perspective, is not inconsistent with good governance if the extent of such guarantees is fully disclosed and reflected in the privatisation proceeds.

[38] Pension rights already earned are maintained as part of the public pension system.

[39] Pension rights already earned are protected. The relevant regulation ("TUPE") further stipulates a minimum level of occupational pension coverage for the new employer.

### *4.7 Assessment and auditing of the privatisation process*

Ex-post controls on the privatisation process in most countries take the form of some kind of audits performed by an independent body, e.g. a "supreme audit institution (SAI)", reporting to parliament. A commonly agreed set of good practices in this respect, the *Guidelines on Best Practice for the Audit of Privatisations,* was issued by the International Organisation of Supreme Audit Institutions (INTOSAI) in 1998. In practice, the involvement of auditors and oversight bodies can rarely be deferred to the post-privation phases. In most countries the SAI is the auditor of the business when still in state ownership – a role which, in turn, gains in importance at the time of privatisation at the transaction will take place partly on the background of financial information that the SAI has previously audited. The role of supreme audit institutions obviously differs according to the choice of privatisation methods. However, the general recommendations of INTOSAI (Section 2 of the Guidelines) intended to cover all privatisation situations are the following. The supreme auditing institution should:

- Become involved in the privatisation process as soon as constitutionally possible, consistent with maintaining its independence;
- Where the SAI is the auditor of the business before sale, consider developing explicit guidelines relating to the right of bidders to obtain access to the SAI's audit working papers;
- In planning the audit of a privatisation, plan to cover all major aspects of the sale that have a bearing on propriety and value for money, to identify the key parties to the sale and to take evidence from them, and to be alert to identifying lessons from the sale, including the procedures followed and the outcome of the sale, together with the extent to which the sale objectives were achieved;
- Ensure that it understands the vendor's objectives in carrying out any pre-sale restructuring, and what the vendor did in pursuit of those objectives;
- Ascertain whether the vendor obtained a pre-sale valuation of the business. If not, the SAI should review the reasons for not doing so and, in carrying out any study after the sale has taken place, should consider commissioning its own valuation…
- Examine what options the vendor considered before deciding on the sale method used, and what criteria the vendor applied in deciding on the chosen sale method, including the pursuit of any wider objectives of the privatisation programme.
- Examine whether adequate safeguards were in place to secure that the sale was properly and honestly carried out, and investigate allegations of improper practice, and establish whether there were any lapses in procedures;
- Assess the adequacy of the state's structural arrangements to manage any residual issues, and ascertain whether the public or national accounts adequately reflect any residual assets and liabilities, actual or contingent.

Of particular importance, arguably, is INTOSAI's recommendation that SAI not merely limit themselves to performing *post festum* audits but become involved at an early state in the privatisation process and interact as closely with the main actors as its independence and constitutional safeguards allow.

OECD countries generally support the INTOSAI Guidelines and many have in place auditing procedures that are broadly consistent with them. However, few rely solely on their SAIs to safeguard the transparency and accountability of the privatisation process. In particular, the good practices for SOEs enumerated by the Transparency and Accountability (TrAc) Guide apply equally to SOEs in the process of privatisation. The Guide provides guidance on how to implement the SOE Guidelines in the area of auditing SOE performance. It develops a series of recommendations regarding the three kinds of audits, internal audits, external audits and state audits. These recommendations aim at ensuring the robustness of the information provided both by SOEs and the ownership entities on SOE performance. As such they are relevant both in assessing the privatisation process itself, and in regards to the INTOSAI recommendation that auditing bodies be actively involved already in the pre-privatisation phases (Box 14).

Individual OECD countries' oversight and accountability arrangements differ in practice, reflecting factors such as the organisation of the SOE ownership function within the government, how privatisation is anchored in national legislation and the degree of direct parliamentary involvement in the privatisation process. Virtually all OECD countries have regular oversight of the privatisation oversight by the SAIs, though the exact methods differ (Table 3). There is a continuum from countries that make each privatisation transaction the subject of a separate audit by the SAI; to those where the SAI may, acting on its own or in response to a request from government or parliament, decide to audit to a transaction; to the cases where the auditing of privatisation is part of a more general audit of state ownership agencies.

As a general rule the more stringent procedures are applied by countries that have in the past had relatively active privatisation programmes (e.g. the Czech Republic, Germany, Italy, Slovak Republic, Sweden, Turkey and United Kingdom) though countries like Canada and Denmark also fall in this category. Among the relatively active privatisers who do not systematically audit transactions are found several countries where the privatisation process is subject to stronger-than-average parliamentary scrutiny. It would appear that specialised parliamentary committees (or fiscal committees, in the countries that handle privatisation as part of the government budget procedures) either exert some of the oversight functions themselves or, in some cases acting via governments, direct SAIs to undertake audits of privatisations that are seen as meriting special attention. In addition to the SAIs themselves, several countries rely partly on internal and external auditors of the public administration, the state ownership units/holding companies and in some cases the privatised SOEs themselves.

**Box 14. Elements of the Transparency and Accountability Guide concerning auditing**

***Internal audit.*** The Guide insists on the role of audit committees in supporting and following internal audit plans and their implementation. It recommends that appropriate risk assessments are carried out in SOEs and that performance indicators are audited by internal auditors.

***External audits.*** In addition to having an external audit carried out by independent auditors and to adopting international audit standards, as recommended by the Guidelines (respectively Guidelines V.C. and V.D.), the Guide focuses on procedures for selection of these external auditors and the criteria for their independence. It also asks the audit committees to oversee the external auditors' work and the ownership entities to assess the quality of their work.

***State audits.*** The good practices described in the Guide are based on the Guidelines which recommend the ownership entities to "maintain co-operation and continuous dialogue with the state supreme audit institutions responsible for auditing the SOEs" and to "support the work of state audit institutions and take appropriate measures in response to audit findings" (annotations to Guideline II.2). The Guide more precisely calls for a clear definition of the scope of state audit and for regular in-depth performance reviews of SOEs. It also recommends the ownership entity to discuss the results of state audits with SOE boards, and to disclose appropriately their results.

Source: OECD (2008a)

**Table 6. Auditing and accountability of privatisation**

| Country | Auditing | | | Reporting to parliament | |
|---|---|---|---|---|---|
| | **General oversight by SAI** | **Auditing of individual trans-actions by SAI** | **Other audi-ting or advi-sory bodies** | **Regular or immediate** | **Ad-hoc or on demand** |
| Australia | | SAI may conduct performance audits | Independent probity advisors | | A standing parliament-tary committee over-sees the use of public monies. |
| Austria | SAI audits the state-ownership agency | | | Annual reporting to parliament in case of a privatisation mandate | |
| Belgium | Auditing as part of the budgetary process | | | | In response to questions |
| Canada | | Yes | | | Yes[40] |
| Czech Rep. | | Yes | Internal and external auditors | Regular reporting is mandated | |
| Denmark | | Process, probity and financial soundness are assessed | | Annual reporting by the Ministry of Finance | |
| Finland | SAI audits the state ownership agency | Audits of topical interest | | Annual reporting on SOEs includes privatisation | |
| France | | SAI may audit individual operations | | Annual reporting on SOEs includes privatisation | Ad hoc reporting in the context of the budgetary process |
| Germany | | Yes | | | |
| Greece | | | External advisors and valuators | | Direct supervision by parliament |
| Hungary | | Yes | Internal auditing of the state holding | Mandatory public reporting three months after transaction | |

[40] The Canadian SAI, the Auditor General of Canada, is the auditor of parliament.

| | | | | | |
|---|---|---|---|---|---|
| | | | company | | |
| Ireland | | SAI may audit individual operations | | | |
| Italy | | Yes | Internal auditing of the Ministry | Mandatory semi-annual reporting to parliament | |
| Korea | | | | | |
| Poland | | SAI may audit individual operations[41] | | Annual privatisation report by minister to parliament | |
| Portugal | | Yes | | | Reporting by the ownership entity |
| Slovak Rep. | | Yes | | Regular reporting to government[42] | |
| Spain | SAI may audit the state ownership agency | SAI may audit individual operations | Internal auditing of the government | Regular reporting to a parliamentary committee | Ad hoc reporting to parliamentary committee |
| Sweden | | Yes | Internal auditing of the government | Reporting to parliament following each transaction | |
| Switzerland | | No[43] | | Regular reporting via government to parliament | |
| Turkey | Yes[44] | Yes | | Regular reporting to parliament | |
| United Kingdom | | Yes | | | Dependent on circumstances[45] |

Source: Questionnaire responses.

In almost every OECD countries the privatising agencies are held accountable *ex post* through mandatory disclosure to either parliament or the general public. When the privatisation agency is *de facto* the ownership entity, this reporting is done along with the usual reporting to the Parliament, and/or through the aggregate report, for the few countries who are publishing such a report. Aggregate reports give general information on the evolution state ownership and comment on the large privatisation having been undertaken in the year covered. As for reporting to Parliament, privatisation transactions can be included in the periodic reporting occurring annually and usually associated with the approval of state budgets. They can also give rise to an *ad hoc* reporting, at the request of the Parliament to seek information on matters of immediate concern or on important and politically charged events, which privatisation might well be. In some cases the privatisations will have to be approved *ex ante* by the Parliament and as such they will be a reporting for approval, providing the necessary information to the Parliament to secure the authorization.

The degree of specificity of the reporting, however, does seem to differ across countries. About half of the countries in Table 6 engage in regular reporting, ranging from mandatory

41 The Supreme Chamber of Audit may initiate reviews itself or act at the behest of parliament or the government.

42 Due to the Freedom of Information Act these reports are generally available.

43 No special audits are performed. Privatisations are covered by the regular auditing of government action by the Federal Audit Office.

44 Turkey has two high-level auditing bodies, the Auditing Court and the Prime Minister's High Auditing Board. The Auditing court oversees the implementation of privatisation programmes. Both are involved in auditing transactions.

45 The degree of reporting depends on the legal status of the SOE, the extent of government ownership and the general and parliamentary interest in the transaction.

reporting pursuant to each privatisation transaction, to annual privatisation reports to activity reports of their state ownership units of which privatisation forms a small part. The countries with irregular or ad-hoc reporting form an even more “mixed bag”. In some of them reporting is not seen as necessary because of the oversight functions already performed by parliamentary bodies. In others, ownership units, auditors and other specialised bodies may be summarised directly to answer questions in parliament. In other still, parliament is informed indirectly through questions to the government.

***Summing up: Assessment and auditing of the privatisation process***

Privatisation should be subject to independent oversight from an auditing body such as a SAI, which is well resourced and independent from the executive powers engendering the privatisation process as well as the public authorities carrying it out. Most such bodies report to parliament. Whether every transaction should be audited or a selected subset, and whether this should be done as part of a broader auditing of the state ownership or privatisation agency may depend on the national context. If not all transactions are audited, the SAIs may well act on the suggestion of parliamentary and government entities in identifying suitable targets, but it is essential that the SAIs also retain the powers to initiate procedures on their own.

A SAI should normally be involved during the different phases of the privatisation process. This is particularly important where the SAI is also the financial auditor of the SOE to be privatised, in which case the potential buyers will be reliant on financial information provided by the SAI, but pre-sale performance audits can also be helpful in assuring the efficiency and probity of the process. The SAIs should be encouraged to work with other similar bodies where these exist – including the internal auditing functions of government, parliamentary oversight units and the auditors of the SOEs – subject to proper protections of the independence of all institutions involved.

High levels of transparency and accountability must surround the privatisation process. Regular disclosure to parliament and the general public is normally of essence, though in countries with few privatisations it may have, on cost efficiency grounds, to be replaced by *ad hoc* reporting. Countries have different practices regarding reporting on individual transactions or submitting annual privatisation reports, just as they differ in respect of whether the state ownership (or privatisation) agencies are charged with reporting or the respective resort ministers. There are no grounds for preferring one method to the other, as long as the more “aggregate” forms of disclosure do not prevent parliamentarians and the general public from availing themselves of detailed information regarding individual transactions.

## 5. The corporate governance of privatisation

What may be referred to as the corporate governance of privatisation are situations in which the actual process of privatising gives rise to agency problems between companies and owners, and between majority and minority owners, that go beyond the ones that may already be present in the corporate environment. Such situations would fall into two broad categories. First, some of the general corporate governance challenges for SOEs may gain extra dimensions in the context of privatisation. Secondly, the process of transferring ownership may by the source of new and separate types of misalignment of incentives among the major players. Some of the main issues of the two categories are discussion in sections 5.1 and 5.2.

### *5.1 Corporate governance of companies in the process of privatisation*

In "the new landscape of privatisation" privatised enterprises with a majority or otherwise dominant remaining state ownership will no doubt be an enduring feature. By and large this is the reality that the SOE Guidelines, with their main emphasis on listed SOEs, were intended to address. However, some specific governance issues related to the situation where privatisation is either imminent or a partly privatised SOE is widely perceived as being considered for further government divestment. This section aims to highlight some of these, against the background of the good practices laid down in the SOE Guidelines without an ambition to cover all of the Guidelines' potential applications to companies in the process of privatisation.

#### *5.1.1 Boards and owners*

As governments corporatize SOEs in contemplation of privatisation they will normally wish to benefit from the agreed good practices that the SOE Guidelines establish for the state's role as an owner (Chapter II). For instance, the Guidelines recommend that the state should "not be involved in the day-to-day management of SOEs and allow them full operational autonomy" and "let SOE boards exercise their responsibilities and respect their independence". The SOE boards, in turn, should (Chapter VI) "be composed so that they can exercise objective and independent judgement" and "have the power to appoint and remove the CEO". Whilst not specific to the privatisation process these recommendations carry special weight when an SOE is, for example, in the process of preparing in IPO and hence has an interest in convincing markets of its commercial viability, or when partly privatised SOEs aim to shore up their market valuation with a view to further stock offerings. Put bluntly, excessive political intervention before and during privatisation depresses privatisation revenues and could in more extreme cases call into doubt the integrity of the entire process.

The SOE Guidelines do not militate against the appointment of ex-officio directors drawn from civil services. They do not take an explicit position against politically-connected board members either, but the Guidelines' annotations do recommend that board members should "not act as individual representatives of the constituencies that appointed them". This is potentially problematic in the context of politically charged privatisation programmes. Many OECD governments reserve the right (as alluded to in earlier sections) to use changes in SOE board composition as a short-term tool to change corporate directions. If this is done consciously to further the goal of privatisation then the utility of taking such measures is – from the perspective of the present report – in the balance. At the same time, the international privatisation literature is full of allegations of government owners interceding directly with, or replacing, the CEO in pursuit of their political objectives[46].

One question is therefore, how best a government can enhance the credibility of an SOE's board arrangements prior to or as part of the privatisation. In the early phases this argument can be taken only so-and-so far, even amid a strong formal commitment to full corporatisation of the enterprises concerned. In the pre-privatisation period it is unlikely that the incumbent board will agree to a company policy that will generate a high political cost for the government, no matter what its impact might be on the firm's performance. Subsequently, in the words of Nestor (2005),

[46] Some such examples were reviewed by Camacho (2008).

"privatised companies need to have a state-of-the-art board nomination process". The author further argues that, at a minimum, this might justify for cumulative voting or similar mechanisms to ensure that the minority shareholders in partly privatised SOEs gain board representation. Another way to do this would be to follow a Swedish-inspired board nomination process, which allows minority shareholders to participate in the shareholder committee that nominates board members.

In respect of SOE board independence, an interesting distinction is between governments that own their SOEs directly (whether through sector ministries or a state ownership function) and those that hold them via an incorporated holding company. The holding company will normally be subject to company law and its directors subject to fiduciary obligations. This creates a *de jure* independence from government which also, though in practice independence may *de facto* be more limited, makes it easier for the ownership function to pursue "opportunistic" privatisation practices responding to market opportunities rather than political pressures.

Once a credibly independent and competent board has been established potential conflicts of interest between the board and the (majority) government shareholder may arise. According to national legislation board members are usually subject to fiduciary obligations defined *vis-à-vis* either the shareholder body or the company. In both cases (and, arguably, particularly in the first) board would be expected to deny following instructions that they deem to be inconsistent with the interests of non-state shareholders[47]. In the context of privatisation, this issue may for instance arise when the state owners propose as part of the process to divest or otherwise dispose of corporate assets in ways that the board is not convinced is in the interest of minority shareholders.

A related case may arise when the state proposes to change the SOEs' capital structure, for instance in the context of self-privatisation through share issuance by the enterprise itself[48]. This situation would moreover be at risk of inconsistency with the SOE Guidelines, which recommend that legal and regulatory frameworks should "allow sufficient flexibility for adjustment in the capital structure of SOEs, when this is necessary for achieving company objectives". However, the text obviously implies that the flexibility of the capital structure is pursued subject the nature of the 'company objectives' as specified by the SOEs' owners.

### *5.1.2 Mechanisms for disproportional government control*

*Golden shares seem the answer to a politician's prayer, in that they allow a government to privatize an SOE, withdraw from involvement in day-to-day management, yet still protect the "national interest" by preventing the privatized company to fall into the clutches of an acquirer (especially the evil foreign variety).*

*Megginson (2005)*

Short of retaining a majority ownership, governments have employed a number of mechanisms for continuing to control or influence partly privatised enterprises in excess of the

[47] This is further strongly supported by the SOE Guidelines, Chapter 3 of which deal with the equitable treatment of shareholders.

[48] Poland's questionnaire response identified this as an area of potential misalignment of incentives between board and owners.

state's ownership share. The formal justification for doing so is mostly "strategic concerns" such as security of supply, access to vital resources and safeguarding national security in the post-privatisation era. Additional reasons have involved the political economy of privatisation. Resistance to privatisation from influential national constituencies have been overcome by the state promising to maintain a continued veto over key corporate decisions.

The mechanisms for disproportional government control form a continuum, ranging from regulation bearing on corporate decisions; to control enhancing mechanism akin to the ones used by private sector companies; to "golden shares" conferring special voting rights in almost totally privatised enterprises. They may be summarised as follows (for an overview of their application in OECD countries, see Table 7):

- *Regulatory and contractual requirements.* As mentioned earlier, much of the recent privatisation has focused on utilities and network industries, many of which remain subject to sectoral regulations. Dependent on whether these are more stringent than what might have been applied to an independent private operator in like circumstances, these may be an important tool for continued government influence. In addition, some countries (e.g. Australia) have concluded long-term contractual arrangements with SOEs prior to privatisation.

- *Golden shares.* In its purest form a golden share is a share which, through stipulation by the company's articles of association, carries specific rights. In OECD countries these rights most commonly include making board appointments and vetoing strategic decisions such as takeovers and asset disposals. In the significant minority of OECD countries that do not allow voting right differentiation in the common stock of publicly traded companies, the special rights of a golden share have to be established by law.

- *Legal requirements.* In a number of countries legal provisions securing governments a continued influence over privatised firms are wrongly referred to as "golden shares". One such example has been the oft-cited Volkswagen Law in Germany. In several Eastern and South European countries laws authorising a government veto over corporate decisions by certain privatised enterprises are currently in place (Table 7).

- *Control enhancing mechanisms.* Instruments allowing shareholders to separate ownership and voting rights in listed companies (control enhancing mechanisms – CEMs), commonly considered as a key instrument for family controlled company groups, are equally available for states to retain control over partly privatised enterprises. The most commonly used such mechanisms include dual voting right shares, ownership and voting caps, supermajority provisions[49] and in some cases also pyramidal holding structures (Bortolotti and Faccio, 2007). In some cases these mechanisms may be hard to distinguish from golden shares. For example, Portugal Telecom features a dual voting share structure whose A-shares (in government hands) confer very wide-ranging rights[50]. The use of such mechanisms in the corporate sector more generally – and in relation to the Principles of Corporate Governance – is discussed in detail in OECD (2007).

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[49] The questionnaire response from Ireland specifically mentioned, as an option for retaining control,

[50] This led the European Commission to refer Portugal to the European Court of Justice in January 2008.

Table 7 seems to conform to the findings of a recent study, which indicated that there is a high degree of substitutability between post-privatisation instruments (Bortolotti and Faccio, 2007). In their study of privatisation in 22 OECD member countries the authors concluded that "through either direct ownership. Levering devices or golden shares governments maintain control of almost two thirds of privatised firms". This is a poignant observation against the background of the "new privatisation landscape" discussed earlier insofar as it indicates that while not all limit themselves to partial selloffs in sensitive sectors, many tend to use alternative methods to retain an equivalent degree of control – or at least a veto – over (certain kinds of) corporate decisions.

The use of golden shares has been circumscribed in the European Union since 2002. In two landmark cases, the European Court of Justice[51] gave right to the European Commission in finding that golden shares in a number of European countries were contrary to EC law. In practice the award generally limits the use of golden shares to situations where demonstrable threats to national security and related concerns, where similar criteria are applied to foreign and domestic investors in like circumstances[52]. However, as follows from the preceding text, given the multitude of control instruments available to governments this may not in practice prevent the separation of ownership from control in privatised enterprises.

[51] The cases were C-58-99 and C-483-99. The Court set the criteria that national legislation that establishes golden shares must accord with the principle of proportionality, be based on non-discriminatory criteria which are known in advance and be non-discretionary. For further details, see Kutznetzov (2005).

[52] The application of the proportionality principles to regulation of (foreign) investment in enterprises for security reasons was addressed by the OECD Investment Committee in May 2008 (OECD, 2008b).

**Table 7.Mechanisms for disproportional government influence in privatised companies**

| Country | Control enhancing mechanisms | Golden shares | Legal or regulatory requirements | Comments |
|---|---|---|---|---|
| Australia | | | Legislative or contractual requirements may be imposed. | Mostly related to ownership restrictions |
| Austria | | | | |
| Belgium | | Yes (1) | | Related to appointing board members and preventing the disposal of strategic assets. |
| Canada | | | | |
| Czech Rep. | | | | |
| Denmark | Shareholder agree-ments may be used | | | Applies to the case of trade sales. |
| Finland | Shareholder agreements may be used | One case, not specifically related to privatisatio n | | Shareholder agreements relate to decision-making, qualified majority, powers of management, lock-up situations, dividend policy. |
| France | | Yes | | Concerns ownership caps, board composition and asset disposal . Limited to the protection of strategic national interests. |
| Germany | Pyramidal structures have been used (2) | | Legislative requirements may be imposed | |
| Greece | Shareholder agree-ments may be used | | | |
| Hungary | | Yes (3) | Regulation may be a source of continued state influence | Golden shares are established for a number of countries by the Privatisation Framework Law. |
| Ireland | Supermajority provisions may help leverage government influence | In rare cases | | |
| Italy | Voting right caps in some sectors (3) | Yes (3) | Government decrees may be used to veto certain corporate decisions | Applies to privatisation in "strategic sectors" |
| Korea | | | Regulation may be a source of continued state influence | |
| Netherlands | | Yes (1) | | Concerns board representation and veto over strategic decisions (1) |
| Norway | Shareholder agree-ments may be used | | | |
| Poland | | | A law ensures continued government control in case of threats to the public safety and order | Most of the network industries are concerned by the law. |
| Portugal | Some cases of dual-voting shares, and voting and ownership caps (1) | | In a few companies governments are entitled by law to exercise a veto over board decisions (1) | |
| Slovak Rep. | Shareholder agreements in strategic industries | | | Typically private investors gain managerial control, while the state retains a board majority |
| Spain | | | Government may impose ownership and voting caps and block certain board decisions | |
| Sweden | | | | |
| Switzerland | | | | |
| Turkey | | | The articles of association of certain companies provide for continued state representation on corporate boards | |
| United Kingdom | | Yes | | Scope varies according to sector |

Source: Questionnaire responses unless otherwise stated. (1) Source: Oxera (2005). (2) Source: Bortolotti and Faccio (2007). (3) Source: European Commission (2008).

A frequently voiced argument in favour of maintaining control instruments post-privatisation is that an attempt to abolish such instruments could be counterproductive. It might not lead to privatised companies with a more contestable ownership, but rather discourage governments from privatising altogether[53]. In sensitive sectors this is probably true, so an assessment of the merits of the approach would have to hinge on weighing the societal benefits of an improved efficiency of the SOE following its stock market listing against any negative corporate governance and capital market consequences of the chosen control structures. Moreover, the complementary methods of retaining state influence reviewed above do not necessarily have identical adverse effect and, if at all, should be selected with a view to minimising the fallout.

The SOE Guidelines provide guidance concerning the use of control mechanisms in state-owned enterprises. Chapter III prescribe equitable treatment of all shareholders including (Annotations, citing the Principles) by protecting them "from abusive action by, or in the interest of, controlling shareholders acting either directly or indirectly". In the case of SOEs, as opposed to other listed companies, the "abusive action" would presumably take the form of extracting political rather than pecuniary private benefits from the enterprise. Furthermore, "the potential for abuse is marked when the legal system allows, and the market accepts, controlling shareholders to exercise a level of control which does not correspond to the level of risk that they assume through exploiting legal devices to separate ownership from control". The Annotations to Chapter III therefore goes on to conclude that governments "should, as far as possible, limit the use of golden shares and disclose shareholders' agreements and capital structures that allow a shareholder to exercise a degree of control over the corporation that s disproportionate to shareholders' equity ownership."

***Summing up: Corporate governance of companies in the process of privatisation***

The credibility of the privatisation process and the size of privatisation proceeds, especially in the case of sequenced public offerings, often hinge on the quality of corporate governance. One way of enhancing the independence of SOE boards may be to transfer the state ownership function to a holding company, thus adding an "insulating layer" of corporate accountability. As the process of privatisation gains hold, mechanisms should be established to ensure an adequate board representation of the new outside shareholders. Of crucial importance is safeguarding a sufficient degree of board independence so as to enable SOE boards to protect the minority shareholders, including against further privatisation measures that are not seen as being in the interest of all shareholders.

On the issue of post-privatisation corporate governance, the SOE Guidelines (like the Principles of Corporate Governance) apply the principle of freedom of contract to control instruments in SOEs and other listed companies. In other words, disproportionate control is acceptable provided the non-state shareholders are fully informed of its nature and scope prior to making their investment. However, government vetoes to be used in certain circumstances (e.g. through golden shares and legislation to a similar effect) are inherently less transparent than fully disclosed shareholder agreements or, say, voting right differentiation established through SOEs' articles of association. The latter, in turn, is less transparent than the government deciding to remain majority shareholder or maintaining a blocking minority in a given state-owned enterprise.

[53] This argument closely echoes the discussions about separations of ownership and voting rights in listed companies that were until recently ongoing in the EU.

### 5.2 Managing the transfer: the role of the incumbent management and board

*Managers' incentives to focus on financial performance come from two primary sources. First, they derive from the expected change in compensation associated with changes in financial performance, weighted by the probability that the executive remains employed. Second, they come from the effect of performance changes on the probability of being fired, weighted by the expected loss in compensation from being fired.*

*(Cragg and Dyck, 2003)*

The management of SOEs considered for privatisation, and to a certain extent also non-executive board members, have a direct interest in whether or not a privatisation goes ahead and, if so, what privatisation methods are employed. As a general rule, if an SOE is loss-making and inefficient then incumbent staff fears privatisation on account that the new owner(s) are likely to downsize the payroll. Managers will share this fear, except where the preferred privatisation method is management buyout, in which case they obviously stand to be the ultimate beneficiaries of post-privatisation efficiency gains.

The question is how much SOE managers can actually do to discourage or prevent privatisation of their company. In most OECD countries it would not be acceptable for high-ranking SOE employees speak out publicly against their government's privatisation policies. However, they have scope for collusion with (other) employee groups, which may be protected by powerful political interests and trade unions. In countries with mandatory employee representation on corporate boards (especially in the case of SOEs that are already listed) this scope for collusion may extend to the SOEs' non-executive board members as well.[54]

Managers and boards often have a freer hand in influencing the method of privatisation. Here, apart from their interest in MBOs[55] (which have anyway become much rarer as privatisations have grown in size) they will normally prefer public share offerings over trade sales on account that they are more likely to retain their positions in a listed company than if the SOE is converted to a subsidiary of a competing enterprise. A concrete illustration of this – albeit admittedly predating 2000 by a couple of years – is provided in Box 15. SOE managers have a manifest interest in initial public offerings which, firstly, maximises their own chances of staying employed. Secondly, given that they do stay employed, a widely dispersed share ownership post-privatisation will normally be in their long term interest. The well-known "free rider problems" tend to weaken shareholder powers vis-à-vis corporate managers in a situation where owners are many and small. Some countries have in the past tried to address this problem by privatising block holdings into the hands of a "hard core" of stable investors but have in recent years been more

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[54] Nestor (2005) highlights the case of Germany where the Kromme Corporate Governance Codes has had to provide for separate strategy meetings between the shareholder appointed members of the board without the presence of the employees, "recognising the that the latter impair the board's capacity to discuss delicate business planning issues without the risk of a leak".

[55] In Hungary, SOE board members are requested to disclose, prior to the commencement of the privatisation process, whether they are interested as potential buyers.

reluctant to do so because of the value discounts on stock offerings when this method is employed[56].

**Box 15. Management and boards with an interest in the privatisation method: a US example**

In the United States, the privatisation of the United States Enrichment Corporation (USEC) during the Clinton administration led to a lot of subsequent debate. USEC's directors, led by board chairman William Rainer, approved the company's sale in June 1998 by a 3-to-1 vote (a fifth board member abstained).

The privatisation took place through a public stock offering, an option drawn up by USEC's incumbent management. That plan won out over competing bids from General Atomics and Lockheed Martin to buy the company outright as well as a non privatisation option. It was no surprise that USEC's managers preferred the IPO route. Lockheed and General Atomics both had their own management teams, so USEC's senior officials were likely have been out of a job if the company had been sold to an outside bidder. Instead, at least six members of the old guard currently hold top positions at the new USEC.

Moreover, William Timbers, CEO of the new and old company, requested Rainer for a waiver so he could participate in the privatisation debate, stating that he and other board members would protect the integrity of the process. Board meeting minutes obtained under the Freedom of Information Act show that Rainer authorized Timbers and a USEC lawyer to hear the ostensibly confidential presentations of competing bidders and subsequently allowed Timbers and other senior managers to critique those bids before the board. USEC's financial adviser, investment firm J.P. Morgan – which earned more than US$ 12.5 million in fees in return for its services – was also permitted to argue before the board in favour of management's IPO scheme.

Source : Silverstein and Urbina (1999)

Moreover, managers of a well-corporatized and profitable SOEs will normally argue in favour of privatisation through IPO not only as their preferred method of privatisation and but equally in preference over a continued state ownership. In addition to the reasons just mentioned, corporate managers foresee opportunities for greater financial and operational freedoms once the "straitjacket" state ownership is removed. They may also perceive a chance for larger personal earnings once their company's incentive structures have been aligned with those prevailing in the private sector. This is one of the reasons why external advisors involved in the decision whether or not, and how, to privatise should (as discussed in section 4.5) be free of conflicts of interest with the SOE management. In practice, however, problems may arise since many of the pre-privatisation considerations will necessarily rely on information provided by the corporate insiders.

In the case of trade-sale privatisation other incentives may arise, depending on the financial health of the SOE. If the enterprise is loss-making or, for other reasons, not likely to be retained as a separate entity after privatisation the managers must consider the prospect of not remaining on their posts. In this case, the main incentive problem is how to keep them actively engaged in the SOE's operation until privatisation. If management foresees a realistic chance of remaining in their jobs following the transfer then the challenge for the state owners is that, as soon as a (group

[56] Nestor (2005). The author also notes that in the absence of formal shareholder agreements it is not always clear whether core shareholders are aligned with government interests. Nestor cites the example of the unsolicited bid for Telecom Italia by Olivetti that was ultimately supported by some of the state's "handpicked" shareholders.

of) likely purchaser(s) has been identified then the managers face strong incentives to align themselves with the interest of these people rather than those of the – still – state owners.

### *5.2.1 Incentivising SOE managers for privatisation*

Given the sometimes conflicting interests of managers of companies to be privatised, one solution would be to "incentivise" them. One way of doing this would be for the state owners to design benefits packages for the managers of pre-privatisation SOEs so that the managers' financial interests become aligned with the objectives of the government. Another would be to oblige managers legally or contractually. It follows from the previous section that in doing so there can be no one-size-fits-all solution: depending on the situation such incentivisation measures would have to neutralise radically different sets of adverse incentives.

For this and other reasons OECD countries practices in this regard have differed substantially. Another factor appears to be the different national contexts in which privatisations have taken place over the last decade. A number of countries express themselves in favour of incentivisation in principle, without taken a position on how exactly to design incentives packages. Regarding specific national practices, some salient features appear to be:

- As a general rule, the countries that have privatised a large number of enterprises fully (e.g. the transition economies) generally express themselves in favour of the use of financial incentives. This may partly reflect the attraction of general, cross-cutting schemes in a situation where limited administrative resources can be devoted to the oversight of each particular case. Ireland alluded in its questionnaire response to a way of establishing a general mechanism for incentivising, in a limited way, SOE managers, namely by putting in place employee share ownership plans. In most cases the highest paid members of staff will presumably be the main beneficiaries of such schemes.

- At the opposite extreme, some countries that have had to privatise largely un-corporatized SOEs – often amid public resistance – tend to see the issue in a more political light and generally prefer the "stick" to the "carrot". Several South European OECD countries commented in their questionnaire responses that their privatisations are based in law and managers and board members that do not conform can be disciplined or removed.

- Between the two positions, are countries such as Australia which has also sometimes relied on sale laws to streamline the process, but equally favours cooperation agreements between the government and management/boards as a way of facilitating cooperation. The Danish authorities opined that while "a carefully designed incentive element in management's pay may in many cases support an alignment of interests with those of the shareholders" a close and constructive dialogue will always be the main instrument for alignment.[57]

The aforementioned problem with managers' potential alignment with the interests of the prospective owners has come to the forefront in recent years because of the ascent of new classes

[57] Sweden, generally supportive of management incentives during privatisation, mentioned specifically the practice of offering "stay-on bonuses" to management fearing unemployment as result of the ownership transfer.

of investors such as private equity companies as participants in the privatisation process. One of the most frequently cited examples of this is Blackstone's 2006 acquisition of 4.5 per cent of the shares in Deutsche Telekom from a state-owned financial institution. Levantini (2007) observes that "for years, the Governments worldwide have been very suspicious of PE intervention in privatisations because it was perceived as overly lucrative and possibly value destroying for the acquired companies. Governments were also not accustomed to the PEs' high recourse to leverage."

**Box 16. Incentivisation of management by a private equity firm: QinetiQ of the United Kingdom**

A decision to sell a minority stake in the business to a strategic partner was taken in early 2002 in the light of poor market conditions and the absence of a commercial track record. The competition for a strategic partner began in March 2002 even though the market was poor and the commercial terms of the important Long Term Partnering Agreement (the LTPA) had not yet been agreed. The Department [of Defence] considered that a delay to the privatisation process could have had an adverse impact on long term value by undermining staff morale, damaging customer relationships and restricting QinetiQ's commercial freedom at a key stage in its development.

Twelve investors were selected to participate in the competition and four were shortlisted. The difficult timing and complexity of QinetiQ's business increased the market's perception of risk and contributed to there being only two compliant bids, in July 2002, both from private equity firms. The Carlyle Group were appointed "preferred bidder" in September 2002, before the detailed terms of the LTPA had been agreed. The sale to Carlyle was signed in December 2002 and completed in February 2003, when the LTPA was signed.

As is normal for private equity firms, Carlyle used share incentives to align management's interests with their own, that is, to realise the maximum possible increase in the value of the equity in the short to medium term. The Department considered that its interests in terms of incentivising management to increase the value of the business were aligned with Carlyle's. Although it did not want management to make very large returns purely as a result of the privatisation it accepted that management could make significant amounts of money if this was linked to the growth in the value of the business. The Department did not, therefore, seek to influence the structure of the share incentive scheme.

Carlyle amended their proposed management incentive structure before being appointed preferred bidder to reflect advice from QinetiQ management. The Department subsequently approved the scheme after Carlyle was selected as preferred bidder. Its approval was based on a review of a limited range of potential outcomes, which it believed were realistic at the time. Up to 20 per cent of the equity was made available to management and employees, subject to performance targets being met. Unusually for such deals, but in line with the Department's objectives, share incentives were made available to all QinetiQ staff, including a small allocation of free shares. Not all staff took the opportunity to invest their own money in the business.

The structure of the deal resulted in QinetiQ having a relatively low equity value of £125 million and high levels of debt. The equity value increased to £1.3 billion between the 2003 sale and the 2006 stock market flotation. This was strongly influenced by the improved business performance achieved by QinetiQ management following expansion into the US defence market and into the civil market in the UK and elsewhere. This contributed to a 36 per cent increase in revenue and a 261 per cent increase in operating profit between 2003 and 2006. The increase in the equity value was also influenced by an upturn in the value of defence and technology stocks. The value of the shares of the top 10 managers was £107 million at the time of the flotation, from an initial investment of £537,250.

Source: National Audit Office (2007)

An example of PE participation in a trade sale, which was apparently not value destroying but both highly leveraged and, arguably, "overly lucrative" for some of the participants is provided in Box 16. The UK government attempted – and to a large extent succeeded – to boost privatisation proceeds through a phased trade sale. Incumbent managers were incentivised directly by the new part-owners with the purpose of maximising the market value of the still partly state-owned SOE. However, the question arose about value-for-money considerations and the avoidance of agency problems in a situation where the incentivisation of SOE managers runs in the hundreds of millions.

There is a consensus that government owners should not attempt to incentivise SOE boards. Non-executive directors in SOEs may themselves be ambivalent about privatisation – particularly when sale methods other than IPO are selected, making it a near certainty that they will lose their board positions – but offering them financial incentives may be neither necessary nor appropriate. As noted by several OECD countries in the pre-privatisation phase they are (in most countries) political appointees who could be replaced by persons loyal to the government's intentions. Secondly, granting similar financial incentives to boards and managers could well be counterproductive, potentially aligning the board members' interests with those individuals that they are supposed to supervise.

***Summing up: Managing the transfer: the role of the incumbent management and board***

In the recent experience of OECD countries, resistance by SOE boards and managers to the privatisation process *per se* has not been a serious problem. Managers and non-executive board members have, however, had an interest in influencing privatisation methods and they have occasionally succeeded. A challenge for governments is subjecting the preference of SOE managers (especially in large and well-run enterprises) for IPOs to a critical and independent scrutiny against alternatives such as trade sales and no privatisation. In doing so, they need to consider not only pricing but also, among other things, the likely governance arrangements of the enterprise following privatisation.

SOE managers during the privatisation process may face incentives that do not always correspond to the objectives of the government owners. In particular, where new owners are identified prior to the actual transfer of control the interests of managers hoping to be retained become aligned with these new owners. Governments may incentivise managers through either financial inducement or formal performance requirements – or, through contracts, a combination of the two. The consensus among OECD countries seems to be that financial and other incentives for incumbent management may be considered, provided the incentives are solely linked to the implementation of the privatisation programme and will not lead to management influencing the decision making process.

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