IDB Invest

CORPORATE GOVERNANCE TOOL FOR STATE-OWNED ENTERPRISES

Corporate Governance

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Corporate Governance Tool for State-Owned Enterprises

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Acronyms

PPP	Public-Private Partnerships
IDB	Inter-American Development Bank
IFC	International Finance Corporation
COSO	Committee of Sponsoring Organizations of the Treadway Commission
EICE	Statutory Corporation
SOE	State-owned enterprise
CG	Corporate governance
TN	Technical Note
OECD	Organization for Economic Cooperation and Development

Summary

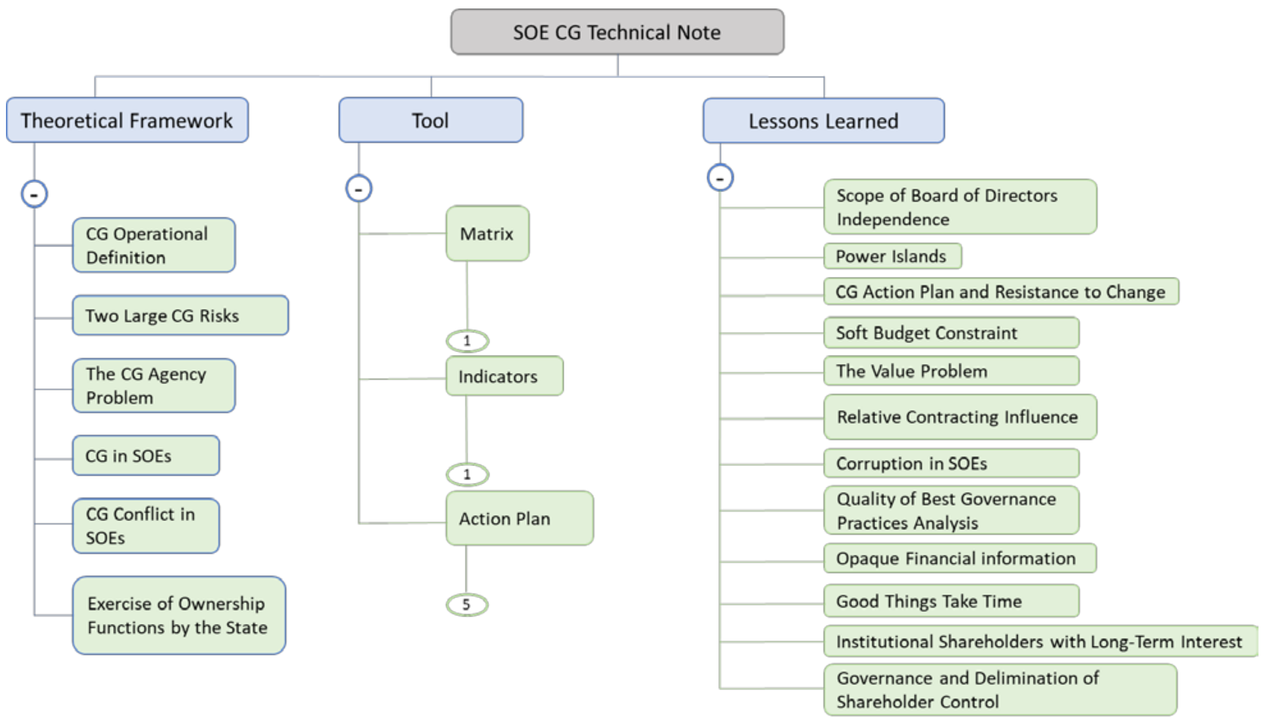
This technical note (NT) contains the concepts and methodology to promote adoption of best corporate governance (CG) practices for state-owned enterprise (SOE) clients of the IDB Group. First, this document provides the theoretical CG framework, its definition, large risks, and conflicts. Second, it provides the tool to evaluate the application of best practices, and third, it illustrates indicators that complete the CG analysis, which can also be used to build and monitor the action plan.

This technical note modifies and updates NT 106 published in 2010 by the IDB and intended exclusively for water and sanitation companies. Unlike the earlier edition, this new version is aimed at a broader segment of SOEs. It considers the lessons learned from applying the IDB CG tool over a decade as well as the updates from OECD and the IFC to

> *State-owned enterprises play an important role in the region as government instruments to provide services where the market cannot offer options for efficiency or competitive neutrality, or for strategic purposes. In many countries, they contribute significantly to the gross domestic product, provide public services for the population (industries like water and sanitation, electricity, or transportation), and represent an important part of consolidated public expenditure. Nevertheless, SOEs present, or may suffer from, problems in their corporate governance. There are opportunities for improvement in their operational efficiency, reduction in associated financial risks, and achievement of greater transparency in the use of public resources.*

their CG guideline documents for SOEs through the rich experience these entities have collected from their first versions in 2005. The progression matrix for best practices emphasizes two domains: the first consists of an important group of practices that should be adopted by the government in general and state entity-owners in particular (22 practices) to strengthen their role as owners; the second domain, with most of the practices (115), is aimed at the decision-making sphere of the CG bodies of the companies, especially the annual general meeting, board of directors, senior management, and auditing.

Finally, the document uses small text boxes to illustrate some lessons learned in applying the NT 106 tool to many companies in Latin America and the Caribbean since 2009.



Introduction

Objectives

The overall objective is to update and adapt the CG assessment tool from NT 106[1] (i) to be able to use it with SOEs from all industries, not just sanitation and water, primarily for IDB Group clients; (ii) to take into account CG developments since 2010, and (iii) to consider the fiscal aspects related to SOEs in order to have a comprehensive view of their impact on public finances.

Scope and Definitions

This document is first aimed at all people interested in management of state-owned enterprises[2]. In particular, it is proposed as a reference guide to facilitate the work of Inter-

[1] https://publications.iadb.org/en/corporate-governance-water-and-sanitation-enterprises

[2] See onwards for relevant definitions. It should be noted that in different contexts a public company is understood as one with shares registered and traded in public stock markets; in a different sense, it is possible to refer to public companies as those owned by a national or federal government body or that are under the

American Development Bank (IDB) Group officials and consultants, including their private arm, IDB Invest, in their responsibility to acknowledge, diagnose, assess, monitor, propose decisions, and open dialogs related to the operation of state-owned enterprises in which the IDB or one of their bodies is considering financing projects. The methodology may also be especially useful for officials of ministries and bodies that manage the property of SOEs as well as the directors, managers, and executives of SOEs in Latin America and the Caribbean that wish to understand the criteria and techniques applied by the Bank in order to prepare themselves to establish plans to adopt CG best practices. Other welcome users are officials of co-financing credit institutions at all levels, researchers, academics, and other participants in the public debate.

The definitions used for ownership and control, general interest objectives, government bodies of the SOEs, owning entity and the like are those used by OECD in their 2016 document "OECD Guidelines on Corporate Governance of State-Owned Enterprises" (pages 15-18).

Now then, the CG methodology presented here may also be applied somewhat to state-owned enterprises where the ownership body is regional or municipal, as is the case of public utility, health, urban development, transportation, micro-financing and other companies, although the definitions adopted by the national accounting and statistic systems would not consider these last categories to be state-owned companies.

Another aspect of scope that should be cleared up refers to the legal form of the SOEs. The most common is "corporation", which in Spanish is "*sociedad anónima*", although it may also cover limited liability corporations and limited partnerships (*sociedad de responsabilidad limitada* and *sociedad de comandita por acciones*). SOEs in English may be considered "statutory corporations" signifying a government-owned company with or without other owners or government shareholders, whether national, federal, state, or local. Generally, the expression SOE (EPE in Spanish) refers to firms where the national government possesses or controls the majority of the voting power. However, the nature of the problems and challenges confronting many SOEs is also shared by other state-owned entities with significant degrees of administrative autonomy that have the primary purposes of providing goods or services to the market, i.e., at prices paid by purchasers and with the intent to cover costs and generate earnings, but that do not have a legal form of a corporation but of an entity created or constituted by a legal act.

Additional files

This document contains additional files that are a key part of the technical note. These files, which may be consulted in the final publication of the web page as links to the principal Technical Note document, are:

1. CG Matrix (Excel format): contains 137 best practices recommended for SOEs classified by domain, attribute, and category and sorted by four degrees of

jurisdiction of control of that type of state body. To reduce the possibility of confusion, in this document the preferred expression is "state-owned enterprises" (SOE) in place of the official translation of OECD that uses the term public companies. Finally, the methodology excludes companies where the state ownership is temporary, for example, as the result of some type of rescue intervention.

progression from the most basic through the most sophisticated. This is the first file that should be studied and mastered, which is organized as a workbook and designed to facilitate participation of directors and executives in workshops in order to prepare the first assessment of the CG status for each SOE. This file should be studied once the principal work text has been reviewed.

2. Indicators (Excel format): this workbook can be used to control collection of information that will be the input to calculate CG indicators and to automate the corresponding calculations. It is organized the same as the progression matrix. At the beginning, it generates the baseline indicators and then helps in monitoring results of the CG action plan.
3. Action Plan and Logical Framework with Example (Excel format): this workbook serves as backup for all projects and activities adopted by the SOE in its action plan. It organizes monitoring of action plan progression.
4. Support documents to apply the tool. These are especially useful references to delve into the concepts, methodologies, and techniques of the tool to use for different cases, since different types of situations will probably be encountered in the tasks to analyze, alter, and monitor SOE CG. These include:
    a. APPENDIX F Company-Level Tools: Information Request List and Interview Guide. This is part of "Corporate governance of state-owned enterprises: A Toolkit" document. (World Bank, 2014)
    b. OECD (2017), *Methodology for Assessing the Implementation of the G20/OECD Principles of Corporate Governance*, OECD Publishing, Paris. http://dx.doi.org/10.1787/9789264269965-en (OCDE, 2017)
    c. OECD (2018), *State-Owned Enterprises and Corruption: What Are the Risks and What Can Be Done?* OECD Publishing, Paris. https://doi.org/10.1787/9789264303058-en.
    d. SOE Questionnaire (Esp.) r.xlsx: This contains a corporate governance screening tool used by IDB Invest during the initial phase of studying the SOE as a possible client.

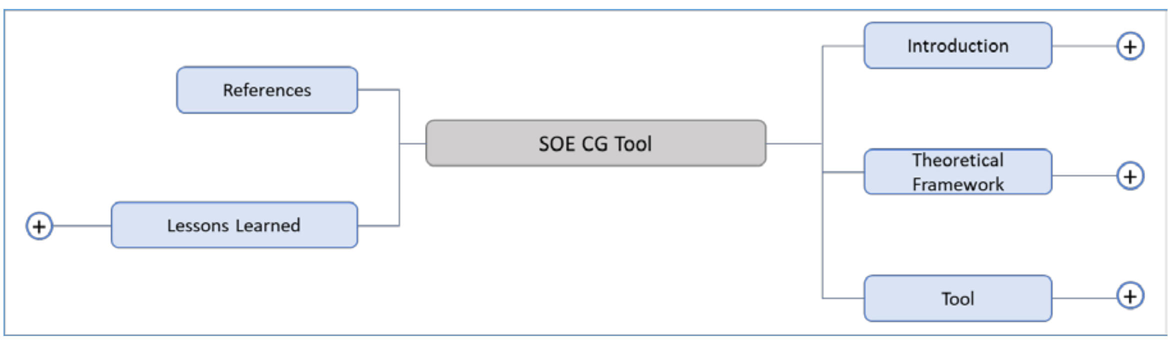
Acknowledgements

In developing the consultancy that prepared the "Corporate Governance Tool for State-Owned Enterprises," the authors received valuable guidance, support, and commentaries.

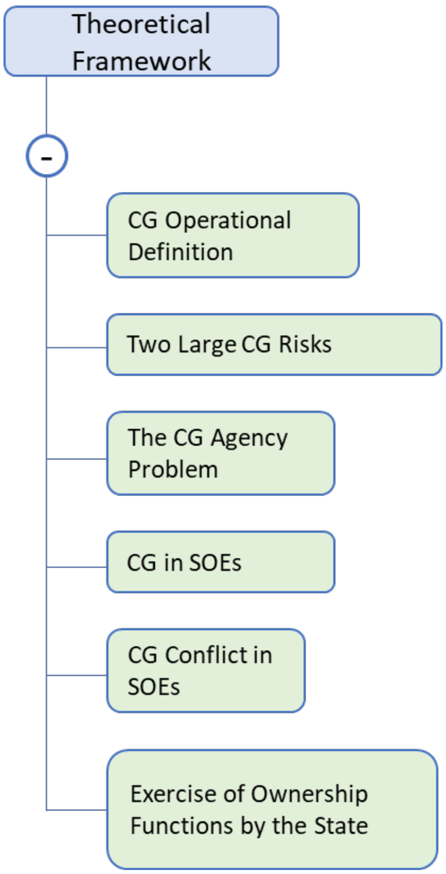
First, the Technical Group of the Consultancy must be recognized, which includes Marta Viegas, Yvon Mellinger, Emilio Pineda, Gerardo Reyes, and Alejandra Duran-Bohme. They defined the ToR, contributed to narrowing down the specific scope of the tool, elements of NT-106 that should be updated, contributions from other academic sources and multilateral institutions in applying good CG throughout the world, particularly in the ALC region, and the lessons from the experience of applying NT-106 to numerous water and sanitation SOEs over the previous ten years. They also enthusiastically reviewed and commented on the drafts of the principal report, the best practices progression matrix, and the other materials of the methodology. Finally, they gave their support to obtaining interviews with experienced officials from different areas of the IDB Group and IFC, interviews that also served to bring to fruition and enrich the work.

Gabriel Azevedo defined clear expectations for the practical use of the tool. Tatiana Zornosa worked tirelessly as an assistant consultant to the author during all phases of the consultancy.

Ignacio Puente provided observations on form and content that are appreciated.



Theoretical Framework. CG: What is it and what is it good for in state-owned enterprises?



CG operational definition[3]

This is where a reference to CG in general begins. Later on, CG of SOEs will be discussed more specifically. According to the OECD, "Corporate governance of a company involves the establishment of a set of relationships among company administration, their administrative council, shareholders, and other interested actors. Corporate governance also provides structure wherein company objectives are established and the form of achieving them is determined along with supervision of their attainment" (OCDE, 2016, page 9). To understand the scope of this generic definition exactly, one must consider the explanation of OECD in the same document and page: "The principles are centered on listed

[3] Dallas (2004: 21). Here the original definition was adapted in referring to "*sociedad anónimas*" [corporations] to the most general case of companies that includes state firms that are not organized as stock companies.

companies[4], both financial and non-financial. To the extent considered applicable, the principles may also be a very useful tool to improve CG of non-listed companies. Although some of the principles may be more appropriate for large companies than for small ones, legislators may be interested in creating awareness of the advantages entailed in good CG for all types of companies, including small, unlisted ones" (Ibid., page 9). IDB Invest cordially shares the same appreciation with the OECD.

Now then, for the purpose of this technical note, this definition is very broad since CG is described as a simple power relationship structure within the company. In order to move toward a more operational definition, it is suggested that it be complemented by a proposal for company governance. The most general and broadest state action is expressed through the action of executive power bodies and of agencies constituted by the state. In contrast, SOEs have a configuration different from ministries, secretariats, or public establishments: states create SOEs for operation and assessment as economic units. CG is then the interaction of management, members of the board of directors, and owners of a company to direct and control the firm and ensure that contributors to the capital structure (owners and financial creditors) receive the part of the income and assets of the company to which they are entitled. This operational definition is designed to address the interests of the community as a whole, just as corporation law in each country secures the regulatory apparatus by which corporations are regulated for the common good. It must be recognized for CG that the set of best practice recommendations must be able to contribute to efficiency and a proper assignment of productive resources with a favorable impact on well-being, which serves the interest of society as a whole.[5] If the power structure served all interest groups without distinction, CG could not restrict the tendency to opportunistic behavior of many of the company's counterparts.[6] In addition, the necessary counterpart

[4] Listed companies are companies registered as issuers in the stock market, specifically those with shares listed and traded on the exchange. Some SOEs are not listed companies, although they do issue registered and traded debt securities.

[5] Kraakman, Davies, Hansman, et al. (2004). *The Anatomy of Corporate Law: A comparative and Functional Approach*. Oxford University Press. Page 18.

[6] This aspect was emphasized by economic Nobel Laureates like Tirole, Jean (2006). *The theory of Corporate Finance.* Princeton University Press. Chapter I "Corporate Governance, Section 1.8 "Shareholder Value or Stakeholder Society?" Pages. 56-64;" Williamson, Oliver (1985) *The Economic Institutions of Capitalism. Firms, Markets, Relational Contracting.* The Free Press. Esp. Chapter 12 "Corporate Governance. Pages. 298-325." For example, the latter: "*More seriously, however, is the possibility that inclusion of partisan constituencies on the board leads to opportunism. One interest group that had reached a bilateral agreement with the corporation, if also participating in the board level decisions, would have influence to extract additional concessions from the corporation during contract execution. Opportunism is especially likely when many stakeholders are represented on the board and the exchange of favors among them (logrolling) is feasible. Moreover, in this regard, corporate assets may be generous in support of "worthy causes" with which such groups are sympathetic".* (page 311) (Free translation).

of a company that had to work for all their stakeholders would be that they all must have fiduciary duties of loyalty to the company, just like administrators and employees. In ordinary language, it can be said that CG is a system with a purpose: generate sustainable value without having abusive attitudes.

OECD identifies a basic economic role: "Good CG is not an end in itself, but a means to create confidence in the market and in the integrity of companies, which in turn is essential for companies to access capital for long-term investment."[7] The emphasis on confidence has to do with the fact that millions and millions of households throughout the world have their savings invested in shares and securities issued by companies that finance their capital and debt with those resources through stock exchanges. In addition, such companies generate more than 200 million jobs. It is necessary that there be confidence that these issuers will answer to their creditors, shareholders, investors, and workers.

To achieve this market confidence in companies as subjects that act with integrity and manage to pay their debts and preserve the capital under management, CG must be a valuable tool that mitigates the agency costs within the companies and thus contributes to create the value of the company, improve transparency standards, increase efficiency of operations and costs, and preserve balanced relationships with interest groups.

Nevertheless, it is important to highlight that CG and its practices must be applied based on the needs, complexities, and challenges of each company.

> For example, corporate image for some SOEs is a vital issue, resulting from the application of transparency and integrity criteria transversally throughout their operations. In other cases, and depending on markets, the products or services and the setting, this standard has not been reached, but it is still considered that the image is driven by publicity or promotional investment in a determined type of message or information. In the first case, corporate culture will be better able to respond to citizen expectations, and not just those of investors and clients, while in the second the company could strengthen weak points or neutralize strategic threats, knowing that substantial efforts cannot be carried out on all fronts simultaneously.
>
> Hence, the CG Best Practice Matrix presented herein does not propose that all companies adopt the maximum number of practices, but it recognizes that companies may move forward gradually, applying prudent priority criteria through four large degrees or phases. The practices were grouped visually, placing the simplest on the left and the most demanding on the right. This is not a rigid formulation but rather proposes a sense of direction for progression in CG. In practice, progression is not achieved by completely homogeneous phases; best practices have been seen in some areas in companies that had very limited progression in others at the same time.
>
> Experience suggests that companies with a greater need to adopt stricter, more complex CG models are the ones where agency problems lead to greater efficiency and

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[7] OECD (2016), *OECD and G20 Principles of Corporate Governance*, OECD Editions, Paris. http://dx.doi.org/10.1787/9789264259171-es. Preamble, page 7.

equity risks among owners, administrators, and other interest groups. Nevertheless, CG best practices may also be costly, whether they are adopted voluntarily by the companies or they become a legal regulation or requirement.

In general, business situations where there is a greater need for CG practices are:

- They have sales, consolidated assets, and liabilities of dozens or hundreds of billions of dollars, and their main projects take advantage of economies of scale and scope with competitive production and distribution technologies for which they must finance massive long-term investment and finance working capital with outside resources, for example, in infrastructure sectors or projects that mature slowly. That is why they must approach financial markets as issuers of complex stocks, bonds, or securities. There they are subject to regulatory requirements and CG such as the US Sarbanes-Oxley Law and similar ones of other countries. Upon compliance with more sophisticated CG practices, issuers obtain the trust of capital markets, they are more likely to obtain more favorable credit risk scores, and they meet requirements of regulatory agencies and market supervisors. Thus, they may finance significant long-term amortization investments at acceptable financial cost. This is part of the benefits expected of good CG. An estimate of the inherent costs is: "*Sarbanes-Oxley costs vary … a lot: generally, almost one out of three organizations spends US$ 500,000 or less annually in compliance with Sarbanes-Oxley, and a little less than half spend less than US$ 1 million. Nevertheless, this does not tell the whole story. A significant number of large companies spend US$ 2 million or more per year, as do organizations from industries including insurance and telecommunications*" (page 1, Executive summary)[8]. An significant number of relatively smaller size companies have ceased to be registered issuers or have lost interest in going public in order to avoid the increase in associated regulatory costs.

- Many differentiated functions, organization charts, and complex manuals have been established to coordinate the work of thousands of collaborators and divisions or deployment of strategic business units that compete internally for resources with the home office or *holding*. Those responsible for each department tend to consider that their own activity is the priority except that they are subject to control from above. Companies serving growing markets need dozens, and sometimes hundreds, of middle and lower managers, the latter for operational functions along with those needed for modern administrative coordination in production and distribution, logistics, marketing, methods of oligopolistic competition, among other processes. But company growth also makes it necessary to deploy a layer of senior management capable of selecting and evaluating middle management, coordinating

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[8] Protiviti. Risk & Business Consulting Internal Audit. 2016 Sarbanes-Oxley Compliance Survey. Understanding the Costs and Benefits of SOX Compliance. Consulted on the internet on March 13, 2019: https://www.protiviti.com/sites/default/files/united_states/insights/2016-sox-survey-protiviti.pdf

their work, and planning and assigning resources for companies as a whole[9].

- They have encountered the need to adjust their product and market portfolios with different dynamics and stages of maturity, investing in some and divesting others apparently to assign liquidity to products with greater potential and extract cash from stable businesses or those threatened by the competition. This strategic behavior can lead to resistance and conflicts of interest between top management and the boards or administrations of the subordinate business units (subsidiaries). Risks of opportunistic behavior may also arise here, which must be acceptably forecast in the rules of the CG game. For SOEs, there are very important sectors that, until two or three decades ago, were artificial monopolies created by law, but that over the years have changed the dynamic of their product portfolio because of the appearance of new technologies, globalization, and change in political preferences, for example, telecommunications, transportation terminals, railroads, ports, electric power distributors, hospitals, secondary education institutions, local financial institutions, and postal services, among others.

In conclusion, CG and its practices should not be applied as if dealing with a rigid regulatory code for all types of SOEs. On the contrary, best practices constitute essential recommendations to be implemented with intelligence, according to the needs, complexities, and challenges of each company. Each practice has some expected benefits and some adoption costs. The companies must clearly identify those costs and benefits as one of the first steps of an action plan.

Two large risks of CG

There are two basic risks described in CG literature: Loss of value and misappropriation of value. These risks apply equally to private companies and SOEs.

1. *The risk of loss in value*

This CG risk consists of the possibility that company value is lost due to failures in the system (set of standards, relationships, and internal bodies) whereby management is directed and controlled. This risk appears when interaction between ownership and control is deficient. Clearly there are other possible sources of losses for any company, particularly for SOEs, that arise from outside factors, such as threats from the business cycle, competitive

[9] Chandler (1977) explains the relationship between company growth, middle management appearance, and strengthening, and the subsequent need for upper management, as well as the corresponding loss of administrative meddling by owners associated with the separation of ownership and control: *"It was precisely here where administration of these first large integrated companies was weak… one reason for this weakness was that the owners still administered. The number of senior managers remained low, and they rarely had time or inclination for an objective assessment and long-term planning... The practices and procedures of modern top management had their beginnings in industrial companies created by merging rather than those that developed extensive sales and purchasing organizations… The change in strategy from the horizontal combination to vertical integration produced the management company for the first time in US industry. In the terminology of this study, a management company differs from an entrepreneurial company in that full-time salaried executives dominate top and middle management. The owners no longer administer the company"* (Chandler, "Chapter 13: Top Management, function and structure", 1977, page 454). (Free translation)

pressure from innovation by others, frozen tariffs in regulated markets, volatility of interests rates or exchange rates that affect the value of debt or investment, natural disasters, operational and engineering risks, etc., as well as internal factors of weakness that are identifiable using strategic analysis. The CG risk of loss of value refers specifically to the power structure of a company becoming a barrier that hinders appropriate response to threats or correction of weaknesses and managing internal risks.

2. *The risk of value misappropriation*

There is a second type of CG risk: the possibility that the company power structure becomes distorted or diverts the distribution of wealth generated by the company to the detriment of all owners, i.e. the risk that earnings sharing and cash flows as well as exploitation of business opportunities are not realized proportionally to the capital contribution and the risks assumed by all owners, including the state, but otherwise controlled through the power structure[10]. In this second CG risk component, the company may create value, but the results are not accurately reflected in the financial statements since, prior to being recorded as earnings they are transferred in one way or another to some internal or external interest group.

This is seen, for example, in firms with significant non-productive assets (non-operational tracts of land, non-competitive or obsolete plants, subsidiaries in recurring crisis, etc.) or excessive liquidity that gives a great deal of power and security to administrators even though they do not produce acceptable yields. Another example of this second component of CG risk consists of the firm not exploiting their best opportunities because those in control act according to incentives that are not convergent with optimization of its value, or they behave more like public employees averse to taking corporate risks in order to protect themselves politically.

Based on these two CG risk components, it would be possible to identify some pathologies like those shown in Table 1 (Fox & Heller, 2006). Note that the Fox and Heller pathologies can also be understood as indicators of CG results. Based on normal or "pathological" results, it is possible to examine CG practices and infer a cause-effect relationship.

[10] This notion was proposed by Fox and Heller (2006) and applied to assess results of massive privatization in post-socialist economies, primarily in Russia.

Table 1. Corporate governance risks / pathologies (Fox & Heller, 2006)

	Corporate Governance Risk / Pathologies
	I. Value not Maximized and no residual cash flow
1	Firms that cannot reform and destroy value deplete cash reserves and realizable assets, but continue in operation
2	Firms that would be viable if they efficiently employ existing capacity
3	Firms that invest cash flow generated in projects with negative NPV
4	Firms that identify projects with actual, positive NPV, but fail to implement them because of management's risk averse attitude
5	Firms that fail to identify projects with positive NPV sufficient for the firm's capacity
	II. Disproportionate distribution of earnings
6	Firms that fail to prevent manipulation of statutory property rights by some owners or administrators who thus achieve a position of control and power greater than they are entitled to based on their capital contribution
7	Firms that fail to prevent diversion of assets by some owners or administrators

Source: Based on Fox and Heller (2006:5).

CG Agency Problems:

Conflicts of interest from the relationship that exists among management, the board of directors, and owners are more commonly referred to in economics as agency problems or principal-agent problem. Agency problems appear when the well-being of one party or subject (the principal) depends on the actions of another (the agent). The principal is defined as that owner of an asset who hands over control or administration thereof to a third party in exchange for compensation.

There are three generic agency problems in the business administration world: owner and administrator conflict, majority and minority owner conflict, and owner and interest group conflict. The first arises when the owner must ensure that the administrator acts in the best interests of the principal. The second arises because minority owners are principals and majority owners are agents, the former needing to ensure that the latter act on behalf of the principals but lack the power to achieve it. The third problem consists of the firm's not behaving in the best interests of those that entrusted it with resources, for example, clients depositing funds to be administered, employees to whom benefits or pensions are owed, contractors that have contributed risks and liquidity, construction projects, etc.

The common denominator of the agency problems mentioned lie in asymmetric information: the agent has more information than the principal and thus the latter cannot ensure that the agent act in their best interest. Consequently, the agent may act opportunistically, and the principal must take measures to avoid this happening. These measures seek to ensure that companies behave with more transparency, responsibility, equitable treatment, and accountability, and include setting up a board of directors and committee structure; assemble a sophisticated internal and external audit system; deploy a reporting and transparency schedule to avoid abuses in conflicts of interest, transactions with related parties, fraud and corruption; organize monitoring of affiliates and subsidiaries;

ensure that business negotiations with their most important social interest groups do optimally defend the company. In other words, companies will adopt CG best practices to the extent they consider it necessary, advisable, and efficient from a cost viewpoint.

This is clearly appreciated in the CG progression matrix that is part of the tool proposed herein. *It is not intended that all companies suddenly adopt the 137 best practices, but that they apply them based on reasonable criteria*.

CG in SOEs

Recent research by OECD in 34 economies (see Table 2) allows us to appreciate the following: a) the total number of 2,111 SOEs is surprisingly small, although it can be speculated that it would increase significantly if the companies of regional and local governments were included; b) companies that are more significant for jobs are statutory and semi-statutory corporations (created by law) with approximately 2.55 million employees, but they are less significant in terms of company value (US$ 469 billion) with an average value of barely US$ 1.08 billion per company; c) corporations not listed on the stock exchange or public markets have a total value of US$ 1.066 billion and average of US$ 661,000 per company; d) there are scarcely 65 listed companies with a total value of US$ 664 billion, but with an average value much higher than the aforementioned cases at US$ 10.518 billion per company. This important OECD statistical research provides clues for state owner entities regarding where to prioritize their efforts to protect assets and to guide SOEs onto the most efficient pathway.

The OECD document reports that there are 1,611 SOEs that, as corporations, are not listed on stock exchanges. However, in many cases they must be classified as creditworthy and in others they are associated with private PPP consortia and large infrastructure projects. They also must inspire confidence and are committed to satisfactory CG. Moreover, there are 435 SOEs that do not meet one or more of the five basic requirements of a corporation (these are: legal personality, limited liability, transferable shares, management delegated under a board-of-directors structure, and investor ownership). It can be expected that relationships of companies in this group with their state owners are distinctive, for example, that are only partially aimed at meeting commercial objectives along with other public policy objectives, which could involve great dependence on public finances as well as risks to their financial sustainability. This group of companies has the greatest number of employees. Relatively frequently this type of conflict is encountered between commercial objectives and public policy objectives among SOEs that provide public utility services, for example, drinking water and sanitation. These weaknesses may be partially resolved by strengthening the companies' corporate governance internally, but to a large extent, they require a strong political commitment of state owner entities or national or federal public policies.

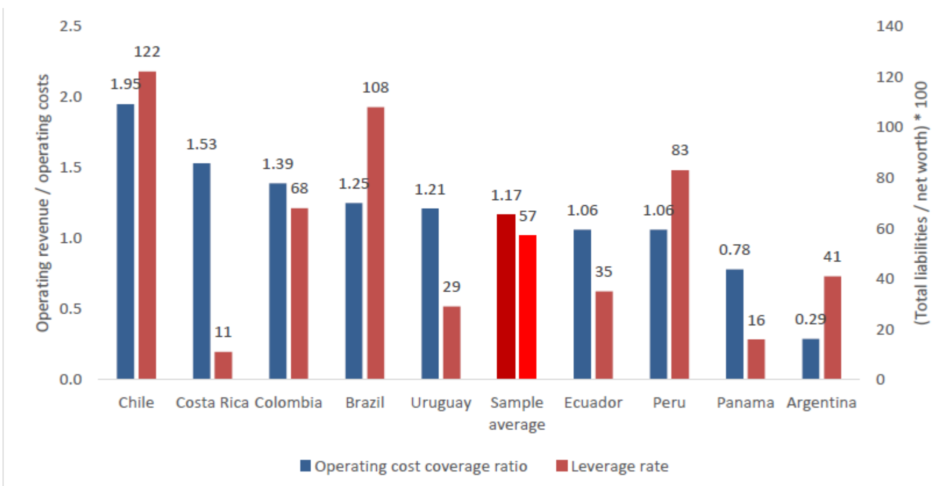
Table 2. Summary of SOEs in 34 countries at the end of 2012

Summary of SOEs in 34 countries (31 from OECD) at the end of 2012				
Type of SOE	**Number of companies**	**Number of employees (thousands)**	**Company values (US$ billions)**	**Average company values (US$ billions)**
Listed companies where the state has a majority ownership	65	985.3	683.7	10.5
Non-listed companies where the state has a majority ownership	1611	2401.4	1065.6	0.7
Statutory corporations and quasi-corporations (created by law)	435	2551.2	468.8	1.1
Total	2111	5937.9	2218.1	1.1
Latin America:				
Chile	34	48.9	22.2	0.7
Colombia	43	80.9	169.5	3.9
Mexico	69	-	83.2	1.2
Source: OECD (2014) The size and sector distribution of SOEs in OECD and partner countries. OECD Publishing. Table 1. Pg. 13.				

Companies (whether private, public, or mixed) must be able to create economic value after meeting their capital cost and make efficient use of their resources. If the company operates in a properly regulated competitive context or in a natural monopoly or oligopoly, as should be the case in public utility markets and the like, it may be accepted that the company does not exploit their users and clients but that the company investment administered by the SOE has the end result of greater coverage and quality of public utility services at an efficient cost, i.e. a result of greater general economic well-being. Consequently, the SOE with CG best practices should simultaneously achieve private profitability and satisfactory corporate profitability. The great importance of CG in SOEs lies with contributing to limited public and private investment of resources in valuable goods and services, such as water and sanitation, transportation, microfinancing, urban development infrastructure, and the like, achieving greater positive social impact and not following the road to corporate expenditure that does not achieve their corporate purpose or is for the unjustified benefit of certain interest groups. However, sometimes adoption of CG best practices in SOEs sticks to processes and requirements (clearly useful and desirable) without generating substantial changes in economic efficiency of these firms. *Evidence is illustrated below from three sources*.

A work document published by the European University Institute (2018) comes to the following conclusion regarding water and sanitation companies in Latin America and the Caribbean: "*Insufficient financial resources keep operators from expanding the network and increase the rate of coverage and quality of service, which has negative consequences in terms of efficiency and equity. Excessive dependence on the government creates financial* *uncertainty and opens the door to political interference and favoritism" (Ducci and García Merino 2013)*[11] (Bartomeu-Sanchez & Serebrisky, 2018, page 14) (free translation). This study presents the following graphic comparing financial performance measured by coverage of operational costs and leveraging (Figure 18, page 15). The authors consider that there is a restriction on capital from the state, that much more investment is needed in order to meet sustainable development goals, that companies with business models that cover their operational costs have greater access to external sources of long-term financing, and of course, lenders avoid less reliable companies in the long run. However, leveraging in itself is neither good nor bad. Therefore, the matrix speaks of a key concept of corporate finance: optimal capital structure that every SOE must seek for their particular situation and risk.

Graphic 1. Contrasts of water and sanitation SOE financial performance in Latin American capitals (select countries), 2012



Source: Asociación de entes reguladores de agua potable y saneamiento de las Américas (ADERASA) (cited in Lentini 2015).

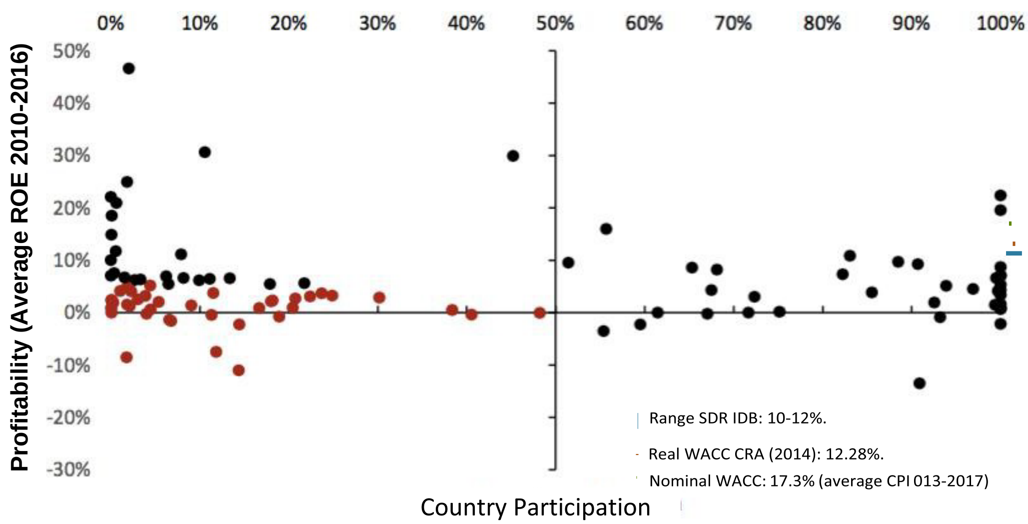
A second illustrative case is that of the state ownership policy (DNP, 2018) defined by the government of Colombia for the 119 companies (in the oil & gas, financial, power, agriculture, health, telecommunications, and transportation industries, as well as other small participations) where they have a capital participation. At the highest level, the government recognizes that the results of SOEs have not been satisfactory. "Over *the last five years, more than 30 minority stakes have had an average return lower than the average inflation rate during that same period (Graphic 1). In the case of controlled companies that meet public policy objectives, low financial return may be the result of costs generated to meet those objectives. On the contrary, in companies with minority participation, since they do not meet public policy objectives (the country does not have control in directing them toward objectives other than generation of financial profitability) the state-owned ratio would focus on generation of an adequate financial return"* (DNP, 2018).

The document referenced includes Graphic 2 which shows the poor performance

[11] The citation in quotes corresponds to the Ducci and Garcia Merino document, found in the Bartolomeu-Sanchez and Serebrisky article.

mentioned, an even worse situation if the cost of capital (measured for Colombia as the corporate discount rate between 10% and 12% real) is taken into account and even more the investment risk.

Graphic 2. Colombia: equity participation and return of companies and country participation



Source: Department of the Treasury and Public Credit, General State Participation Administration, Public Investment and Treasury Consolidator (2016)

The red dots represent companies with minority ownership where average profitability was lower than average inflation for 2012-2016 (4.12%)

Source: Conpes 3927, May 2018, Graphic 1.

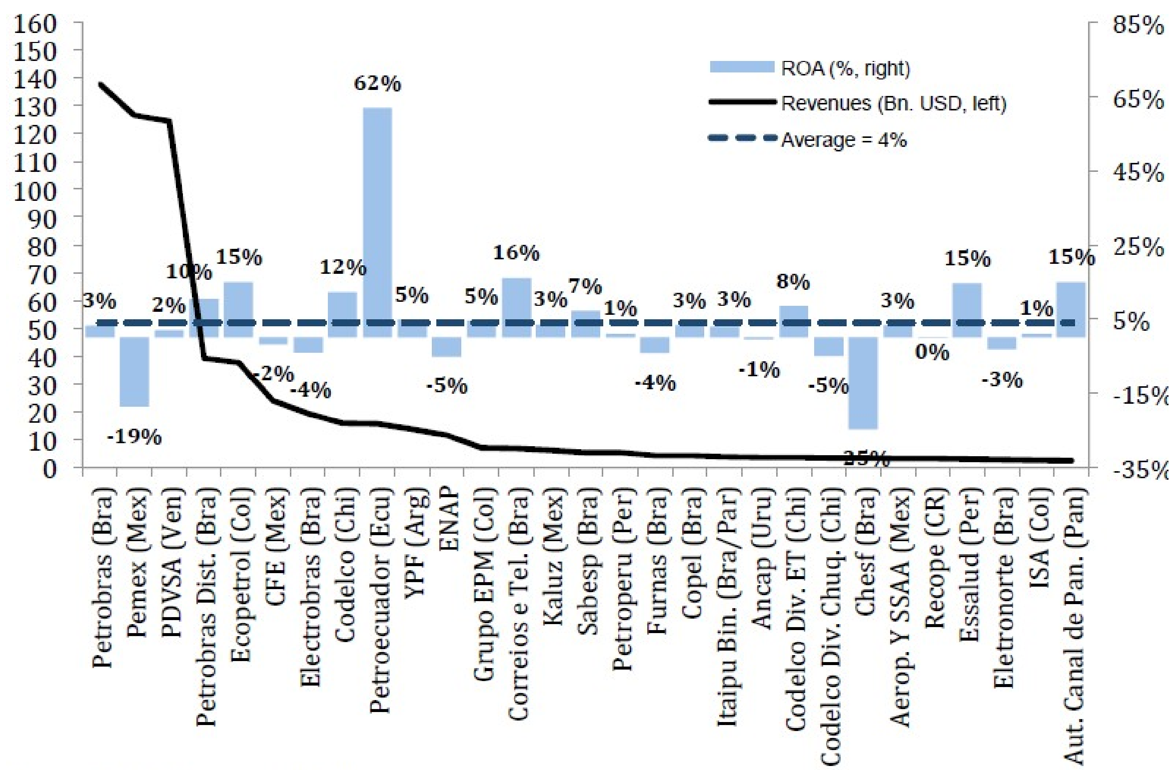
Starting with the above, it can be concluded that: 1) most SOEs of the country destroy value; 2) where country participation is very small, the country cannot control whether these SOEs are meeting public policy objectives; 3) in these cases, the criterion is to sell the participation and meanwhile (which can turn into years) demand that they improve financial performance; 4) the return is also terrible for SOEs with country majority ownership except in a few cases; 5) the graphic confirms that the number one CG risk of SOEs is destruction of value.

A third reference with a scope similar to the above was provided by Musacchio, Pineda and García[12] for the 30 largest non-financial SOEs in the region with income between US$ 3 and US$ 140 billion for 2012 that showed an average return on assets of 4% (see dotted line), barely around the inflation rate and again with no capacity to recover the cost of capital or the investment risk. The authors note that weak financial performance (see Figure 2 of that study below) is confirmed in spite of the fact that some of those SOEs were partially privatized with implementation of CG reforms to professionalize management, improve brakes and counterweights, and significantly advance financial disclosure. That is to say that such reforms served to show better financial performance in only a few cases. Moreover, according to the

[12] Musacchio, Aldo, Emilio I Pineda Ayerbe and Gustavo García (August 2015). "State-Owned Enterprise Reform in Latin America. Issues and possible Solutions." Discussion Paper N° IDB-DP-401.

authors, SOE financial returns do not compare well with large private firms in the region.

Graphic 3. Largest SOEs in Latin America: income (US$ billions) and ROA (%), 2012



Source: America Economía (2012).

In conclusion, SOE performance and sustainability are extremely important since they may go beyond enunciation of public policy objectives as justification for creation of SOEs and assess whether such purposes are actually fulfilled. Corporate governance of SOEs must never lose sight of this focus. In fact, OECD guidelines for SOE CG begin highlighting the need for consistency between objectives and results: "*The state exercises ownership of public companies in the interest of all citizens. It must cautiously assess objectives that justify public ownership as well as disclose and review them periodically".* (OECD 2016, p.19, I – Reasons that justify public ownership). This guideline is the result of experience gathered by OECD in the SOEs of member countries. It is advisable for the SOE to have a suitable CG framework, but this alone does not help if it does not contribute to the company's being sustainable and efficiently applying public resources.

CG Conflicts in SOEs

The CG risk and its pathologies, particularly for SOEs, arise from the existence of basic conflicts in three areas: separation of ownership and control of companies, different manifestations of the agency problem, and the effects of the companies' activity on interest groups.

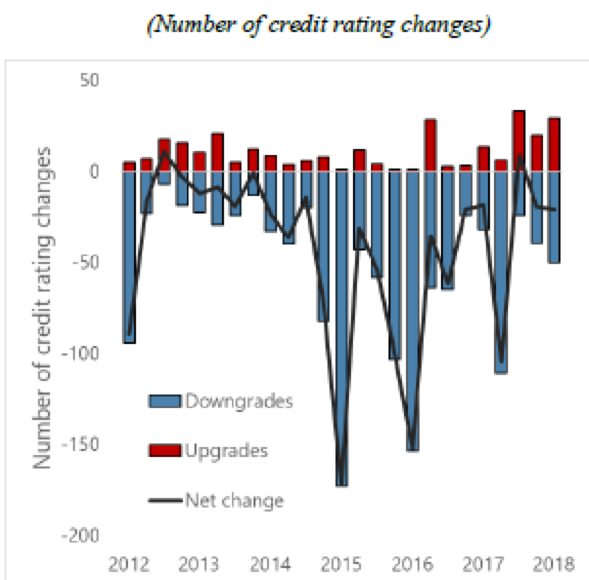
1. Separation of ownership and control

OECD designed their CG guidelines for SOEs understanding that "The Guidelines are applicable to companies that are under state control, whether it is the last beneficial owner of the majority of the shares with voting rights or if it exercises an equivalent degree of control by any other means… Different forms of exercising state control also give rise to different governance modalities. For purposes of the Guidelines, the term 'ownership' implies 'control'". (Op. cit. pages 15-16).

In economic theory, the so-called common goods dilemma is well identified as public goods or common goods enjoyed by everyone tend to be the object of abusive behavior precisely due to the fact that no one in particular can claim ownership. Companies that are exclusively state owned are one of the variations of the common goods dilemma since there are no actors with incentives to defend the value of those public properties. For example, every citizen of Mexico City, Buenos Aires or Lima considers that they have very little time available to study the web page for every SOE in their country, attend general meetings or events reporting results, ask for explanations, and even less to join with others to propose corrective action. This phenomenon is similar to what the literature describes as "small investor apathy" in listed companies with atomized ownership. Small shareholders trust that some other shareholder or shareholder block is defending their interests as a by-product of brokering their owner interests. In the last instance, the effects of creating or destroying value of a wholly state-owned company devolve on taxpayers as a whole, i.e. citizens. Executive authorities of government administrations have the duty to supervise SOEs, but they do not have economic incentives to do so since they know that the period in which they exercise their power is limited on the one hand, yet their biggest priority is usually linked to carrying out policies for which they were elected. Thus, political theory presumes that they do not act as owners in the full sense, but barely like temporary custodians in the limited sense. Consequently, SOEs currently constitute the extreme case of separation of ownership and control: in the end ownership belongs to the citizens (who have paid the taxes that fund capital invested in SOEs and who will have to pay new taxes if the SOEs are not financially sustainable) but it is a purely passive ownership since control (the capacity to name the board of directors, or most of it, and managers or principal executives, and the ability to influence or determine the major decisions [cf. Berle and Means, supra]) belongs to the politicians.

SOEs often consider themselves isolated and protected by their owner states and do not deem it necessary to actively adopt a set of financial sustainability strategies in the framework of CG that helps them change course. It is a mirage since the fiscal shield in many countries has been lost. Sovereign credit ratings have deteriorated and this has affected SOE ratings as well. In these circumstances, the need for CG is more urgent. SOEs that depend more on the treasury will probably be much more vulnerable than those that make progress on the road to generate value and reduce value misappropriation. Evidence: in 2018 the IMF and World Bank documented how fiscal deficits of emerging economies have increased public debt indicators as a share of GDP to unprecedented levels. "*Public debt in emerging markets has increased substantially in recent years, approaching levels last seen during the debt crisis in the 80s (Figure 1 and Graphic 1 of Appendix 2, 3). Public debt has increased by 11 percentage points of GDP over the last five years, reaching 51% in 2018. A* *breakdown of the debt origin finds that public debt increases have been driven primarily by considerable fiscal deficits. Depreciation of national currency against the US dollar has also raised debt"* (page 1)[13]. The markets reflect this perception as well in the credit risk ratings of emerging economies, as shown in Graphic 4. Please note here that the SOE ratings are usually lower than those of the states to which they belong, or the same if those states have guaranteed those liabilities. Moreover, in the same study, the IMF and World Bank warn about debt assumed by SOEs in situations of financial stress, which are not clearly recorded as public debt or guaranteed by the states, and that are only disclosed as such on the brink of the default event.

Graphic 4. Change of credit ratings in emerging economies, 2012 - 2018



Source: IIF and World Bank staff calculations.
Note: It is based on the number of credit rating upgrades minus credit rating downgrades (including ratings watches) and are the average of S&P, Fitch, and Moody's ratings.

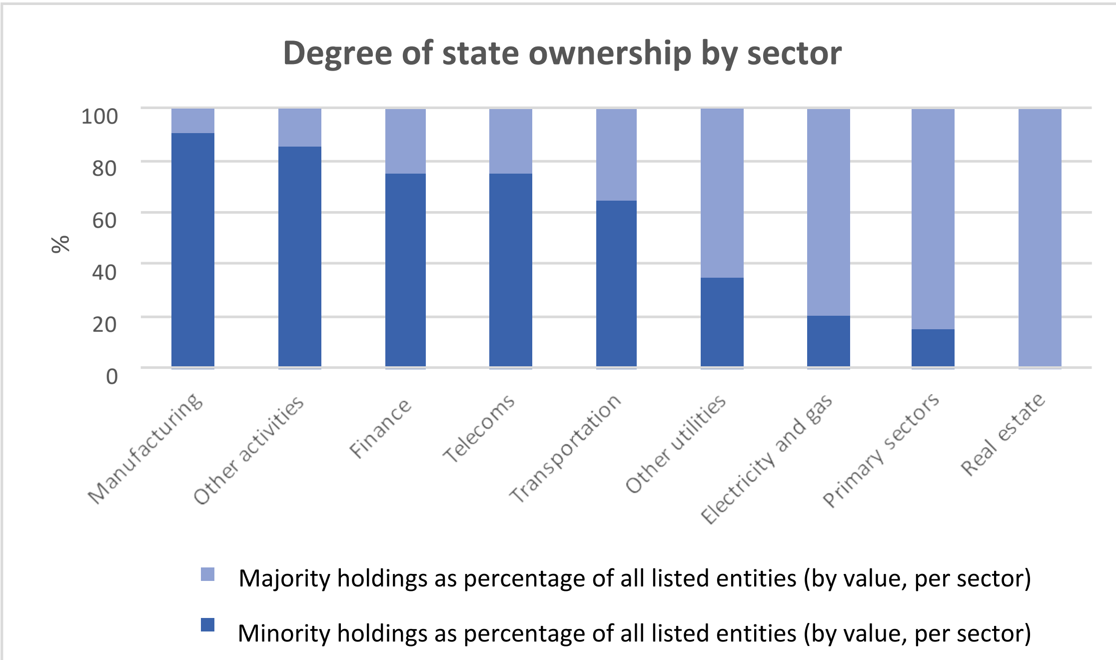
It is clear in this international scenario that SOEs increasingly need capital beyond that which the states supply from liquid resources and the capitalization they agree to make with a charge to the profit distribution. For example, there are SOEs that need to approach capital markets for this purpose, where in principle they can obtain resources at adequate cost and terms by competitive negotiation of risk and conditions. Therefore, SOEs must offer confidence just like private issuers. A good number of SOEs have already borrowed at high levels. The document cited states: "*Countries with a high level of state enterprise (SOE) and public-private partnership (PPP) debt can benefit by strengthening corporate*

[13] DEVELOPMENT COMMITTEE. (Joint Ministerial Committee of the Boards of Governors of the Bank Group and the Fund on the Transfer of Real Resources to Developing Countries). September 17, 2018. DEBT VULNERABILITIES IN EMERGING AND LOW-INCOME ECONOMIES. Approved by Akihiko Nishio (World Bank) and Hugh Bredenkamp (IMF). Prepared by a joint World Bank-IMF team. The World Bank team was led by Boris Gamarra and included Sebastian Essl, Charl Jooste and Yuto Kanematsu under the guidance of Doerte Doemeland and Paloma Anos Casero. The IMF team was led by Hans Weisfeld and included Tamon Asonuma, Rodrigo Garcia-Verdu, Judith Gold, Geoffrey Keim, Samuel LaRussa, Joyce Saito, and Modeste Some.

governance and improving fiscal risk management" (page 7).

The interior world of SOEs receiving all their investment resources from an unlimited state patronage and a public bank in preferential terms has been reduced. Graphic 5 shows the statistic collected by OECD which illustrates that, among publicly listed SOEs, the state tends to retain majority shares in the primary sector (including oil and gas production and refining), electric power and gas, and public utility services, while in telecommunications, finance and transport services its equity stake now tends to be in the minority.

Graphic 5. Degree of state ownership by sector in listed companies, OECD countries



Source: OECD (2014). The size and sector distribution of SOEs in OECD and Partner Countries. OECD publishing.

States are assigned economic functions that, in principle, can be fulfilled in different ways: by organizing provision of certain goods or services directly from centralized government agencies; creating specialized organizations to provide services that the private sector does not provide, whether for lack of interest or because the state prefers to exercise control there; becoming associated with investors through PPPs to combine capital, capacity, and risk management on large projects, or finally encouraging the private sector to take on such tasks in exchange for subsidies or fiscal, tax, or financial incentives granted by the state.

OECD recognized that SOEs were often created and sustained among developed economies for reasons like solving market and regulatory failures (cases of natural monopoly, supply of public goods and merit goods) but also for controversial reasons, like "strategic" sectors.[14] There has also been a great deal of experience of changes going in the opposite

[14] See OECD, 2005b: 32. The expression "strategic" sector was controversial because it became a wildcard: there were business activities where the state sought to obtain extraordinary profits, grant price subsidies to important social or political groups, promising but deficient "nascent industries", declining activities with

direction from the public sector to the private. In the last decades of the last century, a large movement toward privatization of SOEs was recorded in OECD countries, which was later accompanied by reconversion of the old socialist economies and in emerging countries. A good number of cases were successful, but others were costly failures and provided valuable lesions, including:

a) Conditions and practices of good CG are fundamental so that both SOEs and privatized companies can achieve good performance.

b) In the case of those that continue as SOEs, a well-defined state-owned policy overseen by a specialized state body is recommended for CG to function fully, implementation of internal incentives to advance toward efficiency and gradually achieve SOEs' going from destroying value to generating it.

c) There is no unique, definitive solution, a type of panacea for the SOE: "*There are many other solutions that establish appropriate incentives for public company managers and governments to produce results that address the objectives that governments established for their public enterprises… There is no unique solution for all the problems of public companies… None of the options (privatization, partial privatization, holding companies, and centralized management and control models) will resolve all or even most of the problems faced by state companies".* (Musacchio, Pineda Ayerbe, & Garcia, 2015, page 42) (Free translation)

d) Some countries, like China and Brazil, have retained control of property in the hands of the state, but they have also registered their most important SOEs on stock exchanges in order to force them to accept market discipline.

e) A mechanism of similar scope consists of inducing the SOEs to finance their CAPEX under market conditions rather than continuing to provide preferential funding through the state bank, and gradually exercise themselves to become good credit subjects without offering state guarantees in advance or the expectation of periodic restructuring by the state[15]. These lessons show different degrees of progression. For example, energy and gas SOEs have been more proactive in undertaking programs in the above-mentioned directions while other SOEs, even in the same cities, have been resistant to change.

Nevertheless, there are still challenges. In OECD, for example, there are only 65 SOEs listed on the exchange that thus comply with the value regulation requirements of each market and with a mature CG, but they have an average market capitalization of US$ 10.5 billion (see Table 2).

So, SOEs belonging to these large categories also demonstrate the phenomenon of separation of ownership and control. First of all, it must be remembered that the ultimate owners of all SOEs are the respective taxpayers. But those masses of citizens have absolutely no access to information and even less to the leverage of power. They are

deficits but many employees, sectors exposed to high risks, activities in the interest of national defense, etc. The common denominator of the "strategic" sectors was having achieved the political qualification as such. In most countries, "strategic" SOEs were subjected to large purges.

[15] "Soft fiscal constraint" to which Musacchio, *et al*. refer.

represented by those holding the status of government leaders who consider that the SOEs under their authority are instruments of government and feel that it is legal to want to use such instruments in favor of the parties that were victorious in the elections. In many cases, SOEs become part of the distribution of political power. SOEs may be subject to control of temporary custodians (government leaders) whose power horizon and responsibility tends to be located approximately within the term of their mandate. Given these risks, there is no one to claim ownership in the SOE owner general meetings (or equivalent bodies). Administrators that are accountable and the “owners” to which they are accountable are effectively the same. That custom is the antithesis of good CG. Practices that are recommended in the progression matrix of this technical note can contribute to progression along the appropriate road.

Many countries make great efforts to define modern regulatory frameworks and complementary contractual arrangements of what can be done by way of CG. Table 3 studies the conditions of risk and explores different ways to handle risk distribution between the state and the private sector on infrastructure projects. There are many possibilities for contractual arrangements with public and private participation. Financing, enterprise, and political viability of the different contractual arrangements depend in large part on local conditions. Vives, *et al*. (2006) proposes a sound methodological approach inspired by economic contract theory and in the best practices to identify more suitable contractual arrangements for each group of local conditions. For example, when local conditions are weak (a legal framework that does not clearly document the protection of ownership rights, political instability that could convert SOEs into prey of expropriation, history of macroeconomic or exchange rate volatility, weak fiscal capacity to back up public investment in or announced subsidies to projects), the perception of risk by private investors for investing resources and efforts on a long term horizon is elevated. Sometimes, some of these factors may be neutralized by appealing to mechanisms that can make contractual arrangements viable where not all the investment risk and effort is assumed by the public sector, as shown in Table 3 below. But at other times, state entities have no choice but to try a merely public contractual arrangement, for example, for water and sanitation service, or a transport terminal where private operators have no interest.

Now consider how far CG can contribute. If a determined project were financially viable with a given rate horizon, but the affordable rates actually went up because the SOE’s internal management allowed some spending factors to get out of control, that is a problem of CG not of a contractual arrangement. What can be achieved in SOE CG has a defined impact because of the conditions themselves of the contractual arrangement and because of the scope and efficacy of the regulatory framework. The methodology of contractual arrangements of Vives, *et al*. (2006) makes a lot of sense in suggesting that no contractual arrangement is valid or invalid generically or permanently and that the most potentially efficient organizational schemes of service and greater positive impact on well-being may not be viable when local conditions are weak, for example, vulnerable to clientelism or poorly administered hiring systems. CG also cannot solve viability problems caused by macroeconomic risks (e.g., financing projects in dollars that have exclusively local currency income exposes viability when the economy is vulnerable to volatility in the exchange rate [the case of AySA, Argentina]), or when dealing with geological projects [the case of Hidroituango, Colombia] or environmental projects [global warming effects] and the like.

Table 3. Contractual arrangements for infrastructure projects: range of public-private participation, duration and variability when local conditions are weak.

Contractual Arrangements on Infrastructure Projects: Range of Public-Private Participation, Duration and Viability When Local Conditions are Weak

Contractual Arrangements	Assignment of Responsibilities				Duration	Weak Local Conditions				
	Oper. and admin	Comm'l Risk	Capital Investment	Asset Ownership		Legal Framework	Political Risk	Fiscal Space	Willingness to Pay	Size and Location
Completely Public										
1 Public Non-Corporate Company	□	□	□	□	Undefined	✓	✓	0	✓	✓
2 Completely Public - SOE	□	□	□	□	Undefined	✓	✓	0	✓	✓
3 Joint Venture – Public	□	□	□	□	Undefined	✓	✓	0	✓	✓
4 Cooperatives	□	□	□	□	Undefined	✓	✓	✓	✓	✓
Administration Contracts										
5 Outsourcing	▨	□	□	□	Less than 1 year	✓	0	0	✓	✓
6 Administration Contract	▨	▨	▨	□	3 – 5 years	X	0	0	0	✓
7 Franchise	■	□	□	□	5 years or more	X	0	0	0	✓
Concession										
8 Leasing	■	□	▨	□	8 – 15 years	X	0	✓	X	✓
9 Concession	■	■	▨	□	25 – 30 years	X	X	✓	X	X
10 Joint-Venture – Private	■	■	■	▨		X	X	0	X	✓
11 BOT / BOO / BOOT	■	■	■	■	20 – 30 years	X	X	✓	X	X
Completely Private										
12 Completely Private –sales	■	■	■	■	Undefined	X	X	✓	X	X
13 Completely Private – license	■	■	■	■	Undefined	X	X	✓	X	X
14 Completely Private	■	■	■	■	Undefined	X	X	✓	X	✓

Conventions

□	Public Liability
▨	Public and Private Liability
■	Private Liability
✓	Contractual risk of this line IS feasible given the conditions of this column
0	The contractual arrangement of this line IS NOT feasible, given the conditions of this column, BUT IT COULD BECOME feasible with some contractual reinforcement
X	Contractual arrangement of this line IS NOT feasible, given the conditions of this column

Mechanisms to make contractual arrangements viable

a. Political Risk Insurance
b. Partial Credit Guaranty
c. Partial Sovereign Risk Guaranty
d. Subsidies
e. Institutional Strengthening prior to the company (credit agreement)
f. Financing in local currency to avoid exchange rate risk
g. Arbitration Rules
h. Supply Agreement (guaranty of minimum sales volume)

Source: Vives, Antonio, Angela M Paris and Juan Benavides (IADB); Peter D Raymond, Darío Quiroga and Javier Marcus (PwC). "Financial Structuring of Infrastructure Projects in Public-Private Partnerships: An Application to Water Projects." Washington, Inter-American Development Bank, 2006.

For some SOEs, the reality of the natural monopoly has dominated and been more lasting than, for example, public services of electric power and telecommunications, partly because the former have not shown technological advances compared to the latter. Consequently, SOEs lack strong incentives to be competitive and control their costs, especially when regulation is weak and internal CG mechanisms allow internal groups with more influence in the power structure to take advantage.[16] Failures in collective action lead to this separation of SOE ownership and control being relevant insofar as control is exercised according to non-convergent public policy objectives or, even worse, when there is a risk that control of SOEs contributes to destruction of the value of public ownership incorporated in those companies. If effective control of the companies is vulnerable to political manipulation, for example, then the ultimate owners, i.e., the citizens, may be left without an effective capacity to bring about changes and ensure that the companies are managed without deviating from their objectives: they no longer have a voice in management, they do not have a majority in the shareholder meeting nor do they participate in that body, or the shareholder meeting simply does not exist and members of the board of directors do not answer to them but to elected political representatives for whom the set of objectives and public to satisfy is multiple and diverse. Separation of ownership and control under urban development thus generates vast challenges to CG.

The question can then be raised as to what extent is it reasonable to expect that CG adopted by the most powerful and influential actors in the state-owned entities, boards of directors, and managers will be the solution, whether the CG contributions are substantive or relatively marginal. In some cases, reconvert a traditional SOE (whose only owner is the state) into a listed corporation and adopting a program to link private capital in sufficient proportion so that there are minority shareholders with some participation on the boards of directors, a certain oversight and monitoring capacity and great sensitivity to returns can contribute more to company sustainability than if reforms were only limited to adopting CG regulations. This is compatible with conserving the state's majority share of capital (cases like Ecopetrol, ISA and Isagen in Colombia that were listed on the stock exchange between 2007 and 2010; or SABESP in Brazil, listed on the NYSE since 2002). Minority participation of other shareholders adds to transparency and executive and management independence. It makes company performance subject to orderly market monitoring. It inspires confidence that the company is overseen by specialized supervisors. It is an important step forward, a significant support for CG. But, obviously, it is not the perfect solution for the large risks any company faces. Moreover, this type of program, partial sale of capital or partial capitalization through the stock exchange, is not viable for many SOEs.

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[16] The impact is clear in the long- term rates in the US. Between 1929 and 2006 the relative prices of water and sanitation compared with electric power increased six-fold while electricity rates fell by at least half compared to the total consumer price basket. Meanwhile, water and sanitation prices increased by 2.6 compared to the total consumer price basket (U.S. Census Bureau, Price Indexes for Personal Consumption Expenditures by Type of Expenditure). The natural monopoly for power weakened because technological advances allowed more competition but not for water and sanitation, which enables internal power groups to extract income when neither CG nor regulation of SOEs is strong.

2. Different manifestations of agency problems[17]

Agency problems originate in the existence of asymmetric information of a principal and an agent, which makes it difficult for the principal to observe the characteristics or effort of the agent. The overflow of agency costs is reflected in losses of efficiency that can affect both principals and agents. The most relevant agency problems in complex companies are those that occur:

i) Between owners (principal) and administrators (agents delegated by the principal to protect their interests). There are companies where the ownership structure is concentrated in relatively few shareholders or strong shareholder groups, especially in Latin American countries; in the other extreme, when share ownership is very distributed, each shareholder or group of shareholders has a very low percentage of capital, a situation that favors the influence of administrators on the boards of directors in practice, a more frequent phenomenon in companies listed in English-speaking countries.

ii) Between majority owners (agents) and minority owners (principals). The agents can hold an absolute or relative majority, but in any case, sufficient to have "control" of the majority on the board of directors and, therefore, of naming the chief executive (CEO) and their team, for example. Another variation is observed when there are two or three owner groups with a relative majority, which can become allies or adversaries. Strategies appear that are called "strategic behavior" that can include individual decisions, decisions of the board of directors, the shareholder meeting, or a search for outside allies. The common denominator is the risk that agents act to the detriment of the principals thanks to asymmetric information. Meanwhile, minority owners do not get the necessary voting power to elect representatives to the board of directors nor do they have effective access to company information and important decisions.

iii) Between the company (agent) and outside interest groups (principals), the latter especially in regulated industries like banking and public services. For example, bank account depositors actually lack information about how financial intermediaries administer deposits. The same is true of savers in pension funds, contributors to social security systems (pensions, health), compulsory insurance, investors in fiduciary schemes, mutual funds, and many others. The history of financial crises is full of this third type of agency problem, so those industries are subject to state intervention of usually strong regulation and supervision. Even so, knowing that controlling these risks is not completely guaranteed, it becomes necessary to adopt complementary protection, like deposit insurance institutions and guaranty funds.

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[17] A similar notion, arising from another conceptual framework, would talk of transaction costs (Oliver Williamson, op. cit).

The format of issuer corporations and regulation applicable to the stock market offers a fundamental feature: it constrains the types of opportunism of agents in a position to exercise control or great influence. Nevertheless, the history of the financial crises of recent decades demonstrates again and again that this type of risk has not been completely neutralized in spite of great reforms. The challenge of combining better CG with better regulation without falling into excess paperwork is still in effect, and that is what in large part validates efforts to provide instruments and methodologies that contribute to substantive progression in this area.

CG structure of contemporary corporations is the cumulative result of the evolution and efforts to find adequate responses to those agency problems, and in general terms, is compiled in the principal corporate legal standards complemented by laws that regulate issuers of shares on the exchanges. [18] CG best practices are consequently aimed at improving the quality of information for the principals, improving opportunities for timely and appropriate control of principals over agents, fortifying the consistency of incentives to align the interests of principals and agents, and to provide effective compliance with fiduciary duties of diligence, loyalty, good faith, and accountability by the agents.

3. The effects of company activities on interest groups

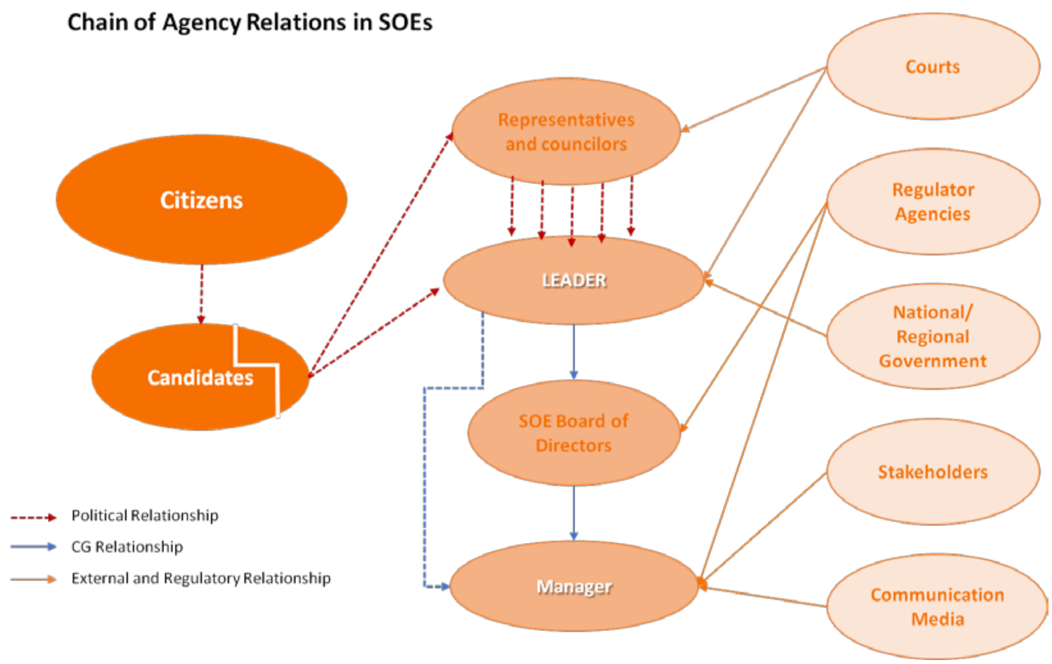
Typically, there are strong interest groups other than capital structure contributors: users, workers, contractors, and many others in addition to the multiple externalities inherent in the companies' activities.

The chain of complex agency relationships (see Graphic 6 below) of SOEs, where CG relationships overlap with political control relationships and action and intervention of many other agencies and interest groups, makes SOE management a more difficult exercise than in the case of many private companies.

This analysis is fully consistent with the following illustration of the chain of agency relationships around public service SOEs, applicable equally to many of the other important sectors, such as infrastructure, energy, transportation, and health services. SOEs are subject to various types of authority or influence relationships: the political type that fall to the government leader under whose guidance the company operates; that of outside agents, and that of CG itself. Oftentimes, relationships among these three classes conflict and send contradictory signals and orders. The frequent reaction of SOE boards of directors, and especially managers, is to adopt behaviors that avoid confrontation with the most powerful interest groups, thus protecting the status quo and favoring bureaucratic survival over company performance.

[18] Kraakman, Davies, Hansman, *et al*. (2004) prepare a comparative analysis of response of corporate law to agency problems in more important legal systems. Roe (in Jeffrey and Roe, 2004) states that political institutions affect good corporate governance and indicates that social democracies weaken owner control and favor the increase in costs of management agency: principals lose when the power of administrators is biased toward adoption of low-risk decisions that favor management stability, toward unnecessary liquidity retention in the firms, against paying owners larger dividends, and toward promotion of administrative and labor cost overruns. The focus of the agency theory explains that stakeholders want laws and structures that generate income and thus distort incentives between principals and agents and increase CG risk.

Graphic 6. Multiple principals, one agent in SOEs, as an agency problem



Source: Economía y Empresa

The Fiscal Impact on SOEs

The SOE is a commercial company that undertakes an economic activity where the state has all or most of the capital ownership. It is understood that the state has made this investment to meet economic and social development objectives because it finds that doing it through a company is more socially stable than if it were done through a public, non-business establishment. Nevertheless, in many cases SOEs deal with complex infrastructure programs in different sectors that, although they are not economically public property, are accepted as “merit” goods where the state explicitly agrees to assign public resources. Then the issue arises of the extent to which the SOE may be able to make its investment and undertake its economic activity, achieving sustainable results based on the equity invested by the state or if, on the other hand in addition to the former, it needs or seeks additional support from the state in the form of public budget items, financial support in the form of concessions, commercial protectionism or monopolies, and especially favorable concessions. In the end, the question must be analyzed of whether optimal use is being made of scarce public resources or whether there are alternatives, in addition to the complementary question of whether this is a matter of SOE CG or fiscal policy. A CG program for state companies may concentrate on establishing a suitable menu of incentives so that these firms achieve the objectives for which they were created without interfering with fiscal and political subsidy decisions. Thus, it is necessary to count on modern regulation in the case of public utility services, and on the other hand, a corporate information architecture that can reveal the actual cost of the activities corresponding to commercial objectives and the other activities related to SOE public policy objectives. However, in other industries that are not regulated public services, the need to have disaggregated financial information is even greater. On this basis, fiscal mechanisms may be considered and defined to favor or stimulate determined sectors. The main criterion would continue being not to mix company management decisions with fiscal or regulatory decisions.

1. Political abuse of SOEs

Although already mentioned in the first version of NT 106, political abuse of SOEs has been treated more fully and formally in the literature of the last decade. For example, countries that want to become members of OECD must submit to a broad review of their practice of good CG in SOEs and demonstrate that they have adopted actions to prevent the possibilities that goverment leaders or authorities can co-administer or interfere with professional management. Efforts are also being made to discourage government leaders from unjustifiably influencing decisions on hiring, project selection, administrative and executive staff selection and hiring, rates, etc., in exchange for a certain attitude of acceptance or tolerance of low performance. This is basically a variant of the classic case of separation of ownership and control of a corporation where the ultimate stakeholder, the citizen, does not have ideal mechanisms to access information on how decisions are made and even less to control how shareholders may perceive cash flows that the company could generate.

Musacchio, *et al*. (2015) highlights what they call the SOE CG problem associating the advantage of information from managers of these firms vis-à-vis ministers and boards with a lack of high-power incentives (there is no variable compensation for good performance) and with the attrition managers suffer that attempt to correct sources of poor performance (Musacchio, Pineda Ayerbe, & Garcia, 2015, page 10). In particular, the authors attribute significant deficiencies in SOE CG to the phenomenon of multiple principals (collective action problems): "*The agents in public companies may be poorly supervised because there is a problem of 'multiple directors' or 'a collective action problem'. That is, state companies have too many directors which could include boards of directors, ministries, the Congress, the executive and others, and none of these directors want to assume the total cost of supervision because none receives benefits (Dixit, 1997). The problem arises from the fact that, since normal supervision of a state company takes up bureaucratic time, a minister may delegate the task to another agency or the Finance Minister; i.e. the monitoring cost will change" (McCubbins, Noll, and Weingast, 1987)"*. (Musacchio, Pineda Ayerbe, & Garcia, 2015, page 10) (Free translation).

The roles of CG regulation, supervision, and internal standards

1. The roles of regulation

The first distinction of this aspect that must be understood is that it refers to stock exchange regulations in the case of SOEs that have moved forward in their capital structures and act as debt securities, stocks or mixed securities, like convertible bonds. In this case, regulation is aimed at protecting investors from the risk that the issuers can manipulate information and disclosure, or after issuance, they can fail to meet the conditions to which they were obligated, including the use of the investment. For stock markets, SOE obligations are essentially the same as those of private issuers. Unlisted SOEs should have transparency obligations similar to those of listed private companies on account of their responsibility to government capital and to so many "stakeholders".

The other aspect refers to specific regulations of certain sectors, such as public service providers that are a legal monopoly or the result of a concession granted by the state. Operators or administrators of such services may be SOEs, private companies, or public-private partnerships (PPP) where the state may have a majority or minority participation. The risks faced by these projects and the proportion in which state participants and the private sector assume such risks may not be easily defined in advance for all contingencies. That is, it deals with incomplete contracts where many contingencies may arise throughout their execution, and therefore, they usually anticipate government mechanisms to address matters that emerge among the parties. This is one of the reasons why there is a conflict of interest at high echelons of public administration of large works interested on the one hand in the project successfully fulfilling its purpose, and on the other, in regulating operating conditions to avoid situations of exploitation or abuse of the public or manipulated operation of the market. The case of some public utility services that are "natural" monopolies is one of these. The case of some financial institutions of the state is another.

2. *Supervision*

The quality of CG supervision and effective application is essential. OECD recognized that these institutional aspects external to the companies themselves, whether state or private, depend in large part on legal traditions of each country.

In some societies, supervision and effective application of the regulatory frameworks is exercised by specialized government agencies under the aegis of which different types of companies operate. For example, the financial sector is usually supervised by agencies specializing in banking supervision, besides the central bank. Companies enrolled as issuers in the stock market are subject to inspections of commissions or state agencies that supervise the exchanges. These agencies are generally concerned with monitoring operating conditions and the risks the financial companies assume, whether they are state-owned or private. During the last two decades, after the great crises that began in 1998 and 2007, it was recognized that government supervision had been weak and poorly implemented.

In other countries, particularly the English-speaking legal tradition, effective supervision and enforcement of CG have a private component at times more important than that of the government. Shareholders, interest groups, self-regulatory organizations, private exchanges, business unions, chambers of commerce, associations of minority shareholders, and other actors often make demands, claims, and litigious actions, appeal to alternative dispute resolution mechanisms and other recognized measures to obtain compensation for damages.

The experience of public or private supervision is not uniform. The great 2007-2008 financial crisis in industrial economies demonstrated the weaknesses of both public supervisors and private mechanisms in regard to being aware of the risks, acting to timely neutralize them and avoid the collapse of companies where the risks of destruction of value and misappropriation of value had already grossly materialized. Aspects such as disclosure and monitoring transactions with related parties under conditions far from the market, operation of the corporate control market, relationship between boards of directors and senior executives, business risk management at the highest level, and the possibility of effective shareholder participation in shareholder meetings many times demonstrated the failure of enforcement of internal CG standards, including the case of companies supervised by the state or that enjoyed a certain state exemption or support (e.g., Fannie Mae, Freddy Mac in the United States). In summary, for SOEs, action of government supervisory agencies and actions of supervision and enforcement started by private actors did not represent strong guarantees to internal CG. Only action of state ownership entities through a solid state ownership policy capable of bringing about substantial reforms in the SOE CG is promising as long as governments accept recommendations like partial privatization that can introduce private parties to claim ownership in the capital, on the boards and thus mitigate the typical state CG risks described.

3. *Transparency*

The fundamental guideline is that adherence to high standards of transparency and disclosure can mitigate some inherent investment risks even when there are weak governance and public institutions and other social and environmental risks. In other words, transparency seeks to strengthen conditions that favor efficient investment above all. Obviously, the issue of transparency and integrity may be assimilated within the broader notion of sustainability since corrupt institutions do not last or, if they do, it is at the cost of an institutional failure in meeting their objectives.

The essential contribution of transparency in SOEs lies in reducing asymmetric information in the principal relationships of agency within the firms. That is where the greatest, early efforts must be focused, because an opaque environment is where the highest agency costs thrive.

Second, although also very important, is the contribution of transparency to an environment of integrity in management of the SOEs.

One of the important by-products of the theoretic framework includes contributing conceptual tools that can be applied in SOE analysis from the focus of CG, for example, relationships between the company and the state; relationships between the company and its principal internal and external interest groups; composition, responsibilities, and practical role of the board of directors. There are clear risks of agency costs in each of these cases due to the possibility that one or more of these interest groups may take actions that are contrary to company sustainability. The important issue of incentives of each important interest group will then be analyzed and to what extent the main known CG recommendations in most of the literature are useful either to prevent or mitigate such agency costs and therefore contribute to an organizational scheme that is professional, neutral, and consistent with making decisions so that the company takes the road to value creation, efficiency in their economic and commercial activities, and is not bled by those interest groups or political structures.

Functions of State Ownership

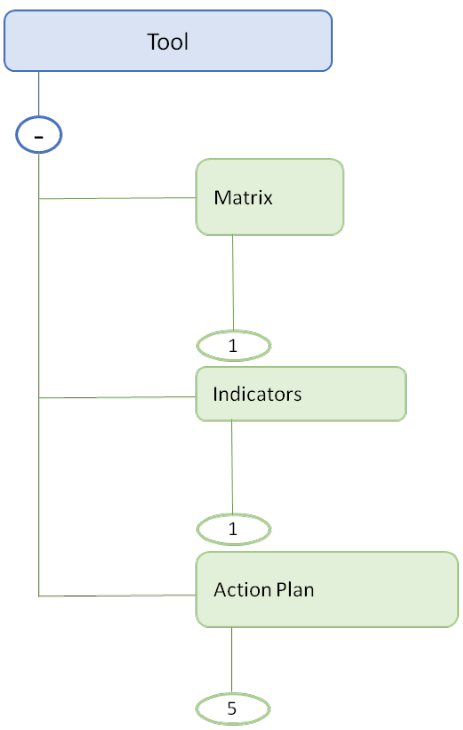
According to OECD (2015), the state must act as an informed, active owner and must ensure that governance of the companies is exercised transparently and responsibly. Based on experience, exercising these functions is necessary for SOEs to obtain the benefits expected of their performance. Thus, the state owner must invest seriously in the following:

> First, the state must have personnel capable of supporting the exercise of the ownership rights.
>
> Second, this team must be capable of installing information mechanisms to mitigate the problem of asymmetric information between the principal and agent.
>
> Third, it must prepare a state ownership policy in regard to the combination of its investments in SOE with a conceptual framework; analysis of the inefficiencies in the company portfolio administration and weaknesses in their management and control as well as adequate monitoring of how they meet the "strategic" objectives of SOEs, weaknesses in SOE management, justification and alternatives for portfolio rotation for best compliance with state purposes, among other key aspects; formulation of the policy with objectives, action plan, and decision proposals that will be adopted at the highest level of government; projected flow of investments and recovery of funds for the state as a product of SOE performance; baseline and results indicators in applying the state ownership policy.
>
> Fourth, the owner state must prepare a policy on public disclosure and ensure its quality.
>
> Finally, fifth, it must establish a clear compensation policy for boards of directors and thus motivate and attract qualified professionals and managers.

Contrary to what happens in the private sector (incentives for private company ownership arise from motives for economic earnings), the public sector lacks similar incentives, and usually management of the SOE obeys the mandate of public policy and relationships with interest groups; what matters is to comply with government programs in a politically inexpensive way which can leave SOE sustainability as a secondary priority.

Starting with these incentives it is possible to explain why a persistent tendency has been found in SOE CG diagnoses. In spite of recognizing internal problems, SOE administrators often choose to follow courses of action that do not challenge the most negative aspects of the power structures. A CG action plan is essentially a proposal for change. Thus, inevitably it will step on toes, affecting internal and external interests to a greater or lesser degree. If the proposal for SOE CG reform does not obtain strong support from the state owner agency and, of course, from the board of directors, that proposal will possibly not actually be embraced, even though it is approved in principle. Therefore, adoption of a serious CG program often remains as a resource of last resort that must be adopted when the company has tried everything else and is already in trouble. In the first place, incentives make the company first exhaust all other options to delay the effects of the problem afflicting it, for example, transfer the burden to the state or third parties, restructure debt, seek subsidies, tax relief, special programs, etc. In the second place, because CG involves costs and its results are long term, then, if a government in office, which must be held accountable in the medium term, sees the option of solving the problem, even only cosmetically, without incurring the costs associated with CG, it does so.

The tool



The tool presented herein is expanded and revised from the first version of Technical Note 106 in 2010 aimed at water and sanitation companies. It was designed to be useful for analysis as well as for the action plan. The tool will be applied using workbooks in Excel files attached to this document. The first file is the CG progression matrix that refers to best governance practices (Matriz CG.xlsx). The second file is a workbook to facilitate preparation and calculation of CG results indicators (Indicators CG.xlsx). The indicators show the impacts of practices in the CG risk matrix, i.e. look for signs of the main agency problems. Both files were designed complementarily. The second file includes a tab that organizes the list of information requirements at the beginning, which each company must prepare. Finally, this file contains the action plan form, built from the logical framework methodology.

The CG tool for SOEs should be used with intelligence and practicality. It is designed to be used with different degrees of depth. For example, when IDB Invest or a potential investor in the SOE begins the study, it can examine the initial information of the checklist to which the next subtitle refers. Thence a preliminary analysis may be done in regard to whether the SOE meets some minimums that justify a more complete study and verify confirmation of the degree of application of good practices in degrees of progression two and three. Now, if it is a project that was already subject to a first mission on technical aspects and it is necessary to assess institutional strength of the company and its capacity to mitigate or prevent risks of value destruction and misappropriation, then it will be advisable to address a much more complete CG audit that examines the additional steps the company should take and considers a broad action plan that is well integrated with the major strategies. The tool is a very powerful instrument that can provide a major service in different contexts.

Information Requirements

The information requirement document is a checklist of documents that can show the existence and application of CG practices. This checklist is an Excel document attached to this document with the title "Information Request form.xlsx". The purpose of this list is to facilitate collection of evidence. The documents required are general ones; however, some companies may have more specific documents or policies depending on the nature of the business.

In carrying out CG, collection of information is done before completing the matrix since it is necessary to have this information in order to fill it in.

Matrix

Starting with the review of existing practices, the tool's update is based on four primary sources[19]:

1. OECD, "OECD Guidelines on Corporate Governance of State-Owned Enterprises": published as an update in 2016 of the document originally published in 2005. These guidelines are a set of recommendations to ensure that SOEs operate with transparency and efficiency.
2. World Bank, "Corporate Governance of State-Owned enterprises: a toolkit": published in 2014, the document provides a global CG framework for state-owned companies. Based on the World Bank Group experience and best practices, especially those of the IFC, it is dedicated to professionals participating in creation, implementation, and monitoring of SOE CG.[20]

[19] The matrix of the tool in NT-106 consists of 89 practices originally conceived for water and sanitation companies. These practices are also valid for SOEs that issue shares and have significant participation by private shareholders.

[20] This notation in the document acknowledgements should be kept in mind: "This set of tools was produced jointly by a team from the Finance and Markets Global Practice (FMGP) of the World Bank and Global Governance Practice (GGP) of the World Bank Group. It was financed by the World Bank, International Finance Corporation,

3. IDB Invest, "Corporate Governance Screening Tool": a questionnaire used by the IDB Invest division of the Inter-American Development Bank as a method to quickly investigate the CG risk of the SOE that is looking for financing services.
4. In addition, the matrix was compared with that of "Legal Strategies for the Protection of Principals", taken from "Agency Problems and Legal Strategies", chapter 2 of *The Anatomy of Corporate Law: A Comparative and Functional Approach* of Kraakman and Davies (2004), page 23.

Many other sources, studies, and experiences were also consulted with the idea of recovering, completing, and reviewing the content of NT 106 published in 2010. One of these is: https://publications.iadb.org/es/publicacion/14134/transparencia- impulsando-eficiencia-en-empresas-proveedoras-de-servicios-de-agua

The matrix has two principal objectives:

1. Assess the CG in companies where IDB or IDB Invest is considering placement of resources, whether financing or capital.
2. Facilitate a task of accompanying or consulting for companies that need to improve their practices by assessing and designing an action plan.

The matrix may contribute to the analysis, but it is not a complete analysis in and of itself. Applying the matrix does not necessarily mean knowing whether its CG is achieving the objectives since CG is not just a control list but is effective to the extent that it can mitigate large agency costs and, therefore, the greatest weaknesses in the owner state-company and counterpart-company relationships.

the Korean School of Public Policies and Management of the Institution for Development, and the Global Partnership Facility Trust Fund. Page 13.

Illustration 1. Components of the SOE CG Matrix

CG Matrix:
Dominion → Attribute → Category → Practice

State Owner Dominion

SOE Dominion

Dominion	Attribute	Category
A. SOE CG Framwork	A. State ownership policy for SOE	A. Legal status of the state owner of the SOE
		B. SOE as a business company
	B. Powers and restrictions of the state owner	A. Responsibilities of the state owner
		B. Regulatory separation
		C. Designation of directors
B. Company CG	A. Commitment to CG	A. Commitment to CG
	B. Board of Directors	A. Composition of the board of directors
		B. Role of the board of directors
	C. Environment of Control	A. Internal processes and controls
	D. Transparency and Disclosure	A. Accounting
		B. Disclosure
		C. Audits
	E. Financial and fiscal discipline	A. Fiscal and operational flows
		B. Financial policies and performance
	F. Treatment of minority shareholders	A. Rights to information and control
		B. Investor and shareholder rights for action
		C. Transactions with the state owner
	G. Other stakeholder, environmental and social matters	A. Other matters: stakeholders, environment and social

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Just like its predecessor tool, the matrix has four degrees of progression that identify the strength of the practices applied on the one hand, and the capacity of the company to address difficult demands on the other. Nevertheless, this time there is an additional significance. Degree of progression 1, which reflects basic performance of acceptable practices, is considered the minimum needed for IDB Invest to finance the SOE without incurring great risk.[21] If these first level practices are not met, then IDB Invest should not finance the SOE, unless there is a clear commitment to meet them. Degree of progression 2, next performance step, reveals whether the directors are making an effort to apply standards similar to those of private commercial companies, especially in financial information, audit and control, and key decision disclosure practices. Degree of progression 3 reflects CG practices that are the necessary bases to reduce significant agency costs so that the SOE creates value, discloses its comprehensive financial condition, and effectively manages conflicts of interest. Finally, degree of progression 4, the most demanding, reflects practices that make the SOE obtain a good national and international reputation in regard to effectively implemented CG standards and mitigate the principal sources of agency costs.

[21] Especially in cases where financing will not have sovereign guaranty, the opposite of what occurs in most bank financing

Now the matrix groups together the CG best practices in two domains: the CG framework for SOE and the company's CG.

The first domain focuses on practices that the company could not adopt without a fundamental agreement, defined impulse, and some clear, ambitious goals of the state in general through the legal and regulatory framework, and of the state owner entity of the SOE, e.g., state ownership policy.

The second domain corresponds to CG best practices that can be adopted internally by statutory bodies of the SOE.

Table 4. SOE CG Progression Matrix. Outline

CG PROGRESSION MATRIX FOR STATE-OWNED ENTERPRISES – OUTLINE

<table>
<tr><th rowspan="2">Dominion</th><th rowspan="2">Attribute</th><th rowspan="2">Category</th><th colspan="4">Degrees of Progression</th></tr>
<tr><th>1
Degree 1: Acceptable CG Practices</th><th>2
Degree 2: Additional Steps to Assure Good CG</th><th>3
Degree 3: Large Contributions to Improve CG Nationally</th><th>4
Degree 4: Leadership</th></tr>
<tr><td rowspan="5">A. CG framework for SOE</td><td rowspan="2">A. State ownership policy for SOE</td><td>A. Legal status of the state owner and the SOE</td><td rowspan="18">Acceptable practices mean that, if they are not implemented, IDB Invest will not finance the SOE, unless there is a clear commitment to implement in the short term.</td><td rowspan="18">Financial information, audit and control practices, and key decision disclosure enable tracking of whether the SOE management is similar to the standards applied in commercial private corporations.</td><td rowspan="18">CG practices that are the necessary bases to reduce significant agency costs so that the SOEs create value, thoroughly disclose their financial situation, and effectively manage conflicts of interest.</td><td rowspan="18">The SOE is generally recognized for their good reputation in regard to effective implementation of CG standards, so the main sources of agency costs are mitigated.</td></tr>
<tr><td>B. SOE as a business enterprise</td></tr>
<tr><td rowspan="3">B. Powers and restrictions of the state owner</td><td>A. State responsibilities</td></tr>
<tr><td>B. Regulatory separation</td></tr>
<tr><td>C. Designation of directors</td></tr>
<tr><td rowspan="13">B. Company CG</td><td>A. Commitment to CG</td><td>A. Commitment to CG</td></tr>
<tr><td rowspan="2">B. Board of Directors</td><td>A. Composition of the board of directors</td></tr>
<tr><td>B. Role of the board of directors</td></tr>
<tr><td>C. Environment of control</td><td>A. Internal processes and controls</td></tr>
<tr><td rowspan="3">D. Transparency and disclosure</td><td>A. Accountability</td></tr>
<tr><td>B. Disclosure</td></tr>
<tr><td>C. Audit</td></tr>
<tr><td rowspan="2">E. Financial and fiscal discipline</td><td>A. Fiscal and operational flows</td></tr>
<tr><td>B. Financial policies and performance</td></tr>
<tr><td rowspan="3">F. Minority Shareholder Treatment</td><td>A. The rights of information and control</td></tr>
<tr><td>B. Shareholder and investor right to act</td></tr>
<tr><td>C. Transactions with the state owner</td></tr>
<tr><td>G. Other interest group, environmental and social matters</td><td>A. Other matters interest group, environmental and social</td></tr>
</table>

1. Dominion in the CG framework for SOEs. This is aimed at the owning entity or state-control shareholder, especially at attributes of state ownership policy and its commitment to CG of companies where it is the minority, but relevant, controlling owner or shareholder. The objectives of this section: understand the environment in which the ownership is exercised, how the public policy objectives are

contemplated, whether or not it is a strategic company, and the company independence. This dominion recognizes that the SOE will not make vast progress in its CG without determined support and political will of the state owner entity, whether national, regional or local.

2. The dominion of SOE CG includes those practices that can be adopted by company bodies and have seven attributes.

    a. The board of directors. This body, by playing a special role of principal and agent at the same time, has great influence in how CG is conceived and the other controls for efficient company performance. Therefore, the practices in the tool assess its efficacy, efficiency, and independence.
    b. The commitment to CG. These are practices that reflect how committed the decisions in the shareholder meeting, boards of directors, and executives are to CG so that the firm is oriented toward more satisfactory efficiency results. The following citation is a good way to synthesize practices gathered under this criterion: *"The notion of corporate governance applied to public companies attempts to reflect as faithfully as possible the incentives faced by private companies. In the case of public companies, corporate governance refers to decision-making organization in a public company"* (Andres, Schwartz, & Guasch, 2013, page 93).
    c. The environment of control. This refers to the processes whereby the company achieves a clear authority structure in decision-making and information on how such guidelines are executed. It assesses internal control, compliance, and audit processes that ensure better management of risks of misappropriation and destruction of value.
    d. Information transparency and disclosure. This attribute recognizes a very strong relationship between SOE transparency and its efficiency and productivity. Therefore, it considers four aspects: the quality of financial information; scope of complete, timely, and dependable disclosure of company performance; effective compliance with external and internal standards, and the soundness of the auditing system.
    e. Financial and fiscal discipline. CG practices belonging to both aspects are closely related. A company with poor financial performance surely will request direct or indirect support from its owner. The SOE with excess liquidity will probably be pressured by its state owner to transfer resources to the public funds (Musacchio, Pineda Ayerbe, & Garcia, 2015). CG practices in this attribute are grouped into two categories:
        i. Fiscal and operational flows. This is about establishing how it has been possible to identify and differentiate commercial objectives from those of public policy that the state asks the company. With clear objectives, it is already possible to separate the origins of resources and the respective outflows and report on the resulting set of flows between the company, the ownership entity, and the principal interest groups. Finally, ambiguities can thus be eliminated and the fiscal restraint practices can be expressed explicitly.

ii. Financial policies and performance. The set of practices in this category describe a route to progress for the SOE's corporate finances, moving toward progressive value generation processes until reaching and maintaining investment grade ratings as a credit subject.

f. Treatment of minority shareholders. This includes practices that safeguard protection and equitable treatment of minority shareholders and mitigate the devaluation the company could endure in the market for that reason. Three categories are grouped in this attribute:
   i. The rights of information and control. These practices try to reduce the risk of asymmetric information and risk of privileged information on the part of majority shareholders. Participation of minority shareholders is better protected with this type of practice and improves decisions made by the board of directors.
   ii. Shareholder and investors rights to act. This section discusses the actions to which investors and shareholders have the right, for example, having access to arbitration tribunals, accurate and up-to-date information, and having at hand effective tools for leaving the company or transferring their shares.
   iii. Transactions with the state owner. This category assesses the relationships that exist with the owner entity. These include disclosure of information on the size of such transactions and whether or not they occur under market conditions, as well as participation in meetings, dividend distribution, transaction agreements and disclosure. Here it is intended that the relationship is that of a good businessman not plundering resources.

g. Other interest group relationships. This attribute includes best practices that the company must have to mitigate the risks that these groups could represent for the organization. It must be clear that any action is within the duty of the SOE to generate economic and social value. Finally, these relationships must not be counter to the company's corporate purpose.

Below is a count of the compiled and updated practices and incorporated into the SOE CG progression matrix proposed herein:

Table 5. Number of CG best practices classified by degree of progression for each domain, attribute, and category

CG PROGRESSION MATRIX FOR STATE-OWNED ENTERPRISES - OUTLINE

			Degrees of Progression			
Dominion	Attribute	Category	**1** **Degree 1: Acceptable CG Practices**	**2** **Degree 2: Additional Steps to Assure Good CG**	**3** **Degree 3: Large Contributions to Improve CG Nationally**	**4** **Degree 4: Leadership**
A. CG framework for SOE	A. State ownership policy for SOE	A. Legal status of the state owner and the SOE	2	2	2	2
		B. SOE as a business enterprise	2	1	2	2
	B. Powers and restrictions of the state owner	A. State responsibilities	0	1	1	0
		B. Regulatory separation	1	1	1	0
		C. Designation of directors	1	0	1	0
B. Company CG	A. The commitment to CG	A. The commitment to CG	3	3	2	1
	B. Board of Directors	A. Composition of the board of directors	2	3	3	1
		B. Role of the board of directors	6	7	2	1
	C. Environment of control	A. Internal processes and controls	4	4	2	2
	D. Transparency and disclosure	A. Accountability	1	1	0	1
		B. Disclosure	4	3	1	1
		C. Audit	1	1	1	0
	E. Financial and fiscal discipline	A. Fiscal and operational flows	3	4	3	2
		B. Financial policies and performance	4	3	5	4
	F. Treatment of minority shareholders	A. The rights of information and control	2	2	2	2
		B. Shareholder and investor right to act	3	2	1	0
		C. Transactions with the state owner	1	2	1	0
	G. Other interest group, environmental and social matters	A. Other matters interest group, environmental and social	4	3	1	0
		Total per level	44	43	31	19

There is a total of 137 CG practices. There are 44 corresponding to degree of progression 1; 43 to degree 2; 31 to degree 3, and 20 to the degree of leadership.

For comparison, in NT-106, the matrix considered 89 practices distributed as follows:

Table 6. CG Progression Matrix for water and sanitation companies. Technical Note 106

CG PROGRESSION MATRIX FOR WATER AND SANITATION PUEs (PRIMARILY STATE-OWNED) from NT106

	Degree of Progression				
Attributes	1	2	3	4	Total
A. COMMITMENT TO CG	6	5	5	1	17
B. STRUCTURE AND FUNCTIONING OF THE BOARD OF DIRECTORS	6	7	6	2	21
C. ENVIRONMENT AND CONTROL PROCESSES	2	1	1	1	5
D. TRANSPARENCY AND DISCLOSURE	3	5	4	1	13
E. TREATMENT OF MINORITY SHAREHOLDERS AND SECURITY HOLDERS	5	5	3	2	15
F. FINANCIAL DISCIPLINE	6	6	3	3	18
Total	28	29	22	10	89

The 54% increase in the number of practices is due to several factors.

- Some practices of NT-106 are actually an aggregation so that they are divided for better understanding in the new proposal.
- The SOEs subject to the new methodology include other sectors besides water and sanitation, such as infrastructure and transportation works, finance, energy and other public utilities. Often, they have to do with complex projects that may involve public-private partnerships with different degrees of exposure to risk and the financing components of which are not protected by sovereign guaranty. Thus, IDB Invest must carefully examine the consistency and reliability of the ratings assigned to a prospective SOE.
- It is also very important to have collected new developments contributed by OECD and the World Bank Group resulting from application of the guidelines and methodologies of many SOEs in industrial and emerging countries.
- Finally, it is recognized that the companies that must be analyzed here are typically medium to large organizations with clear mandates for commercial operations that acquire their competing inputs, resources, and productive factors and that have been adopting business models and decision, information, and control processes and mechanisms originally developed for modern, large commercial companies to operate properly.

Meanwhile, to appreciate the relative importance of the domains, categories, and attributes, the count of practices is shown below, adding horizontally:

There are 22 CG practices where the state owner takes the lead while there are 114 that the company can assume internally.

Table 7. SOE CG Progression Matrix. Outline count of practices by level and category

CG PROGRESSION MATRIX FOR STATE-OWNED ENTERPRISES - OUTLINE

			Degrees of Progression						
			1	**2**	**3**	**4**	**Total Practices**		
Dominion	**Attribute**	**Category**	**Degree 1: Acceptable CG Practices**	**Degree 2: Additional Steps to Assure Good CG**	**Degree 3: Large Contributions to Improve CG Nationally**	**Degree 4: Leadership**	**By Category**	**By Attribute**	**By Dominion**
A. CG framework for SOE	A. State ownership policy for SOE	A. Legal status of the state owner and the SOE	2	2	2	2	8	15	22
		B. SOE as a business enterprise	2	1	2	2	7		
	B. Powers and restrictions of the state owner	A. State responsibilities	0	1	1	0	2	7	
		B. Regulatory separation	1	1	1	0	3		
		C. Designation of directors	1	0	1	0	2		
B. Company CG	A. The commitment to CG	A. The commitment to CG	3	3	2	1	9	9	115
	B. Board of Directors	A. Composition of the board of directors	2	3	3	1	9	25	
		B. Role of the board of directors	6	7	2	1	16		
	C. Environment of control	A. Internal processes and controls	4	4	2	2	12	12	
	D. Transparency and disclosure	A. Accountability	1	1	0	1	3	15	
		B. Disclosure	4	3	1	1	9		
		C. Audit	1	1	1	0	3		
	E. Financial and fiscal discipline	A. Fiscal and operational flows	3	4	3	2	12	28	
		B. Financial policies and performance	4	3	5	4	16		
	F. Treatment of minority shareholders	A. The rights of information and control	2	2	2	2	8	18	
		B. Shareholder and investor right to act	3	2	1	0	6		
		C. Transactions with the state owner	1	2	1	0	4		
	G. Other interest group, environmental and social matters	A. Other matters interest group, environmental and social	4	3	1	0	8	8	
		Total per level	44	43	31	19	137	137	137

Finally, the complete proposed matrix is found on the "Matrix Draft 2" sheet of Excel file "Matriz CG comparativa 20190417.xslx" which is attached to this work document.

Indicators

Indicators are a basic element of the CG tool since they allow observation of how close the company is to generating sustainable value without abusive attitudes. Within the tool, the indicators have two uses that we call “general” and “particular”. First, general use consists of assessing the company as a whole, as a set of practices that cause the company to generate value, being sustainable with itself and with its environment. Secondly, particular use of indicators helps to see the progression of the practices particularly to achieve a specific result. This second use is helpful in building the action plan. The user will see that these proposed indicators will aid in a better understanding of the practice to evaluate.

There are 31 indicators presented here, and they were prepared from the categories of the progression matrix. Each of them measures specific achievement, but they must be analyzed together to perform the assessment. The definition of each is provided below.

Table 8. Definition of SOE CG Indicators

CG Indicators in SOE

Indicator Name	Definition
	Ownership policy of the State for the SOE
Fiduciary Duties of Controlling Shareholders (FDCS)	The enterprise has rules so that the controlling owners (or the state) respond to the minority shareholders (or taxpayers through the ownership entity) in relation to the specific risks of asset's diversion, enterprise's opportunities being taken advantage of, and manipulation of minority shareholders' property rights and in general the allegiance to the fiduciary duties of care, loyalty and good faith.
Legal Risk Drivers (LRD)	Impact of contractual controversies among public service enterprises and their stakeholders. Indirectly measures the alignment of interest groups with the company. Litigation should be the last resort for resolving differences among interest groups and the enterprise.
Equality of Legal Treatment (ELT)	Shows if there is a favorable treatment of SOEs in law, whether with respect to labor laws, tax laws, government's guarantees of non-embargo of funds, exposure to lawsuits exemptions with respect to bankruptcy law or business laws.
	CG Commitment
Ownership Structure (OS)	Shows the distribution of the number of owners and their ownership shares, by type of share.

Ownership Concentration (Go)	Shows how the enterprise's ownership is distributed among owners of different sizes for each class of shares. The computation should include those shares owned directly or indirectly.
Board	
Participation of Independent Directors (PID)	Shows the degree of participation of independent directors in the BD.
Authority of BD over Management (ABDM)	Shows the degree of effective authority of the BD over management.
Oversight Role of BD (OR)	Shows the extent of BD's activity in its oversight functions.
Administrator's Protection Ratio (APR)	Measures the perceived risk to directors and officers with respect to the operating income.
BD's Annual Self-evaluation	Shows if there has been an annual self-assessment of the board
BD attendance	Measures the average attendance of BD members
BD Meeting Frequency	The number of BD meetings in a year measures how active the board is, and the degree of trust it extends to management.
BD Committee Meeting Frequency	Same.
Subject Matter Distribution	Measures the actual focus of the board during meetings.
BD Compensation Ratio	Shows the sum of all items paid to directors, including expenses and stock options or equivalent, as a percentage of EBITDA.
Transparency and Disclosure	
Information Disclosure (ID)	This indicator shows the degree of public disclosure of relevant enterprise information. The indicator will oscillate between 0 and 4, where 0 represents no exposure and 4 represents the maximum information exposure.

Transactions with Related Parties (TRP)	Measures the disclosure of material transactions with the owner state and controlling shareholders, company's subordinates and other state-controlled entities; and BD members and company officers. These transactions have been subject to approval by the BD so minority shareholders had the opportunity to vote timely. The external auditor does not find that these transactions have been set apart from market terms, so there is no risk of potential abuse.
Integrity	Shows the extent of enterprise and BD commitment to integrity.
Financial and Fiscal Discipline	
Impact of Non-Commercial Objectives (INCO)	Estimates the economic impact on the enterprise for assuming economic commitments beyond those that the SOE would accept if it were run exclusively according to business criteria.
Fiscal Impact (FI)	Measures the cost incurred by the state to support the utility in proportion to the total income of the company.
Financial Information Quality (FIQ)	Progress in implementing International Financial Reporting Standards (IFRS) or in the re-expression of financial statements complying with local laws to IFRS.
Economic Value Added (EVA)	Measures the enterprise's creation of value after deducting the cost of capital replacement.
DUPONT	Breaks down profitability into cost structure, turnover of investment, and leverage.
Tobin's Q	For listed companies: It is the relationship between the stock price and the book value of the stock.
Excess of Management Expenditures (EME)	Theoretically they are expenditures made by managers in excess of those strictly necessary for fulfilling the enterprise's commercial objectives. As a proxy for EME, benchmarking is suggested.
Treatment of minority shareholders	
Payment of Dividends (PD)	Records the existence and dividends paid by the SOE. It indicates the recognition of the owner's rights to decide the destination of their investment's return, instead of being retained systematically in the enterprise.
Other Stakeholder Relations, Environmental and Social Issues	
Salary Gap (SG)	Capacity of negotiation of public utilities' enterprises with respect to workers. It is the margin by which the SOE's salaries exceed the average market salary for similar jobs.

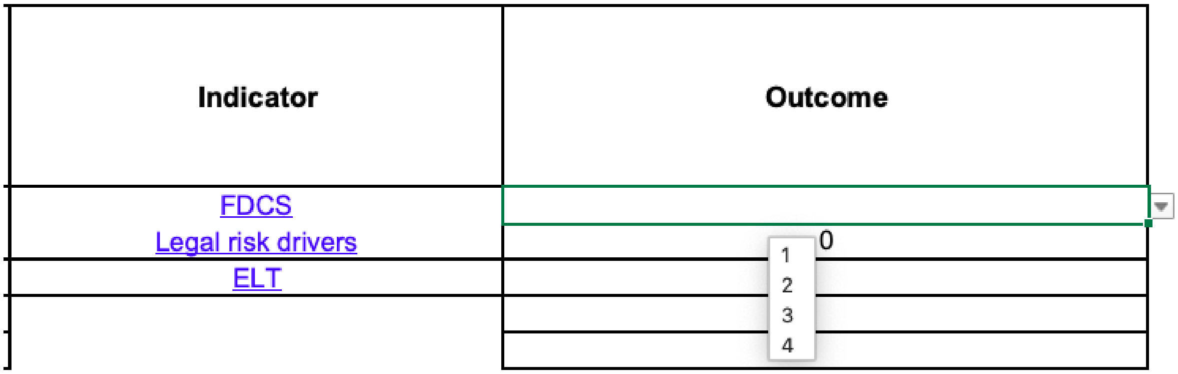
Contract concentration (Gc)	Measures the concentration of contracts assigned by the enterprise to its contractors or goods and services providers.
Contracting Processes (CP)	Measures the proportion of contracts awarded according to its type: by tender, list or direct hire.
Customer's Satisfaction (CS)	Diverse indicators of customer satisfaction and service quality.
Customer service (CSV)	Measures the effort to solve customer service requests (petitions, claims and complaints).

In order to facilitate its calculation, an Excel tool called “Indicators CG.xlsx” was designed that has 27 tabs. The first three with blue, red, and yellow are the most important. In the first place, the “information request form” contains the list of documents necessary to obtain the indicator variables. Included in the list is a column where whoever is responsible for collecting the files may select whether they have the file displaying a list and inserting the symbol ✔.

Graphic 7. Main tabs in the indicator tool

In the second place, the “matrix scheme” tab includes dominion, attribute, category of the progression matrix together with the suggested corresponding indicators, and a column with results (“Outcome”). The column of indicators not only lists them, but it has a hyperlink that links to indicators with the “Indicators” tab, where the user may see what the indicator is about. The “Outcomes” column shows the results of the indicator after the calculation. Since some indicators do not need to be calculated, there are cells that display a dropdown list with the score that the user gives to the indicator (see Graphic 8). The user knows what these list indicators are by defining the indicators on the “Indicators” tab.

Graphic 8. Example of the "Outcome" column



In the third place, the "Indicators" tab contains the definition, formula, variables and where the information is found to obtain the variables. Once the definition has been read, the user will find the hyperlink "go to tab" in the first column beside the indicators (see Graphic 9). Each of these hyperlinks goes to the tab where the indicator is calculated.

Graphic 9. Example of the "Indicators" tab

	Indicator Name	Definition
Go to tab	**Legal Risk Drivers (LRD)**	Impact of contractual controversies among public service enterprises and their stakeholders. Indirectly measures the alignment of interest groups with the company. Litigation should be the last resort for resolving differences among interest groups and the enterprise.

To clarify, the indicators shown here are a sample of what can be used to assess the CG and the practices. If the user considers it relevant, different indicators may be constructed to assess a same practice.

The Action Plan: What are We Going to Do?

The CG action plan is applied with greater or lesser scope depending on how this tool has posed it in each case. If it is a relatively quick review completed internally by a creditor or consultant to provide an analysis of CG practices effectively implemented by the company and to provide an initial estimate of the size of the CG agency costs or risks incurred, the resulting report will surely include a set of recommendations for the financing entity and the SOE to use without digging into much detail. Nevertheless, if the credit entity, taking into account the consultant's report and other information necessary to contemplate a financing project, considers that it is useful to conduct a CG audit where the detailed application of the practices are confirmed and documented and where top management is more definitely involved in order to discuss and agree on this analysis, it will already make sense to formally propose a significant CG action plan. This action plan may be designed as a participatory and duly supported exercise that will be prepared in various stages, and of course, it will be subject to approval by the SOE's general management or president's office and validation by the board of directors and the entity that represents the controlling state owner. To summarize, the tool serves different purposes, including basic review, audit, and consultancy leading to an action plan integrated with the firm's strategic plan.

Socialization of results from the first analysis

In most cases it makes sense to encourage participation of part of the management team in the first analysis to reveal CG practices that apply according to the progression matrix as well as those that do not apply, plus the most important group of practices: those that the team manages to agree to as appropriate and as possible to implement. The outside consultant or executive of the financing entity may reach a similar result on their own but counting on the participation of the SOE managers will save time later. Those will be interested in the process of formulating a CG action plan. It is recommended that each step not be taken as a mechanical exercise but that allowance is made for real reflection by the members of the work group, the board of directors, and the management committee. One objective is to help the different workshops prompt a definition of criteria by SOE senior management that is useful to create and consolidate the CG action plan. It is very important at this time to focus above all on the principal real risks for good CG.

The work team, and if appropriate, the CG consultant or auditor, must perform a serious study of the practices that effectively apply to the company. This goes beyond what is written in some company standard; it is about reviewing the organization's actual behavior. The analysis of the work team, or CG consultant or auditor, must be presented to the management committee and the board of directors as a work tool, but it must not replace performance of the proposed exercises. Some would prefer to present the "technical" analysis after the aforementioned bodies have reached their own conclusions. Others will rather send the "technical" analysis as study material in advance to expedite the management committee and board of director exercises. In any case, the technical analysis level of detail should be greater. The questions arising must address the key issues of CG.

The success of the workshop with the board of directors and the controlling state entity is the necessary condition for the process to continue at the highest level. Therefore, the discussion must be framed in the most thoughtful terms, without personalizations and with the commitment to complete discretion until the process reaches the implementation phase.

Some of the options that must be considered a product of the discussion may lead to reforms in the articles of association, in other cases to in-depth adjustments of some formal (explicit and written, like the board of directors regulation) or informal (unwritten but being followed, like political influence on naming trusted executives and even minor operational personnel and administrative staff) rules of the game. It is only advisable in the short term to propose adoption of new practices that have a high likelihood of validation with a prudent balance between the ideal versus the practical.

Reconciling the results of measuring perception and the diagnosis

The three suggested phases ("technical" diagnosis of the work team or CG consultant or auditor, management committee exercise, board of director exercise) are useful for the process to move forward consistently and objectively. This opens opportunities for each instance of hierarchy to speak out (in fact, the work team is directed by general management, and the CG consultant or auditor must prepare professional, independent work), enriching how the same facts or activities are appreciated from different perspectives and providing the opportunity for responsible debate in a controlled context about matters that in many companies are not usually discussed due to the status quo.

The results of the CG indicators complement the exercises conducted on the progression matrix. They fulfill the function of recording that the purpose of CG practices is to contribute to mitigation of company conflicts and prevent and mitigate CG risks.

Definition of goals by attribute (level of progression)

The final exercise of the board of directors must be a suitable basis for the action plan. Very few practices in yellow indicate that CG in that ESPAS is perfect, a conclusion that should be received with caution. Too many practices in yellow could appear very ambitious or the effort involved underestimates the effort to carry it out. Moreover, do not forget the principal of gradualness: some good governance practices must be preceded by others in order to implement them successfully.

It will be easier to organize the CG action plan, assigning tasks, defining responsibilities, setting goals, resources, indicators and results, when there is clarity in the analysis, understanding of the scope of a determined practice, and how it will contribute to reducing agency costs and the certainty about who will be responsible for implementing the practice (whether it is an internal administrative matter or requires decisions at a higher level)

Implementation Phase

The consultant or management committee during this phase must propose the process to ensure formulation, negotiation, and adoption of a program where the SOE can implement good CG practices. Implementation policy, strategy, and outline guidelines will be proposed for this so that it is differentiated by the different levels of complexity identified in response to the most relevant elements of the analysis that arose from the analysis of the progression matrix, stoplight, and indicators.

Monitoring and Control Phase

For this phase, the consultant or management committee must propose the monitoring, control, and accountability outline that can assess good CG practice adoption and implement corrective actions if necessary.

The consultant must take into account the formulation of assessment and impact indicators that enables monitoring of the provider's management and assessment of the results achieved.

Other resources

1. *The detailed CG information dashboard*

Appendix A is a useful document to take into account during the analysis process. This appendix corresponds to Appendix F of the World Bank document (2014 "Corporate Governance for State-Owned Enterprises: a Toolbox". This document essentially covers the same sections of the CG matrix from the technical note and has slightly more than 200 information requirements. It can be used selectively in an initial SOE CG assessment or exhaustively in a due diligence audit or inspection for the SOE that has already taken clear-cut steps and has a serious commitment to change in regard to the issue. This dashboard has two purposes: first, complete information requirements that support the analysis and later verifications in financial, legal, human resources, due diligence, etc. areas. Second, it takes into account when to probe topics in depth during interviews with the respective company directors and executives.

2. *Methodology for assessing the implementation of the G20/OECD principles of corporate governance*

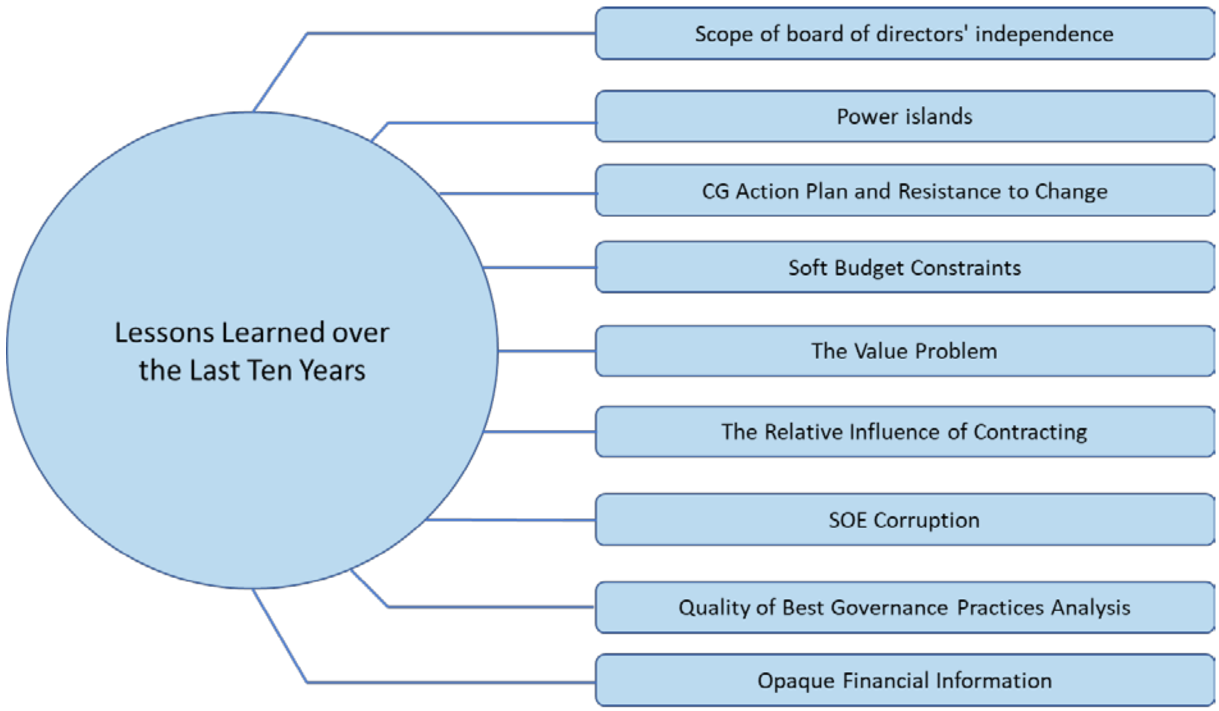
This document is based on the CG principles of the G20/OECD and sustains the manner in which these principles are implemented in different jurisdictions as well as establishing the bases for public policy discussions. This document may be used in the assessment of whether a CG recommendation or best practice is actually being applied. Therefore, it is also useful to analyze results of implementing the CG action plan. The fact that the assessment of results in this document is not based on rankings must be considered; it takes into account the particular circumstances and context of each case.

3. *State-owned enterprises and corruption: What are the risks and what can be done?*

This document complements knowledge and debate of the factors that cause corruption in SOEs. Based on the case studies, the practices of integrity and transparency can be supplemented and thus reduce CG risk of misappropriation of value that leads to corruption and encourage a responsible and effective exercise of state ownership.

In summary, for the purposes of using the tool for assessment, it is recommended that these previously mentioned documents be reviewed in order to have the set of knowledge necessary for the consulting team to validate the tools that must be taken into account according to their needs.

Lessons Learned over the Last Ten years



In this section, the consultancy reviews the reports on 14 contracts completed for the IDB in applying NT-106. This exercise allows for a comparison of the different degrees of progression in adopting best practices by these companies upon performing the analysis and how the management teams and, in some cases, the boards of directors identified them. Therefore, this exercise makes it possible to compare the initial status of the different companies and the degree of commitment that these teams and boards had defined in principle to address CG improvement processes over the near term. Different situations were encountered. For example, some with "yellow light" practices, those that the companies wanted to improve, represented a large proportion of the total practices assessed. In these cases, a substantially ambitious action plan was considered. In other cases, it could be shown that the companies did not have a particular willingness to adopt changes and, therefore, the "yellow light" practices represent a small proportion of the total map of practices.

In large part, the difference between these two extremes has to do with the perception that the company would have had about the real possibility of adopting changes given the political environment and power relationships with the principal interest groups. In any case, the IDB Group will examine what initiatives are critical in moving forward to build a solid financial relationship in efficient financing that affects the value of each SOE as a credit subject and their capacity to satisfactorily implement large investment programs.

Scope of Board of Directors Independence

This is the case of a water company in a medium-size city. First, the shareholder configuration of this company includes participation of local and national governments as well as private minority shareholders. The board of directors was elected at the general shareholder meeting with the mayor presiding. Most of the directors have experience in the private sector and influential careers, but they are picked based on the confidence the mayor has in them. The board of directors has no real autonomy. For example, if the director does not do what the mayor recommends, the board goes into crisis and there is room for replacements, which makes the directors please the mayor, and they end up validating the interests of a government program. Thus, if the mayor wishes the government to pay dividends for social programs, they do so. The lesson that can be taken from this experience is that, even though the members are independent in the sense that they do not depend economically on the company, the controlling shareholders, or administrators, and they have a background of experience in the private sector, in practice their independence is limited. In this way it is very important to analyze the power configurations beyond the roles. This reaffirms the importance of having members on the board of directors with political and economic independence.

Power Islands

A company tackled a large investment, but the administration broke down: provision of service continued under the business model with no interruption, even though an independent unit was created for a new project that answered solely to the general manager. This independent unit was a different world and a separate island of power with its own budget and finances, no real communication with the rest of the company. The result of this separation was a project with cost overruns, problems with contractors, delays in delivery, and no financing for supplementary phases. The CG is important to identify power islands and make timely corrections.

Sometimes, the previous case is generalized. Each area management or business unit becomes a power structure in the upper echelons. This power is measured by the CAPEX budget line item available to the respective vice president or manager and by the size of their payroll. The information only moves vertically within that area, and the horizontal links of information are reduced to a minimum. Planning exercises are an actual negotiation with support from outside power sources. The company begins to look like an archipelago where "control" is spread out.

CG Action Plan and Resistance to Change

Two cases that reveal opposite biases
In the first, which happens with some frequency, after performing the stoplight tool exercise and identifying CG best practices already adopted (green light) that are impossible to adopt in the short term (red light) for legal reasons or convenience and those that executives consider feasible and advisable (yellow light). That tricolor map is subject to management and board of directors' consideration where it is trimmed a bit and approved by the mayor, government, or minister. Then it is discovered that the action plan budget involves an agenda of change in the actual power relationships that include informal standards and entrenched customs. A sometimes overt, sometimes passive, resistance may exist, and the action plan, that would have been able to be carried out in a two-year period, fades away. The second case has also been validated, although not as frequently. The action plan has formal support by the government and the board. A work group is designated to be responsible for support and monitoring. The action plan is described under a solid logical framework with resources, projects, supervisors, baseline, indicators, etc. However, only a small number of the projects move forward; most of them are rescheduled again and again. Support for the action plan in the management committee or executive committee does not materialize in an effective direction. The CEO also does not act with enthusiasm. The CG program was adopted "word of mouth" on the website but for image purposes. But no real impact is achieved.

Soft Budget Constraints

The SOE in a small country performs a service at the national level, an inheritance of the colonial period. Historically, it provides water service better than the sewer service. The people think the water is a free right, as do all the political parties. The SOE operates without an economizing guideline. The rates have been frozen for many years, and the collection effort is minimal or there is no significant micro measurement. The government pays the difference in the cost of the company and collections. The investment is financed with credit outside the government. Recently, with the oil and gas crisis, the fiscal capacity to subsidize shriveled away, and the company had to make adjustments on the fly. However, spending was very rigid due to different political frameworks. Interest groups had spending in their hands and to reduce it was a very difficult job, even though it was necessary to do so. There were accusations of corruption. Another political party won the elections. Finally, there were no more changes other than reducing the level of investment and continuing with the so-called “low level balance”. For many years the Treasury Minister criticized the company’s finances and results in their budget messages and announced in-depth corrections.

The Value Problem

Even though large public companies can also be listed on the exchange and they issue active shares in the financial market, the problems most relevant to the CG of state-owned enterprises have to do with how their directors do not pursue more efficient performance of those organizations but they let it lose value and are captured by different interest groups. The Colombian case is cited here since the source of information is public. The document CONPES 3851[22] can conclude that 75% of the 111 companies analyzed therein in 2014 showed return on equity (ROE) lower than the country's cost of capital,[23] i.e., they lost value. State-owned companies are vulnerable to abuse by politicians, often among them directly from the government leaders themselves and, indirectly, the action of counterparts with influence such as unions, contractors and suppliers, groups of clients or users, plaintiffs for presumed damages, communities seeking specific benefits, and many others.

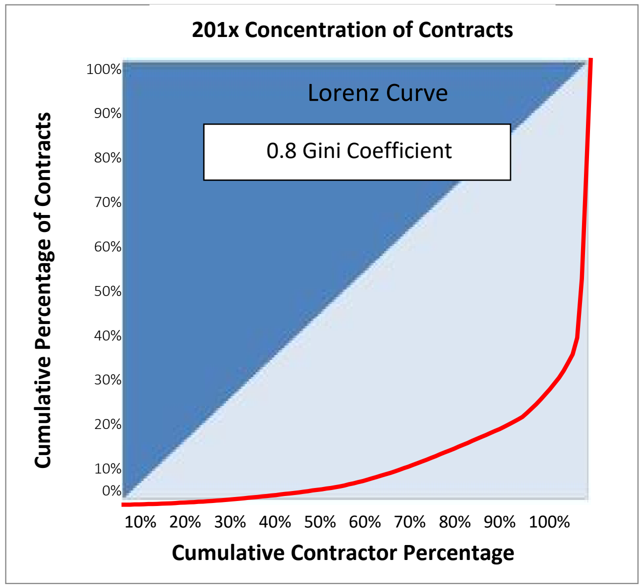
Frequently, the state-owned enterprises are affected by non-neutral, biased regulations that create favors on one or the other side of the scale. When CG problems overflow, the state companies no longer meet the objectives for which they were created and become a bleeding artery for the governments that then must be supported not because that is the best way to contribute to overall well-being but because the public ownership entities have become trapped in a chain of political contingencies and pressure.

In addition to companies already mentioned that have the country as a shareholder, in Colombia there are a few hundred other companies with owners that are territorial entities, as is the case with water and sanitation, urban transport, other public utility and non domestic services, hospitals, and cleaning. In practice, most of the government leaders consider those companies to be part of the administration and that the respective managers are part of the council. In conclusion, CG as an internal system of the SOE will hardly achieve its overriding purpose if there is no high-level political commitment above that SOE.

[22] Colombia. Ministerio de Hacienda y Departamento Nacional de Planeación (Department of the Treasury and National Planning Department) (November 22, 2015). The general policy on state ownership of national companies. CONPES is the Spanish acronym of the National Council for Economic and Social Policy of the National Government which makes decisions based on documents. In this case the document is CONPES 3851.

[23] The Social Discount Rate (SDR) is used as reference, with a range between 10% and 12%.

Influence Relative to Contracting



This Graphic illustrates a frequent situation in companies that make different sizes of investment through large, medium and small contracts. The database shows that 50% of small contractors obtain barely 4% of the contract values while the large contractors (3% or so) are assigned 60% of the awards. This leads companies to focus their attention naturally on large contractors. Even though there is no formal representation of any kind on the board of directors or the organization chart, large contractors play a large practical role of influence in the power system. Contracting systems using SOEs can apply fair rules of the game for selection, assignment, monitoring and control, but they can also be exposed to infringement. Tenders, open and online contests, reverse auctions, and other mechanisms have been tried with varying success. The degree of concentration in itself does not indicate corruption, but it is a permanent situation that must be monitored.

SOE Corruption

OECD published a document on the perception of corruption in SOEs of 37 countries.[24] They consulted 347 directors and executives of SOEs and 28 senior officials of ministries or entities in charge of managing the ownership of the SOE. The Table below in this frame summarizes part of the results. "Almost half of the participating SOEs (and 42% of those interviewed), at least one of the interviewees reported that corrupt practices occurred along with other irregular practices related to their company during the previous three years" (page 11). The study found, among other interesting aspects, some results that stand out:

"Those interviewed in companies with totally commercial results were more likely to have been witness to corrupt or irregular practices over the last three years than interviewees of firms with mixed (public policy and commercial) objectives. In both types of enterprises, the interviewees see the same likelihood and impact of future risks of this type. Nevertheless, the companies with public objectives report that they face greater obstacles together to promote integrity, including: objectives in conflict, pressure to break rules, individual opportunistic behavior, a perception that the likelihood of getting caught is low, relationship between the company or board and political officials, ambiguous chains of command or inefficiencies between the board and other hierarchies, and inadequate remuneration or compensation. Interviewees from companies with totally commercial objectives are more likely to face violations in information, regulations, theft, fraud and antitrust or competition protection rules" (page 25).

[24] OECD (2018), *State-Owned Enterprises and Corruption: What are the Risks and What Can Be Done?,* OECD Publishing, Paris. https://doi.org/10.1787/9789264303058-en.

Table 1.4. Top reported corruption risks: Perceptions of likelihood and impact of risks materialising

Based on respondents' rankings of select risks (Annex 1.A1) for the likelihood of occurrence in the company and the impact of occurrence

More likely risks	More impactful risks
1. Violations of data protection and privacy	1. Receiving bribes
2. Favouritism (nepotism, cronyism and patronage)	2. Falsification and/or misrepresentation of company documents, or false accounting
3. Non-declaration of conflict of interest	3. Fraud
4. Procurement/contract violations (delivering sub-par goods/services, violating contract terms with suppliers)	4. Offering bribes
5. Interference in decision-making	5. Money laundering
6. Stealing or theft of goods from your company	6. Anti-competitive, anti-trust activities or collusive activities
7. Fraud	7. Illegal information brokering
8. Illegal information brokering	8. Violations of data protection and privacy
9. Receiving bribes	9. Procurement/contract violations (delivering sub-par goods/services, violating contract terms with suppliers)
10. Violations of regulations (health and safety, environmental)	10. Violations of regulations (health and safety, environmental)

Note: Based on responses of 347 individuals, across 213 companies, ranking 24 corruption or other irregular practices for their likelihood of occurrence and the impact if it materialised as low, medium or high. The list of risks put forth for assessment are found in Annex 1.A1.
Source: OECD 2017 Survey of anti-corruption and integrity in SOEs.

[25] Idem, page 27.

Quality of Best Governance Practices Diagnosis

It is important to recognize that the practice progression matrix tool for CG of NT-106 does not apply itself automatically. The process to reach a sensible identification of practices passes through training to unify understanding of the basic concepts and to recognize the scope of the practices. The latter makes it possible to avoid biases of optimism and benevolence in scoring or self-assessment that practices were or could be effectively adopted. A consolidated, carefully vetted matrix is a good basis for establishing a realistic action plan. On the other hand, an optimistic, benevolent matrix because of a burst in enthusiasm can lead to an action plan deserving applause at the beginning, but that is discreetly abandoned in a few months. The table below in this frame shows a representative case of this type of relatively frequent error: the SOE that initially considered carrying out 33 practices, but six years later recognized that they had applied barely 20 practices. Their initial action plan sought to adopt 22 new practices at all levels of difficulty in one year including five of the easiest, seven intermediate, seven advanced and three at the leadership level. Six years later, they recognized that they could adopt 15 practices and even this estimate could have been optimistic.

201x vs. 201(x+6) CG Progression Matrixes

	Degree 1		Degree 2		Degree 3		Degree 4		Total	
	201x	201(x+6)	201x	201(x+6)	201x	201(x+6)	201x	201(x+6)	201x	201(x+6)
Green	14	12	11	4	8	4	0	0	33	20
Yellow	5	5	7	7	7	3	3	0	22	15
Red	4	6	2	12	2	12	2	7	10	37
Does not apply	5	5	9	6	5	3	5	3	24	17

Opaque Financial Information

One of the first signs that there are problems in CG quality comes from the review of financial statements. This table gives an example where the restrictions on public access to financial information and outdated and omitted relevant information are combined. This failure in transparency affects confidence in the company. Many SOEs do not issue shares, have not tried to obtain credit in the capital markets, and feel safe within the public finance playpen. They afford the luxury of being opaque. They publish tons of poor-quality information ostensibly to district attention from trustworthy, timely, and exact reflection of SOE financial reality.

CALCULATION OF THE DEGREE OF INFORMATIVE EXPOSURE

	2015
Accounting Documents	Select the response that is closest to the actual exposure level of each document
Audited Balance Sheet	Delivered only to controlling bodies
Income Statement	Delivered only to controlling bodies
Audited Cash Flow	Delivered only to controlling bodies
Audited Statement of Changes in Equity	Delivered only to controlling bodies
Notes to the Audited Financial Statements	Delivered only to controlling bodies
Budget Performance	Published on the internet for public access
Qualified Opinion of Independent Auditors	Delivered only to controlling bodies
Social management Report	Published only on the intranet
Relevant Information **	
Issues with disclosure required by law	Published on the internet and traditional media
Operations or acts that cause variations of 5% or more in the total value of assets, liabilities, operational income, operational profit or profit before taxes.	Outdated information
Signing, modification, or termination of contracts that are part of the company, directly or indirectly, with the Municipality of xxxxx as a matrix, their subordinates or the subordinates of the matrix, when the amount is greater than or equal to 1% of operational income.	Published on the internet and traditional media
Non-compliance for a period greater than or equal to sixty (60) days for two (2) or more obligations as long as such obligations represent no less than five percent (5%) of current liabilities of the entity.	Outdated information
The existence of relevant legal or administrative actions, once the litigation or requirement is addressed by the company and the decisions issues about them that could affect the entity significantly.	Published only on the intranet
Changes in company purpose	Published on the internet and traditional media

Score	2014	2015
0 Outdated information	0	0
1 Delivered only to controlling bodies	6	6
2 Published only on the intranet	4	4
3 Published on the internet for public access	3	3
4 Published on the internet and traditional media	12	12

Disclosure Degree*
1.8

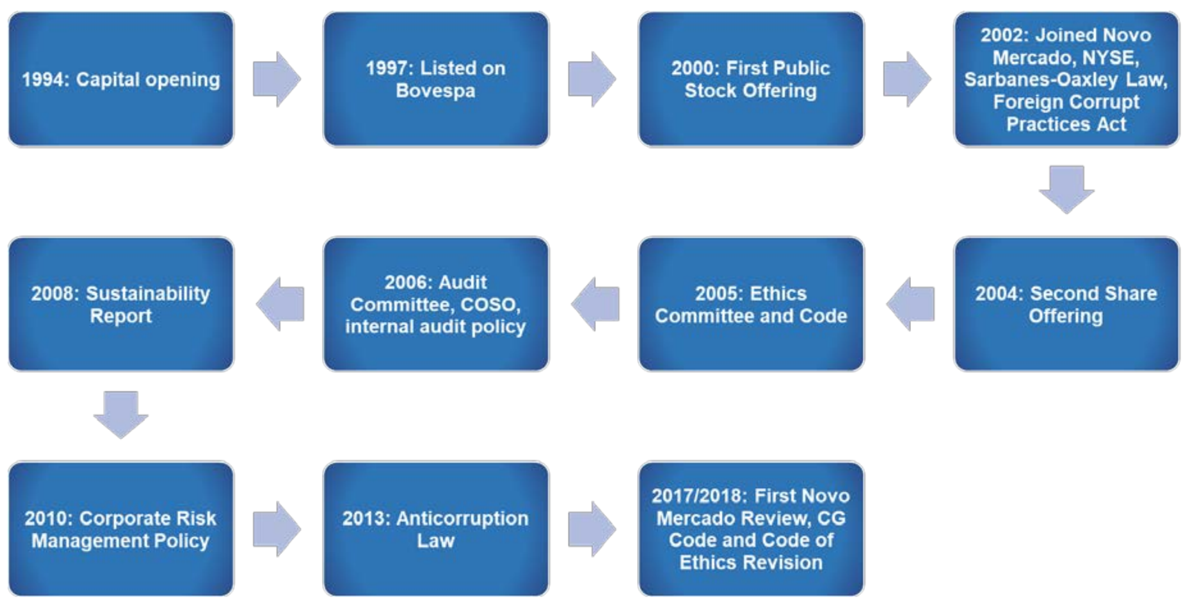
*The index varies from 0 to 4, where 0 represents no information exposure and 4 represents maximum information exposure.

** Relevant information is any situation related to the company of with securities issued by it (financial debt, bonds, etc.) that would have been taken into account by a prudent and diligent expert selling, purchasing or preserving the securities of the issues or at the time of exercising the political rights inherent to such securities. Relevant information includes the matters where the company has the legal duty to disclose, such as: a) accounting and financial situation, b) legal situation, c) commercial or labor situation, d) corporate crisis situations, issuance of securities, f) securitization processes

Good Things Take Time

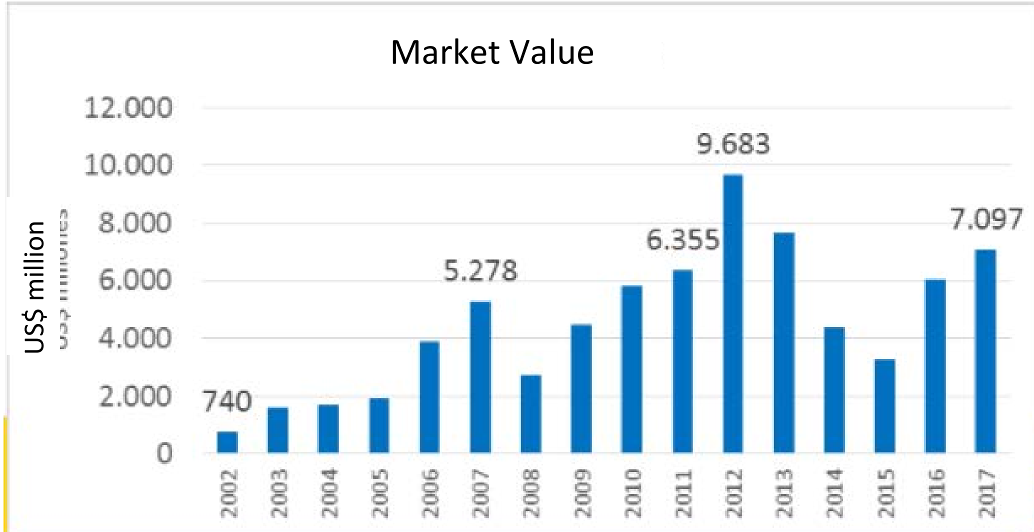
CG is a process, a road the company takes and requires will and determination of years, which changes according to its needs. Illustration 1 below shows the timeline of the CG process of a company with 28 million clients. The results of CG implementation over the years are seen in the evolution of the market value of the company in illustration two of this frame. This company opened up for public distribution of shares in 2000. In ensuing years, it joined the Novo Mercado in Brazil and the NYSE in the United States, the Sarbanes Oxley Law and the Foreign Corrupt Practices Act. By 2005 and until now, the company has been embracing more standards, laws, and policies.

Illustration 2. CG Process Timeline



The implementation process illustrated in the above timeline is complemented by the following image: in 2002 the market value was growing. The low values show the loss of value due to economic crises

Illustration 3. Market Value of the Company and its CG Process



Graphics Source: Company Presentation to the Corporate Governance Roundtable.

All this is a lesson that the process of a company to consolidate good corporate governance is an enduring commitment and does not yield immediate results, but progress can be seen over the long term.

Institutional Shareholders with Long-Term Interest

Another lesson learned in the 10 years since the tool was launched is that, to the extent that companies obtain active participation from large institutional shareholders with a long-term calling, they have managed to expand themselves outside of their original market since they have accessed international capital markets, inspiring confidence. An almost completely state-owned SOE changed to a public-private capital model 20 years ago. The firm adopted a growth model that over the years led it to expand beyond its traditional social objective and manage a portfolio of companies, including outside of its regional market and later the national market. The company learns to incorporate relationships with other interest groups. In 2016, based on a new corporate strategic plan, the company is organized and positioned as a business group, creating three large strategic business groups. As a group, the company currently has several key aspects of good CG, such as: an exemplary control environment, the state majority shareholders' clear respect for corporate autonomy in exchange for good returns, a consistent organizational structure, optimal capital strategy and consequently high credit rating, disclosure and transparency policies, formal CG documents and codes. The adoption of all these practices was accompanied in the same period by appreciation of the share price (from January 2016 to June 2018 the shares appreciated 21.5%), international recognition of the Dow Jones Sustainability Index and the Colombia Exchange. Institutional shareholder participation with long-term horizons has contributed to directing management of this SOE to create greater value and to apply macrostructures and management guidelines where commercial objectives are not sacrificed.

One case known in the practice has to do with the governance agreement of the SOE and its single state owner. Both parties to this agreement would assume obligations. The ownership entity would have an explicit written commitment of respect for the company's administrative autonomy, which included the mayor's framing their action with the SOE exclusively through the board of directors, that they would not intervene in human resources management except nominations that were the responsibility of the board of directors; it would not participate in or influence the contracting process; it would follow the rules of the game as recommended by OECD as far as naming and changing the general manager and to lead CG best practices at the company as well as its affiliates. In regard to the board, the mayor committed to maintain at least five, highest qualified independent directors with support in legitimate consulting systems. He would also guarantee assessment processes for both management and the board of directors itself. The municipality also committed to maintaining independence in operational management of financial resources without interfering with company financial administrative decisions; to delegate the annual budget discussion on the board of directors that formally corresponds with COMFIS and promote company participation in the municipal development plan.

The SOE, for its part, agreed to comply with the financial management indicators defined by the board of directors with minimum expected results in EBITDA, return on equity, and other financial indicators as well as a policy of dividends of up to 30% of annual profits with the possibility of extraordinary dividends as long as they would not affect appropriate cash management. The obligations of both parties also included appropriate mechanisms of communication in order to avoid multiple channels, to adopt principles of transparency, impartiality, and objectivity in personnel recruitment and hiring. The company would have an independent outside audit compatible with the conditions agreed with the multilateral bank. As to interest groups, the company activities would have to be framed in its corporate purpose and aligned with strategic objectives. In terms of rates and subsidies, the company would have to comply with the law to the limit of regulation. Actions related to interest groups should not compromise corporate viability.

These reciprocal obligations of the municipality and the company, and others described in the signed agreement, have been generally fulfilled for more than 12 years in spite of the agreement's not being legally binding. This indicates that a broad convergence of mutually respectful behaviors has been preserved, which can be seen in the financial and operational performance of the company and where the specific weight of the dividends paid have stayed within the municipal budget year after year.

The municipality has a powerful incentive not to place the company capacity to keep dividends current in danger. The company has significantly diversified geographically through investments and affiliates in other regions of the country and abroad, and to that end has assumed calculated business risks. The company has defined and renewed capital structure policies with the participation of other investors in specific projects and the multilateral, international, and national financial sector.

Thus, it can be considered that this is a case where a balance has been achieved between the rights of decision, exposure to risk, and rights of cash flow of each relevant interest group through a governance agreement that delimits the performance of the state control shareholder.

In this case the attitude of civil society organizations has also been very important to preserve the framework of respect and high management standards despite occasional temptations or circumstantial political pressure that may arise.

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