

**CHARACTERISTICS OF A
FULLY CORPORATISED
GOVERNMENT TRADING ENTERPRISE
AND
CHECKLIST FOR NATIONAL
STOCKTAKE OF GTE REFORMS**

Background papers prepared by the Special Premier's Conference Coordinating Task Force on GTE Reform.

Reproduced by the
NSW Treasury
August 1991

INTRODUCTION

A Task Force of Commonwealth, State and Territory officials was established following the November 1990 Special Premiers' Conference to perform a coordinating role among the three other working groups on Government Trading Enterprises (GTE) issues (the tax treatment of GTEs, Loan Council controls on borrowing and national performance monitoring) and to explore matters which could not be canvassed elsewhere but which could be important to the progress of GBE reform.

In terms of its consideration of other issues in the reform of GTEs the Task Force concentrated on two related tasks. These were:

- specification of the characteristics of a fully corporatised GTE; and
- development of a checklist which could be used in regular stocktaking of where each government is up to in the process of GTE reform.

In specifying the characteristics of a corporatised GTE the intention of the Task Force was to establish a set of principles which could be considered by governments in preparing for the reform of enterprises. The objective was to establish a theoretical benchmark incorporating some general principles about the reform of GTEs. While there may be agreement on many of these general principles, there are likely to be legitimate reasons for differences between governments in the application of these principles. For example, their application may be impeded by structural problems at the Commonwealth/State level which relate to the taxation system and the inability to transfer CSOs between levels of government. It was not the intention of the Task Force to suggest that governments bind themselves to a particular application of the model in their reform efforts. The characteristics specified could be supplemented by drawing together the experience of governments in the reform of GTEs, the problems they have encountered and the strategies employed to overcome them.

The Task Force's paper on the characteristics of a fully corporatised GTE is in two parts. The summary covers the broad principles of corporatisation while the rest of the paper outlines a possible application of those principles.

The objective of the Task Force's GTE Reform Checklist is to provide a basis for governments themselves to review progress towards reform of major GTEs. The checklist of criteria can be used by governments to establish a database on each major GTE. The database could include criteria incorporating characteristics of a model GTE against which progress in reform could be measured. Such criteria could be complemented by a listing of current restrictions on commercial operations by GTEs together with special advantages pertaining to these enterprises. These characteristics could include: CSOs, product market restrictions, borrowing environment and investment controls, exemptions from taxes and charges, price controls, employment and wage restrictions, dividend policy and financial monitoring arrangements. By updating such a database on an annual basis, it should be possible to track the progress of reform on a case by case approach. A 'pro forma' checklist for governments to review progress in GTE reforms has been prepared by the Task Force as a discussion paper.

The papers prepared by the Task Force provide background information which governments could use as reference points in the reform of GTEs within their jurisdiction. The papers were submitted to the Special Premiers' Conference held in Sydney on July 30, 1991, which decided to release them for general distribution.

The papers should be of assistance to all NSW GTEs considering, planning or undergoing corporatisation.

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August 1991

Discussion Papers on

**The Reform of Government
Trading Enterprises**

Prepared by a Task Force on Other issues in the
Reform of Government Trading Enterprises, April 1991

Discussion Paper No. 1

Characteristics of a Fully Corporatised GTE

CHARACTERISTICS OF A FULLY CORPORATISED GTE

Summary

The government trading enterprise sector represents a very significant component of the Australian economy. As a consequence, it is essential that inefficiencies existing in this sector be tackled in the interests of microeconomic reform.

The achievement of maximum gains to both productive and allocative efficiency requires that these organisations become more commercially (ie profit) oriented and the markets for their output be opened to competition. This paper presents characteristics of a fully corporatised GTE as information for governments in designing reform programs. Corporatisation does not necessarily involve 'incorporation', which only involves establishing a government enterprise as a public company under the companies code. Corporatisation of GTEs instead involves a range of reforms directed at full commercialisation and market re-organisation.

The objective of the paper is to promote some common understandings on underlying principles which might act as long-term targets for governments in Australia with respect to those enterprises they intend to totally commercialise. Rather than being prescriptive, the purpose of the paper is to provide some goalposts for governments. Even where there may be agreement on the principles, there are likely to be differences between governments in the application of these principles. Also, industry specific characteristics may call for different applications of these principles among government enterprises even within a particular jurisdiction.

The achievement of effective government enterprise reform requires that seven fundamental pre-requisites be satisfied. These pre-requisites (or principles) essentially define the characteristics of a fully corporatised GTE. The first four principles are critical in achieving productive (ie technical) efficiency, while the last three are necessary for ensuring allocative (ie economic) efficiency.

1 Clear and Non-Conflicting Objectives

- Improved performance requires that each enterprise has a clear understanding of the objectives which its owning government wishes pursued. Where conflicts among commercial, social and regulatory objectives exist, it is important that the enterprise has clear guidance on any trade-offs that may be necessary.
- Clarity is not sufficient in itself; also required is that commercial objectives be given a key role. In this regard, maximisation of the value of the government's investment in the enterprise (or at least its rate of return on that investment) should be a prime objective for each enterprise.
- The provision of social policy related services, often referred to as community service obligations, should be the product of explicit contracts between the enterprise and the government. Ideally the provision of such services should be open to competitive tender as a means of minimising the costs of providing non-commercial services. The fee paid to an enterprise for delivery of these services should be fully funded and identified in the normal budget process.

- Any policy or regulatory function traditionally undertaken by the enterprise should be removed to separate specialist agencies subject to direct ministerial accountability.
- To avoid subjecting Ministers to conflicting objectives, ministerial responsibility for the commercial success of an enterprise should be separated from the responsibility for associated regulatory functions and responsibility for negotiating the delivery and funding of community service obligations.

2 *Managerial Responsibility. Authority and Autonomy*

- To ensure that an enterprise's Board is suitably qualified to oversight the pursuit of commercial objectives, Directors should be appointed solely for the contribution they can make on account of their business management experience, their knowledge and skills. Directors should not be appointed to represent interests other than the commercial objectives of the owner (that is. government). Social or regulatory objectives should be set by the appropriate Government Ministers, not the Board.
- In order for an enterprise to maximise its efficiency in a commercial environment, its Board and management should have the authority to make the major decisions affecting the performance of the enterprise. These decisions would cover such things as the terms and conditions of employment, the determination of the enterprise's structure, determining where inputs should be obtained and, importantly, implementing the investment and borrowings program of the enterprise.
- In doing so, the only constraints imposed by the government as owner should be through defining the "core" activities to which the enterprise is expected to limit its activities, the overall dividend policy the enterprise is to pursue, the target rate of return expected on the government's investment and the broad limits of the enterprise's new capital expenditure and associated borrowing programs (ie debt/equity structure).
- In all other respects of the enterprise's conduct and organisation, the government as owner should operate at arm's length from the Board and management of the enterprise in order that managers be fully accountable for their performance.

3 *Effective Performance Monitoring by the Owner-Government*

- Providing the Board and management with the flexibility they need to manage the day to day operations of the enterprise in order to achieve commercial goals ensures that they can be held personally accountable for the performance of the enterprise.
- Because government enterprises are subject to much less performance assessment by the equity and debt markets than their private sector equivalents, governments need to establish independent and objective performance monitoring arrangements sufficient to ensure that the Board and management are held accountable for an enterprise's performance.
- Monitoring should focus primarily on the commercial performance of the enterprise. The monitoring arrangements should clearly specify the enterprise's information

disclosure and reporting requirements and the performance targets against which outcomes will be judged.

- The basis for the monitoring process should be corporate and business plans, which would be agreed to between the monitors and the enterprise following extensive consultations. The corporate plan should state the long term (say 3 to 5 years) corporate objectives of the enterprise, while the business plan should provide forward estimates of income and expenditure statements, the balance sheet and source and applications of funds statements for the year ahead.
- Given the specialist expertise required by monitors, a central monitoring unit reporting to the shareholding Ministers should be charged with the task of assessing the performance of all a government's enterprises. Such a unit should also provide advice to the shareholding Ministers on an enterprise's proposed core industry activities, rate of return, dividends and capital structure. The performance of such a unit should itself be subject to periodic assessment.

4 Effective Rewards and Sanctions Related to Performance

- Strict performance monitoring processes are not an end in themselves, but a basis for incentive systems aimed at encouraging and rewarding good performance and discouraging and penalising bad performance by Directors and management.
- The appropriate rewards and sanctions must be pre-defined against agreed performance targets, understood and strongly applied if they are to motivate the Board and management to maximise the performance of the enterprise.
- The reward structure needs to cover such things as salary, non-cash rewards (ie fringe benefits), bonus schemes, profit sharing arrangements and the like, and needs to be firmly tied to any disparity between an enterprise's actual and target performance
- Sanctions may include tightening the reporting and oversighting requirements, reducing the range of industry activities the enterprise may engage in, removing discretion over investment and borrowing decisions, salary reviews, loss or reduction of non-salary remuneration components and, ultimately, the termination of employment. Prior to the exercise of this final sanction, however, the other sanctions need to be exercised in a graduated way in response to inadequate enterprise performance.

5 Attaining Competitive Neutrality in Input Markets

- Competitive neutrality involves government enterprises not facing any special competitive advantages or disadvantages over their private sector counterparts because of their government ownership. Without a level playing field, inefficiencies in an organisation can survive more easily.
- The existence or perception of a government guarantee of debt funding needs to be overcome by the application of an explicit fee by the government to eliminate the interest rate advantage associated with continuing government ownership. The fee should be commensurate with the credit risk the enterprise would face if it had no guarantee. Alternatively, where borrowings are undertaken on the enterprise's behalf by a central borrowing authority, any explicit guarantee should be removed and the

enterprise charged full commercial rates of interest related to the credit risk of the enterprise in the absence of any guarantee.

- Government equity needs to be costed on the same basis as that supplied by private investors to privately owned enterprises, by ensuring that the rate of return expected on government equity is equivalent to that expected in the private sector for an enterprise with a similar commercial (i.e. market) risk profile.
- Government enterprise should not be subject to any restrictions on labour resources (ie award pay and conditions) that do not apply to private sector enterprises.
- Government enterprises should face the same taxation (or taxation equivalent) arrangements on their commercial operations as apply to their private sector counterparts.

6 *Attaining Competitive Neutrality in Output Markets*

- Competitive neutrality in output markets requires that any protective barriers which reduce the degree of competition faced by government enterprises in the markets they serve be removed, otherwise their costs and product quality will not be subject to competitive disciplines.
- Where there is evidence of market failure, any regulatory regime should be targeted on the relevant failure and the enterprise should be subject to the same legislative regulations as are equivalent private sector enterprises (eg the Trade Practices Act).

7 *Effective Natural Monopoly Regulation*

- The removal of legislative barriers to competition may not result in a more competitive operating environment in certain markets served by some government enterprises. This may be because of the possibility that the government enterprise enjoys a natural monopoly in those markets (eg gas, electricity, water and sewerage transmission/ distribution networks) or that the long term existence of legislative barriers to competition in the past has provided the incumbent government enterprise with significant advantages over any private sector operator.
- This situation requires a public policy framework which seeks to regulate the government enterprise to ensure that its natural monopoly powers are not abused. Wherever possible, this regulation should stress structural measures designed to ensure that unavoidable monopoly in some markets (eg electricity transmission grid) does not result in unnecessary monopoly in related, naturally competitive markets (eg electricity generation). Conduct regulation (such as direct price control) is prone to error and evasion and should only be used where competition in one form or another is not feasible.

Introduction

This paper deals with reform of Government Trading Enterprises (GTEs).

In particular, it specifies characteristics of a fully corporatised GTE. Rather than being prescriptive, the purpose of setting out these characteristics is to provide some goalposts for governments. Even where there may be agreement on the principles, there are likely to be some differences between governments in the application of these principles. Also, industry specific characteristics may call for different applications of these principles among government enterprises even within the same jurisdiction.

The aim of the paper is therefore to promote some common understandings on underlying principles which might act as long-term targets for governments in Australia.

Rather than specifying ideal internal and operational conduct within enterprises themselves, the paper focuses entirely on the relationship between the owning government and its enterprises. In this way, the issues are addressed from the owning government's, as opposed to an enterprise's, perspective. The assumption is that, if the correct structures and incentives are in place, ideal internal arrangements and conduct will both define themselves and be possible. Consistent with the thrust of what follows, internal details are seen as purely management prerogatives, and not directly the responsibility of government.

Nature and Importance of Government Enterprises

The enterprises which are the concern of this paper have been referred to variously as 'government business enterprises' (GBEs), 'government trading enterprises' (GTEs), 'public trading enterprises' (PTEs) and 'government owned enterprises' (GOEs). This paper uses the term 'government enterprise' to refer to enterprises covered by all these various designations.

However labelled, the government enterprises which are the subject of this paper are those government entities which sell the majority of their services and so derive a substantial proportion of their revenue from those sales, with full self-sufficiency possible in principle without detracting from a government's social and economic objectives.

Government enterprises contrast with government agencies either wholly or largely funded by 'Crown' income (ie receipts from taxes, regulatory fees, royalties, fines, interest and dividends from government investments and grants and advances from other tiers of government).

The government enterprise sector represents a very significant component of the Australian economy. Work undertaken by the Australian Bureau of Statistics indicates that, in the 1988/89 financial year (the latest year for which comprehensive and comparable data are available), 240 identified government enterprises contributed:

- 6 per cent of total employment in the Australian economy (473.000 employees);
- 7 per cent of the net operating surplus (\$5 billion);
- 10 per cent of total wages and salaries in the economy (\$17 billion);
- 10 per cent of gross domestic product (\$30 billion); and
- 19 per cent of the net capital stock (\$984 billion).

Purpose of Reform

Given the fundamental significance of government enterprises to the Australian economy, in the interest of microeconomic reform it is essential that any inefficiencies which exist in this sector be addressed. That some reform in the government enterprise sector may be called for is a consequence of an increased recognition in recent times that some of these enterprises have tended to perform relatively poorly; using labour and capital resources inefficiently, being less profitable and more of a drain on public funds than necessary, and producing the wrong mix of goods and services relative to consumer preferences.

As such, reform processes within the government enterprise sector are not intended to single out the public sector, but are being instituted in parallel with reform processes being initiated by government in the private sector.

Reform is not an end in itself, but a means to a more fundamental end. The fundamental objective of reform is to improve efficiency in its widest sense. Efficiency has two main dimensions:

- productive (or technical) efficiency, which depends on the degree to which enterprises choose least-cost methods of production, which in turn:
 - is a reflection of the quality of management performance in day-to-day operations and in making investment decisions, and
 - depends largely on the extent to which managers bear the consequences of their actions, and particularly the extent to which an enterprise's key decision-makers face strong personal incentives to produce its services in a least cost manner and to seek out innovations which improve the value of goods and services produced relative to their costs; and
- allocative (or economic) efficiency, which depends on the degree to which the production of goods and services matches consumer demand, with losses occurring because either:
 - the prices charged by a government enterprise for the resources it uses do not cover the value to society of those resources in alternative uses, or
 - it possesses a significant degree of monopoly power in the market for the services it provides.

The efficiency with which government enterprises use society's scarce resources is therefore a function of the rules and regulations which shape the external disciplines imposed on individuals within those enterprises and those which affect the price enterprises pay for their inputs and the competitive conditions they face in the markets for their outputs.

General Framework of Analysis

The reform processes outlined in this paper focus on the ideal administrative and market changes required to improve the efficiency of government enterprises. At the outset it must be recognised that the problem confronting government as owner of its enterprises is similar in many respects to that facing owners of private sector enterprises, namely the so-called 'principal/agent problem'.

A principal/agent problem arises whenever a principal has objectives which can only be achieved by an agent with immediate responsibilities for the decisions, or better information, or both. Like privately-owned firms, the government as owner or 'principal' of an enterprise in effect engages other persons (as its agents) to perform services on its behalf which involves delegating some decision-making authority to those agents.

Government ownership of an enterprise does not solve the principal/agent problem. While government ownership can be presented as an invitation to agents to adopt the 'public interest' objectives of the principal and to be free of other constraints and obligations, it is not apparent that Boards of government enterprises are well equipped to determine what the public interest is, let alone have an incentive to pursue it. In any event, such a loose definition of managerial objectives is not conducive to efficient management and operation of the enterprises concerned. Rather than remove the principal/agent problem, government ownership merely puts it within the context of a particular institutional structure.

Given that the Board and management of an enterprise (the agents) will typically have different incentives and superior knowledge, the problem confronting the government (principal) is how to construct a framework that ensures the desired outcome is achieved. The solution is not to change the nature of the organisation per se, as the dominance of the 'public' companies form of organisation over other forms of organisation is due to the fact that it allows management by specialists.

In identifying solutions to this problem, this paper recognises that governments interact with their enterprises in three different ways:

- as a shareholder/owner/investor;
- as a regulator (on behalf of consumers in general); and
- as a provider of social goods and services.

As an owner or shareholder, the perspective taken is not identical to the ordinary shareholder in the private sector, but is that of a 'concentrated' shareholder. The closest analogy to the private sector is the relationship between a holding company (the government) and one of its subsidiaries (the enterprise).

Approaches to Reform

Governments have available three broad approaches to enhancing the performance of their enterprises. The first involves administrative changes to the operation and management of enterprises, most particularly involving the adoption of:

- clear and non-conflicting objectives;
- sufficient management responsibility, authority and autonomy;
- independent objective monitoring of performance; and
- an effective system of rewards and sanctions.

Where the primary objective of such an exercise is maximising the value of the investment to the shareholder (or at least maximising the rate of return on equity), the above four steps constitute a process known as 'commercialisation'.

Secondly, there are measures aimed at promoting increased competition (sometimes referred to as ‘market re-organisation’), variously involving:

- competitive neutrality in input markets;
- competitive neutrality in output markets; and
- the effective prevention of abuse of any remaining market power.

Finally, the government can transfer ownership of an enterprise to the private sector (ie ‘privatisation’).

To date in Australia, governments have preferred to pursue improvements in the efficiency of their enterprises through administrative and market changes rather than through privatisation.

Scope of Corporatisation

While enterprises remain under government ownership, reform designed to improve the efficiency of the government enterprise sector ideally involves what has become known as ‘corporatisation’.

Drawing on the work of the Commonwealth, NSW, Queensland and NZ Governments and the Industry Commission, corporatisation involves all seven reforms identified above as required for full commercialisation and market re-organisation. Hence, corporatisation encompasses both commercialisation and market re-organisation; it is an alternative to (full) privatisation but can be implemented in conjunction with partial privatisation with only a few modifications.

Corporatisation does not necessarily involve ‘incorporation’, which only involves establishing a government enterprise as a public company under the companies code. In fact, the requirements of the companies code of themselves do not impose any of the conditions essential to reform, and so do not guarantee any improvement in an enterprise’s performance. While incorporation is sometimes used as a symbolic gesture to deem that a government enterprise has been fully corporatised (ie complies with each of the seven principles), by itself it does little to achieve the objectives of corporatisation.

Fundamental to the success of the corporatisation process (and key to distinguishing it from processes encompassing only commercialisation and/or market re-organisation) is the recognition that several of the conditions of reform depend on the implementation of other conditions for them to have the desired impact on the efficiency with which government enterprises use resources. In fact, effective reform involves the eventual adoption of all conditions for corporatisation, not just a select or convenient few.

If reforms are not introduced as a complete package, the sequence in which reforms are introduced is important. Most importantly, complete management authority should not be introduced until high quality accountability mechanisms for the performance of Boards and management are established and Directors of requisite quality have been appointed.

These interrelations also imply the desirability of setting out the whole plan, including timetable, for the full reform of a government enterprise before commencing the process.

The remainder of this paper examines in more detail the pre-requisites for each of the seven conditions for corporatisation. The discussion of each necessarily assumes that all other six conditions will also be met.

Pre-Requisites for Clarifying Objectives

A necessary pre-requisite for improved performance is that government enterprises have a clear statement of the objectives which their government require them to pursue, as well as clear guidance on trade-offs where objectives conflict.

No enterprise can be expected to operate efficiently if it has poorly specified or contradictory objectives; clear objectives provide a direct focus for management and prevent management from using multiple objectives to excuse unsatisfactory performance. Where constraints are to be observed in pursuing nominated objectives (such as confining the enterprise to a particular line of business and or requiring pricing practices to ensure an efficient use of resources), they should be clearly specified.

Clarity is not sufficient of itself, however; also required is that commercial performance be the pre-eminent target. As government enterprises are engaged principally in tradeable activities, the main way an enterprise affects the community's overall welfare is through the quality of its commercial performance in undertaking those activities. By obliging managers to take account of costs in terms of forgone alternatives, a clear incentive exists to improve productive efficiency. Likewise, managers will be poorly rewarded for effort put into discovering the optimal level of production unless profits play a major role.

As a corollary, unsubsidised non-commercial objectives expected of government enterprises should be kept to the bare minimum. This is not to say that government enterprises could not undertake totally social functions (eg home care duties for the disabled and infirm), but they should do so on a commercial basis (ie be fully reimbursed for their costs) in a competitive market where they have earned their service contract by competitive tender.

The most appropriate specification of a commercial objective is the maximisation of the (long-term market) value of the government's investment in the assets being managed. This involves the enterprise being expected to achieve rates of return on assets employed equivalent to those earned by private sector counterparts.

Social policy outcomes should not emanate from government enterprises except where there are explicit commercial contracts to provide social outcomes. Ideally, the following requirements should be met:

- To establish whether the subsidised or free provision of certain goods or services by government enterprise represents a cost-effective means of achieving a government's social or equity objectives. The non-commercial roles traditionally performed by those enterprise should be examined to determine whether there are more efficient means of achieving society's objectives (eg via social security payments or tax concessions).
- Where possible, in order to avoid conflicts of objectives and encourage the least-cost provision of community service obligations (CSOs), the tendering for the supply of CSOs should involve the enterprise competing with other potential suppliers willing to provide the non-commercial function in return for an explicit fee.
- Where an enterprise is the only feasible supplier of a product which a government wishes to subsidise, the terms for the supply of the subsidised activity should be based on arm's-length negotiations between government and the enterprise concerned

resulting in a formal contract specifying the type, quantity, quality and cost of the goods or services commissioned.

- CSO costs should be estimated on a demonstrated avoidable cost basis, with the onus of proof being on the enterprise, the costing procedure conforming with a long-term avoidable cost approach, and the information being available to full public scrutiny.
- The fee paid to an enterprise for the provision of CSOs should be funded directly from the budget with the necessary revenues being raised either from general revenue or a uniform levy on users. Compared with cross subsidies, this arrangement is more likely to generate intense scrutiny of the definition of those services to be provided under the auspices of a CSO and to emphasise the requirement for detailed verification of the costs involved. Levies on the industry itself may share some of the disadvantages of explicit cross subsidies.

To avoid conflict of interest, and to ensure that the Board and management are not distracted from their central task of overseeing and managing an enterprise's commercial affairs, any regulatory and policy roles traditionally undertaken by government enterprises should be removed to separate specialist advisory bodies accountable to the Minister. To the extent that government enterprises interact with various regulatory regimes, they should do this in the same way as any of their private sector counterparts. Government regulatory requirements should apply to the entire industry in which the government enterprise operates, not just to the enterprise itself or to private sector participants.

To avoid subjecting Ministers to conflicting objectives, it would be best if ministerial responsibility for the commercial success of government enterprises were separated from the responsibility for defining and monitoring associated regulatory functions and responsibility for defining and monitoring the appropriateness, effectiveness and efficiency of CSO provision by government enterprises.

Ideally, this would be achieved by vesting these three responsibilities in different Ministers. The Finance Minister/Treasurer as recipient of dividends from government enterprises may be best placed of existing portfolios to be the owner/monitor Minister, responsible for exercising owner sanctions for poor enterprise performance and accountable to Parliament for allowing persistent poor enterprise performance. As guardian of the 'public purse', the Finance Minister/Treasurer has the most direct interest in the commercial success of government enterprises. Other Ministers, being recipients of budget allocations (ie subsidies), are more interested in either community service obligations contracted out to government enterprises or industry regulation so that they may have a conflict of interest if also given a commercial ownership role.

An alternative approach might be to establish a separate ministry for government-owned enterprises were it felt important to keep the taxing and dividend setting functions separate.

The industry Minister could be the Minister responsible for industry-specific regulation rather than for ownership/monitoring.

To ensure a consistent approach to clarifying the commercial objectives of enterprises and to maximise the incentive on governments to focus on strategic matters properly the concern of owners, a single government enterprise Act or similar set of guidelines should be drawn up placing a number of obligations on enterprises in terms of their performance (requiring them

to perform in a commercial manner, to emulate best private sector practice wherever possible, to be socially sensitive organisations and good employers). This would ensure:

- the establishment of some common ground rules for government enterprises, in a more explicit fashion than the companies code;
- necessary accountability of Ministers to Parliament
- that Ministers/governments maintain their valid roles as shareholders or owners (not operators) of enterprises, by requiring Boards to make public any 'political interference': and
- that different Ministers were charged with the responsibility (and held accountable) for separately monitoring the commercial, social and regulatory performance of government enterprises and taking corrective action in the event of enterprise commercial mismanagement or non-compliance with CSO contractual obligations and/or industry regulations.

With regard to individual enterprises, particular objectives should be agreed and clearly set out in a statement of corporate intent (published as part of its corporate plan). Such a statement would form a type of contract between the Board and the government as owner or shareholder in relation to the enterprise's objectives. The enterprise's commercial objectives within any financial year should be expressed in a formal business plan showing forward estimates for the components of its income and expenditure statement and balance sheet.

Pre-Requisites for Management Responsibility, Authority and Autonomy

Giving government enterprises a clear, commercial objective will not be successful in generating sound economic performance unless the Board and management are given the authority to make the key decisions required to achieve efficient commercial outcomes. Externally imposed controls stifle managerial creativity and innovation, and dilute and diffuse responsibility between managers and the government agencies which set the controls, with the frequent result that nobody can be called to account.

A key to the success of government enterprise reform lies importantly with enterprise Boards being good enough to create correct management incentives and being strong enough to resist commercially unwanted shareholder/political interference by the owner motivated by political rather than commercial considerations. The quality of Directors and the CEO of an enterprise, and their personal effort and commitment, are therefore important determinants of the enterprise's performance.

Directors should be appointed solely for the contribution they can make on account of their business management experience, knowledge and skills. There should be no statutory requirement for representation of interest groups (consumers, producers or welfare groups), as such appointments create the expectation that these Directors should pursue the interests of their constituencies rather than the commercial performance of the enterprise. Political considerations should be pursued via the political process (ie either by explicit budget funded CSO contracts with the enterprise or by industry-wide regulatory requirements the costs of which are borne by all industry customers).

Once appropriate Boards are in place, management should be given the authority to make the key decisions required to achieve efficient commercial objectives. The Board should have the authority to appoint the CEO. It is essential that an enterprise's important internal decisions be made by individuals with a strong incentive to maximise the value of the enterprise and who possess the requisite specific knowledge. Business decisions are complex and often require a considerable degree of industry- and organisation-specific knowledge. Neither Ministers nor their advisors generally have the requisite information and organisation-specific knowledge.

Autonomy enables those with specialist information to best act on it; the purpose is to make the Board and management clearly responsible for bottom line results (otherwise responsibility will be shared with the interfering shareholder or owner).

The requisite managerial autonomy does not however, involve complete freedom from any owner-imposed constraints on operations. First, the government as shareholder or owner should appoint the Board and define the enterprise's role in terms of acceptable 'core' activities. As in privately-owned firms, shareholder approval should be sought for strategic actions outside the enterprise's prescribed (or 'core') activity since new ventures may put the shareholder's equity at risk.

Secondly, with regard to dividend arrangements, unlike the case for privately-owned enterprises, the government as shareholder or owner should basically determine the objectives of dividend policy in accordance with its preference between income and capital growth. Unlike the case with privately-owned enterprises, the government as owner or shareholder may be constrained from expressing its preference by the transfer of ownership.

The actual level of dividend payment in a particular year should, however, be the subject of recommendation by the Board in line with the established policy, taking into account relevant information on the level of 'shareholder's funds' at current market valuation, past and prospective profitability, proposed levels of capital investment and the associated funding requirements. The government may, however, expect a 'special' dividend (or more correctly a 'capital remittance') from a government enterprise in cases where assets exceed capital needs.

Thirdly, as a 'parent company' with a portfolio of enterprises, the government as shareholder or owner has a direct interest in the likely impact which each enterprise's investment strategies and the associated borrowing intentions may have on future returns on its investment in those enterprises. Hence, the government as shareholder or owner will wish to endorse both:

- the size, nature and timing of major capital expenditures (and possibly the appraisal methods used); and
- the level of borrowings in light of the enterprise's overall performance against expectations, details of expected profitability of major new investments and the capital structure (and so debt/equity ratios) most consistent with the shareholder's risk preferences.

Fourthly, the government as shareholder or owner should choose the external auditor. This is consistent with private sector practice as under the companies code, it is the responsibility of shareholders to appoint the auditor.

With these exceptions, management should have complete responsibility for:

- production policies (ie decisions on the type, quantity and quality of each good or service produced);
- marketing, distribution and pricing policies (within any regulatory framework applying to monopolists although, ideally, the removal of barriers to competition should obviate the need for government price control);
- terms and conditions of employment;
- implementing capital investment and borrowings within shareholder-approved limits;
- cash management;
- organisation structure; and
- the sourcing of purchased inputs.

Pre-Requisites for Effective Performance Monitoring by the Government as Shareholder

Other reforms are likely to have little impact on the efficiency with which government enterprises use resources unless their performance is subject to independent, objective and rigorous monitoring and assessment with managers being rewarded or sanctioned on the basis of their contribution to that performance. Hence, performance monitoring itself is a pre-requisite for achieving necessary accountability for performance.

If commercial objectives and authority for managers to make key resource-use decisions are to be effective in promoting productive efficiency, the Board and management of an enterprise should be held personally accountable for its performance.

Ideally, there should be no difference between a government enterprise and a privately-owned enterprise except for ownership, but it is this very exception of ownership which makes monitoring and accountability doubly important (and doubly difficult). Government enterprises are exposed to less scrutiny by the equity and debt markets than comparable private sector organisations, given the absence in respect of government-owned enterprises of both:

- a market for corporate control and the ability to structure remuneration packages so that managers have an equity interest in the enterprise; and
- the powerful incentive-aligning properties of bankruptcy since the government is rightly or wrongly perceived as standing behind all its enterprises.

As a consequence, it is necessary for government to develop monitoring and incentive mechanisms which are surrogates for the accountability mechanisms facing privately-owned enterprises because of the role played by debt and equity markets. The economic function of accountability mechanisms is to provide the basis for an on-going set of incentives which align the interest of the government as shareholder or owner with those of the enterprise.

Formal contact between the government as shareholder or owner and the enterprise's Board should be kept to the minimum level required to preserve management autonomy and facilitate accountability, as monitoring is not concerned with:

- improving performance by direct control of the day-to-day running of the enterprise; this should be the responsibility of the CEO; or
- management evaluation; this is the responsibility of the Board.

Performance monitoring procedures to encourage more commercial approaches involve the setting of a range of financial and non-financial targets, adoption of agreed measurement conventions, and comprehensive public reporting.

The monitoring process should concentrate upon overall commercial performance and, at least where this is satisfactory, the Board and management of a government enterprise should continue to have considerable freedom to run their businesses on a day-to-day basis.

A key performance indicator from the government as shareholder's or owner's point of view is the rate of return on capital employed. The assessment of an enterprise's performance should focus on the returns achieved relative to those earned by comparable private sector organisations. For this purpose, the assets of government enterprises need to be measured in terms of their current (market) values.

To assess the extent of productive efficiency promoted by the improved incentive arrangements, and to measure whether financial targets are being met inappropriately by reductions in the quality of inputs, the monitoring of various non-financial efficiency and effectiveness indicators is also likely to be important.

A reliable flow of quality information from government enterprises to monitoring agents is an important requirement for the effective assessment of performance against targets. Without such information it is extremely difficult for monitoring agents to evaluate performance. In particular:

- the monitoring arrangements should clearly specify an enterprise's information disclosure and reporting requirements in order to facilitate both on-going monitoring and ex-post audits of performance; and
- the annual report should fulfil both the requirements and the purposes of its private sector equivalent as should any half yearly or quarterly financial reports.

A distinction should be made between commercially sensitive information disclosed to the shareholder on the one hand and general financial results, CSO requirements and regulatory compliance reported to the general public on the other. The former should be provided by way of confidential private correspondence whereas the latter should be through annual public reports of the enterprise or monitoring body (eg budget papers in the case of CSOs or annual reports of regulatory agencies).

Ex post monitoring arrangements are also required, reviewing annually the actual relationship between target and actual performance, with a view to establishing the extent to which management decisions were responsible for any shortfall in performance, as opposed to cyclical and other exogenous influences.

Underpinning the whole monitoring process should be agreed corporate and business plans, prepared in (informal) consultation with the monitors and confidential to the enterprise and the government, which should provide a basis for the monitors' assessments as well as serve as an instrument to assist the Board and management in fulfilling their respective responsibilities.

The detailed business plan should provide, for each of the years of the planning period, projections of at least:

- the anticipated rate of return, both for the organisation as a whole and for proposed major investments;
- the anticipated dividend to be paid; and
- the associated stream of anticipated borrowings.

The 'bottom line' financial performance projections should be supported with:

- detail on the expected prices, gross receipts and costs by major categories underlying the rate of return projections: and
- an assessment of the sensitivity of the main projections to changes in key macroeconomic or business-specific assumptions.

The choice of monitors is also important. In fact the extent to which public sector monitoring succeeds in aligning the actions of managers with the interest of the government as shareholder or owner to the same degree as does the potential for the transfer of ownership or bankruptcy in the private sector depends critically on two factors.

First much depends on the strength of the incentives for enterprise managers to provide detailed information to shareholders. This is a classic agent/principal problem but in the government enterprise's case it is worse due to lack of external scrutiny. Government enterprises face strong incentives to provide a minimum of information at least cost and without diverting significant resources into its production, as collecting such information is costly and a threat to the commercial autonomy of the organisation.

Secondly, also important is the ability of monitors to assess the information provided by government enterprises. This is the case not only because a vast range of industry-specific knowledge is required to make sense of information but also because monitors may not bear the risks of inadequate evaluations and thus not face incentives to verify and analyse information as strong as do their private sector counterparts. The difficulty facing monitors may be exacerbated by the fact that for many government enterprises there are no industry 'benchmarks' against which performance might be judged. Also, none of the monitoring devices provide the continuous and unrelenting scrutiny which characterises private sector monitoring.

Against this background, the development of monitoring criteria and assessment of comparative performance requires specialist expertise which might be in scarce supply within portfolio departments and central agencies. A central monitoring unit would have the distinct advantage that it could pool monitoring expertise and experience. It would also facilitate monitors themselves being subject to strong incentives to provide high quality and impartial analysis.

Independent private sector monitors might also have a role in assessing the performance of monitoring agents, either in an on-going sense or on, say, a three-yearly basis by conducting a full financial audit and management performance review.

Besides independent monitoring within government, external institutional arrangements creating disciplinary pressures and monitoring activity should also be encouraged.

Pre-Requisites for Effective Rewards and Sanctions

Accurate independent monitoring of management's commercial performance makes sense only if the Board and management were subject to rewards and sanctions strongly linked to their performance. Ministerial rewards and sanctions should be applied to Boards which, in turn, should reward and discipline CEOs (and management).

The mechanisms used in government enterprises to align the interests of managers and owners should aim to replicate, as far as possible, the mechanisms used in the private sector (or their effects). Bonus remuneration schemes and the possibility of management losing their jobs through lack of performance would provide some substitute for the threat of takeover. Directors should be rewarded for good enterprise performance by some profit sharing or bonus scheme, given the absence of equity participation. The conflicts these mechanisms seek to control relate to three dimensions of management behaviour: choice of effort, risk exposure and time horizon.

Ultimately, responsibility for poor performance should be indicated by the timely dismissal of Directors, rather than by failure eventually to re-appoint Directors at the expiry of their term of office. Any unwillingness by Ministers to apply sanctions in the event of non-performance will greatly undermine the effectiveness of performance-based rewards systems in promoting efficient resource use.

Prior to the exercise of this final sanction, however, graduated sanctions are needed in response to inadequate corporate performance. They could take the form of, for example, (the threat) of increasing reporting requirements (say, from quarterly to monthly), granting less autonomy with regard to investment and borrowing decisions and reducing the range of industrial activities the enterprise may engage in.

Directors of government enterprises should bear the same legal personal liabilities for the enterprise's fate as do Directors of private companies.

Pre-Requisites for Competitive Neutrality in Input Market

When a government enterprise enjoys special advantages in the cost of the resources it uses (or suffers disadvantages) by virtue of its ownership, resources may be diverted from more efficient competitors or more highly valued end uses.

Any advantages and disadvantages of public ownership should be identified and removed. In particular:

- capital inputs need to be properly priced by implementation of rate of return targeting (this will ensure that equity capital is not priced below loan funds);

- the government should charge an explicit fee for any interest cost advantage provided by the guarantee against bankruptcy or default (either explicit or implicit) associated with continuing government ownership (with such fees reflecting the credit risk of the enterprise if it were a stand alone entity); and
- where government enterprises borrow through a central borrowing authority, the cost of credit should be at full commercial rates (that is, as if the enterprise did not enjoy an explicit or implicit government guarantee) if a government guarantee fee is not charged. Ideally, corporatised entities should not enjoy government guarantees (or guarantee fees), but be charged full commercial rates on the explicit understanding that their operations are not government backed.
- a government enterprise should be subject to all taxes (or their equivalents) facing private sector participants in both input and output markets.

Pre-Requisites for Competitive Neutrality in Output Markets

The markets in which many major public enterprises operate are characterised by government-imposed restrictions on direct competition, based on the belief that competition may not lead to socially desirable outcomes.

Regulation is only required in the face of some identified market failure (whether externalities, market power or information asymmetries are involved). It follows that each regulatory regime should be targeted on the relevant failure or failures. The normal pattern seems to have been for market failure to have provided the rationale for the introduction of regulation, but for the scope of regulation to be then extended to a wide range of matters which are the subject of general or sectional interest regardless of whether there is any element of market failure. Also, the fact that some aspects of an industry's behaviour demand regulation does not mean that all are proper subjects for official scrutiny.

Hence, where there is no evident market failure or where any failure is relatively trivial, regulatory barriers to competition in markets supplied by government enterprises and their captive government business should be removed, since many of the productive inefficiencies of government enterprises are the direct result of the lack of competition.

Where market failure is non-trivial, government enterprises should be subject to the same requirements to comply with regulatory legislation as privately-owned competitors (eg trade practices legislation).

Pre-Requisites for Effective Natural Monopoly Regulation

In some circumstances, the removal of legislative barriers to entry may do little by itself to promote competition in two sets of circumstances. First, the existence of other barriers to entry such as sunk costs and strategic entry deterrence behaviour may preclude competition. The endowment which government enterprises have built up during a long period of statutory monopoly may not be easily challenged by new entrants. As a result, removal of barriers to entry may require complementary policies to reduce anti-competitive behaviour against potential entrants by incumbent government enterprises.

Secondly, the existence of natural monopoly may also preclude the emergence of competition upon removal of legislative barriers to entry.

In these cases, the choice is between:

- direct regulation of the enterprise to avoid the exploitation of its monopoly power (or conduct regulation): or
- the introduction of some form of competition for the market as distinct from competition within the market (structural regulation).

While the constraints imposed by governments on their enterprises in the markets they supply should take the form of explicit regulatory provisions based upon detailed analyses of the relevant economic and technical issues present to the industry, some general principles can be identified.

The answer to the natural monopoly problem traditionally was thought to lie in conduct regulation in the form of rate of return regulation or price control; there is now a large body of evidence showing that such heavy-handed regulation undermines incentives to produce outputs at the lowest possible cost.

The problem for conduct regulation stems from the information disadvantages facing regulatory authorities. To guard against the possibility that customers in regulated markets may end up paying more than those in unregulated markets (by manipulation of the regulatory structure), regulators need to collect detailed information about the cost structures of the firms. There is difficulty in detecting anti-competitive behaviour and of enforcing measures intended to combat it (it is hard enough to reach an acceptable definition of predatory pricing, let alone detect and deter it).

Structural regulation (with regulators concerned with the way to which a market is organised) may be preferable to conduct regulation where there is asymmetry in information between the regulator and the regulated. As it is difficult to know whether an enterprise is operating at maximum efficiency, the best approach is to impose market structures which give incentives to maximise efficiency. The regulation of structure is designed to reduce or remove the opportunity for undesirable conduct rather than to prohibit it from occurring.

Even where monopoly is unavoidable, there are several devices available which can harness some of the advantages of competition to reduce the need for regulation. These include:

- ‘franchising’, which involves bidding at regular intervals among potential entrants for the rights to serve exclusively the market for a defined period;
- contracts to supply services to or on behalf of governments. This works best where there are potential competitors with the requisite skills, where sunk costs are not high and where technological and market certainty is not great;
- ‘yardstick competition’, which involves bringing enterprises indirectly into competition with each other in respect of cost reduction by, for example, making the price one enterprise can charge dependent on the unit cost level achieved by another (and vice versa). Incentives to cost reduction exist because each enterprise retain the benefits of any cost reductions it achieves while its prices are linked to the costs of the other enterprise(s);
- ‘functional separation’, which involves fencing off the area of natural monopoly as far as possible by barring an enterprise which enjoys a natural monopoly in one activity

from also participating in competitive activities, with a view to ensuring that unavoidable monopoly does not lead to unnecessary monopoly in other, naturally competitive markets. In this way, concern about predatory pricing becomes unnecessary, as do lower bound price caps. There remains the need to regulate the general level of pricing of the monopolistic activity, but conduct regulation to ensure conditions of effective competition in competitive activities is rendered unnecessary once the incentive to “exclude” is removed. Functional separation could, however, lose whatever economies that may have arisen as a result of the enterprise with a monopoly activity engaging in the related, potentially competitive activity.

While structural regulation may ease problems of enforcement, it may however be at the cost of scale or scope economies foregone. Hence, no regulation mechanism is free from problems and inefficiencies. There is a trade-off between that underlying market failure and the inevitable weaknesses of any regulatory intervention designed to tackle it. A central objective is, therefore, to develop structures which minimise the need for regulation. The answer, wherever possible, is to find mechanisms for making markets work – to lean with market forces rather than against them.

Discussion Paper No. 2

Checklist for National Stocktake of GTE Reforms

The following “pro-forma” checklist of descriptors could be used by governments to undertake a regular survey (or stocktake) of the current state of affairs regarding the corporatisation of each of its major trading enterprises.

Objectives of Enterprise

- What are the commercial objectives defined by the Government for the enterprise?
- What are the non-commercial (social) objectives expected by the Government of the enterprise?
- Does the enterprise have an annual statement of corporate intent (publicly available) and annual and medium term business plans (privately available to Government in its capacity as owner) and, if so, what form do they take?
- What guidelines has the Government laid down for the provision of community service obligations (CSOs)?
- What is the estimated additional cost to the enterprise of providing these CSOs, and on what basis are they calculated?
- What is the method of funding the costs of CSOs provided by the enterprise?
- What is the nature of any regulatory or policy roles with respect to the industry or related industries performed by the enterprise on behalf of any Ministers?

Management Responsibility, Authority and Autonomy

- What procedures and criteria are followed in appointing the enterprise’s Board?
- Who appoints the enterprise’s CEO?
- What limits do the Government place on the scope of the commercial activities to be undertaken by the enterprise?
- Does the enterprise have formal contracts with relevant portfolio Ministers specifying the nature, cost and Government financial reimbursement for all CSOs undertaken by the enterprise?
- Does the enterprise have a long-term dividend policy, and who determines the timing and the amount of any annual dividend payments to the Government?
- Does the Government as owner place any limits on the types of projects and the overall level of the enterprise’s new capital expenditure and/or associated borrowing programs?
- Do relevant Ministers impose any day-to-day controls on operational aspects of pricing, borrowings, investment, employment or expenditure?

Performance Monitoring

- What are the enterprise's current information disclosure and reporting requirements to the Government and to Parliament?
- What is the nature of the financial targets set for the enterprise?
- On what basis are the enterprise's assets currently valued?
- How are the results of these performance measurements disclosed to the Government and/or the public, and in what form?
- Which Ministers are responsible for respectively monitoring the enterprise's commercial performance, CSO contract fulfilments and regulatory compliance?
- Which agencies undertake the respective monitoring of the commercial/CSO/regulatory performance of the enterprise on behalf of different arms of the Government?

Rewards and Sanctions

- How does the remuneration of Board members and senior management relate to the performance of the enterprise?
- Under what conditions can members of the Board be dismissed, and who would make the decision to dismiss?
- Is there a gradation of rewards and sanctions which would come into effect in the event that the enterprise started exceeding or falling short of pre-agreed performance targets or standards?

Competitive Situation in Input Markets

- If the enterprise is required to obtain its finance from a central borrowing authority, is it charged commercial interest rates commensurate with its credit risk as a stand alone entity without explicit or implicit government guarantees?
- What proportion of the enterprise's debt attracts a government guarantee? What is the nature of any fees paid by the enterprise to the Government in the form of a government guarantee charge or its equivalent?
- Which Commonwealth, State and local government taxes are the enterprise exempt from or subject only to concessional rates?
- What other costs or benefits of public ownership are there accruing to the enterprise in capital or labour markets, relative to those experienced by private sector counterparts?

Competitive Situation in Output Markets

- Are other public sector organisations obliged to purchase items from the enterprise that could otherwise be supplied by private firms? If so, how important is such business to the enterprise?
- What exclusive trading rights are conferred on the enterprise by the Government? What other barriers to entry exist in the enterprise's market?
- From which legislative requirements or regulations generally affecting the private sector is the enterprise exempt?

Natural Monopoly Regulation

- What is the objective and form of any price control regulation imposed by the Government on the enterprise (or other form of conduct regulation specific to the enterprise)?
- Which Minister is responsible for regulating the market conduct of the enterprise in this way?