SOE Governance and Realistic Performance Target Setting: Issues and Challenges

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Background

• The SOEs have to fulfil the twin objectives of commercial efficiency and social responsibility.

• The challenge to ensure a reasonable return on investment, while discharging their constitutional and social obligations.

• As wings of the welfare state, the enterprises have the mandate to act as model employers, and conduct their business in an ethical manner.

• The environment of competition and globalisation makes the tasks all the more challenging.
• Liberalization of the Indian economy in 1991 resulted in a **paradigm shift** in the policy of GOI towards SOEs.
• The enterprises lost the monopoly assured by the government.
• The regime of commanding heights for the public sector gave way to the open economy & market forces.
• The public sector has to face competition instead of protection by the government.
PHASE: ECONOMIC LIBERALISATION (1991)

- Strategic, high-tech and essential infrastructure area to be opened up to the private sector.
- Sick PSEs be referred to BIFR.
- Social security mechanism to protect workers.
- A part of the government’s share-holding in the public sector would be offered.

- Autonomy to Public Sector
- Professionalisation of public sector Boards
- MOU between Enterprise and Ministry.
Phase Resurgence (2004)

- **Strong & effective public sector.**
- Social objectives to be met by commercial functioning.
- **Full managerial, commercial autonomy to profit making PSUs**
- Generally, no privatisation of profit making companies.
- Existing *Navratnas* will be retained in the public sector.
- To modernise & restructure sick CPSEs.
- PSEs be encouraged to enter capital market.
- Chronically sick CPSEs to be sold off/closed.
- Economic reforms with human face.
Accountability of PEs

Three main issues:
(i) Accountability for what?
(ii) To whom?
(iii) How?

Accountability of PE’s (Top Management) to
(a) Parliament
(b) Audit
(c) Vigilance
(d) Courts
(e) Shareholders
(f) Society
(g) Others
Constituents of the External Environment

- President of India
- Union Cabinet
- Administrative Ministry
- Corporation: Board of Directors

- Parliament
- Supreme Court and High Court
- CAG
- CVC CBI
- Public Press
- Planning Commission
- DPE
- Finance Ministry
- Trade Unions
- SC, ST Commission
- Labour Ministry
- Statutory Authorities, PF, Environment, Factory etc

- Shareholders
- Customers
- Suppliers
- Creditors
- Society

- Pvt. Co.'s, MNC's, Markets
Corporate governance of state-owned enterprises is a major challenge in many economies. But, until now, there has not been any international benchmark to help governments assess and improve the way they exercise ownership of these enterprises which often constitute a significant share of the economy.” (OECD, Paris, 2005)
OECD Guidelines for State-Owned Enterprises

• The government should not be involved in the day-to-day management of SOEs.
• The state should respect the independence of SOE Boards.
• Empower and improve the quality of SOE board
• SOEs boards should monitor management without undue political interference.

• **SOE boards should have the same responsibilities and liabilities as per company law.**
Code of Conduct for Govt. as Owner

• Departments- **custodians** of public enterprises on behalf of Government and public at large.

• **Arms-length-distance** by the Ministries.

• Not more than two Govt. nominees on the Board.

• In extraordinary situations, Govt. may give instructions to the Company only through **directives as per due procedure.**

• There should be a **negative list** of areas which must be kept away from the intervention of the Government due to their commercial, operational or administrative nature.

  - Arjun Sengupta Committee Report
• The Industrial Policy of GOI as part of the Economic Liberalization announced in 1991 mandated that autonomy be granted to Public Sector Enterprises, their boards be professionalized and Annual MOU between Enterprise and Ministry be drawn.

• The Policy of GOI was further reformed in 2004 to build a strong & effective public sector whose social objectives are to be met by commercial functioning, and that full managerial and commercial autonomy be given to profit making PSUs.
• (MoU) is a negotiated agreement between the Government and the management of the CPSE.

• **MOU system is regarded as an instrument to grant further autonomy to the public enterprises.**

• It is intended to fix targets of the CPSE at the beginning of the year and evaluate their performance at the end of the year vis-à-vis the targets fixed.

• Draft MOU is submitted by company to DPE after approval by Board and the administrative Ministry.

• **Autonomy and empowerment of the public enterprise are necessary conditions for effective MOU**
Recommendations

• Government as the owner must take the initiative to empower the SOEs with **full managerial and commercial autonomy**.

• **Board of Directors** should be given full powers in commercial and administrative matters.

• The **complex web of ownership structures** must be simplified fixing clear responsibility and authority.

• **Ownership Policy of the government** must be spelt out without any ambiguity in respect of the functionaries who would exercise the ownership functions.

• **Self regulation** by authority exercising ownership functions.
• Board of Directors should govern and decide.
• **Interface** between SOEs and government ministries and agencies in respect of **decision making** process must be **eliminated**.
• Ownership role be given to **one ministry**, say the DPE or Economic Affairs, instead of to numerous authorities as at present.
• **One year MOU** suffers from limitations regarding outcomes in a year’s time.

• Generally **projects take more than one year** to be completed. The non-financial parameters having projects need 3-5 year time frame for implementation.

• As such there should a flexibility of **3/5 year parallel MOU** (to be chosen by particular public enterprises). The targets may be divided on yearly basis for annual targets setting and performance measurement in the annual MOU document.
• **Commitments / assistance** from government as per MOU document should be reviewed and complied with.

• **RFD** of the Department should reflect such commitments for review and assessment of the Department’s achievement.

• Role of *government Director* who represents the Ministry /Government need to be assessed to ascertain his contribution in achieving the targets and assistance provided by him through his Ministry.

• There should be midterm review of the MOU targets.

• Annual MOU review by Task Force should be more realistic and must adjust targets due to slippages based upon recorded realistic factors.
• Board of the SoE must **exercise the delegated powers**, otherwise the SOE’s performance will not be significant.
• PSEs holding huge funds parked in Banks!
• Economy needs these funds for investment
• Boards can't spend!
• **WHY?**
• **Can the enabling conditions be created?**
• Human Resource Management must go beyond mere **training**.

• Some of the targets (on CSR & Sustainability, R/D, projects) need to be assessed by **third party** external agencies by selecting high value projects.

• Expert agencies may be engaged as **Resource Groups** to assist Task Force.

• Such agencies should be able to present better forecasts and provide global benchmarks for comparison and better target fixing.
• BoD of SoE should have more power in the MOU.
• An empowered Committee of Directors and Independent Directors constituted by the Board should draft and monitor the MOU document.
• Commitments/assistance expected from the Government should be relevant and related to the fulfilment of the agreed performance targets.
• These obligations should have a direct bearing on the performance of the enterprise, and their effect on the performance should be quantified.
• Regarding commitment / assistance from the government / administrative ministry, it is suggested that the **government nominee Director** in the Board of the CPSE should be designated as the Nodal Officer of the ministry and be entrusted with the responsibility of facilitating the required support and assistance from the ministry / government in implementation of the MoU.

• The contribution of the Nodal Officer (Government Nominee Director) should be recognized by making entry in his annual confidential remark by his reporting authority with a report from the Chairman of the enterprise.
• The rating of CPSEs from Excellent to Poor has to be done on a realistic basis.
• It is recommended that a **Moderation Committee** (MC) under the chairmanship of Secretary, DPE with representatives from Task Force (at the level of chairman of Task Force), Ministry of Finance, Ministry of Corporate affairs etc. may be constituted to go into this critical issue and recommend final moderated ratings for CPSEs on a realistic basis.
• Realistic performance target setting depends on autonomy and empowerment of the enterprise to avoid one sided exercise in the MOU process.

• It is being realised that many public enterprises have vast unexploited potential, which need to be fully developed for higher return on investment.
• The state-owned enterprises suffer from district governance challenges.
• There is limitation on autonomy of the Boards of public enterprises.
• The **Independent Directors** are not always selected on grounds of professional experience and expertise.
• Many Director **vacancies** are not filled up in time.
• **Interference** from sources of power outside the Board restricts exercise of authority by the Board.
• Corporate governance cannot be meaningful in developing the full potential of the public enterprises to participate effectively in the MOU process.
• The MOU system can be a tool of empowerment of SOEs
• The **Board** of Directors should be empowered to play their **strategic** role
• With renewed stress on improved profit, sound management principles and good corporate governance practices, the public enterprises are capable of becoming **world-class companies**.
thank you!
Target Setting Process: Looking back and looking forward

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Backdrop

- State Owned Enterprises were established to fulfill social objective as well as to achieve developmental goals.

- The first wave of SOE reforms was initiated in 1970s and 1980s, when a major effort was made to improve SOE performance while maintaining public ownership.

- The second wave of reforms focused on privatization, sale of enterprises to private investors with a belief that under the government vigil the private sector could achieve social goals.

- The third wave of SOE reforms shifted back to the improvement of SOEs while maintaining public ownership. With the experiences of market failures the public sector can only achieve the social and developmental objectives.
Performance of SOEs

**Performance Issue:** Capacity of SOEs to achieve their fullest potential has been an issue, reasons being

- Lack of autonomy (bureaucracy)
- Multiple control points (dispersed accountability)
- Conflicting roles

**Performance Contract System** was adopted as a tool to improve performance of SOEs through streamlining accountability and reducing government control.

India adopted a system of Memorandum of Understanding

- Initially French system
- Later converted to signaling system
- Evolved into a comprehensive score card tool taking a holistic view and including all the critical performance areas of an enterprise
Components of MoU

Components of Indian MoU System:

• Mission
• Objectives
• Criteria
• Target Setting
• Scoring/Evaluation
• Grading
• Incentivizing
Performance Criteria

- Performance criteria defined by Government through Govt. Guidelines
- MoU system in India includes Financial and Non-financial criteria
  - 50% financial criteria like gross margin, net profit, EVA, PBDIT etc
  - 50% Non-financial criteria like Capital expenditure (expansion, technology upgradation, Project implementation, HRD, Sustainable Development, CSR etc
- Key Determinants:
  - Currently, the performance targets of enterprise are fixed based on their performance for last 5 years. In the case of enterprises performing badly, the targets are fixed based on the average performance of the last three years
  - Alternatively there are other mechanisms for deciding targets such as inter-firm comparisons and trend analysis for assessing performance improvement.
  - Yardstick competition is applied by a target-setter based on the unit costs in similar enterprises, Work study and management audit is also used to set up targets, which represent reasonably efficient performance, though this method is slow and costly.
Determinants of Target Setting

- Capacity utilization and expansion are also considered for determining targets
- Nature of enterprise (social sector enterprises, sick and loss making enterprises could have lower weightage for financial criteria)
- Presence of private players in area of operation could also lessen the emphasis on financial criteria
- Group Targets
- Negative marking for non-compliance
- *Negotiations conducted for finalizing the targets*
Negotiation

The CPSEs enter into a process of negotiation with government for finalising the performance targets. The steps involved:

- At draft stage of MoU development
- During finalisation
- Agreement on performance targets
- Mid review of progress
- Determining timelines for achievement of targets
- Negotiations due to gaming have constrained evolving realistic targets which could be seen from the fact that the real growth of targets in financial terms is less than 5% as most of it is neutralized by inflation
Issues in Target setting

• Long list of performance criteria
  • Currently the MoU signed by the enterprises has more than 20 financial targets and around 10-15 non-financial which is a big number. Ideally the targets should be between 6-8 in No.

• Discrepancy between MoU Targets and Targets for other business plans submitted to the ministry
  • CPSEs have a tendency to fix separate targets for MoU and for other planning documents

• Flow of Information
  • There is no proper flow of information between the enterprise manager and the ministry leading to poor target setting
  • This also effects the process of negotiation

• Lack of Research:
  • Lack of research base and Information asymmetry between SOE and ministry. Soft targets leading to over achievement which is rewarded
Issues in Target setting

- **Process limitation:**
  - MoU a negotiated/Agreed/written document and has been used more for gaming than accepting challenges of improving upon the performance targets
  - Does not follow the bottom-up approach

- **Corporate governance issue:**
  - Lack of accountability at the top level
  - Fixing Boards responsibility for targets

- **Monopoly/government control**
  - Does not give benchmarks to set with other players
Strengthening Target Setting

- **Improve data flow:**
  - A robust Management Information System to developed and implemented
  - Industry/sectoral data to be collected and shared with Ministry, Task force and other evaluating agencies and stakeholders from time to time

- **R&D/Innovation Cell:**
  - Target setting process to be backed up by strong research evidence on industry/sector on a continuous basis
  - Innovation cells to be established

- **Benchmarking (Outputs/Process)**
  - Benchmarking exercise to be continuously done with similar sectors global including private sector
  - Benchmarking of processes across industries in public and private sector vital

- **Group Targets**
  - Targets which need more than one organization to contribute for its achievement are identified
  - Helps in sorting out cross cutting issues for better achievement of results

- **Incentives and Disincentives**
  - PRP is being implemented since 2010 integrated with MoU system. PRP is low when benchmarked with Korean SOEs
  - MoU guidelines (2015-16) provides for negative marking in case of non-compliance to corporate governance and other issues
Comprehensive Tools Used

- **Balanced Score Card**: used for SOEs to improve enterprise profitability, provide required guidance to enterprise managers, build consensus and improve communication among stakeholders. Jinshan Telecom a unit of China Telecom (an SOE) implementing BSC with considerable success. The present system does not take the full view of the balance scorecard.

- **Economic Value Added**: tool designed to give managers of SOEs better information to make decisions. Introduced by the State-owned Assets Supervision and Administration Commission of the State Council (SASAC), for 129 Chinese SOEs under direct administration of central government since 2010. EVA is RoI – Cost of Capital. Many Maharatnas and Navaratnas have cut into the EVA (to be explained through financial ratios).

- **Total Factor Productivity**: TFP is a composite measure of technological change and changes in the efficiency with which known technology is applied to production. The translog index of technology changes is based on a translog production function, characterization by constant returns to scale. There are enough number of cases where enterprises have been found doing well on the financial front but their TFP is either stagnant or declining or is not rising in proportion to the growth of the financial parameters (to be explained Algebraically).
Factor Productivity (average partial and total) of CPSEs in India

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Source: Calculated from the CMIE Prowess Database
Total Factor Productivity in CPSEs
Return on Investment and Equity of CPSEs
Calculation of Economic Value Added (EVA) of PSUs Equity Shares for the period 1998-99 to 2008-09 (Contd…)

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Calculation of EVA of PSUs Equity Shares for the period 1998-99 to 2008-09

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Source: Concerned CPSE annual reports and Prowess data base
Thank you
Corporate Governance and Performance at the State level: The case of Indian Power Utilities

Sheoli Pargal
Lead Economist

January 2015
Key Questions

- What is the extent to which Corporate Governance good practices are followed at the state level?
- Does governance in fact impact performance of these utilities?
- Is there an empirical basis for focusing on it?
- What can be learnt from the experience of well-performing state/central PSUs?
Background: Study of Power Utilities at the State Level

- Electricity Act of 2003: Focus on Sector Governance
- Unbundling and Corporatization: Fundamental Changes in Electricity Sector Structure
- Analytic Framework and Data
Electricity Act 2003: Spotlight on Governance...
Aim at improved sector operation, better service delivery

- **Unbundling**
  - Bring Accountability and Transparency to Power Sector Operations

- **Corporatization**
  - Insulate Utilities from State Develop a Commercial Orientation

- **Independent Regulation**
  - Limit Role of State in Sector Introduce Competition Balance consumer and investor interests
The Structure of the Power Sector has been Altered – From SEBs to Multiple Companies

Bundled or unbundled with holding/residual company

Unbundled without holding company

Bundled

Transco separate, Genco & Discom bundled

All Unbundled: One Discom

All Unbundled: Multiple Discoms

- Tripura Corporation
- Sikkim
- Nagaland
- Mizoram
- Jammu & Kashmir
- Arunachal P.
- Goa
- Manipur
- Jharkhand
- Tamil Nadu
- Punjab
- Himachal P.
- West Bengal*
- Uttarakhand
- Meghalaya
- Maharashtra
- Chhattisgarh
- Assam
- Uttar P.
- Rajasthan
- Orissa
- Madhya P.
- Karnataka
- Haryana
- Gujarat
- Delhi
- Andhra P.
Study Approach, Data and Coverage

- Review
  - Utility compliance with corporate governance requirements
- Statistical analysis of relationship with utility performance

- Data
  - From Power Finance Commission on all utilities
  - Basic quantitative corporate governance data on 69 utilities (desk study)
  - Detailed qualitative data from interviews (Board, mgt., SERCs, government), websites and annual reports on 21 utilities
  - Experience of Gujarat, West Bengal and Delhi
Corporate Governance

- Requirements for State Utilities in India
- External Accountability
- Internal Accountability
- Overall Quality of Corporate Governance
Companies Act applies: State Corporatized Utilities
DPE, SEBI Clause 49 are only Guidelines

Companies Act (mandatory)
- Minimum 3-member Board,
- Audit committee: min 3 members, 2/3 of which non-executive
- Minimum frequency of meetings

DPE Guidelines (recommended); also SEBI

Board Composition:
- Executive or “full-time” directors” <50% of the Board.
- Government representatives ≤ 2 (< 1/6 of the Board)
- Independent directors ≥1/3 of Board (if the chairman is a non-executive); else 50%

Board Functioning:
- Meet ≥ 4 times per year, with max 3-4 months between meetings.
- Peer evaluations of non-executive Board members

Audit committee:
- Required
- >= 3 members, two-thirds of which, including the chairman, must be independent directors.
- Able to understand basic financial statements

Government-Board Relationship
- Clarity about where the Board has decision-making powers and where the Board must seek government approval.
External Accountability: Government- Board Relationship needs to be Arms Length but isn’t always!

Number of Gov. Directors
- Discoms
- Gencos
- Transcos

Number of Utilities
- No more than 2
- More than 2

Government Involvement
- Recruitment, Promotion
- Other Routine Matters

Gov. Participates
Board Independence limited: Too few Independent Directors

About 40% of sampled utilities have at least two independent Board members.

15% of utilities comply with DPE guidelines – including utilities in Assam, Gujarat, Haryana, Madhya Pradesh, Orissa, and Uttarakhand.

31 utilities (46% of the sample) have no independent directors on their Boards - including utilities in AP, Chhattisgarh, Gujarat, Haryana, Karnataka, Maharashtra, Orissa, Punjab, Rajasthan, Tripura, and UP.
Progress in Public Accountability -- but More is Needed

40% publish audit reports on their websites
86% file their accounts on time
Internal Accountability: Monitoring Management, Strategic Oversight

Board Effectiveness in Monitoring depends on Independence, Size and Stability

Average Chairman/CMD Tenure

- Haryana: DHBVN (D)
- Uttar P.: KESCOM (D)
- Rajasthan: AVVNL (D)
- Delhi: DTL (T)
- Uttar P.: UPPTCL (T)
- Rajasthan: JVVNL (D)
- Orissa: OPTCL (T)
- Haryana: UHBVN (D)
- All Others (Avg.)
- Wb. Bengal: WBSETCL (T)
- Madhya P.: MPPoKVVCL (D)
- Andhra P.: APSPDCL (D)
- West Bengal: WBPDCL (G)
- Maharashtra: MSPGCL (G)
- W. Bengal: WBSEDCL (D)
- Delhi: TP-DDL
- Tripura: TSECL
- Madhya P.: MPPTCL (T)

Average 2.2 years

Board Size

- Average Chairman/CMD Tenure:
  - Average 8.3

- Number of Directors
  - Discoms
  - Gencos
  - Transcos

- Number of Utilities
  - 4-6: 8
  - 7-9: 22
  - 10-12: 7
  - 12+: 1
Ability to Monitor and Incentivize Management Requires Distance – and tools!

Audit Committee Headed by Independent Director

Executive Directors

Limited use of Specialized Committees for Monitoring MIS/ERP in only 1/3 utilities; limited use of Merit-based Performance Mgt.
## Index of Compliance with Basic Guidelines

| Indicator               | Utility Receives a 1 if... | Share of sample (%) meeting this | Sample size | Number of utilities complying |
|-------------------------|----------------------------|________________________________|-------------|------------------------------|
| **External Accountability** |                            |                                  |             |                              |
| Independent Directors   | >= 33% or >=50% if chairman is executive | 15                               | 67          | 10                           |
| Govt. Directors         | <=2                        | 28                               | 67          | 19                           |
| Audit made Public       | Yes                        | 45                               | 67          | 30                           |
| Publish Accounts        | Yes                        | 58                               | 67          | 39                           |
| Use External Auditor    | Yes                        | 100                              | 67          | 67                           |
| **Internal Accountability** |                            |                                  |             |                              |
| Executive Directors     | <=50%                      | 81                               | 67          | 55                           |
| Board Size              | <=12                       | 97                               | 67          | 65                           |
| Audit Committee         | Yes                        | 93                               | 67          | 62                           |
| **Overall**             |                            | 61                               | 67          |                              |
Utility Boards Dominated by State Government

Share of Utilities in Compliance with Basic Good Governance Practices

- Executive Directors
- External Auditor
- Accounts are published
- Government Directors

Percent

- All sample utilities
- All sample distribution utilities
**Internal Processes and Accountability (Detailed study of 21 utilities; avg. compliance 46% )**

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**Management Practices**
- ERP/MIS *
- Performance-Linked Incentives *
- Employee Training Policy *
- Merit-based Promotions *

West Bengal, Gujarat and Delhi do well
Governance and Performance

- Expected Relationships
- Correlations
- Exploratory Regression Analysis
Expected Relationships

A higher share of **independent directors** will be associated with stronger performance.

Agnostic on the relationship between share of **executive directors** and performance, though the fact that DPE restrict the share would indicate a negative expected relationship.

**CMD tenure** is expected to be positively related to firm performance.

**Board size** is expected to be negatively related to performance or might have an inverted U-shaped relationship with performance, with a “mid-size” Board being optimal.

**Basic corporate governance index** is expected to be positively related to performance.
Correlation observed:
Corporate Governance and Performance

Profit per unit excluding subsidies, 2010

Profit/Unit:

(+) CMD Tenure
(+) % Independent Directors
(-) % Executive Directors
(+) Detailed Index

R² = 0.42

Detailed CG Index score
## Regression Results: Exploratory Analysis

### Dependent Variable: Profit per Unit excluding Subsidies (2010) - All Utilities

#### State-Level Controls incl. Regulatory Indexes

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#### Utility-Level Controls

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#### Corporate Governance Variables

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| N  | 61 |
Bringing it all together

- Conclusions
- Recommendations
Conclusions

- Corporate Boards are undermined by State Govt.
  - Too few independent directors
  - Short CMD tenures
  - State involvement in procurement, recruitment, etc.

- Implementing DPE guidelines can lead to higher profits
  - Independent directors
  - Executive directors

- Need external source of scrutiny, pressure to perform
  - SERCs? Regulating/sanctioning SOEs is hard, the revolving door
  - Market listing?
  - MoUs? ... but state interference? Data?
Recommendations

Professionalize and empower the Board
- DPE guidelines
- Independent directors appointed by committee including CEA/CERC
- Lenders to appoint an independent director

Institutionalize arms length relationship with state government
- Articles of Association (WBengal)
- MoU (as in CPSEs) but adapted for situation of state utilities
- “Shadow Listing” (WBengal)
- Divest some equity to CPSUs such as NTPC or PGCIL?

Greater accountability through “full” unbundling (staff, accounts)
- Operational and financial independence of each unit

Invest in data
- For Board to manage and monitor performance
- For external stakeholders (government, public, regulator) to monitor Board