Principles of corporate governance in Ukrainian state-owned companies: Concept note

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Version 2 – August 28, 2014

Context

The Ukrainian government proposes a fundamental restructuring of the Ukrainian gas market. As a result, the market will be deregulated and Naftogaz of Ukraine will be unbundled as a gas monopolist. Instead, a number of new companies will be set up, based on the principles of the EC’s Third Energy Package.

This represents a unique opportunity to establish a clean-slate corporate governance system at these companies rather than reform governance at existing companies. This also offers the government an opportunity to have the new companies become champions of good corporate governance in Ukraine. First, they can drive this process by setting higher standards of corporate governance that others can use as an example. Second, they can give a strong impetus to the development of the national capital market, showing how good governance matters for raising debt and equity.

What corporate governance is about

Corporate governance was originally understood under Shleifer and Vishny’s 1997 classic definition: “Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment.” The definition had become much broader as more and more corporate stakeholders were included (not only providers of financial capital).

International Financial Institutions, such as the IFC or EBRD, now commonly use the following definition that was adopted by the Global Corporate Governance Forum: “Corporate governance refers to the structures and processes for the direction and control of companies. Corporate governance concerns the relationships among the management, Board of Directors, controlling shareholders, minority shareholders and other stakeholders.”

Consequently, the three most important corporate governance bodies are the general meetings of shareholders, the board of directors, and the management team (see Figure 1).

1 Useful comments by Yuriy Vitrenko are gratefully acknowledged.
2 This definition was itself adapted from the definition in the 1992 UK Cadbury Code.
Why corporate governance matters

The purpose of developing corporate governance at the newly created gas companies is threefold:

- **Enhance corporate performance.** As a result of separation of ownership, control and management, the corporation is faced with the agency problem, meaning that management possesses superior information about the corporation and may not act in the best interest of the company and its stakeholders. Good corporate governance offers a solution to the problem by reducing that information asymmetry through improved transparency and accountability. First, this helps to prevent outright stealing from the company (massive tunneling of funds and misappropriation of assets due to corruption was allegedly the main cause of loss-making at Naftogaz). Second, this leads to more efficient investments, risk management, and improved operational performance.

- **Improve access to capital.** By becoming more transparent, corporations become more attractive investment targets for outsiders and are in a much better position to raise external capital. In Ukraine’s current weak institutional setting, international financial institutions (IFIs) are the only prospective investors who can feasibly assure themselves of protecting their investment. However, by investing in local companies, they can motivate private investors to step in and co-invest. Besides improving the cost of funding for the company, the debtors will impose covenants that will serve as an important additional incentive for maintaining good corporate governance.

- **Develop capital markets.** Due to better protection of shareholder and creditor rights, investors are more willing to invest in well-governed companies rather than in poorly...
governed ones, especially in countries with weaker institutions. Therefore, a large number of well-governed companies will collectively attract more debt and equity capital, encouraging the development of a capital market, which is otherwise nearly non-existent in Ukraine. The newly created gas companies can pioneer this process. In many other European countries, major gas companies' stock forms part of blue-chip indices (e.g., RWE and E.ON on the Frankfurt Stock Exchange, GDF Suez on the Euronext Stock Exchange in Paris and in Brussels, OMV on Vienna Stock Exchange, or Eni on Milan Stock Exchange).

Despite the common definition and general agreement that corporate governance matters for corporate performance, researchers have recently agreed that there is no one-size-fits-all approach to corporate governance, and that efficient governance solutions will differ depending, at least, on the company’s institutional setting and ownership. In our case, these three factors can be described as follows: (a) the weak institutional setting of the a former Soviet Union republic; and (b) full state ownership. We discuss these elements seriatim.

Corporate governance matters more in emerging markets

Emerging markets are generally characterized by weaker institutions, including poorer legal protection of investor rights. Under poor protection by the state, the company may try to convince investors that their investment is safe by raising its level of corporate governance. Specifically, the company may (a) offer investors extensive disclosure of corporate information on its business and performance, and (b) undertake voluntary obligations to respect investor rights.

Figure 2. The importance of corporate governance compared to the importance of financial indicators (Source: McKinsey & Company, Global Investor Opinion Survey 2002)
Strikingly, McKinsey & Company found that good firm-level corporate governance plays a much more important role in Eastern Europe than it does in the rest of the world. Figure 2 shows the results of a survey of minority shareholders who were asked, “How important is the firm’s corporate governance for you, compared to its financial indicators (such as profitability or growth potential), in deciding in which company to invest?” As the figure shows, 40% of investors in Eastern Europe find corporate governance to be more important (world’s highest percentage), while only 15% of such investors find financial indicators more important (world’s lowest percentage).

McKinsey & Company also found that most investors in the world are prepared to pay a price premium for the shares of a well-governed company. The percentage of such investors is more or less the same across the world, equaling some 75-78% (McKinsey & Company, 2002). However, as Figure 3 shows, the size of that premium is the lowest in Western Europe (13%) and North America (14%) and the highest in Eastern Europe and Africa (30%). In particular, it was 38% in Russia. This further supports the thesis that good firm-level corporate governance matters more in countries with poor investor protection.

*Figure 3. Price premium investors are prepared to pay for a well-governed company (Source: McKinsey & Company, Global Investor Opinion Survey 2002)*
Corporate governance in state-owned enterprises

A more complex agency problem

As we said earlier, the agency problem is the conceptual foundation of corporate governance. However, this problem is more complex and more severe in state-owned companies (SOEs) than in privately owned companies.

- It is more complex because there is another layer of the agency relationship, that between the citizens of the country (as the principal) and the government agency representing the interests of the state (as the agent). As a result, when there is no ultimate accountability to ultimate owners, managers lack incentives to run SOEs efficiently. Second, the government agencies may be incompetent or corrupt. Third, the SOEs may be used in the interests of political actors controlling the government agency.

- The agency problem is more severe because the degree of information asymmetry and the free-rider problem may be greater in SOEs than in privately owned companies because it is more difficult for the citizens to control the government agency than it is for dispersed shareholders to control the board and management of their company.

Consider one of the companies that will be set up as a result of the proposed gas market reform: *Mahistralni Gazoprovody Ukrayiny* (MGU), the future owner and technical manager of the gas transmission system that will lease this system to an independent system operator. Since the transmission system may not be privatized, the state will be the only shareholder in MGU.

- As Figure 4 shows, the people of Ukraine is the ultimate shareholder of the company (the principal), while the Ministry of Energy and Coal is the government agency formally representing the citizens in that company and playing the role of the General Meeting (the agent).\(^3\) The citizens have no direct access to the board of directors, as the shareholders of a privately owned firm do (through the General Meeting of Shareholders). Compared to a privately owned firm, an additional – and serious – problem may be that management will act in the best interest of the controlling stakeholder, that is, the Ministry and the individual(s) controlling the Ministry (such as the Prime Minister, the Minister, or some other politician), not the interests of the citizens.

- Since the institutions empowered to monitor state decisions are absent or lacking in Ukraine, the government agency may have the company disclose less information (leading to greater information asymmetry). The people of Ukraine is also subject to the free-rider problem even more than dispersed shareholders are because they have no well-specified share in the company (so depreciation of that share due to mismanagement cannot be measured). Nor do they have formal grounds to participate in the General Meeting. That is, they have even less incentive to demand information or take action against the company than dispersed shareholders do.

\(^3\) Obviously, the interests of the citizens could also be represented by the Cabinet of Ministers of Ukraine or some other government agency, but the nature of the agency problem would remain the same.
Yet another potential concern is that the government agency – or, for that matter, the political actors controlling it – will provide hidden subsidies or offer low tariffs to the SOE’s customers. The reason is that the political actor will be tempted to maintain the paternalistic social contract, which is common in less developed economies endowed with natural resources: The citizens cast their votes for the political actor in exchange for the subsidies or allow him/her to dispose of the surplus obtained from the SOE’s operations at his/her discretion. Although the cost of such paternalism is ultimately borne by society (as subsidies and investments in the SOE are financed from the government budget), its benefits accrue to the political actor.

In particular, most Ukrainian households pay an artificially low price for gas produced in Ukraine (which equals as little as one-tenth of the fair priced charged for industrial consumers, being about $400 per thousand cubic meters). Since low gas revenues from households undermine the government’s ability to invest in the maintenance and development of the gas production infrastructure, own gas production drops steadily as that infrastructure wears out (and so does the Ukrainian government’s ability to subsidize the households in the long run). As a result, the government eventually has to increase its gas imports from Russia – at the market price – and further increase its dependence on Russia as the resource provider.
This is the problem of regulatory governance, which is beyond the scope of this Concept Note. Suffice it to say here that fair pricing and an independent regulator enforcing such pricing are crucial for the efficient functioning of the regulated industry, in which the SOE is active.

Proposed solutions

The IFIs have been well aware of the issues we discuss here. Their earlier approaches to the problem have traditionally advocated privatization as the solution. The most commonly invoked argument was that private ownership creates incentives for the private owners to run the company efficiently. Perhaps less emphasized, but no less important effect of privatization is that it transfers the rights of control to private owners, thus depoliticizing the decision-making at the privatized company.

Another major benefit of privatization is the increase in public scrutiny over the company (through improved disclosure and shareholder activism). In general, in the parlance of the economist, privatization creates governance mechanisms that help to resolve the problems of incomplete contracting.

However, privatization may not always be feasible, particularly in sectors with strategic importance or industries requiring increased public control over safety. In addition, many privatization recipes have failed, especially in the countries of the former Soviet Union in the 1990s, exposing the importance of the institutions that support the functioning of private ownership (e.g., legal rules and the enforcement system). Academics have increasingly agreed that, in such cases, privatization can only be realized gradually, with institutions created first.

Nonetheless, the benefits of privatization in SOEs such cases should be achieved through governance mechanisms that approximate complete contracting or promote efficient solutions when contracting is incomplete:

- **Incentives to run the SOE efficiently.** This element refers mostly to managerial incentives, that is, management needs to be compensated as well as it would in a comparable private company. This implies that such compensation should be at a level sufficient to attract, retain, and motivate people with the professional skills necessary to run the SOE to work for it. In addition, management compensation must be linked to corporate performance. A number of qualifications are appropriate, however.

  First, performance indicators in an SOE would obviously be different than they are in a listed company. For example, management incentives cannot be linked to the share price; nor is managerial stock participation possible. Yet, they can be linked to measurable financial or non-financial corporate objectives, such as realizing a certain level of revenues or attaining a certain level of infrastructure development. Such objectives – often referred to as key performance indicators (KPIs) – are necessary for corporate decision-making in the first place.

  Second, numerous corporate failures around the world have demonstrated that KPIs are susceptible to gaming, smoothing, and mere manipulation. Therefore, corporate objectives ought to be clearly stated, well monitored, and revised when the business circumstances change. In addition, KPIs should be used as guidelines, not as sole targets, for determining the level of managerial compensation. Rather, they should be part of a holistic evaluation of
management’s contribution, which would also take into account the new circumstances and the effort undertaken by management.

Third, because such assessments are necessarily subjective, a key question is who is best placed (and most trusted) to perform them. As follows from Figure 4, a well-governed SOE needs to have mechanisms for that purpose at the level of the board of directors and the level of the ultimate shareholders, being the citizens (see the following paragraphs on this). One particular concern for SOEs in regulated industries is to make sure that management should not misuse the SOE’s privileged or monopoly position in its quest for high performance. However, this does not change the fact that managerial compensation in SOEs can be linked to corporate performance.

All in all, management has the best expertise and is best informed to propose a corporate strategy. In practice, it is also management who will propose a strategy – including the KPIs and incentives – before the fiscal year begins. That strategy will be reviewed by the board of directors, which will have the exclusive right to ratify, amend, or reject it. At the end of the quarter/year, management will report to the board, and the board will evaluate management in view of the original projections and, possibly, the changed business situation, as well as decide how to reward/punish management. (In case of very poor performance, the board will dismiss management.)

- **Depoliticized corporate decision-making.** Political insulation of the company requires an explicit withdrawal of the government and its agencies from any political influence and intervention with the SOE’s business beyond the state’s reasonable and transparent interests as a shareholder and the agent of the citizens.

One condition for achieving this are national level regulations and corporate procedures that are as objective and verifiable as possible. This implies, particularly, a clear separation of the regulatory functions and clear ownership policies. In our earlier example, the Ministry of Energy and Coal of Ukraine would not be suited to perform the role of the General Meeting in MGU (see Figure 4), if it retained the regulatory function. To eliminate that conflict of interest, the Ministry would have to transfer that function to the National Regulatory Commission for Energy of Ukraine (NRCEU).

The regulator’s primary duty is to protect the interests of consumers, where possible by promoting competition. For example, the energy market regulator would determine the tariff methodology for the natural gas transmission system and natural gas storage facilities, as well as for natural gas distribution system operators. (The government – perhaps, through a specialized government agency such as the ministry – would still perform the strategic planning function, as well as ensure oversight of environmental, energy saving, and safety regulations.)

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4 This is not to say, of course, that such evaluations are arbitrary. Objectivity can be achieved due to clear statement of the corporate objectives/incentives and the use of established evaluation techniques (such as the 360-degree feedback).

5 The normal practice is also that most decisions proposed by management are approved by the board after a critical review.
Another condition is independent corporate decision-making bodies, particularly, a strong and independent board of directors. In particular, the board of directors should be composed of a majority of independent directors, and the positions of the board chairman and the CEO should not be jointly held by one person. Given the board’s monitoring function, the remuneration of directors should not be linked to the SOE’s performance. The board’s decision-making should be further strengthened and made independent through specialized board committees (such as the nomination/remuneration committee, the audit committee, and the ethics committee), which are preferably composed entirely of independent directors. Finally, the board should itself undergo a formal review by an external reviewer.

- **Public scrutiny over the SOE.** In principle, the SOE owes its accountability to the people of Ukraine, its ultimate owners, rather the government agency that it immediately answers to. Extensive disclosure and exceptional transparency are required to make it easier, if not feasible, for the analysts, the media, and the public to scrutinize the SOE’s management and board of directors. International experience has demonstrated that public scrutiny and media pressure can have a very powerful effect even in privately owned companies.\(^6\)

First of all, this implies clarity about the SOE’s strategy and its objectives (including separation of social and commercial activities). It also implies clear disclosure of the financial results and their independent audits (through annual reports and frequent interim reports, as well as regular conferences for the media/public); corporate governance policies and compliance with these policies; audit fees paid to the external auditors; remuneration paid to top managers and board members; information on transactions involving conflicts of interest, related-party transactions, and material procurement contracts; and the like.

In sum, the above principles should become the backbone of the corporate governance system in Ukrainian SOEs. The state must only ensure that it gets a fair return on its investment in the SOE, achieving corporate efficiency and avoiding market abuse.

**International practices**

International corporate governance practices in SOEs are very diverse and depend largely on the institutional setting (including the national legislation), the degree of state ownership in the firm, and the industry (including the industry regulations). For a valid illustration, we have chosen European oil and gas companies as a reference (see Table 1).

Three principal conclusions can be drawn from Table 1. First, the state’s share is usually held either through a specialized holding company or directly through the government (e.g., a ministry). Second, listed companies are generally more transparent than SOEs. Third, however, being state owned does not prevent a company from attaining a high degree of transparency and extensive disclosure. In fact, the Italian oil and gas company Eni, in which the state owns a controlling stake, has demonstrated this by becoming of the world’s best-governed and most transparent companies.

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\(^6\) For example, in 2003, the compensation package of the newly hired CEO of Albert Heijn, a major Dutch supermarket chain belonging to the privately owned group Royal Ahold, was reduced and the board chairman of the group resigned after fierce protests by the consumers against the size of the package.
### Table 1. State ownership in European oil and gas companies

<table>
<thead>
<tr>
<th>Company</th>
<th>Country</th>
<th>Description</th>
<th>State owned?</th>
<th>Listed?</th>
<th>Agency representing the state</th>
<th>Disclosure/transparency</th>
</tr>
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<tbody>
<tr>
<td>GDF Suez</td>
<td>France</td>
<td>A multinational company operating in the fields of electricity generation and distribution, natural gas and renewable energy</td>
<td>Yes</td>
<td>Yes</td>
<td>4 directors (out of 17) are representatives of the State (appointed in accordance with the national law).</td>
<td>Medium low</td>
</tr>
<tr>
<td>OMV</td>
<td>Austria</td>
<td>An integrated international oil and gas company. Its main businesses are exploration and production of oil and gas, natural gas distribution and power generation, and refining and marketing oil products.</td>
<td>Yes (31.5%)</td>
<td>Yes</td>
<td>Österreichische Industrieholding AG (ÖIAG) ÖIAG owns 31.5%, IPIC 24.9%, free float is 43.3%. There is a consortium agreement between ÖIAG and IPIC providing for block voting and certain restrictions on transfers of shareholdings.</td>
<td>High</td>
</tr>
<tr>
<td>Eni</td>
<td>Italy</td>
<td>A multinational oil and gas company. Operations: exploration &amp; production; gas &amp; power; natural gas; power generation; refining &amp; marketing; engineering &amp; construction</td>
<td>Yes (30.303% golden share)</td>
<td>Yes</td>
<td>Ministry of the Economy &amp; Finance (3.934% held through the state treasury and 26.369% held through the Cassa Depositi e Prestiti) → also has a Board of Statutory Auditors</td>
<td>High Champion of good corporate governance, various for its transparency</td>
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<td>Fluxys</td>
<td>Belgium</td>
<td>A company mainly acting as a natural gas transmission system operator. In 2004, its infrastructure comprised about 3,700 km of pipelines and a terminal in Zeebrugge, Belgium.</td>
<td>Yes (77.7%)</td>
<td>No</td>
<td>Publigas, the Belgian municipal holding company in the natural gas sector that was created in 1996. Publigas brings together Belgium’s intermunicipal energy companies. Board of directors of Fluxys: shareholder representatives + state representatives</td>
<td>Medium high</td>
</tr>
<tr>
<td>Petoro</td>
<td>Norway</td>
<td>Manages Norway’s portfolio of exploration and production licenses for petroleum and natural gas on the Norwegian continental shelf</td>
<td>Yes (100%)</td>
<td>No</td>
<td>This portfolio is collectively called State’s Direct Financial Interest (SDFI). The company also has a control function surveying Statoil’s production on behalf of the government. Petoro is not an operator of any fields and does not directly own the licenses.</td>
<td>Medium high</td>
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*Note: Disclosure/transparency ratings range from low to high, with medium high being most transparent.*
<table>
<thead>
<tr>
<th>Company</th>
<th>Country</th>
<th>Description</th>
<th>Access</th>
<th>Control</th>
<th>Other</th>
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<tbody>
<tr>
<td>E.ON</td>
<td>Germany</td>
<td>A holding company based that runs one of the world's largest investor-owned electric utility service providers. In 2003, E.ON entered the gas market through the acquisition of Ruhrgas.</td>
<td>No</td>
<td>Yes</td>
<td>–</td>
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<tr>
<td>RWE</td>
<td>Germany</td>
<td>An electric utilities company based. Through its various subsidiaries, the energy company supplies electricity and gas to more than 20 million electricity customers and 10 million gas customers, principally in Europe.</td>
<td>No</td>
<td>Yes</td>
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Raising capital by SOEs in emerging markets

A distinct feature of fully owned SOEs is that they have no option of raising equity and, therefore, only can attract debt capital. In terms of corporate governance, creditors play a disciplining role: They constrain managerial discretion by imposing additional limits on spending, asset transfers, and risk taking. In addition, in regulated industries, the incentives of the shareholders and creditors may be particularly well aligned, since there is little uncertainty about the industry, and the cash flows are quite stable.

In Ukraine, however, the debt market is very shallow, and the cost of debt for Ukrainian companies is prohibitive, perhaps due to the weak institutions discussed above. Under the present circumstances, IFIs are the only type of investor that can feasibly offer debt capital on terms comparable to those in developed economies and “assure themselves of getting a return on their investment”:

- An investor such as IFC or EBRD can compensate for the weak institutions and catalyze investment by private investors. In addition, numerous IFIs have recently adopted a unified approach to corporate governance, making it easier for multiple IFIs to invest in the same project without carrying out independent evaluations.

- Investments in large well-governed companies will stimulate the development of capital markets, which is one of the policy priorities for many IFIs. This will also offer a broader opportunity to drive corporate governance change at the national level, encouraging changes in law and changes at the regulatory level.