ADDRESSING THE SECTORAL AND CORPORATE GOVERNANCE REFORM NEEDS OF STATE-OWNED ENTERPRISES: THE EBRD APPROACH

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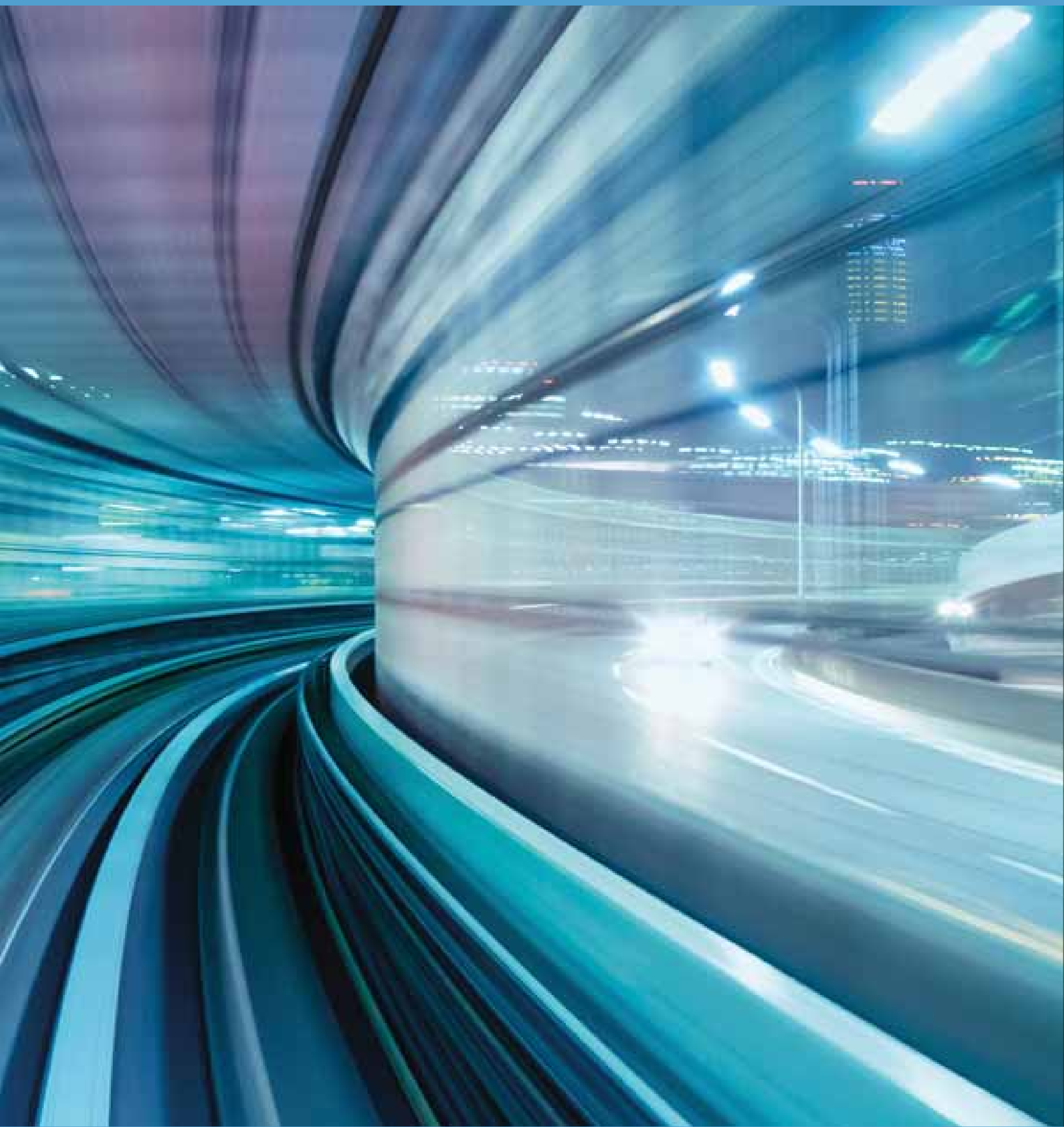

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State-owned enterprises (SOEs) still play an important role in many economies in which the EBRD invests, especially in key industries such as energy, water, gas, road and railway infrastructure, railway transport and postal services, but also in sectors where the need for the state's involvement is less obvious,including telecoms shipping and even manufacturing services.

Against a backdrop of ever-increasing complexities in global supply chains and a succession of crises such as Covid-19 pandemic, the Russian invasion of Ukraine and spiralling inflation, SOEs have been an important source of stability in many developed and emerging economies. They have also been instrumental in maintaining the flow of essential goods and services to citizens and the economy. This is why, in recent years, international financial institutions including the EBRD have stepped up their focus on policy engagements with SOEs. While the core mandate of the Bank remains private sector development, increasing the quality of policy interventions with SOEs improves the investment climate and enables more private ownership.

In the past, SOEs were seen mainly as obstacles to economic development, especially when the state mandate extended into areas where the private sector proved to be much more efficient and innovative. Recent crises have revealed another side of SOEs' function. For example, the climate crisis has shown that for renewable energy to scale up to the level required by the Paris Agreement, electricity networks must be able to manage the flows of energy – and those networks are state-owned in most countries. In the case of Ukraine, SOEs have been crucial in ensuring the flow of indispensable goods and services throughout the country, such as maintenance of electricity and transport networks that were, in some cases, badly damaged and by maintaining functioning of railway transport and postal services. Once the aggression ends, SOEs will be just as important in helping to rebuild the country.

While ensuring stability in matters such as energy and food security is paramount in the short term, we should not lose sight of the bigger picture: the need to achieve balanced and sustainable development and move the dial in terms of the reliability and quality of services of public interest. In parallel with providing finance for major infrastructure improvements, there is also a great need to advance the reforms in both the governance and sectoral legal frameworks as well

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as market structures. This provides a unique opportunity to combine sector-level reforms and improve the efficiency and capacity of SOEs involved in those sectors.

SECTOR AND GOVERNANCE REFORMS OF STATE-OWNED ENTERPRISES: TWO PIECES OF THE SAME PUZZLE

SOE governance, sectoral policies and market reforms are closely related. The notion of sectoral reforms refers to changes made in an industry or market – frequently with heavy state participation – such as the energy or transport sectors. This often includes interventions such as unbundling, setting up an independent regulator, introducing public service contracts and tariff reforms. SOE governance reforms focus on improving the management and accountability of SOEs (including through enhanced corporate governance structures) and the way these enterprises are overseen by the state as the shareholder. By combining these two types of reforms, governments can address systemic problems that affect both the quality of public services and the efficiency of SOEs. In sectors where public services are crucial, such as infrastructure,

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SOEs are typically used as vehicles to ensure delivery of policy and social goals in terms of development and performance.

In some cases, the borders between SOE reforms and sector reforms can be blurred and it can be hard to tell where one starts and the other finishes – especially if we are looking at an SOE with a natural monopoly in a given sector of a country. Changing something in the SOE would have an immediate impact on the whole sector and vice versa.

Important synergies can be achieved by combining these policy tools and realising that the interplay between SOE governance reforms and sector reforms can be seen through several perspectives.

First, when it comes to promoting both financial and operational efficiency, SOEs often operate in sectors that are essential for the economy and society. If these enterprises are inefficient or ineffective, it can (and often does) result in lower productivity, higher costs and reduced quality of goods and services. Policy action can mitigate this risk for essential sectors and natural monopolies. In other cases, however, SOE reform could just serve to diminish the role of the state in the economy. For example, unbundling SOEs in the infrastructure sector, including the energy industry, is often a policy tool to foster private-sector participation and improve efficiency and productivity.

Second, when it comes to the relationship between SOEs and public finances, companies that do not operate effectively present a fiscal risk and can become a drain on the state budget. They may also be the reason behind inefficient allocation of state budgets. This often happens when the state subsidises the SOE because it performs a service of public importance, but without clear parameters of the quality and cost of the service provided, which translates into less funding being available for other priorities of the government. SOE privatisation can also offer an opportunity to improve the state budget by realising income and reducing liabilities. Other times, SOEs are at risk of becoming a vehicle for political or populist goals – for example, when a certain good or service is supplied below cost recovery, thus hampering market competition and ultimately the economic development of the country, or when the SOE is used for clientelism.

It is important to have clearly defined dividend policies that take all of these considerations into account and that are also aligned with the state-owned enterprise's strategy and investment plans.

It is therefore in the government's own interest to ensure that SOEs deliver on what is expected of them and do so in the most efficient manner possible. Here, sector reform can be helpful in strictly defining the nature and quality of the services to be provided by the SOE in the form of a public service obligation or different performance contracts, which are costed according to a methodology agreed between the SOE and the state and which then become a contractual obligation of the SOE to the state. This helps to clarify expectations from the company and also provides transparency on the actual cost to the government for requiring these services. In case of deviations from the defined targets, it is easier to distinguish justifiable deviations from mismanagement or even corruption, thereby strengthening the accountability of the SOE's decision-makers.

On the other hand, the state may look at profitable SOEs as a source of revenue for the state budget. While this is legitimate, it is also very important that any potential dividends from the SOE are considered within a broader context and that the company's profit can – to the extent needed – be used for its further growth and development, which includes contributing towards meeting sectoral objectives. For example, a profitable energy company that depends on coal should certainly be encouraged, if not expected, to use part of its profits to decrease its carbon footprint. This is why it is important to have clearly defined dividend policies that take all of these considerations into account and that are also aligned with the SOE's strategy and investment plans.

EBRD'S WORK TO STRENGTHEN SECTOR REGULATION AND STATE-OWNED ENTERPRISE GOVERNANCE

The EBRD has a long record of investment and policy dialogue in key sectors across economies where it invests, as well as supporting SOE company-level transformations. This is also recognised by the EBRD Strategic and Capital Framework 2020-25,[1] which defines "stepping up support for commercialisation of SOEs in countries with potential for privatisation" as a priority action and in numerous EBRD country strategies.[2]

This is why the Bank developed a new technical cooperation programme called SOEs Management Assistance Reform and Transformation (SMART). The programme is designed to help the EBRD provide the most appropriate and tailored policy advice to support delivery of strategic transactions with states or SOEs combining governance and sector reforms.

The SMART programme includes support measures that can be undertaken on three levels. First, upstream reform support of SOEs' governance envisages engagement with the state and individual authorities as owners of SOEs, with the aim of improving broader rules governing SOEs such as laws, regulations and standards, as well as building an institutional framework and capacity for overseeing SOEs and setting clear objectives by the ownership function. One level below, on the sector level, the programme envisages support for regulatory improvements that can consist of the redesign of the governance architecture for the sector, amendments to sectoral laws and regulations, development of various tariff methodologies, contractual arrangements between sectoral actors, unbundling, as well as institutional reform and capacity building to sectoral regulators.

The third possible level of intervention is at the level of SOEs themselves. Here, the measures may include corporate governance action plans – tailored plans to improve corporate governance structures and practices at SOEs – as well as corporate development programmes that go beyond the governance structures of the SOE and aim to improve its operational and financial efficiency, strategic and business planning processes, and asset management, and support necessary organisational restructuring within the SOE.

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Finally, as a component that underpins these three levels of engagement, the programme also includes various state, sectoral and SOE-level diagnostic engagements. These are meant to provide the Bank with an understanding of relevant rules, practices and challenges on the ground and inform further policy interventions so the reform needs of economies and clients can be answered effectively.

1. The EBRD Strategic and Capital Framework 2020-2025 can be accessed at https://www.ebrd.com/what-we-do/strategy-capital-framework, (last accessed on 19 September 2023).
2. The argument for SOE reform and improvements in corporate/sector-level governance is further strengthened by the fact that SOE reforms feature as priority activity in the vast majority (30 of 36) current country strategies. In particular, many country strategies envisage support in the commercialisation of SOEs, including improvements in the corporate governance in specific sectors, depending on the country context.

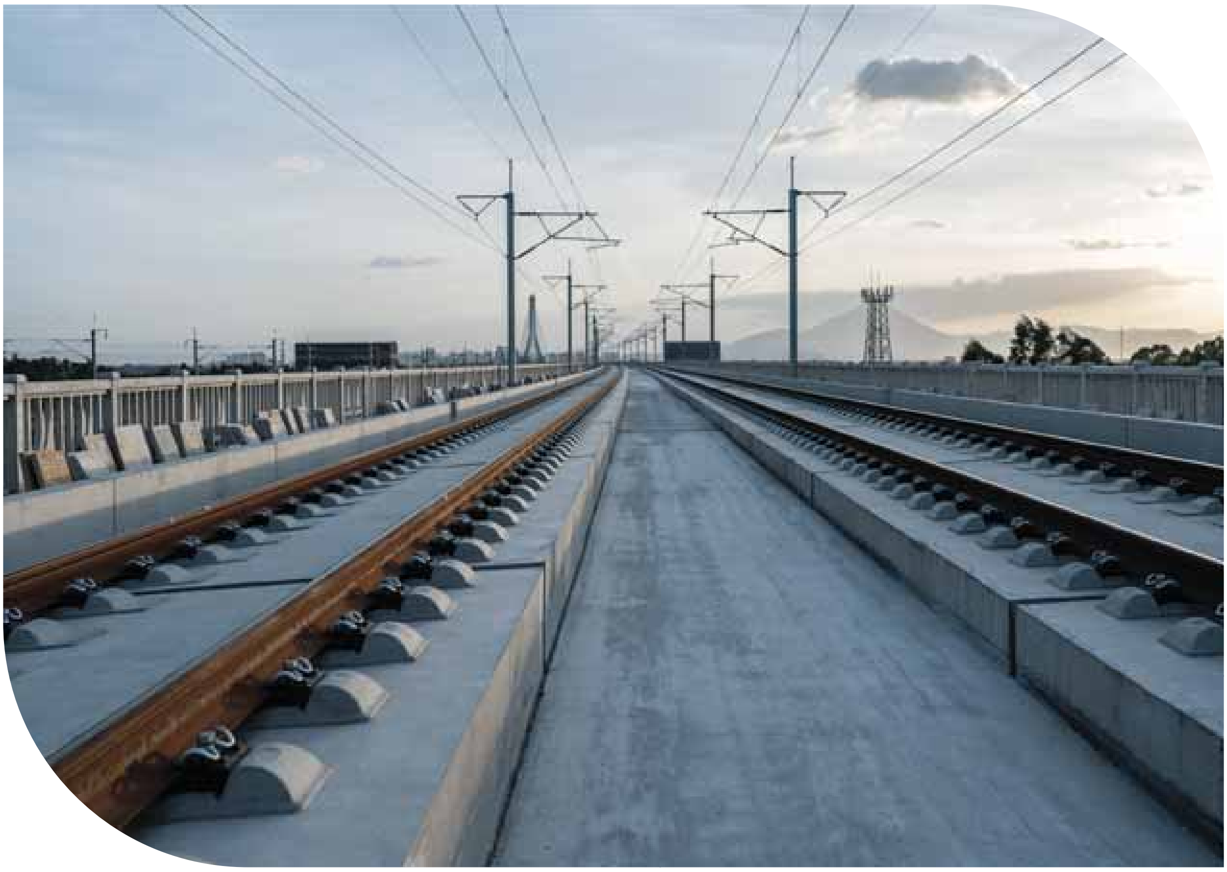
By providing this targeted programme, the EBRD aims to accelerate the mobilisation of resources and be able to react more quickly to appetite for reforms that are complementary to the Bank's financing. In addition, by being able to cover more areas within a single reform package, the EBRD can also bring focused interventions and leverage on the work of other international financial institutions.

SMART FOR UKRAINE: ASSISTANCE WHERE IT'S NEEDED MOST

In addition to the horrific human cost of the invasion, Ukraine also faces unprecedented financial and economic costs. The recent *Ukraine Rapid Damage and Needs Assessment* report,[3] prepared jointly by the government of Ukraine, the United Nations, the European Commission and the World Bank, estimates the total reconstruction and recovery needs at US$ 411 billion as of 24 February 2023. The report also estimates the implementation priorities for 2023 alone amount to US$ 14 billion, with a primary focus on the most urgent needs such as energy, housing, and critical and social infrastructure.

> "Following the EBRD's ambition to commit up to €3 billion in 2022 and 2023 to help Ukraine's economy continue functioning, the SMART programme was designed to include a specific set of actions in addition to the ones mentioned above, to assist with the wartime resilience of Ukrainian state-owned enterprises as well as their contribution to reconstruction efforts."

3 World Bank, Government of Ukraine, European Union, United Nations (February 2022-2023), *Ukraine - Rapid Damage and Needs Assessment*, (English). Washington, D.C., World Bank Group. Available at: http://documents.worldbank.org/curated/en/099184503212328877/P1801740d1177f03c0ab180057556615497, (last accessed on 19 September 2023).



Following the EBRD's ambition to commit up to €3 billion in 2022 and 2023 to help Ukraine's economy continue functioning, the SMART programme was designed to include a specific set of actions in addition to the ones mentioned above, to assist with the wartime resilience of Ukrainian SOEs as well as their contribution to reconstruction efforts. The possible reform interventions here therefore include support to the companies and/or ministry with war-time crisis response and recovery – such as resilience and recovery needs assessment, planning and management of supply chain, logistics, workforce and assets in the wartime and recovery context, support for cyber security, debt and risk management and contingency planning, measures aimed at facilitating procurement in both emergency and recovery contexts as well as integrity support and anti-corruption measures to ensure funds are used for the purposes for which they were intended.

SMART for Ukraine was inspired by EBRD assistance to Ukravtodor, the national road agency with core procurement functions and anti-corruption reforms. First initiated on the back of a loan signed in 2020, these reforms took on a whole new meaning when Ukravtodor was transformed into the State Agency for Restoration and Development of Infrastructure in January 2023. Further policy assistance may be deployed to help the government build anti-corruption and compliance capacity in other core SOEs, including Ukrainian Railways, and to train board directors to oversee SOE activities meaningfully and independently. This builds nicely on the EBRD's long-term involvement in the SOE reforms in Ukraine, which included the roll-out of corporate governance transformations in most of the top 10 Ukrainian SOEs and development of comprehensive amendments to the national regulatory framework for state companies.

CONCLUSION

The Covid-19 pandemic, followed by the energy crisis and the war in Ukraine, reminded everyone of the need to build back better, fuelling the need for both financial and policy support and highlighting the importance of the role SOEs will play in these efforts. Hence, there is a need to enable our clients (both governments and SOEs) to turn challenges into opportunities and embark on reforms that may redefine those markets for decades to come. The EBRD stands ready to support these ambitions with a balanced mix of sector and governance reforms that can help put states and SOEs on a path towards responsible and sustainable development for the benefit of our economies and their citizens.