Accountability and Transparency
A Guide for State Ownership

Chapter 2

Reviewing Performance

This chapter will discuss how to review SOE performance, both on an on-going and annual basis. It will describe the different systems and processes that can be put in place to track and review SOEs' performance on a regular basis, in order to identify problems early and react to them promptly. It will also review in-depth how to evaluate SOE's performance on a yearly basis, i.e. what are the processes involved and the typical information included in performance documents. Finally, it will give some indications on how to develop relevant benchmarking, as the basis for discussing the SOE strategy and assessing the evolution of its value and potential risks.

2.1. Overview

The State's obligation to review the performance of portfolio companies is central to the OECD Guidelines: "*Its prime responsibilities include setting up reporting systems allowing regular monitoring and assessment of SOE performance*" (Guideline II.F.3). To review performance effectively, the ownership entity must first ensure that it has access to accurate and relevant information on a timely basis. The information should allow the ownership entity to continuously evaluate performance and, when necessary, communicate its concerns to the company. Regular and timely reporting reduces the risk of bad surprises and typically gives more time for the ownership entity to take necessary measures. The ownership entity should therefore monitor the performance of portfolio companies both on an ongoing and annual basis.

When putting in place any system for monitoring and reviewing SOE performance, it is necessary to underline the central role of the board. "*The boards of SOEs should be assigned a clear mandate and ultimate responsibility for the company's performance*" (Guideline VI.A). The implementation of the SOE's strategic objectives will depend primarily on the quality of the board. As a first step, the ownership entity should therefore ensure that SOEs have competent boards. It is a prime responsibility of the state as an owner to "*establish well-structured and transparent board nomination processes in fully or majority owned SOEs, and actively participate in the nomination of all SOEs' boards*" (Guideline II.F.2).

Once competent boards are in place, it is necessary that they have continuous training and that they regularly evaluate their own performance. "*SOE boards should carry out an annual evaluation to appraise their performance*" (Guideline VI.F). Based on this evaluation, the ownership entity should be able to sanction bad performance by renewing the board. Although this Guide does not focus on the role of SOE boards, their key role in monitoring performance is important to keep in mind.

The system for **ongoing performance review** typically combines formal and informal mechanisms. The evaluation system needs to balance the information needs of the ownership entity against the autonomy of SOE management. It should therefore avoid putting excessive reporting requirements on SOEs and not bypass the board in monitoring management's performance. Ownership entities will also have to develop their own capacity to treat this information in a productive manner.

The **annual performance review** requires analysis by the ownership entity beyond the company annual reports. This will include an assessment of financial and non-financial results against key performance indicators that have been established in the process of defining corporate objectives and targets. Based on this analysis, actions to be taken by the SOE and the ownership entity will be identified. Evaluation of annual performance should also be used, together with appropriate benchmarking, as the basis for discussing objectives for the coming year. It will also be the basis for discussing the SOE strategy and for assessing the evolution of its value and potential risks.

In order to make the best possible use of the performance review process, it is recommended that corporate performance be compared against a relevant benchmark. This is also recommended in the annotations to Guideline II.F.3 stating that, to monitor performance, the ownership entity "*could be helped in this regard by developing systematic benchmarking of SOE performance, with private or public sector entities, both domestically and abroad. This benchmarking should cover productivity and the efficient use of labour, assets and capital. This benchmarking is particularly important for SOEs in non-competitive sectors*". **Benchmarking performance** adds useful information to the performance review. It brings perspective and allows taking into account any external effects, such as changes in input prices, etc.

In sum, the process of reviewing performance has three important elements. Each of these elements is covered in more detail below, in order to provide guidance on the main steps involved:

- Ongoing monitoring of performance.
- Developing robust systems to review yearly performance of each SOE.
- Benchmarking SOE performance.

When establishing the process for monitoring and reviewing performance, it is important to keep a balance – both legally and functionally – between the ownership entity's information requirements and the necessary autonomy of boards and management to carry out their responsibilities. Consideration should also be given to the internal capacity of the ownership entity to process and make relevant use of the information requested from SOEs. The monitoring and evaluation system should thus remain as balanced and simple as possible.

2.2. Ongoing monitoring of performance

Ongoing monitoring of performance is the system that the ownership entity puts in place to track and review performance on a regular basis. The ownership entity needs to be informed regularly on the performance of each SOE with respect to the agreed targets. In case of partially owned SOEs, the information provided to the ownership entity should, as a matter of principle, also be provided to all other shareholders.

Ongoing monitoring ensures early identification of problems and opportunities. It allows the ownership entity to react promptly on underperformance or on significant changes in the enterprise's environment that may impact its performance. It also allows focusing on priorities, which often is a key factor for medium-term performance.

Some countries will rely mostly on state representatives within SOE boards to be kept informed adequately of SOE performance (see Box 2.1 for the Italian example). Some other countries will put in place a number of more formal processes, such as management information systems with regular detailed reporting requirements. These could entail significant workload both for the SOE concerned and for the ownership entities. Careful consideration should thus be given to the adequate degree of formality of monitoring processes. Relevant cost-benefit analysis should be performed in this regard (see Box 2.1).

The system put in place for ongoing monitoring must on the one hand ensure the collection of sufficient information for the ownership entity to be able to react adequately and promptly in case of underperformance. Part of this system might include a requirement for continuous disclosure by management and/or a "no-surprise" policy, similar to exchange listing rules but also covering events with potential political impacts (see the New Zealand example in Box 2.2). On the other hand, the system must avoid excessive and burdensome additional information requirements for SOEs in comparison with private sector companies. To find this balance can be a delicate task for the ownership entity, and a dialogue with the individual companies about the costs and benefits of different information requirements can therefore be useful.

Box 2.1. **Monitoring of SOE performance monitoring**

A. In Italy

The Ministry of Economy and Finance, which is the ownership entity, carries on a constant monitoring on SOEs' performance and management. Each company is thus required to provide the ministry with the following detailed information and documents:

- the annual budget for the incoming year;
- half-yearly reports on performance and financial results, with details on the differences with the budget and the previous year's figures;
- the estimated year's end figures.

SOEs are also required to point out the potential critical areas and give all relevant information, including the business plans approved by the board.

In addition, the shareholder can receive information on each SOE by its representatives appointed in both the Board of Directors and the Board of Auditors. (The Italian Civil Code [Art. 2449] allows the state as an owner to appoint one or more members of the Board of Directors and of the Board of Statutory Auditors with the same rights and duties of board members chosen by GSM.)

B. Integrated MIS in Greece

A specific and interesting process is being developed in **Greece** in the framework of the current broad reforms of SOE governance. A specific Management Information System has been put in place to collect directly from the SOEs' own information systems the relevant data to monitor their performance. This will constitute a unique system to monitor closely and frequently SOEs' performance. Monthly data will be automatically compared to budget data. The whole system of business plans, budget and performance monitoring will be based on the same data, allowing a closer monitoring and thus greater transparency and accountability.

C. Traffic Lights in the UK

In the UK, a quarterly "Traffic Light" review is done for each SOE. This review evaluates the quality of the shareholder relationship, the implementation of the shareholder model, the quality of the board and management team, the strategy and financial performance.

For each of these categories, a series of questions are to be answered by "yes" or "no" by the portfolio manager with a possibility also to comment. All, or nearly all, "yes" answers give an overall green light, some specific "no" answers may trigger a red light, otherwise the light is amber. (This type of "traffic light" review is sometimes criticised for lacking nuance).

For each category, in addition to the general appreciation, the portfolio manager must indicate the action taken to improve the situation.

An aggregate monitoring table is then built up, indicating for each SOE the colour of the light for each of the categories mentioned above. This is a type of control board for the shareholder executive's work.

It is also important that active ongoing monitoring by the ownership entity does not bypass the board and result in interference in management. The board must be allowed to exercise its responsibilities and the ownership entity's discussions on performance should typically be with the board, even if the ownership also has a dialogue with senior management. This allows the board to retain responsibility to monitor management performance *per se*, as recommended by the Guidelines. There is a balance to be found between ensuring effective ongoing monitoring of SOE performance and avoiding excessive interference in SOE management.

Box 2.2. **No-surprise policy in New Zealand**

In **New Zealand**, the "no surprise" policy is clearly articulated as follows: "*Shareholding ministers expect Crown company boards to adhere to the 'no surprise' policy and be informed well in advance of everything considered potentially contentious in the public arena, whether the issue is inside or outside the relevant legislation and/or ownership policy.*"

Examples of matter that could fall within the "no surprise" policy include:

- Changes in CEOs.
- Potential/actual conflicts of interest by directors.
- Potential/actual litigation by or against the company, its directors or employees.
- Fraudulent acts by the company's directors or employees.
- Breaches of an SOE's corporate social responsibility obligations.
- Significant company restructuring.
- Large-scale redundancies.
- Industrial disputes.
- Significant acquisitions and disinvestments.
- Significant health and safety issues.
- The release of significant information under the Official Information Act of 1982.
- Imminent media coverage of any activity that could attract critical comment or on which shareholding ministers could be asked to express a view.

Source: Owner's Expectations Manual for State-Owned Enterprises, 29 October 2007, CCMAU, New Zealand.

A number of other mechanisms and information channels, such as dedicated contact points within the SOEs or rating agencies, can also be useful to the ownership entity as additional means of getting a better and more complete picture of the company (see the French example in Box 2.3). It is important, however, that such complementary information not confuse the main information channels and depend excessively upon personal relationships. Informal links between the ownership entity and the management should be subject to formal rules, in accordance with company and capital market laws, that ensure that any contacts are transparent to the chair and the rest of the board.

Once the information is collected, the ownership entity must have the capacity to analyze the information and take adequate action. This requires quite specific capacities and competencies that the ownership entity needs to have at its disposal, either in-house or from external experts. There should thus be a balance between the amount of information collected and the internal capacity to treat it.

Box 2.3. **Relationship between SOEs and the ownership entity (APE) and contact points in France**

Acting as an interface between companies and the government as a shareholder, the APE looks after the following aspects:

1. **Monthly reporting implementation:** Companies transmit monthly to the APE sourced directors reports containing the main financial indicators and if necessary qualitative indicators of the activity based on the Executive Committee's internal reporting. The choice of indicators is adapted to each company and is revised regularly.
2. **Regular financial book meetings and preparation of important milestones:** On a regular basis and at least once a year company management teams meet the APE to present main transactions and strategic prospects. These meetings are also the preferred time to highlight the relationship between the APE and the companies and to measure compliance with governance rules … During work on annual budgets for government companies milestone meetings are organised between the concerned public services and the company for a detailed discussion if arbitration is needed. Exceptional investments and external growth operations are subject to detailed upfront presentations before any validation process. Meetings are organised to define accounting methods before the Board of Directors' review of the books.
3. **Searching for better company operational knowledge:** Management teams *define regular correspondents as contact points* within the APE. Management teams propose to their APE contacts fixed meeting programs relative to their specific areas of activity as well as site visits.

Source: *Rules Governing the Relations Between the APE and Companies with a Government Holding*, APE website, *www.ape.minefi.gouv.fr/sections/qu_est_ce_que_l_ape/working_charter*.

Table 2.1. **The main steps and processes to ensure effective ongoing monitoring of SOE performance by the ownership entity**

Main steps	Brief description
Regular information on performance by SOE boards	SOE boards should advise the ownership entity on a regular (monthly or quarterly) basis about where they stand in regards to the achievement of their objectives. They should provide precise data on the realisation of specific targets. To this end, it is advisable that the board meet regularly to conduct a detailed review of the SOE's performance. If there are state representatives on boards, information of the ownership entity might be done "naturally". Ongoing monitoring is part of their function on SOE boards. If there are no state representatives on boards, a specific and formal system might be developed to provide the ownership entity on a regular basis with performance updates. Such progress reports or performance updates could typically include a comparison of actual performance with targets, as well as a qualitative explanation for the current performance. They should also provide main elements of an action plan to address the discrepancies between targets and effective performance. In case of serious underperformance, specific action might be required (see below).

Table 2.1. **The main steps and processes to ensure effective ongoing monitoring of SOE performance by the ownership entity** *(cont.)*

Main steps	Brief description
	Progress reports could also provide information on the human resources including key competencies and the turnover of senior staff members. These progress reports will be provided to the ownership entity on a confidential basis. However, in case SOEs' capital structure is open to other shareholders, the information provided to the state shareholder should not differ from the information provided to all other shareholders.
Put in place systematic information processes	Systematic processes might be developed to monitor more closely and frequently SOEs' performance. Such systems could allow collecting directly from the SOEs' own information systems the relevant data to monitor their performance and automatically comparing it to budget data (see the example of the Management Information System in Greece, Box 2.1).
Develop specific "continuous information"' and/or "no surprise" policy	The ownership entity might develop specific "continuous information" or "no surprise" policies. These will be similar to the requirement for continuous disclosure of market-sensitive information under the usual listing rules, but will have a broader coverage. These policies require SOE boards to keep the ownership entity timely informed about any material or significant events, developments or otherwise that can not only have a significant impact on the SOE's performance and value, but also impact on the sector ministries, the ownership entity or the government either by being contentious and politically sensitive or by attracting public attention in any way. Appropriate implementation of such "no surprise" policy requires SOE boards to understand and be sensitive to the wider policy concerns of the government and be aware of the potential impacts of specific SOE issues on the wider political agenda. The implementation of a "no surprise" policy should not, however, detract SOE boards form their usual obligations nor be an avenue for undue political interference.
Complementary information channels	The ownership entities could develop additional mechanisms to facilitate the flow of performance information to the ownership entity: ● These could include nomination within the senior management team of "correspondents" as contact points for the ownership entity officials. ● They could also include establishing an active dialogue with the external auditors, and even establishing systematic and extensive reporting from the auditors on a regular basis ● Specific "state controllers" might also be positioned within the SOEs in order to have access to information which is not easily accessible by the state as a shareholder.

Table 2.1. **The main steps and processes to ensure effective ongoing monitoring of SOE performance by the ownership entity** *(cont.)*

Main steps	Brief description
Use external information available	External information might also be useful for the ownership entity to complement its own sources. Banks, rating agencies, industry analysts and lawyers could provide the ownership entity with specific ideas on the SOE's strategy, different perceptions of risks and another analysis of performance.
Performance check-up by the ownership entity	The ownership entity might also develop its own evaluation system for a regular performance check-up. This evaluation could be based on performance information provided by the SOE itself. In addition to the evaluation of financial performance, it might also include the ownership entity's own evaluation of key and more qualitative dimensions, such as the quality of the shareholder relationship, the quality of the board and management, and the quality of strategy (see the UK example of Traffic Light Reviews in Box 2.1). These internal reviews might be kept for the ownership entity information only and not shared with the SOE concerned. Such evaluation requires adequate capacity within the ownership entity to collect and analyze the information.
Regular (quarterly) meetings between boards and ownership entities	Besides information collection, the key mechanism for ongoing monitoring of performance might be, if permitted by company law and capital market laws, regular (usually quarterly) meetings between the ownership entities and SOE chairmen (possibly with senior executives). These meetings allow discussion about target achievements with a forward-looking perspective. They are an opportunity to exchange and interact more informally on current issues and emerging trends. However, these meetings should be subject to strict rules and transparent for all board members. Besides identifying issues in target achievement, these meetings could also allow discussing and recommending remedial action.
Feedback by the ownership entity on current performance	The ownership entity or its minister in charge might provide the SOE with written comments and recommendations when appropriate on current performance and target achievement. These comments and recommendations are based on the information collected on current performance and on discussion which has taken place in informal meetings. The SOE might in turn respond in writing to comments received on its performance.

Table 2.1. **The main steps and processes to ensure effective ongoing monitoring of SOE performance by the ownership entity** *(cont.)*

Main steps	Brief description
Revision of targets	Targets could be revised when the external environment has significantly changed, affecting the relevance of hypotheses made to back up the initial targets. This target revision should however remain selective, and requires appropriate discussion between the ownership entity and the board.
Ad hoc meetings	Some specific meetings might be called whenever specific issues arise or significant events occur, having potential impact on the achievement of performance targets. A typical case when there should be a smooth and typically intense exchange between the ownership entities and SOE boards is the case of exceptional transactions such as acquisitions or sales and transfers of material assets.
Take actions in case of serious underperformance	In case of significant shortfalls in performance, boards are expected to provide clear notification to the ownership entity, propose remedial action and keep it informed of the progress on a timely basis. The ownership entity is advised to seek additional information and to work actively with the board to decide on remedial actions. It can eventually review the board composition and appoint special advisors.

2.3. Annual review of performance

Annual reviews of performance are in-depth analyses of a specific SOE's performance done by the ownership entity. These annual reviews allow an assessment of developments during the year and an evaluation of how well the company and the board have performed against the corporate specific objectives set by the state.

The central piece of the annual performance review is the assessment of financial and non-financial performance against annual targets. But it is also useful to include an assessment of operating results, corporate value and risks, board performance and corporate governance practices.

The annual review is a central piece of the accountability process. It provides the basis on which the management, the board and ultimately the ownership entity, will be judged.

The annual review is an important tool for identifying actions that need to be taken in relation to underperforming companies. It is also essential for making adjustments to new performance targets and a natural basis for discussing the development of objectives for the following year.

Performance reviews might vary significantly in depth and scope. In some countries they consist only of brief comments on main performance targets attached to the SOE annual reports. In some other countries extensive analysis is performed on the basis of specific reports which have to be submitted by SOEs. Each ownership entity will have to find the right balance in terms of costs and benefits of requiring specific performance reports from SOEs, in addition to the reports they already publish like private sector companies. Whatever the level of detail and depth of the performance reviews, they should be carried out with rigor and provide a fair picture of the annual performance.

At the center of the annual performance review is the discussion between the board and the ownership entity. This discussion is mostly informal and can allow for a better understanding and interpretation of the formal performance indicators. For this purpose the ownership entity has an important responsibility for developing and articulating a clear judgment on the SOE's performance.

The two other crucial elements to improve accountability are the auditing of performance indicators and their public disclosure. These are not yet widespread practices. However, without auditing of performance indicators their reliability might be questioned. Furthermore, without effective disclosure of these indicators, the accountability to the general public concerning SOE performance remains limited (see Section 1.7).

In addition to annual reviews of performance, some more medium- to long-term reviews could be undertaken. These longer-term reviews would help establish the link between SOE mandates and annual objectives. They would look at what should be in the generic objectives targets, what is the investment and risk profile of the SOE and thus what should be its targeted capital structure. They could in addition discuss in some depth possible benchmarks (see Box 2.4).

Box 2.4. **Longer term owner reviews in New Zealand**

The objective of long-term hold owner's review is, in general terms, to:

- provide advice to shareholding ministers, for discussion between ministers and the board, on any shareholder preferences regarding: *a)* the content of the Statement of Corporate Intent (SCI) for the company's strategic purpose, scope of business, core business, consultation thresholds or investment strategy, in light of the company's strategic direction and investment profile; and *b)* the company's capital structure, in light of its scope of business and core business, its investment profile, its risk profile and the credit-rating benchmark agreed by shareholding Ministers of BBB(flat) and the criteria for exceptions;
- provide a better understanding of the company's performance through benchmarks for measuring performance against comparable companies and/or against the company's past performance, including a set of generic benchmarks for all SOEs;
- provide information on the company's likely equity demands over time, given its planned investment profile and capital structure, and;
- establish processes (such as, potentially, an in-depth strategic review) to look at particular aspects of the company's business where the initial review does not allow for sufficient depth or time to examine such issues.

The terms of reference for the long-term hold review will be agreed between shareholding ministers and the SOE board. Shareholding ministers' expectations or preferences arising out of the review will be included in a "Statement of Shareholder Preferences", which will be available to the board for its consideration. The Statement of Shareholder Preferences should be referred to by the board when developing its SCI in future business planning rounds.

The reviews are not a full examination of the strategic direction of the company. However, they may identify aspects of the company's direction, and make recommendations on issues to be examined outside of the review.

Source: Owner's Expectations Manual for State-Owned Enterprises, 29 October 2007, CCMAU, New Zealand.

The following table describes and provides comments on the mains steps in carrying out the annual review of SOE performance. There might be a great variety in the way each country chooses to realise each step. What will make a difference in terms of accountability is the quality and reliability of the assessments made, whatever the process used to achieve these. These steps are thus mostly indicative and provide only the main actions that will have to be undertaken to ensure an effective performance review.

Table 2.2. **The mains steps in carrying out the annual review of SOE performance**

Main steps	Brief description
Information provided by the board	The board should provide all elements necessary to evaluate the SOE performance as regards the agreed upon targets. This includes firstly the audited performance indicators along with an explanation of why the targets have been achieved or not. These comments qualifying the effective performance regarding the targets is the most value-adding part of the information and will be at the core of discussion between the board and the ownership entity. The ownership entity will also receive all the elements publicly available such as annual (and quarterly) reports. Some formal systems might be developed requiring SOEs to submit specific reviews or reports to the ownership entity as a basis for the annual review (see the example of the Korean specific review report, Box 2.5). These could be extensive and specific reports commenting on a number of performance indicators and providing significantly more information to the state as an owner than what a usual private sector company would be required to do. Careful consideration should be given to costs and benefits of these additional information requirements.
Gathering additional elements	In addition to the elements provided by the SOE itself, the ownership entity might gather additional elements, discuss and evaluate specific issues and make judgments on important topics which might complement the assessment and put it in perspective. This could be done, among other things, through the complementary information channels mentioned above in Section 2.2, particularly the auditors, both external and state ones, as well as industry analysts, rating agencies, etc.
Discussion with the board	Annual reviews might be discussed with the boards of the SOEs concerned. Discussion will allow qualifying the performance and will provide more background to the ownership entity to understand the factors explaining such performance. This formal or informal discussion with the SOE board is the central stage of reviewing performance by the ownership entity. It allows the ownership entity to develop and confront its own judgment about the SOE's performance.

Table 2.2. **The mains steps in carrying out the annual review of SOE performance** *(cont.)*

Main steps	Brief description
In-depth internal discussion	Some specific mechanisms might be developed within the ownership entity to discuss in-depth annual reviews. As an example, internal panels including senior management of the ownership entity, in addition to the officer usually in charge of following a specific entity, would allow developing a broader perspective and fresh views on the evolution of performance of the SOE concerned.
Summary of the performance review	A summary document should be developed by the ownership entity underlying the most important elements of annual performance. This document should provide an overall qualitative evaluation of the performance, together with main performance indicators as regards original targets. This summary performance document could be shared with the SOE concerned. This would be useful as the summary document will also constitute a good basis for the development of the following year's performance targets.
Publication of synthesis document	It might be useful for the general public and the media to have access to a synthesis document providing the list of main performance indicators or outcomes against targets for each SOE. This synthesis table would at least provide outcomes against main financial targets, including profitability, capital structure and dividend. It could also mention the existence or not of special or policy-oriented targets.

Box 2.5. **Korean review report**

Each year the Minister of Planning and Budget sets a series of up to 30 performance indicators for each SOE. Each year SOEs have to submit "completion reports" on their performance both to the Minister of Planning and Budget and other line ministries. These performance reports can range from 200 to 1 000 pages.

2.4. Benchmarking performance

Benchmarking SOE performance means that SOEs are compared with companies in the same industry that are of similar size and subject to similar complexity and risk. These "peers" could be from the private or the public sector, domestic or foreign. The chief purpose of benchmarking is to identify performance gaps and areas of potential improvement. It allows taking into account the impact of market evolution or other "external" factors on performance.

The following table presents the main steps in benchmarking SOE performance are:

- Identify relevant peers.
- Develop relevant industry research.
- Collect performance information for peers and compare it with actual performance.
- Interpret comparisons.

It is often challenging to benchmark the performance of public sector enterprises as they might be in sectors where there are no similar public or private sector enterprises. In this case, benchmarking could be done with foreign companies active in the same sector.

The rate of return is often very useful for benchmarking performance, since it focuses on the cost of capital, which is often underestimated or neglected by SOE management. However, estimating the cost of capital for SOEs is not always straightforward and includes a series of judgments and assumptions, including on the riskless rate of return, the asset beta and systematic risk (see Box 2.6).

Box 2.6. **Estimating the cost of capital**

The estimated cost of capital (k) is based on the assumption that the SOE is subject to income tax and that it is independent from the proportion of debt and equity in the SOE capital.

The basic formula is as follows: $\mathbf{k = R_f (1 - T) + \Theta\beta}$, where:

$\mathbf{R_f}$ = the riskless rate, proxied by the current five-year government stock rate. For value-based reporting, it is desirable to have a rate that reflects the value weighted average duration of the entity's future cash flows. Unless there is a clear reason to use a different term, the five-year rate at the beginning of the reporting period is recommended.

T = the marginal personal tax rate on interest income.

Θ = the (estimated) tax adjusted market risk premium: the tax adjusted excess over the riskless rate (**Rf**) of the expected rate of return to investors in a fully diversified portfolio of equities.

Rf – the riskless rate.

β = the relevant asset beta: denotes systematic risk that is the degree of association of returns from a particular investment with the returns from the whole market. For value-based reporting, where the reporting entity has different lines of business, the systematic risk to be assessed is the risk of the separate lines of business. The beta for the entity as a whole needs to reflect a weighted average of the betas of the individual businesses that make up the entity.

Beta is likely to be the most difficult variable to determine when estimating the cost of capital rate. The process involves the following two steps:

- As the equity of SOEs is not traded, the returns to the equity holder are not observable. This problem can be addressed by identifying comparator firms (with similar characteristics, in terms of output supplied, nature of customers and suppliers, types of trading contracts, and so on) that do have traded equity, and using their returns to estimate an equity beta. Any such comparison involves a degree of judgment.
- The recommended formula for estimating the cost of capital rate requires an asset beta. An asset beta is a measure of systematic risk in the absence of debt. Most comparator firms have debt, and their equity betas must be converted to asset betas. An average of the asset betas of the comparator firms is then calculated to arrive at the asset beta for the particular investment or line of business being assessed.

Source: Estimating the Cost of Capital for Crown Entities and State-Owned Enterprises, October 1997, A Handbook prepared for the Treasury, New Zealand.

The use of synthetic financial ratios might also facilitate benchmarking when enterprises are not in the same industry. Different measures of value creation could be used (see Box 2.7 for the methodology of measuring value creation in the UK).

Box 2.7. **Methodology for measuring value increase in the UK**

The UK Shareholder Executive selected an economic profit methodology to measure the increase in shareholder value. The ***Economic Profit*** is the after-tax operating profit (EBITA) less the cost of capital charge for the operating assets. It thus excludes the gains and losses arising from non-operating assets, the financing flows and tax impacts of the debt/equity capital structure.

This measure of value creation has the following advantages:

a) It is grounded in the fundamental drivers of economic value creation, such as growth and return on invested capital, and explicitly charges for the economic cost of the invested capital.

b) It reflects generally accepted and understood practices in the financial community for how to analyse value and value changes.

c) It applies to all business in different sectors across the portfolio.

d) It demonstrates historic performance, rather than changes in future expectations, as well as changes in ongoing performance.

e) It is flexible enough to measure both in-year performance, through economic profit, and cross-year performance through value change.

Source: Shareholder Executive Annual Report, 2005-2006.

EVA is an example of a well-established, widely used measure which is applicable to a wide range of industries consistently. It might thus be very useful in benchmarking the performance of SOEs across sectors and time (see Box 2.8).

Box 2.8. **Value-based reporting and use of EVA in New Zealand**

A core expectation for SOE boards is that there is a continual focus on managing for value… Boards should understand the company's value drivers and monitor enterprise value constantly. To support this … ministers also encourage the use of VBR. VBR represents a useful tool to assist both ministers and boards to advance the objectives of SOEs. The most widely used form of VBR is Economic Value Added (EVA) performance measurement.

EVA is a useful additional measure of performance for any long-term owner of businesses, and it can be calculated from publicly available information. EVA focuses on the changes in a company's economic value from a shareholder perspective. In light of the government's current long-term hold policy for SOEs, EVA can help measure their economic performance over time. It is internationally recognised as a measure of performance.

Put most simply, EVA is net operating profit minus an appropriate charge for the opportunity cost of all capital invested in an enterprise. The resulting EVA is therefore the profit (or loss) in excess of (or below) an investor's required return. A key benefit of EVA is that the system encourages a mindset in which managers recognise that all capital has a cost and therefore they should allocate capital to its most effective use.

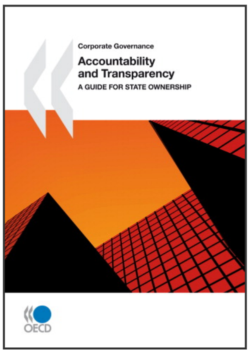
While each SOE is required to be as profitable and efficient as comparable private sector companies, a number of SOEs have no companies with which to compare their performance. EVA is a useful benchmarking tool in such cases. Some SOEs already use EVA for internal purposes and/or publish their EVA results… Shareholding ministers support and encourage this approach. By providing decision-makers with additional information focusing on shareholder value, EVA should be able to contribute to improving overall performance over time.

Source: Owner's Expectations Manual for State-Owned Enterprises, 29 October 2007, CCMAU, New Zealand.

Whatever peer is chosen for benchmarking, there will still be differences in a number of dimensions. It will always be challenging to make robust like-with-like comparisons. Consequently, care is always required in interpreting comparisons of performance. The review of generic benchmarks used to evaluate an SOE's performance could be done regularly within the framework of medium-term reviews as described in Section 2.3.

Table 2.3. **The main steps in benchmarking SOE performance**

Main steps	Brief description
Identify relevant peers	It is critical and challenging to identify relevant peers with which performance of a specific SOE could be compared meaningfully. In many cases it will be difficult to find perfect peers as SOEs are often active in newly liberalised industries, with few or still smaller private sector competitors, etc. To do so, the ownership entity could look into the same industry, both in the private and the public sector, as well as abroad. Foreign peers might be useful in many cases to compensate for real domestic peers. When choosing peers for benchmarking, it is also necessary to identify and keep in mind the most significant differences with the SOE concerned. This could be in terms of size, specific business lines, status, regulatory environment, market presence, etc., to the extent that these dimensions might have an impact on objectives and performance. It might be useful to discuss the choice of relevant peers between the ownership entity and the SOE board and management. They might have more in-depth market knowledge and thus provide useful elements to identify main commonalities and differences, as discussed above.
Develop relevant industry research	It is useful for the ownership entity to develop relevant industry knowledge, or to have an easy access to such knowledge, at least for its largest SOEs. The ownership entity should thus collect series of relevant industry-specific indicators, both financial and non-financial.
Collect performance information for peers and compare it with actual performance	The ownership entity and the SOE itself should strive to collect performance information for the identified peers. Synthesis tables of performance indicators could be built up showing the performance of the SOE in a comparative perspective as regards its peers.
Interpret comparisons	Careful interpretation of performance comparison should be developed in order to identify performance gaps and derive areas of potential improvement. Appropriate consideration should be given to the differences among targeted peers, including those concerning the regulatory environment.



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