Natural Resource Governance Institute

Precept 6: State-Owned Enterprises

Nationally owned companies should be accountable, with well-defined mandates and an objective of commercial efficiency.

–Precept 6, Natural Resource Charter

The performance of state-owned enterprises (SOEs) can be an important component in a country's strategy to harness resources for development. Well-run SOEs can help producing countries in several ways: they can secure resource revenues in addition to taxes, nurture local content and improve the country's regulatory capacity. However, building effective SOEs is no easy task. All too often, SOEs become obstacles to private investment, drains on public coffers, inefficient managers of public resources, or sources of corruption and patronage that prevent countries from maximizing returns on natural resources.

As outlined in this note, good governance of SOEs requires: clear and appropriate decisions on the SOE's role and how it is financed (Q6.1); corporate governance systems that limit political interference and allow for effective oversight (Q6.2); and a commitment to transparency and accountability (Q6.3).

PRIMARY QUESTIONS

6.1 | SOE role and funding

Does the government clearly define the SOE's role and establish a working funding mechanism for the company?

6.2 | SOE corporate governance

Do the SOE's corporate governance systems limit political interference in the company's technical decisions, while ensuring effective oversight?

6.3 | SOE transparency and accountability

Are SOE decision-making and operations transparent and accountable?

6.1 | SOE role and funding

Does the government clearly define the SOE's role and establish a working funding mechanism for the company?

To establish an effective SOE, the government must first clearly define what an SOE does and then ensure that it has adequate finances to carry out its role. Failure to clearly delineate the precise responsibilities of SOEs can open the door to inefficiency, conflict of interest and even corruption. With a clear mandate, an SOE can then develop an effective corporate strategy. Once the role and strategy are established, the SOE then requires sufficient and predictable financial resources to execute effectively.

Secondary question	Guidance
6.1.1 **Commercial role** Does the government clearly define a commercial role for the SOE that reflects the company's actual financial and technical capacity?	The commercial role of an SOE is as a profit-seeking business in the extractive sector. Nevertheless, commercial roles vary widely among SOEs. The largest and most complex companies (e.g., Saudi Aramco, Petronas or Statoil) undertake expansive operations and assume high levels of risk, much like large international extractives companies in the private sector. Other SOEs carry out a more limited range of less risky activities, such as holding minority equity shares, selling natural resources on the international market, or developing downstream activities to serve the domestic market. Different countries have built successful SOEs following both high-risk and low-risk commercial approaches. In the countries with the most successful SOEs, the government and the SOE precisely determine the SOE's commercial mandate, and then the SOE sets out a business strategy for pursuing this mandate. A key decision when defining the commercial role is whether the SOE should invest heavily in becoming an "operator" in the exploration or production of a significant share of the country's resources—i.e., the company responsible for leading the technical decisions of an operating group. Assuming an operating role can offer benefits if the company has the technical and financial capacity to perform complex, high-risk activities. Building these capacities can be expensive, so the government must undertake a careful risk-return analysis. If the government aspires to have its SOE play a major technical role, it is critical to build capabilities incrementally. The consequences of not defining a clear role can be catastrophic for national development, resulting in companies that waste scarce human and financial resources on a wide range of ill-suited activities and fail to generate returns for the country. *Researchers should consider:* • Does the government explicitly delineate the SOE's commercial role? Does the delineation indicate activities that the SOE will not carry out? Does it leave too much room for discretion, or confusion, around the company's role? • Does the commercial role chosen for the company represent a well-considered outcome of a risk-reward calculus? (See RGI 2013 Q3.1.1.033.) • Does the SOE have the financial and technical capacity to carry out its assigned commercial role? • If the government aspires to have the SOE play an advanced operational role, is there a clear strategy for building capabilities over time?

6.1.2 **Non-commercial roles** Does the government clearly define the company's non-commercial roles? Does this definition limit conflicts of interest?	SOEs frequently carry out two types of "non-commercial" roles: (a) regulatory roles, including allocating exploration and production licenses, setting and enforcing sector rules, and approving key decisions made by partner companies regarding exploration and production activities; and (b) quasi-fiscal roles, where the SOE executes activities on behalf of the government which are unrelated to its core oil or mining business, such as serving national debt, building or maintaining infrastructure, promoting public health and education, providing consumer fuel subsidies and even purchasing arms. While there is some debate over whether SOEs should take on these roles, the reality is that most SOEs do take on at least some non-commercial responsibilities. Indeed, if an SOE has sizeable resources and technical capacity, it can be the best placed institution to play these roles in certain countries where capacity is lacking elsewhere. The government must take precautions to ensure that non-commercial roles do not hinder SOE efficacy. The government should avoid assigning or allowing an SOE to take on non-commercial roles that are poorly defined or too broad, as these can steer resources away from its core business, impede performance, and avoid the normal checks and balances, such as those in the national budget process (e.g., expansive community development programs or fuel subsidy programs). Furthermore, SOEs with significant commercial roles should avoid taking on a significant regulatory role in the same domain as their commercial focus, as this can open the door to conflicts of interest and/or corruption. For example, if the SOE is an upstream operator, it should not also be responsible for awarding licenses or overseeing operator compliance with laws and regulations. A common strategy employed by many new producers is therefore to assign non-commercial roles to an SOE, such as regulatory responsibilities and capacity building roles, at an early stage of production, and then hive off these roles to dedicated institutions when the SOE begins to assume a more advanced commercial role. *Researchers should consider:* • Are the non-commercial roles of SOEs clearly defined? Do the definitions clearly state what the SOE will not do? Are non-commercial activities consuming resources that could otherwise support commercial activities? • If the SOE plays a regulatory role, does this present a conflict of interest with its commercial activities? Are there examples of weak or biased enforcement of the rules? • Do the SOE's quasi-fiscal activities and expenditures make sense and deliver good value to the country? Are checks and balances on these activities sufficient? • Does the non-commercial role of the SOE deliver benefits to the country? These benefits may include building regulatory capacity, human capital and local supply chains. If not, is there any other public interest justification for the SOE's execution of these activities?

6.1.3
Funding mechanism

Does the government ensure that the SOE has a workable funding mechanism?

An SOE's ability to execute its stated commercial strategy is heavily influenced by whether it has the necessary funds. There is no universal model for SOE funding, and different countries have adopted different approaches to using public revenues and/or market-derived revenues to finance the SOE.

In their roles as financial partners of international companies, or as the sellers of the country's resources, many SOEs collect large shares of public revenues. When deciding what portion of these revenues SOEs should be allowed to retain and spend, governments must navigate between two competing imperatives. Greater financial autonomy can incentivize the SOE to maximize the profitability of its commercial activities over time, as the company is responsible for its own bottom line. It also helps protect the company from political interference or unpredictable government budget processes. However, financial autonomy also reduces the government's ability to scrutinize whether the SOE is using revenues in the national interest, and reduces the share of revenues that enter the country's treasury for budgeted expenditure on other national development priorities. Figure 6.1.3 below shows how these two priorities could be weighed in different country contexts. Researchers can assess whether their country's SOE falls in the appropriate quadrant.

Figure 6.1.3 Determinants of SOE revenue retention

Operational sophistication/ commercial investment needs	Low (share of total government revenues coming from SOE activities)	High (share of total government revenues coming from SOE activities)
High	I. Highest justification for SOE revenue retention	II. High justification for significant SOE revenue retention, but checks and balances are of heightened importance
Low	III. Reduced justification for significant SOE revenue retention	IV. Lowest justification for significant SOE revenue retention

Share of total government revenues coming from SOE activities

Source: Patrick R. P. Heller, Paasha Mahdavi and Johannes Schreuder (2014) Reforming National Oil Companies: Nine Recommendations. NRGI.

Countries employ a range of systems to govern SOE revenue retention. In some cases where the SOE is highly commercialized and afforded significant financial autonomy, the government treats SOE revenues exactly as it would treat revenues generated by private companies—the SOE pays income taxes and other fees, and distributes dividends to (state and non-state) shareholders. At the other end of the spectrum are governments that require the SOE to transfer all revenues directly to the state, leaving SOE funding to annual budget allocations by government.

In addition to retaining public revenues, some SOEs finance themselves via market capital by listing shares on public stock exchanges. When managed well, this can force the company to act with discipline and accountability, while at the same time generating revenues. Public listings create strong incentives for SOEs to demonstrate that their commercial prospects, corporate governance systems, and accounting procedures are sound. Of course, not all SOEs are in a position to list shares. The feasibility of attracting investor capital depends on a number of factors, including the financial viability of the company, the burdens of carrying non-core assets, and the company's non-commercial responsibilities. While public listing for emerging and new SOEs may not be realistic in the short term, a plan to build toward a listing can be a vehicle for improving asset management and corporate governance.

	Some of the largest SOEs have also been able to raise funds through the sale of bonds on international financial markets. As with public equity listings, the requirements for bond sales can also have a positive effect on corporate governance. *Researchers should consider:* • How is the SOE funded? Possibilities include retained earnings, budgetary allocation, foreign equity partners/oil companies, and/or financial markets. • How appropriate is the method of funding? ◦ Where does the SOE stand in the figure 6.1.3? Is there a strong justification for the SOE to retain funds for commercial investment needs, or does government dependency on SOE revenues mean that more checks and balances are needed? If an SOE is dependent on the government budget, does the budget process provide the SOE with a reliable form of funding? ◦ Is the company in a position to raise money on financial markets through public listings or bond sales? If so, does it take advantage of these opportunities, and have they positively impacted governance? If it does not seek funding from the markets, why not?

6.2 | SOE corporate governance

Do the SOE's corporate governance systems limit political interference in the company's technical decisions, while ensuring effective oversight?

The highest-performing SOEs exhibit strong corporate governance. In these SOEs, professional and independent management and boards make key decisions rather than politicians. A good system will privilege sound business judgment, reduce the influence of narrow political interests and allow for predictable planning. This is not to say that SOE boards and management should be trusted on faith to execute strategy benevolently and effectively. Rather, it means that the government and the SOE need to strike the right balance between independent and business-driven SOE decision-making and oversight by government bodies.

Secondary question	Guidance
6.2.1 **Role of state shareholders** Does the government clearly establish the identity and role of state shareholders in the SOE?	State shareholders should not intrude too much in the day-to-day running of the SOE. Among the most successful SOEs, state shareholders tend to only make decisions that define the broad contours of the company's role, while the day-to-day functioning of the company is left to SOE management under the guidance of the board of directors. Governments have taken different approaches to defining exactly which body should represent the government as the state shareholder in the SOE. Some SOEs endow shareholder power to just one institution, such as a single ministry. Research has shown that these SOEs generally make more coherent strategic choices. Other countries split state shareholding across several different government agencies or institutions. This can create useful checks and balances, but it tends to hinder the country's ability to set a consistent and unified approach. It can also paralyze the SOE operationally, especially where the roles of different shareholders are not clearly defined. *Researchers should consider:* • Is there a strong single state shareholder, or is state shareholding split across different agencies and institutions? • Where there are multiple state shareholders, are the roles of each shareholder clearly defined by the government or the SOE? If they are not clearly defined, does lack of clarity lead to a situation where shareholders do not give singular unified direction to the SOE? Are shareholder inputs to decision making politicized? • Do state shareholders limit themselves from excessive intrusions on the day-to-day running of the SOE?

6.2.2 **Board models** Does the SOE have an empowered, professional and independent board?	The boards of most high-performing SOEs have competent and politically autonomous members who are appointed through transparent and well-defined processes. SOEs should select board members based on their technical expertise, rather than patronage concerns. To further constrain the influence of politics, board term limits might also be appropriate. *Researchers should consider:* • Are board members politically autonomous? Are there rules (such as term limits) to ensure that appointments remain independent of politics? Are there term limits for board members? • Are appointment processes transparent and well-defined? • Are there rules forbidding conflicts of interest among board members? How are conflicts identified? • Does the SOE seek board appointments from outside the government? This can help bring the right skills (e.g., industry knowledge and legal understanding) needed for effective decision-making. • Does the SOE avoid appointing too many ministers to the board? While some ministerial appointments may be useful (e.g., minister of petroleum or minerals), appointing ministers can impede effective decision-making as they are often driven by pressing political concerns, rather than the technical concerns that a board should consider in the running of an SOE.
6.2.3 **Staff integrity** Does the SOE invest in staff integrity and capacity?	Improving the competence and integrity of SOE staff can safeguard against narrow and politicized decision-making. Along with training, it is important to develop and enforce meritocratic hiring and promotion practices, to ensure that meeting performance goals is the principal motive of staff behavior. *Researchers should consider:* • Does the SOE follow a code of practice surrounding hires? This might include mandatory training requirements for specific positions. • Does the SOE invest in rigorous training programs to build the skills of current and potential employees? If skills are not available in the local market, is the SOE able to recruit international expertise? SOEs can use international expertise to build the capacity of national staff. • Does the SOE enforce meritocratic systems for internal promotion and performance incentives? • Does the SOE have rules against conflicts of interest for high-level managers? (See RGI 2013 3.3.1.047.) • Does the SOE have strong internal anti-corruption policies, including protections for whistleblowers?

6.3 | SOE transparency and accountability

Are SOE decision-making and operations transparent and accountable?

In many countries, SOEs rank among the most opaque and unaccountable state institutions. The absence of transparency can reduce incentives for the company to act in the public interest. The EITI standard provides a good basis for the improvement of SOE disclosure practices, requiring governments and SOEs to report on: commodity sales, quasi-fiscal spending, SOE joint venture and subsidiary holdings, material payments to SOEs from resource companies, and transfers between SOEs and other government agencies. Beyond these transparency requirements, other internal governance mechanisms and procedures can improve accountability. Along with the measures mentioned below, accountability also depends on SOE governing boards and the role of shareholders (see Q6.2), and the wider sector governance environment. (See precept 2.)

Secondary question	Guidance
6.3.1 **SOE operational and payment data** Does the SOE disclose key operational and payment data?	SOEs should disclose information about operations as well as the payments they receive from companies and transfer to the government. This should include performance information about all business segments (e.g., upstream, downstream) and SOE units and subsidiaries. Data should typically include disaggregated figures on reserves, production and exploration activities, any processing or marketing of commodities, as well as narrative explanations and updates on the main aspects of the SOE's business. **Use the transparency table in annex 6 to answer this question.** Along with the table, researchers should also consider: • Does the SOE or the government have a legal obligation to publish operational and payment data? • If there is a national EITI process, does it result in publication of SOE operational data in line with the provisions 2.6, 3.2, 3.3, 4.2, 4.4, 4.5 and 6.2 of the 2016 EITI Standard? • If operational data is not publicly available, what are the main obstacles to the release of data? Do they relate to capacity, the absence of procedures, or the absence of political will?
6.3.2 **SOE financial reporting and audits** Does the SOE subject itself to independent financial audits and publish the results?	SOEs should maintain their accounts in line with international standards, subject them to publicly available independent audits, and publish summary data and audit findings on a regular basis. Independent audits are one of the most powerful tools to incentivize strong performance, better corporate governance and accountability to shareholders. Problems uncovered in audit reports should be addressed by the SOE in an efficient manner, with progress detailed in the next year's report. *Researchers should consider:* • Does the SOE publish an annual report with complete financial data, including key performance indicators, income statement, cash flow statement and balance sheet (i.e., statement of assets and liabilities)? (See RGI 2013 3.2.5.044 and 3.2.5.045.) • Do external, capable and independent firms conduct the audits on a regular basis? (See RGI 2013 3.2.5.043.a-b and 3.3.1.046.) • Does the SOE, or the ministry that oversees the SOE, publish audit reports and make these available to parliamentarians, media, civil society and the wider public? • Does the SOE, or the ministry that oversees the SOE, hire auditors through competitive public tenders? • Do auditors change periodically? Changing auditors can boost investor confidence in the governance of the SOE. • Are problems in audit reports addressed in an efficient manner and is progress detailed in the next year's report?

6.3.3 **SOE legislative oversight** Does the legislature oversee SOE performance without unduly constraining its decision-making?	The legislature should conduct regular and systematic oversight of any SOEs. Among the important tasks that legislatures or their members can perform are: scrutinizing SOE financial and operational accounts, questioning SOE leadership on deviations between benchmarks and actual performance, and (in some cases) approving SOE budgets. However, overly intrusive or politicized legislative oversight can interfere with the SOE's efficiency. Ex post oversight mechanisms (e.g., scrutiny of SOE annual reports and SOE budgeting), through which SOE leaders face meaningful consequences for poor results, are generally more appropriate for legislatures than ex ante oversight mechanisms (e.g., up-front parliamentary approvals of activities, budgets or license allocations), which can seriously delay or politicize corporate decision making. *Researchers should consider:* • Does the legislature have the information, opportunity and influence needed to play their oversight role effectively? • Is legislative oversight limited to the broad contours of SOE governance and scrutiny of the SOE's performance, or is the legislature able to intervene on more specific issues that may lead to reduced performance of the SOE? • Does the legislature exhibit the requisite capacity, independence and professionalism in its oversight of the SOE?

ANNEX 6. PRECEPT 6: STATE-OWNED ENTERPRISES

This transparency table has been designed to assist with Q6.3.1. It summarizes the specific disclosures that governments should make to help build effective accountability around precept 6 state-owned enterprises. (General transparency requirements that support this precept are covered in the transparency table for precept 2.) Unless otherwise stated, disclosures should be made by government in line with the standards of open data outlined in Q2.1.4. Existing country-specific research on some disclosure items may be available in the Resource Governance Index (RGI) country questionnaires using the indicated question numbers.

For each disclosure, researchers should consider the following questions:

- Is *all* latest information available? If not, what are the exceptions?
- Is *all* historical information available? If not, what are the exceptions?
- Is information provided in sufficient time to enable effective monitoring and scrutiny of activity?
- Is information available in a machine-readable format? Are there any other barriers to access to information? (See Q2.1.4 for background.)

Disclosure item	Guidance
Revenues collected by the SOE	Table or set of tables. Should cover revenues related to SOE participation in exploration and production activities or any regulatory role, including revenue from oil sales; royalties; fees; taxes collected by the SOE; and dividends received from partnerships. **Related standards:** EITI 2016, 4.1.c, 4.5 **Resource Governance Index:** 2013: questions 3.2.2.038, 3.2.3.038.j and 3.2.4.040.
Payments by the SOE to the treasury or other state institutions	Table or set of tables. Should also include earnings retained by the company; and budgetary allocations from the state to the company. **Related standards:** EITI 2016, 4.1.c, 4.5 **Resource Governance Index:** 2013: questions 3.2.2.038, 3.2.3.038.j and 3.2.4.040.
Assets held by the company in subsidiaries and joint ventures	Documents/text listing subsidiaries and joint ventures. Should include the level of SOE ownership in these entities; identities of company partners; revenues earned and retained by subsidiaries and joint ventures; and transfers between the parent company and the subsidiaries and joint ventures. **Related standards:** EITI 2016, 2.6.b **Resource Governance Index:** 2013: questions 3.2.1.037 and 3.2.4.042
Quasi-fiscal expenditures	Table or set of tables. See Q6.1.2 for background. **Related standards:** EITI 2016, 6.2 **Resource Governance Index:** 2013: See question 3.2.2.038.i and 3.2.4.041
Company debts	Table. Should be disaggregated, and should include debts that are owed to the state, where applicable. **Related standards:** EITI 2016, 2.6b
Description of major business activities	Documents/text. See Q6.1.1 for background. Related standards: EITI 2016, 2.6a
Expenditures and budgets	Table or set of tables. Should report on capital and operational expenditures and on any investments. It should disclose budget for the upcoming year and performance against past years' budgets. **Resource Governance Index:** 2013: question 3.2.1.037

Detailed reporting on commodity sales	Table or set of tables. Some SOEs sell shares of production, especially oil. Data reports on these sales should include the name of the buyers, volume and date of sale, types of resource sold (i.e., grade of crude), and sale price. SOEs should also explain the process for selecting buyers. **Related standards:** EITI 2016, 4.2. **Resource Governance Index:** 2013: question 2.1.018
Corporate structure	Documents/text. Should include composition of the board and senior management (including dates of appointment), as well as structure, personnel and responsibilities of key divisions. **Related standards:** EITI 2016, 4.2. **Resource Governance Index:** 2013: question 3.3.048 and 3.3.049

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