

The New Guidelines on SOE Corporate Governance in India

Arun Balakrishnan, C&MD, HPCL

25th June, 2008

Shri Tripathi of the Department of Public Enterprises, distinguished members of the panel, distinguished members of the audience, Ladies and Gentlemen,

It is indeed a pleasure to be here today and be part of this interesting discussion on corporate governance as it relates to state owned enterprises. This is all the more important, that, quite a few of the companies listed in the Fortune 500 list are SOE's and include the Chinese and Russian Oil Companies besides energy and utility companies from France and Italy. Of the 5 Indian companies listed in Fortune 500, four are the Public Sector Oil Companies ONGC, IOC, HPC & BPC. In the oil industry, National Oil Companies play the leading role eg. Saudi Aramco, Iranian Oil Co., Gaz Prone, ONGC, etc though most of them may not be listed companies. There are also a whole host of sovereign investment companies which have multinational operations.

With such large investments and political and economic power vested in SOE's, its but natural to focus on corporate governance practices.

I am glad to note that the "Organisation for Economic Co-operation and Development" (OECD) has launched an initiative to scrutinize the dominant role of SOE's with the aim of setting out guidance on best practice and reform.

The phrase "corporate governance" is relatively new in India. It gained prominence in the early 1990s as a number of scams- securities scam of 1992, disappearance of a number of companies after raising money through the stock market during 1993-94, etc shattered investor confidence. There were also cases of unscrupulous Corporates issuing preferential equity allotments to their controlling group at steep discounts to the market price. All these episodes strengthened the case for corporate governance. Over the years, - financial crisis in the East Asian countries in 1997, corporate scandals in the USA in the beginning of this decade have tended to keep the issue in limelight and new guidelines have been developed. With the advent of Sarbans & Oxley Standards in USA, the need for disclosure of information has become paramount though such compliance

comes with increased bureaucratisation and hence higher costs as well.

Further, companies have realized that good corporate governance is a pre-requisite for accessing funds from competitive capital markets in an increasingly integrated international economy leading to more transparent disclosures.

As far as state owned enterprises are concerned, attitudes seem to have changed about their relevance especially in energy and utility industries. In 1989, the “End of History” by Fukuyama claimed the triumph of economic and political liberalism. Judged as propaganda, the fall of Berlin wall in 1989 did for Big Government what 1929 did for *Laissez-faire*. The dominant idea was that Government’s role is not to run business directly but to create conditions that foster growth of business. It was contended that reliance on market forces would improve efficiency and bring in private investment which in turn would create greater economic growth. The result was a wave of privatization of state owned enterprises and opening of a number of otherwise reserved sectors to private enterprise.

Focus is, however, shifting back to the improvements in the functioning of state owned enterprises while keeping them in the domain of public ownership. Unregulated or poorly regulated private sector especially in the utility and infrastructure sectors can be worse than a public sector. Changing realities are aptly summed up in the Shell scenarios. In 2005, the scenarios explored the geopolitical crisis of security and trust following 9/11 and the Enron scandal with constant tensions between the aspirations for economic efficiency, social cohesion and security. The result has been resurgence in the activism and aspiration of states, with wide support from the public at large.

In the Indian context, once Clause 49 came into effect in 2005 end, the regulatory content for Corporate Governance changed significantly. Additionally, with much greater inflow of Foreign Institutional Investments (FII) into the Indian Capital Markets, there has been an increasing demand for transparency and disclosure from Indian firms to be in line with best practices in the developed world.

The current Govt policies rule out privatization of profit making public sector enterprises and promises full managerial and commercial autonomy to these units. The policy further states that *while retaining existing navaratna*

companies in the public sector, every effort will be made to modernize and restructure sick public sector companies and revive sick industry, while chronically loss-making companies will either be sold-off, or closed, after all workers have got their legitimate dues and compensation'. These policy statements clearly emphasizes the role of State Owned Enterprises in the Indian Economy. The question then is how well the SOE's can play out their assigned role.

In India, there are 244 central public sector enterprises with a cumulative investment of about Rs. 4200 billion. Out of 244 enterprises, 156 are profit making entities with a total profit of about Rs. 900 billion during 2006-07. Forty four CPSEs are listed on the stock exchanges of the country. As on March 31, 2007, market capitalization of all listed CPSEs as a percentage of market capitalization of BSE was 18.35%.

A number of definitions are used to define Corporate Governance. Introduction to the "Guidelines on Corporate Governance to Central Public Sector Enterprises 2007" defines corporate governance as *"a set of relationships between a company's management, its Board, its shareholders and other stakeholders. Corporate governance provides a principled process and structure through which*

the objectives of the company, the means of attaining the objectives and systems of monitoring performance are also set. Corporate governance is a set of accepted principles by management of the inalienable rights of the shareholders as a true owner of the corporation and of their own rule as trustees on behalf of the shareholders."

Sir Adrian Cadbury uses a much broader definition. As per him "*Corporate Governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The corporate governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as nearly as possible the interests of individuals, corporations and society"*.

Basically, corporate governance boils down to honest, transparent dealing by owners and managers, clear-cut demarcation and allocation of responsibility. In India, there is considerable heterogeneity in governance practices among the different kinds of Indian firms- family owned, listed firms, unlisted firms, central and state public sector enterprises, etc. Interestingly, a majority of the listed

companies in India are family owned with their own unique models of succession planning and governance practices.

In the case of state-owned enterprises there often exists contradicting objectives arising out of multiple roles, the State is expected to perform. For instance, the State as a shareholder, the prime motive would be to ensure profitability.

In a second but equally important role, the state would strive to offer universal services to all citizens by charging below cost prices if necessary or in extending service into unprofitable areas, ensuring employment, and developing infrastructure in backward areas, etc.

Separation of various roles is quite often a difficult task and boundaries do tend to blur posing real challenges for the management such enterprises. The sector to which I belong, viz the downstream oil sector is one such. The dilemma and tribulations are extensively debated in the newspapers and I need not dwell on these.

Over the years the government of India has introduced a number of measures to improve accountability of the state owned enterprises.

- A system of performance contracting by entering into Memorandum of Understanding has been instituted. The MOU covers both financial as well as non-financial performance. Powers have been devolved to some of the state owned enterprises by granting them the status of “Navratnas” and “Mini-Ratnas”.
- State-owned enterprises have been in the forefront in implementation of various corporate governance norms issued from time to time whether mandatory or voluntary. Of these, Clause 49 of the Listing agreement issued by the Securities and Exchange Board of India deserves a special mention.
- Requirements of Clause 49 relate to appointment of Independent Directors, Audit Committee, CEO/CFO Certification, Risk Minimisation, Legal Compliance Reporting, Code of Conduct, Disclosures, Other Compliances and Subsidiary Companies.

Clause 49 requires every listed entity to reserve half the board for independent directors if the chairman is an executive director and if the board chairman is a non-executive director, at least one third of the board should

comprise of independent directors. Independent directors can play a crucial role in delivery of counsel to CEOs and in setting the strategic direction for the enterprise. The only caution here is that such counsel or advise should not infringe on the right and duty of management to manage. Another are in a SOE Board is the latitude available to the independent Directors given the role Government Directors necessarily play in the area of policy. This is in a way similar to a family owned enterprise.

However, with the requirement, the need for requisite number of the independent directors with the right qualification and experience has risen significantly and the search for the independent directors has become an unenviable task. Second issue is the size of the board. Between one-third and half, the question is between quality and quantity.

The new Guidelines on Corporate Governance issued last year for the state owned enterprises in India are quite similar to the Clause 49 requirements. These include guidelines with respect to role of the Board of Directors and management, audit committee, code of conduct and business ethics etc. These guidelines are voluntary, however, the Department of Public Enterprises may grade

state owned enterprises on the basis of the compliance with the guidelines.

While, there is no denying that these guidelines promote the objective of good corporate governance, however, certain challenges remain. These flow from the multiple objectives of the state mentioned earlier. Often challenges arise from the equity objective.

To give an example, the state has to take a view as to how much pain can their economies endure given the level of volatility in the oil market and prevailing high prices. However, in the process interests of the minority shareholders become subservient to the interests of the majority shareholder. OECD advises that any obligations and responsibilities that a state owned enterprise is required to undertake in terms of public services beyond the generally accepted norm should be clearly mandated by laws or regulations, and disclosed to the general public. Likewise, related costs should be covered in a transparent manner and “any financial assistance, including guarantee, received from the state” should be disclosed. This would ensure fair treatment for all stakeholders.

As the state owned enterprises in India have more than 50% government ownership, they fall under the ambit of 'the State' and within the meaning of Article 12 of the Constitution of India and this is the genesis for a plethora of controls. Thus in addition to the audit committee, internal audit, statutory audit, the state owned enterprises have audits/reviews by the parent ministry, the Department of Public Enterprises, Comptroller and Accountant General, the Chief Vigilance commissioner, parliament, the parliamentary committees and the Central Bureau of Investigation. The state owned enterprises are also subject to writ petitions to the Supreme Court under Article 32, and High Courts under Article 226 of the Constitution. The state owned enterprises have to work under the aegis of the state, as the state is the majority shareholder. The key question is the parameters of the ownership and review function, composition and empowerment of the boards. The responsibility of complying with the requirements of multiple layers of authority can be quite onerous and time-consuming. **In fact effectiveness of the CEO of a state owned enterprise may lie overwhelmingly in managing the relations with various arms of the government.**

Procurement and employment policies of the state owned enterprises are subject to various guidelines of the

government and are obviously designed to fulfill the priorities of the government of the day. But does it necessarily lead to “*efficient use of resources*”? *Meritocracy* can at times become the casualty.

There is no denying the fact that Clause 49 and the new guidelines for state-owned enterprise provide an ideal for corporate governance. This is essential as the Indian economy and companies operate in an integrated international economy. However, as is the case with any statute, it is quite often implementation which determines the effectiveness.

Be that as it may, I am of the firm opinion that should one make an impartial judgement on the degree of quality in Corporate Governance between the State and the Private Sector in India, the Public Sector Units, especially the Centrally owned ones, stand head and shoulder above the rest.

To conclude, resolution of all these issues in Clause 49 requires informed debate. I am sure the distinguished panel of experts with me here today will provide valuable insight to further improve the corporate governance standards specifically with respect to state owned enterprises.

