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FINDING BALANCE

Benchmarking the Performance of State-Owned Enterprises in Fiji, Marshall Islands, Samoa, Solomon Islands, and Tonga

2011

Asian Development Bank


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VANUATU
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Contents

Abbreviations

ADB	-	Asian Development Bank
CSO	-	community service obligation
FPCL	-	Fiji Ports Corporation Limited
GDP	-	gross domestic product
MIPA	-	Marshall Islands Ports Authority
MPE	-	Ministry of Public Enterprises
MWSC	-	Majuro Water and Sewerage Company (Marshall Islands)
NBV	-	National Bank of Vanuatu
NRW	-	non-revenue water
PAT	-	Port Authority of Tonga
PIC	-	Pacific island country
PPP	-	public–private partnership
RDC	-	Rodney District Council (New Zealand)
RMI	-	Republic of the Marshall Islands
ROA	-	return on assets
ROE	-	return on equity
SIEA	-	Solomon Islands Electricity Authority
SIPA	-	Solomon Islands Ports Authority
SIWA	-	Solomon Islands Water Authority
SOE	-	state-owned enterprise
SPA	-	Samoa Ports Authority
SWA	-	Samoa Water Authority
TPL	-	Tonga Power Limited
TWB	-	Tonga Water Board
WAF	-	Water Authority of Fiji
WAL	-	Waste Authority Limited (Tonga)

Notes:

"$" refers to US dollars.
"F$" refers to Fiji dollars
"NZ$" refers to New Zealand dollars
"SI$" refers to Solomon Islands dollars.
"ST" refers to Samoan tala
"T$" refers to Tongan pa'anga
Fiscal year "FY" is the fiscal year as defined by each country.

Glossary

Asset utilization: Calculated by dividing the total revenue generated by a state-owned enterprise (SOE) in a given year by the book value of its assets in that year, asset utilization measures how efficiently an SOE uses its assets.

Cash ratio: Calculated as the amount of cash, deposits, and liquid securities of an SOE divided by the amount of current liabilities, the cash ratio measures the ability of the SOE to service its current liabilities.

Community service obligations (CSOs): Goods and/or services provided by SOEs where the revenues collected from users are insufficient to cover the cost of provision and provide a commercial return. According to SOE legislation in Samoa, Solomon Islands, and Tonga, SOEs are prohibited from providing CSOs unless they are specifically contracted to do so and receive a subsidy from the purchasing ministry/agency to cover the cost of providing the CSO and the required commercial return. In Fiji, SOE legislation requires SOEs to follow a process when undertaking a CSO, but it is not highly prescriptive.

Commercialization: The process whereby a corporate body is required to operate under the same commercial principles as private sector firms, including the requirement to make an appropriate risk-adjusted return on shareholder funds.

Corporatization: The process of establishing a corporate body in legal form with a balance sheet and a board appointed by the owner.

Informal CSOs: Goods and/or services provided by SOEs on terms that are inconsistent with the SOEs' objective to operate as a successful business and have not been specifically directed under an approved CSO policy.

Insolvent: For the purposes of this report, an SOE is referred to as insolvent when its accumulated losses have resulted in a negative shareholder equity balance.

Market failure: An imperfection in a price system that prevents an efficient allocation of resources.

Mutual SOEs: SOEs with all of their equity composed of contributions from their subscribers who are also the beneficiaries, such as pension funds and insurance companies.

Non-revenue water: Measured as the difference between the total system input volume and the billed or authorized consumption of water, non-revenue water includes unbilled consumption, illegal connections, and technical losses from leaks and overflows.

Ownership monitoring: The function of monitoring the ownership interest in the SOE, which focuses on such matters as governance, profitability, accountability, and factors that influence long-term organizational health.

Public-private partnership: A shared-risk contract entered into between the public and private sectors to deliver a specific output over a period of time.

Return on assets (ROA): Calculated by dividing net income by total assets, ROA is an indicator of how efficiently a firm is generating profits from its assets.

Return on equity (ROE): Calculated by dividing net income by shareholder equity, ROE is an indicator of how efficiently a firm uses its invested capital.

State-owned enterprise: A corporatized entity with a commercial mandate in which the state holds a controlling equity stake. In Fiji, Marshall Islands, Samoa, Solomon Islands, and Tonga, SOEs are also known as public enterprises, commercial statutory authorities, government commercial companies, and public trading bodies. Samoa's public beneficial bodies are not referred to as SOEs in this study because they do not have a commercial mandate.

SOE contribution to gross domestic product (GDP): Calculated by adding the SOE's net income (excluding depreciation) and total wage expenditure and dividing by the relevant country's GDP.

SOE productivity: The contribution to GDP per dollar of fixed assets utilized by the SOE.

Foreword

Pacific island countries recognize the importance of robust and vibrant private sectors to drive economic growth. Over the past decade, countries in the region have introduced important policy reforms to improve the environment for the private sector, and these reforms are beginning to translate into increased investment and growth. State-owned enterprises (SOEs) continue to constrain the economies of Pacific island countries, however, through their absorption of large amounts of scarce capital on which they provide very low returns. While some provide essential public services, many operate as purely commercial ventures and crowd out the private sector. Most have performed poorly. Reforming the SOE sector is vital for private sector development, as it will create opportunities for private investment, reduce the costs of doing business, and improve basic service delivery. Finding the balance between the roles of the public and private sectors is the theme of this report.

This is the second major assessment of the progress of SOE reform in the Pacific region undertaken by the Asian Development Bank. The purpose of the study is to benchmark the performance of SOEs and reform experiences across the region and draw lessons to inform future policy action. The first study, published in 2009, focused on the Fiji Islands, Samoa, and Tonga. Upon publication, these countries requested that the study be regularly updated, and other countries invited to participate. This study responds to this request by including financial data from the most recent years available and adding two new countries: Republic of the Marshall Islands and Solomon Islands. The participation of these five countries must be commended, as it demonstrates their governments' willingness to publicly identify and address the core issues within their SOE sectors.

The Asian Development Bank continues to work with a number of Pacific island countries on SOE reform, and this study illustrates that tangible progress is being made, in particular where the political will to reform exists.

I wish to convey my sincere thanks to the governments of Fiji, Marshall Islands, Samoa, Solomon Islands, and Tonga for their extensive inputs, without which this study would not have been possible. I also wish to thank the authors (Laure Darcy and Christopher Russell) and financial analysts (Erik Aelbers and David Ling) of the study for their efforts in its preparation, and the Australian Agency for International Development, which provided co-financing under the Pacific Private Sector Development Initiative.

I am confident that the study will provide thought-provoking reading and stimulate useful discussions toward further progress in SOE reforms in the Pacific and other regions facing similar challenges.

Robert Wihtol
Director General
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Asian Development Bank

Executive Summary

This is the second comparative study of state-owned enterprise (SOE) performance in the Pacific. The first study, published in February 2009, focused on the SOE reform experiences of Fiji, Samoa, and Tonga during fiscal years (FY) 2002–2006. When the report was published, the governments of the three participating countries requested that the study be regularly updated and expanded to include additional Pacific island countries (PICs). This study responds to this request by including FY2007–FY2009 financial data and adding two further participating countries: the Republic of the Marshall Islands (RMI) and Solomon Islands.

Pacific island countries have demonstrated that state-owned enterprise reform is both possible and desirable.

The purpose of the study is to assess the impact of the SOE sectors on the economies of the participating countries and identify the key performance drivers and reform strategies that can inform future policy action. In the 2 years since the 2009 study was published and presented to senior policy makers in Fiji, Samoa, and Tonga, progress in implementing the recommendations has been uneven, with Tonga continuing to set the pace of reforms while Fiji and Samoa struggle to develop the necessary political consensus for change. Financial results of the SOEs reflect this reality, with Tonga's SOEs continuing to outperform those in Fiji and Samoa. The global financial crisis, which began to affect all of the countries participating in this study in 2009, with reduced remittance flows, tourism arrivals, and demand for exports, negatively affected the returns of the SOEs in all PICs.

This study expands the analysis to include the Marshall Islands and Solomon Islands, and in so doing Melanesia, Micronesia, and Polynesia are now represented. The active participation of these five countries in the study must be commended as a demonstration of their governments' willingness to identify and address the core issues within their SOE sectors. This transparency is an essential precursor to successful reform.

The findings of the study reveal that while SOEs are often established to address perceived market failures or increase accountability in public service delivery, too often the benefits sought from the corporatization fail to materialize. This is principally due to the fact that the process of commercializing the SOEs, or requiring them to operate with the same performance incentives and accountability for results as private enterprises, is incomplete. This problem is not unique to the Pacific. Wherever SOEs are established without the necessary structures and policies to support their commercial operation, they are likely to be driven more by political imperatives than commercial goals, and their financial performance will suffer. The best performing SOEs are those that operate in an environment that supports a full commercial orientation, with strong governance arrangements, performance incentives, and hard budget constraints.

The five countries participating in this study have made some important progress towards placing their SOEs on a more commercial footing, but much more needs to be done. Important milestones include:

(i) **Fiji:** the liquidation of Fiji Ships and Heavy Industries Limited, and the corporatization of the Water Authority of Fiji;

(ii) **RMI:** the 2010 cabinet decisions to restructure the Marshalls Energy Company and to implement a series of good practice principles applicable throughout the SOE portfolio, placing them on a more commercial footing;

(iii) **Samoa:** the successful privatization of the Samoa Broadcasting Corporation in 2008, the preparation of SamoaTel for privatization, and the appointment of an independent director selection committee in April 2010;

(iv) **Solomon Islands:** the 2010 promulgation of SOE regulations to support the 2007 SOE Act, the 2009 privatization of Home Finance Limited, the 2010 tendering of Sasape Marina, and the restructuring of the boards of three large SOEs;

(v) **Tonga:** the privatization of Leiola Duty Free and Tonga Machinery Pool; the restructuring of 10 SOE boards by replacing all public servants and elected officials on those boards with independent directors; the publication of the financial results of the SOEs in local newspapers; the implementation of rationalization strategies for all but three of the SOEs; the development and implementation of a director performance evaluation process; and the adoption of a robust Public Enterprise Amendment Act in 2010 to further strengthen the governance and community service obligation (CSO) provisions applicable to the SOEs.

SOEs continue to place a significant and unsustainable strain on the economies of Fiji, Marshall Islands, Samoa, Solomon Islands, and Tonga. SOEs absorb large amounts of scarce capital stock, on which they provide very low returns. This low productivity acts as a drag on the economic growth rates of each country. SOEs often crowd out the private sector and absorb funds that could otherwise be invested in such high-yielding social sectors as health and education. From FY2002 to FY2009, the SOE portfolios' average return on equity (ROE) was 0.7% in Fiji, -13.2% in RMI, 0.2% in Samoa, -13.9% in Solomon Islands, and 6.0% in Tonga. In each country, this rate is substantially below the profitability target set by the government and/or the commercially established risk-adjusted return. In RMI and Solomon Islands, the chronic operating losses of the SOEs require regular capital infusions from the central budget, further weakening the governments' fiscal positions. In most cases, the SOEs' poor performance is due to weak governance arrangements, conflicting mandates, the absence of hard budget constraints, and lack of accountability. SOEs do not operate with the same efficiency incentives as private sector firms; there are few consequences for poor financial performance and few rewards for profitability.

While all five countries recognize the need for SOE reform, results have been mixed. Progress appears to be directly correlated to each government's effectiveness in protecting SOEs from undue political influence. This reality underscores both the vital nature of political commitment and the sensitivities surrounding SOE reform. In PICs, political opposition to SOE reform stems from concerns about: (i) the potential loss of patronage; (ii) the loss of direct control over SOEs, which are perceived to be important policy implementation tools; and (iii) potential job losses as SOEs are restructured and made more efficient. In some cases, opposition to SOE reform is also rooted in a distrust of the private sector and a belief that in small economies, market forces and competition erode consumer welfare rather than enhance it. This study also critically tests a number of common negative claims about SOE reform, which have specific resonance in the Pacific, and provides policy makers with data that reveal these assertions as myths.

Progress can be made in reforming SOEs where the political will to do so exists.

Of the five countries participating in this study, **Tonga** has benefitted from the strongest political commitment to SOE reform, which has resulted in ambitious SOE rationalization programs and governance practices that have gone beyond the minimum standards prescribed by its SOE law. As a result Tonga's SOEs have outperformed those of Fiji, RMI, Samoa, and Solomon Islands for the past 7 years. **Samoa,** in contrast, has had a history of successful SOE privatization, but has had difficulty harnessing the needed political support to implement the core governance provisions of its excellent SOE legislation. As a result Samoa's SOEs continue to miss their performance targets and little action is taken to restructure or close those that are chronically insolvent.

In **Fiji,** progress on SOE reforms has varied with each successive government, and appears to have slowed under the current administration. While the government is currently preparing several SOEs for greater private sector involvement, and is looking to corporatize additional government functions, only limited progress has been made in recent years in restructuring SOEs and introducing greater transparency in the management of CSOs. The Government of Fiji continues to refrain from imposing hard budget constraints on its SOEs, which in turn continue to generate very low returns.

Reform should focus on placing SOEs on a fully commercial footing.

In the **Marshall Islands,** efforts to reform SOEs over the past 2 decades have had little sustained impact because these efforts have not addressed the more fundamental issues, which include an inability to recover the costs of service delivery and operate on fully commercial terms within an appropriate accountability structure. This is compounded by the lack of an effective ownership monitoring and legislative framework for the SOEs, which further diffuses the responsibility for poor SOE performance. The RMI SOE portfolio has generated operating losses in each year during FY2002–FY2008. The situation should improve, however, with the recent introduction of measures to strengthen the commercial orientation of the SOEs, including a wholesale restructuring of the largest SOE, the electric utility.

In **Solomon Islands,** decades of poor governance practices have led to chronic underperformance, with close to half of the SOEs in the portfolio now insolvent. SOE boards continue to place political imperatives ahead of commercial objectives, in direct violation of the country's robust SOE Act, which was enacted in 2007. Although the Solomon Islands SOE portfolio is the poorest performer among the five countries participating in this study, there are encouraging signs of reform. Since 2009, three large SOE boards have been restructured, and in 2010 the new government committed to implement the terms of the SOE Act.

The most important lessons to be drawn from the SOE reform experiences of Fiji, RMI, Samoa, Solomon Islands, and Tonga are: (i) political commitment is vital to successful reform; (ii) continued financing of poorly performing SOEs does not restore their profitability, and often creates negative performance incentives; (iii) there is a clear link between the lack of effective ownership monitoring and poor SOE performance; (iv) the private sector has the capacity to invest in SOEs and to deliver CSOs; and (v) the process of establishing SOEs will achieve few benefits unless it is supported by the effective implementation of the full suite of supporting arrangements that most closely mimic the disciplines and incentives of a private firm.

The key to successful SOE reform is to infuse SOEs with private sector discipline and competitive market pressures. This tactic forces SOEs to meet their costs of capital and divest any activities that are not commercially viable. When SOEs remain under public ownership, the process of "commercialization" is incremental. Privatization, in contrast, is immediate; it relies on a transfer of ownership to accelerate, intensify, and lock in the benefits of commercialization. Decades of international experience with SOE reform have shown that privatization, supported by robust regulatory arrangements, is the most effective mechanism for bringing about long-term improvements in SOE performance. Full privatization, however, is not always politically feasible nor the most suitable reform mechanism. In these cases, partial privatization (such as joint ventures and public–private partnerships) can help improve SOE performance.

This study demonstrates the significant economic costs incurred by poor management of SOEs and the progress that can be made in reforming SOEs where the political will to do so exists. PICs have demonstrated that SOE reform is both possible and desirable. Placing SOEs on a fully commercial footing, thereby freeing up scarce public capital, will not only enable SOEs to begin to make a positive contribution to economic growth, but will also lead to increased investment opportunities and expansion of the private sector as the engine of this growth.

Introduction

The purpose of this study is to review the progress of SOE reform in Fiji, the Marshall Islands, Samoa, Solomon Islands, and Tonga, to demonstrate the benefits of reform, and to identify successful reform strategies to inform future policy action. This study looks at the process of reform in the five countries, identifies what has or has not worked well, and highlights the key elements of successful action. While the primary focus is on the comparative financial performance of the five SOE portfolios, the study also looks at the empowering legislation, the monitoring framework, governance arrangements, and the extent and nature of parliamentary oversight. These factors all have an impact on the performance of the SOEs.

The term SOE is used in this study to refer to public enterprises, commercial statutory authorities, government commercial companies, and public trading bodies that are majority-owned by the government.[1] With few exceptions these entities are corporatized and have a for-profit mandate.[2] A detailed summary of the SOEs included in the comparative financial analysis is provided in Appendix 1. Financial data are provided through the most recent fiscal year available, which is 2009 for Fiji, Samoa, and Tonga, and 2008 for RMI and Solomon Islands.[3]

The study was prepared with the active support of the ministries of finance or public enterprises in Fiji, Marshall Islands, Samoa, Solomon Islands, and Tonga. Each ministry provided audited financial information on its SOEs and copies of SOE legislation and completed a questionnaire broadly describing its SOE monitoring practices and governance arrangements. This information was then discussed with each agency for further clarification before being assessed comparatively across the five countries. The five participating countries are considered comparable due to their history of SOE reform and broadly similar SOE portfolios. All of the countries except RMI have SOE legislation specifying the governance and oversight arrangements for the SOEs.

Given the nature of the information collected, the report is split into two volumes:

(1) **Finding Balance 2011: Benchmarking the Performance of State-Owned Enterprises in Fiji, the Marshall Islands, Samoa, Solomon Islands, and Tonga,** which focuses on the comparative financial performance of the SOE portfolios in each country, the lessons from their respective reform efforts, and approaches to improve the effectiveness of future reform measures, and

(2) **Comparative Review of the Legal, Governance, and Monitoring Frameworks of State-Owned Enterprises in Fiji, the Marshall Islands, Samoa, Solomon Islands, and Tonga,** which provides a detailed analysis of the frameworks summarized in volume 1, and is available from the Asian Development Bank (ADB) website www.adb.org.

This volume, Finding Balance 2011, includes a set of appendixes that provide FY2008–FY2009 financial indicators for each of the SOEs reviewed, as well as a summary of the methodology used for the financial analysis.

[1] The term public enterprise is used in Tonga; commercial statutory body and government commercial companies in Fiji; and public trading bodies in Samoa. Samoa's "public beneficial bodies," which are not-for-profit corporate entities, are not included in this analysis.
[2] In Samoa, the National Provident Fund and two insurance companies, which are classified by the government as public trading bodies, are not included in the analysis; as mutuals, their shares are owned by their contributors, not by the government. The provident funds in Solomon Islands and Tonga are similarly excluded.
[3] It should be noted that not all FY2008 and FY2009 financial statements have been audited. In Solomon Islands, only one SOE presented audited accounts; all other financial statements for the SOEs had been prepared by independent accountants on a best-efforts basis from the data available within the SOEs.

I. SOEs in Pacific Island Economies: Role and Impact

The SOE model is most successful as a transitional arrangement.

SOEs play a significant role in the economies of every PIC. In most cases, these SOEs have been created to respond to a perceived market failure: they are mandated by the government to deliver goods or services that the private sector is either unable or unwilling to provide. In many cases, the lack of private sector investment is not due to true market failure, but rather to the poor investment climate found in many PICs. Some SOEs are established as new entities, while others are carved out of existing government departments through a corporatization process that is intended to increase the transparency and efficiency of service provision. In the Pacific, as elsewhere around the world, SOEs have been charged with the provision of such core infrastructure services as power, sanitation, telecommunications, transport, and water.

Where true market failure exists, the government has a legitimate role in addressing this failure, and SOEs can play a useful role in this effort. As markets evolve, however, the role of the SOEs and the government as shareholder also should evolve: where the absence of private sector providers is rooted in the private sector's lack of capacity to deliver a specific good or service, the government can help create this capacity over time through tendering of contracts of increasing size and scope; where the private sector has capacity but has demonstrated a lack of interest in providing a specific good or service tendered by the government, this is often due to inadequate remuneration proposed by the government.

It is in the best interests of governments to grow their countries' private sectors, and every effort should be made to increase the role of the private sector in the provision of goods or services that have traditionally been provided by SOEs. Indeed, decades of international experience have shown that private enterprises, through profitability incentives and regulating forces of competition, are able to provide most services more efficiently than SOEs.

The SOE model should therefore be considered only as a transitional arrangement; one that fulfills a market need until the government improves the investment climate for private sector participation. This is true of all SOEs, even those providing core infrastructure services, because private participation in the provision of these services can provide significant efficiency gains.

The reality in the Pacific and elsewhere, however, is that governments—based on emotional and political considerations rather than sound commercial or economic analysis—tend to view SOEs as permanent institutions. In fact, over time many SOEs have moved beyond their core "strategic" function and have diversified into purely commercial activities, directly competing with and further inhibiting the development of the private sector.

The poor financial results of the SOEs in the Pacific, as documented in this study, reflect the intrinsic problems with using SOEs as a permanent service delivery model. While SOEs can be efficient in fulfilling a market need at a given point in time, the lack of robust budget constraints and poor governance practices invariably lead to a deterioration in financial performance. This problem is not unique to the Pacific; SOEs globally suffer from weak

Box 1: Pacific Island Countries Innovate with Private Provision of Public Services

In recent years, Pacific island countries (e.g. Fiji, Samoa, Solomon Islands, and Tonga) have contracted out air transport, road maintenance services, and shipping to the private sector—in some cases without first corporatizing the activity as a state-owned enterprise. Their experience demonstrates that these services can be provided effectively by the private sector, even when the services are subsidized, and that direct contracting with the private sector can be more cost-effective than working through an SOE. Productivity gains from the contracting out of subsidized services to the private sector in Fiji, Samoa, and Tonga have ranged between 20% and 400%.

governance arrangements, conflicting mandates, absence of hard budget constraints, and lack of accountability, which conspire to strip the SOEs of many of the incentives to operate efficiently.

SOEs that have performed well are those with robust governance arrangements, strong commercial orientation, and similar performance incentives as those found in private enterprises. These SOEs have unambiguous commercial mandates, hard budget constraints, and directors who are held accountable for commercial performance. In the Pacific, there are few SOEs that have this profile, but much can be learned from those that do. Two such SOEs are the National Bank of Vanuatu (NBV) and Tonga Power Limited (TPL). Both of these SOEs operate with clear commercial principles and actively seek increased private sector participation to support their growth. Their experiences illustrate how commercially focused governance practices can quickly improve SOE performance.

NBV was established in 1991 to provide retail-banking services to the people of Vanuatu. Years of weak management, political interference, and absence of performance incentives and controls led to NBV's insolvency in 1998. When the bank was recapitalized that same year, a much stronger set of controls was put in place, with hard budget constraints, a new board whose composition was prescribed by law, a new management team, and a clarified mandate to provide commercially viable banking services that contribute to the economic growth of Vanuatu. NBV's robust corporate planning process has kept shareholder, board, and management interests aligned and has allowed the bank to fend off attempts by politicians to interfere with its operations. NBV, which turned a profit for the first time in 2002, has since developed into a sound and profitable financial institution. As a fully commercial SOE, NBV operates at arm's length from the government and is entirely self-financing. It has averaged an ROE of 19.5% during 2002–2009, while maintaining Vanuatu's largest branch network. In order to further grow the business, NBV is now looking to raise additional capital from private sources.

TPL was established in 2008 by the Government of Tonga to acquire the electricity generation and distribution assets of the Shoreline Group Limited.[4] The government made four key decisions at the time of the acquisition. First, it appointed an independent board and chair to the new company and selected directors who clearly demonstrated the right mix of skills to assist the company to operate successfully. Only one minister was appointed to the board, and this was viewed as a transitional appointment.[5] Second, proper due diligence was carried out, and assets were transferred into the new company at fair commercial value. Third, the board was given a clear commercial mandate to pursue a business strategy that would provide the government shareholder with at least a 10% ROE; and, fourth, the government and board were to actively look for opportunities to partner with the private sector, including the possibility of full privatization.

Box 2: Intrinsic Challenges with the SOE Model

While it is recognized that market failures do exist and governments should play a role in addressing them, there are strong arguments against addressing them via SOEs. A 1995 World Bank Study argues that the risk of government failure in establishing SOEs may be greater than the market failures the SOEs are intending to address.

> Government is not a monolithic entity; rather it answers to many constituencies and lacks a unified chain of command. Because no individual or group owns a state enterprise, no one has a clear stake in SOE returns, hence no one has the responsibility and motivation to set clear performance goals and assure they are attained. Instead, politicians, bureaucrats, employees, and other interest groups thrust upon SOEs multiple and often conflicting goals (e.g., profit maximization, employment maximization, and a host of other social objectives) while simultaneously imposing a bewildering and sometimes contradictory collection of constraints (e.g., restricting layoffs, price increases, and the choice of suppliers or markets). Multiple objectives and multiple constraints increase transaction costs, distort the incentives facing SOE managers and reduce managerial effort.

M. Shirley and A. Galal. 1995. *Bureaucrats in Business: The Economics and Politics of Government Ownership, A World Bank Policy Research Report.* New York: Oxford University Press. p. 36.

[4] This nationalization was driven by the new King of Tonga's desire to divest his commercial interests before assuming the throne; the King was a 50% shareholder in Shoreline Group Limited, which operated all of the power sector assets in Tonga. When the decision to divest was made and no private buyer materialized, the government established an SOE (Tonga Power Limited) to acquire the assets.

[5] The Minister of Finance was appointed to the Tonga Power Board in 2008 but resigned in October 2010.

TPL achieved an 8% ROE in FY2010, its first full year of operation as an SOE, largely due to the robust commercial orientation of the company. Indeed, the company's aggressive and even-handed efforts to collect outstanding accounts have resulted in a sharp decrease in accounts receivable, which fell from T$2 million due beyond 30 days at the time of the acquisition to total accounts receivable of T$1 million, of which just T$174,539 were past due as of June 2009. This reduction in receivables has freed up significant working capital that has allowed the company to reinvest T$5 million back into the business.

SOEs continue to have a negative impact on economic growth.

Positive economic growth is achieved through investment in the productive sectors of the economy. In many PICs, however, this growth is hindered by generally low investment rates and productivity. In Fiji, RMI, Samoa, Solomon Islands, and Tonga, ongoing investment in the large public enterprise sectors has the dual impact of limiting the opportunities for private investment and generating low returns on the significant amount of scarce capital stock that they absorb. Combined, these factors serve as a heavy drag on economic growth.

While some of the SOEs in these countries provide essential public services, many do not. Indeed, many SOEs are purely commercial undertakings that compete with the private sector, often with an unfair advantage due to their preferred access to markets and discounted capital. In some countries, SOEs offer higher salaries for skilled managers than the private sector, and as a result divert these scarce resources into less productive economic activities. In these circumstances, the SOEs effectively crowd out the private sector. Moreover, where inefficient SOEs are the sole or dominant providers of essential services—such as power, telecommunications, transport infrastructure, and water—they increase the costs of doing business for all enterprises, depressing the country's ability to create wealth for its citizens.[6] SOEs also place upward pressure on tax rates; low returns on SOE investments result in lost revenue for the government and pressure to compensate through higher taxation. Finally, investing in underperforming SOEs has opportunity costs by absorbing funds that could be better spent on such high-yielding social investments as health and education.

A. Achieving Low Returns

SOEs provide low returns on investment, while absorbing a significant amount of scarce capital stock.

In all of the countries participating in this study, the investment in SOEs is substantial, representing 12%–31% of total fixed assets in the economy in 2008 (Table 1).[7] Despite these sizeable investments, SOEs' total contribution to gross domestic product (GDP) in 2008 was very low: 3.3% in Fiji, 2.1% in RMI, 6.2% in Samoa, and 5.5% in Tonga (Figure 1). In Solomon Islands, the SOEs generated negative value added, actually reducing GDP by -0.3%. Indeed, every dollar invested in SOEs in these countries produced substantially less output than the same dollar invested in the rest of the economy: seven times less in Fiji and five times less in Tonga. Meanwhile, every dollar invested in the SOEs in Solomon Islands actually reduced GDP. In Samoa and RMI, the absence of data on fixed capital investment does not allow a similar calculation, but given the size of the SOE sectors and their poor financial performance, it is likely that the productivity figure was more similar to Fiji or Solomon Islands than to Tonga.

Over time, the consistently lower productivity of the SOE sector served as a significant drag on economic growth. In 2008 alone, it is estimated that the low productivity of the SOEs caused a reduction in the economic growth rates of 0.11%–0.33% in Fiji, 1.09%–1.99% in Solomon Islands, and 0.12%–0.41% in Tonga.

These figures are consistent with the SOEs' poor financial returns; during FY2002–FY2009, their average ROEs were 0.7% in Fiji, -13.2% in RMI, 0.2% in Samoa, -13.9% in Solomon Islands, and 6.0% in Tonga.[8] By comparison, rates of return on private sector investments in these countries were far higher—generally 10–15% for domestic investors

[6] In the absence of effective regulatory frameworks, monopoly providers have less incentive to operate efficiently; this is true whether they are publicly or privately owned.
[7] Limited data availability does not allow the calculation of the % of total investment in the economy which is represented by the SOE sector in Samoa or RMI, but the size of the SOE sector in these countries is substantial, with the book value of SOE assets equal to 68% and 73% of GDP in FY2008 in Samoa and RMI, respectively. If the mutual SOEs in Samoa are included, this figure increases to 103% of GDP.
[8] Figures for RMI and Solomon Islands are for FY2002-2008; figures for Fiji, Samoa and Tonga are for FY2002-2009.

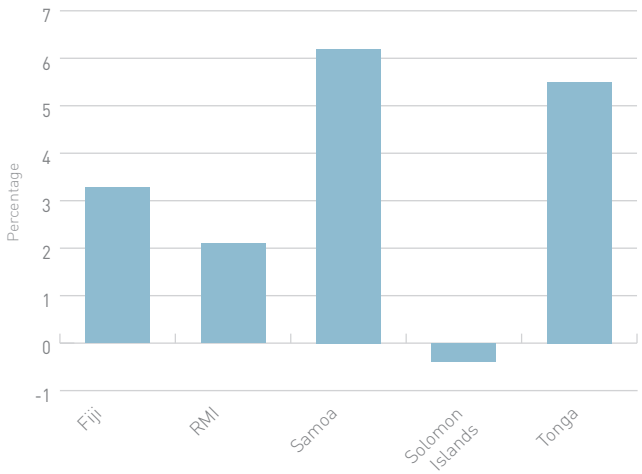
Table 1: **Economic Impact Indicators** Estimates for 2008	Fiji	RMI	Samoa	Solomon Islands	Tonga
SOE proportion of total fixed assets in the economy	12% to 26%	NA	NA	16% to 26%	15% to 31%
SOE contribution to GDP[a]	3.3%	2.1%[b]	6.2%	-0.3%	5.5%
Contribution to GDP per $1 of investment in SOEs	$0.19	$0.04	$0.13	-$0.07	$0.27
Contribution to GDP per $1 of investment in non-SOE sector	$1.26	NA	NA	$1.86	$1.35
Average GDP growth rate for the economy FY2002–FY2008	1.06%	2.76%	2.34%	5.51%	1.10%
Impact of SOEs on GDP growth rate	-0.11% to -0.33%	NA	NA	-1.09% to -1.99%	-0.12% to -0.41%
Average return on equity of all SOEs FY2002–FY2008/2009	0.7%	-13.2%	0.2%	-13.9%[c]	6.0%
Average return on assets for all SOEs FY2002–FY2008/2009	0.4%	-5.9%	0.1%	-4.5%	3.6%
Number of SOEs	20	11	14	11	13

FY = fiscal year, GDP = gross domestic product, NA = not available.
[a] SOE contribution to GDP is for 2008 only and is calculated by adding the net income (excluding depreciation) and the total wage expenditure of the SOE and dividing by GDP.
[b] RMI's annual Economics Statistics Tables, which are prepared by the Economic Policy, Planning, and Statistics Office, calculate the SOE value added using a similar formula, but with different estimates of the variables, resulting in an SOE contribution to GDP of 4.40% in 2008.
[c] This average ROE figure does not include FY2007 data because the consolidated SOE portfolio had a negative net worth in that year.
Sources: ADB Key Indicators, ADB Staff Estimates, Annual Economic Statistics Tables (RMI), Annual SOE Audit Reports (RMI), Ministry of Finance (Solomon Islands), Ministry of Public Enterprises (Fiji), Ministry of Public Enterprises and Information (Tonga), State-Owned Enterprise Monitoring Unit (Samoa).

and 20–25% for foreign investors.[9] A second measure of investment productivity, return on assets (ROA), was also very low for the SOE sector.[10] During FY2002–FY2009, the average ROAs for the SOE portfolio were 0.4% in Fiji, -5.9% in the Marshall Islands, 0.1% in Samoa, -4.5% in Solomon Islands, and 3.6% in Tonga. This combination—a large share of capital stock invested in SOEs and low SOE productivity—resulted in much slower economic growth than would otherwise have been achievable.

Not only are SOE rates of return significantly below those of private sector enterprises, but they are also well below the minimum ROE targets set by three of the countries. In Samoa, the Ministry of Finance has a target ROE of 7% for all of its SOEs, while the target in both Tonga and Fiji is 10%.[11] SOEs in RMI and Solomon Islands do not have ROE targets, but the Solomon Islands SOE Act does

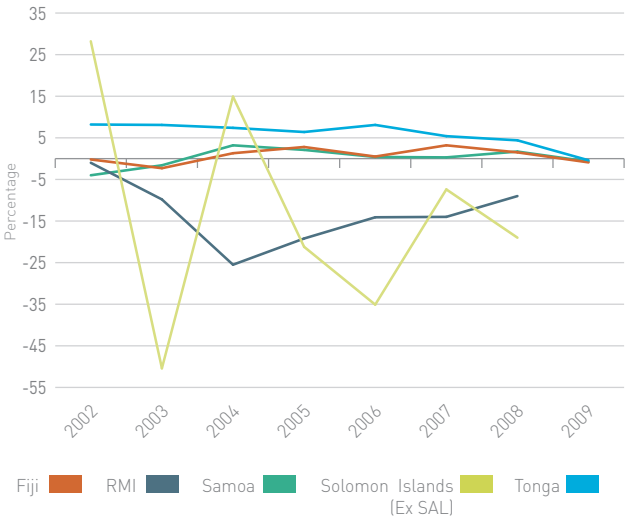
Figure 1: **State–Owned Enterprise Contribution to Gross Domestic Product** (FY2008)



Sources: ADB Key Indicators, Annual Economic Statistics Tables (RMI), Annual SOE Audit Reports (RMI), Ministry of Finance (Solomon Islands), Ministry of Public Enterprises (Fiji), Ministry of Public Enterprises and Information (Tonga), State-Owned Enterprise Monitoring Unit (Samoa).

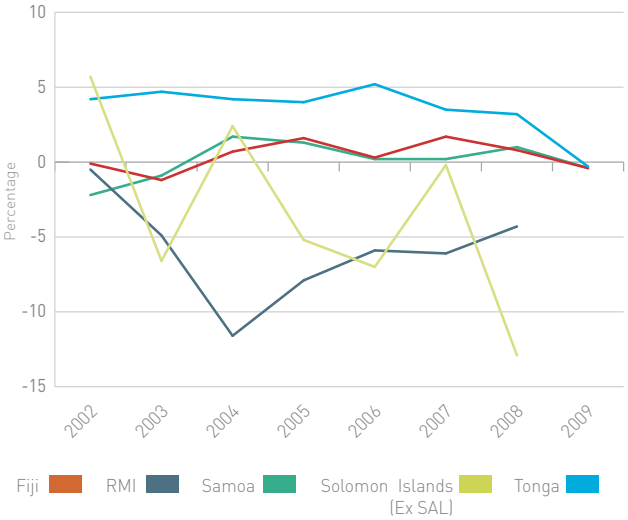
[9] These figures are approximate and taken from interviews with banks and chambers of commerce in each country.
[10] ROA is calculated by dividing net income by total assets. This is an indicator of how efficient a firm is in extracting profits from its assets. ROE is calculated by dividing net income by shareholder equity. This is an indicator of how efficiently a firm uses its invested capital. While both are indicators of profitability and should follow a similar trend, they can vary significantly depending on the amount of debt a firm is carrying. This study, therefore, presents both indicators, thus providing a more complete picture of SOE profitability.
[11] This is the case for the 14 trading SOEs in Samoa, all 13 SOEs in Tonga, and the 12 government commercial companies in Fiji. In Tonga, the requirement is set by the minister, not by SOE legislation; since the Tonga Electric Power Board serves as a regulatory body, it has not been considered an SOE with a profit target for the purposes of this analysis. There is no profit requirement for Fiji's four commercial statutory authorities and the four majority-owned SOEs which are not monitored by the MPE, or for the eight public beneficial bodies in Samoa. The Samoa National Provident Fund, Accident Compensation Corporation, and Samoa Life Assurance Corporation do have a profit requirement; however, they are excluded from this analysis because their equity is owned by their contributors, not by the government.

Figure 2: **State–Owned Enterprise Return on Equity** (FY2002–2009)[a]



[a]Annual ROE for Solomon Islands is presented without the inclusion of Solomon Airlines (SAL) due to its significant profitability swings during 2002–2008 and their impact on portfolio results; if Solomon Airlines had been included, the Solomon Islands portfolio results would have changed the scale of the charts; portfolio ROE including Solomon Airlines was 44% in FY2002, -79% in FY2003, 26% in FY2004, -12% in FY2005, -40% in FY2006, and -22% in FY2008. A portfolio ROE cannot be calculated for FY2007 because portfolio equity was negative.
Sources: Annual Economic Statistics Tables (RMI), Annual SOE Audit Reports (RMI), Ministry of Finance (Solomon Islands), Ministry of Public Enterprises (Fiji), Ministry of Public Enterprises and Information (Tonga), State-Owned Enterprise Monitoring Unit (Samoa).

Figure 3: **State–Owned Enterprise Return on Assets** (FY2002–2009)[a]



[a]Annual ROA for Solomon Islands is presented the without inclusion of Solomon Airlines (SAL) due to its significant profitability swings during 2002–2008 and their impact on portfolio results; portfolio ROA would have been 7% in FY2002, -6% in FY2003, 3% in FY2004, -3% in FY2005, -9% in FY2006, -11% in FY2007, and -12% in FY2008.
Sources: Annual Economic Statistics Tables (RMI), Annual SOE Audit Reports (RMI), Ministry of Finance (Solomon Islands), Ministry of Public Enterprises (Fiji), Ministry of Public Enterprises and Information (Tonga), State-Owned Enterprise Monitoring Unit (Samoa).

require SOEs to operate as "successful businesses," and in so doing, be as profitable as comparable private firms. If the SOEs had achieved these targets, the additional contribution to GDP would have been at least 2% in each country.[12] If they had met the private sector's 10%–15% hurdle rate, the positive impact would have been even greater. Because SOEs absorb so much of the capital invested in their countries, their performance must improve if Fiji, RMI, Samoa, Solomon Islands, and Tonga are to achieve increased economic growth rates.

B. Crowding Out the Private Sector

State-owned enterprises crowd out private investment; even though they are less efficient than private sector companies, they often compete on an unequal basis.

The second major way in which SOEs have a negative impact on the economy is by crowding out the private sector. This occurs in sectors where SOEs enjoy monopoly rights as well as in those in which they compete with the private sector. Where SOEs enjoy monopoly rights, the absence of competition often results in substandard service delivery and high costs. Since these monopoly rights exist in core infrastructure services that are essential for private sector competitiveness, SOE inefficiencies have a direct impact on private sector growth, as discussed below in subsection C.

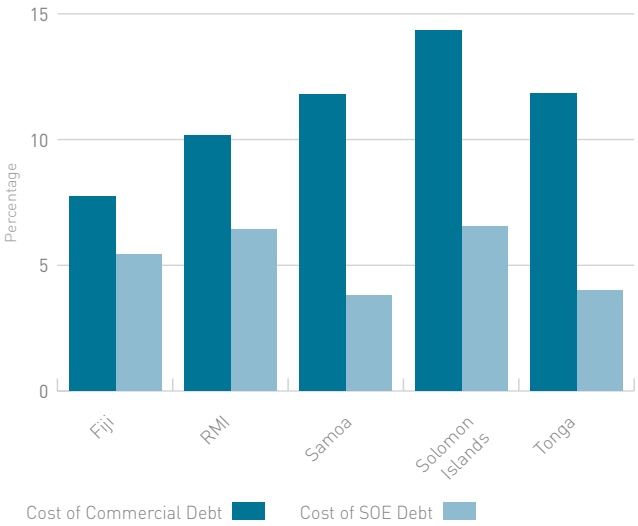
Where SOEs do not have monopoly rights but instead compete with private sector companies, they often do so on a favored basis, making it difficult for private sector competitors to invest and grow. Although private firms are generally more efficient, SOEs enjoy advantages in two key areas, which are not shared by their private sector competitors:

(i) **Preferred access.** SOEs often benefit from preferred access to government contracts.

(ii) **Subsidized capital.** SOEs have subsidized debt and equity, making their capital costs lower than those of private firms and allowing them to remain marginally profitable even though they are less efficient than their private competitors.

[12] These figures are calculated as [the increase in operating surplus required to achieve target ROE for the SOE portfolio]/[GDP for that country].

Figure 4: **Average Cost of State-Owned Enterprise Debt versus Commercial Debt Rate** (FY2002–2009)



Sources: Annual Economic Statistics Tables (RMI), Annual SOE Audit Reports (RMI), IMF International Financial Statistics, Ministry of Finance (Solomon Islands), Ministry of Public Enterprises (Fiji), Ministry of Public Enterprises and Information (Tonga), State-Owned Enterprise Monitoring Unit (Samoa).

Box 3: **Tonga Waste Authority Limited Crowds Out the Private Sector**

In Tonga, the state is involved in waste collection through an SOE, Waste Authority Limited (WAL), as well as through the Ministry of Works, which owns and operates a commercial septic tank emptying business. Both of these commercial operations compete with the private sector. The Ministry of Works implements an aggressive septic tank emptying pricing policy that undercuts and threatens the viability of the private provider. WAL also competes on price in general refuse collection and provides a domestic waste collection service without, in many cases, billing its customers, making it impossible for the private sector to provide a commercial alternative. The government provided WAL with cash transfers of T$340,000 and T$350,000 in FY2008 and FY2009, respectively, as a "subsidy to cover poor commercial practices."[a] Continued government support of WAL is a direct threat to the survival of the private operators in the sector.

[a] Comment made by Ministry of Public Enterprise staff in a governance review.

Subsidized debt, like subsidized equity, creates economic distortions. The interest rates SOEs pay on their debt are substantially below commercial rates and, therefore, lower than the private sector's cost of debt (Figure 4). Often, SOE debt is provided directly by the ministries of finance, state-owned banks, or provident funds under the direction of ministers. This practice has a two-fold effect: (i) it allows SOEs to price their goods and services at levels well below their true cost, encouraging waste and over-consumption; and (ii) it forces state-owned banks, pension funds, and governments to lend money at below-market rates, reducing their returns on investment and—in the case of pension funds—their returns to beneficiaries.

C. Driving Up the Costs of Doing Business

Because SOEs are often the sole provider of goods and services, their inefficiencies increase the costs of doing business.

SOEs are the sole providers of a range of core infrastructure services in the Pacific. While this market exclusivity may have been necessary at the time the SOEs were established, continued lack of competition or effective regulation results in high prices for the users of the services, poor service delivery, or both. In all five countries participating in this study, SOEs are the sole providers of power transmission and distribution services, water distribution, and seaport management. In RMI, one SOE provides all of the fixed and mobile telecommunications services. SOEs also provide fixed line telecommunications and airport services in four of the five countries participating in this study, although they engage with private companies for a range of airport services.[13] In the power, seaport, and water sectors, this lack of competition has resulted in comparatively high costs for services. Commercial rates for power are high by international standards. While largely determined by fuel costs and the cross-subsidization of residential users, it is interesting to note that the lowest rates are in Fiji, the only country that has introduced competition into the sector.[14]

Competition has in recent years been introduced in the mobile telecommunications sectors in Fiji, Samoa, and Tonga, resulting in significant decreases in call rates and improvements in network coverage. In 2009, Solomon Islands awarded a second mobile license to a private

[13] The airport in Solomon Islands is managed by the Ministry of Communications and Aviation; the Solomon Islands is also the only country participating in this study without a telecommunications SOE.
[14] Fiji has competitively tendered the provision of power to the public utility, resulting in three private power-generation contracts.

Table 2: **Selected Service Costs** (in$)	Fiji	RMI	Samoa	Solomon Islands	Tonga
Electricity (average commercial tariff in 2008 per kilowatt hour)	$0.18	$0.38	$0.35	$0.55	$0.42
Water (production cost per cubic meter of water distributed, 2008)	NA	$1.03	$0.87	$0.95	$0.69
Mobile telecommunications (cost of three-minute local call, peak)	$0.40 (2009)	$0.30 (2010)	$0.40 (2008)	$1.20 (2007)	$0.15 (2009)

Sources: ADB 2009. PSD Indicators. March; Digicel; RMI National Telecommunications Authority.

operator, who began operations in 2010, and call rates have declined as a result. Despite there being an SOE monopoly in RMI, call rates have also come down in recent years in line with trends around the Pacific. In the water sector, because tariffs in most of the countries are not indexed to the costs of service provision, costs of services remain a better benchmark of efficiency than tariffs. These are highest in Solomon Islands and RMI, due to low investment, poor metering systems, and high energy costs (Table 2). These two countries also record the highest level of customer complaints.

D. Considering Opportunity Costs

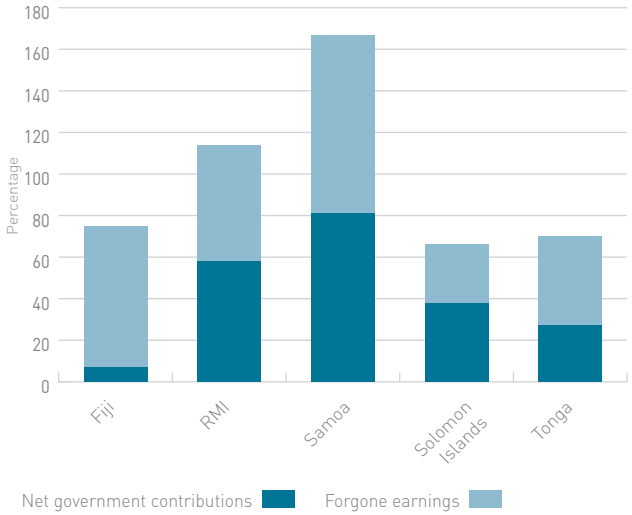
Investing in underperforming SOEs has opportunity costs by absorbing funds that could generate higher returns through more productive activities.

Ongoing investment in underperforming SOEs has both direct economic costs and opportunity costs. The opportunity costs are perhaps most striking when SOE investments are compared to the relatively low rates of public expenditure flowing into the vital health sectors in Fiji, RMI, Samoa, Solomon Islands, and Tonga.

During FY2002–FY2009, the governments provided new funds for underperforming SOEs through cash transfers, debt forgiveness, and asset donations, which totaled $42 million in Fiji, $80 million in RMI, $97 million in Samoa, $52 million in Solomon Islands, and $15 million in Tonga. In return, the SOEs generated losses of $42 million in RMI and $24 million in Solomon Islands, and profits of $33 million in Fiji, $6 million in Samoa, and $26 million in Tonga, falling well short of their government-targeted returns of $406 million in Fiji, $106 million in Samoa, and $50 million in Tonga. The Governments of RMI and Solomon Islands do not set profitability targets, but if ROE targets had been set at 10%, as in Fiji and Tonga, expected earnings would have been $33 million in RMI and $12 million in Solomon Islands. These earning shortfalls, together with new investment in the SOEs, totaled $414 million in Fiji, $155 million in RMI, $198 million in Samoa, $88 million in Solomon Islands, and $39 million in Tonga.

Health. During FY2002–FY2008, total government expenditures on health were $556 million in Fiji, $138 million in RMI, $119 million in Samoa, $135 million in Solomon Islands, and $54 million in Tonga (Figure 5).

Figure 5: **Ongoing State-Owned Enterprise Investment and Foregone Earnings as a Proportion of Total Health Expenditure** (FY2002–2009)



Sources: Annual Economic Statistics Tables (RMI), Annual SOE Audit Reports (RMI), Ministry of Finance (Solomon Islands), Ministry of Public Enterprises (Fiji), Ministry of Public Enterprises and Information (Tonga), State-Owned Enterprise Monitoring Unit (Samoa), World Health Organization National Health Accounts.
Note. Data on health expenditure is for 2002–2008. Data for RMI and Solomon Islands is for FY2002–2008.

II. Comparative Financial Performance of the SOE Portfolios

SOEs have generated low returns in all sectors in which they are active.

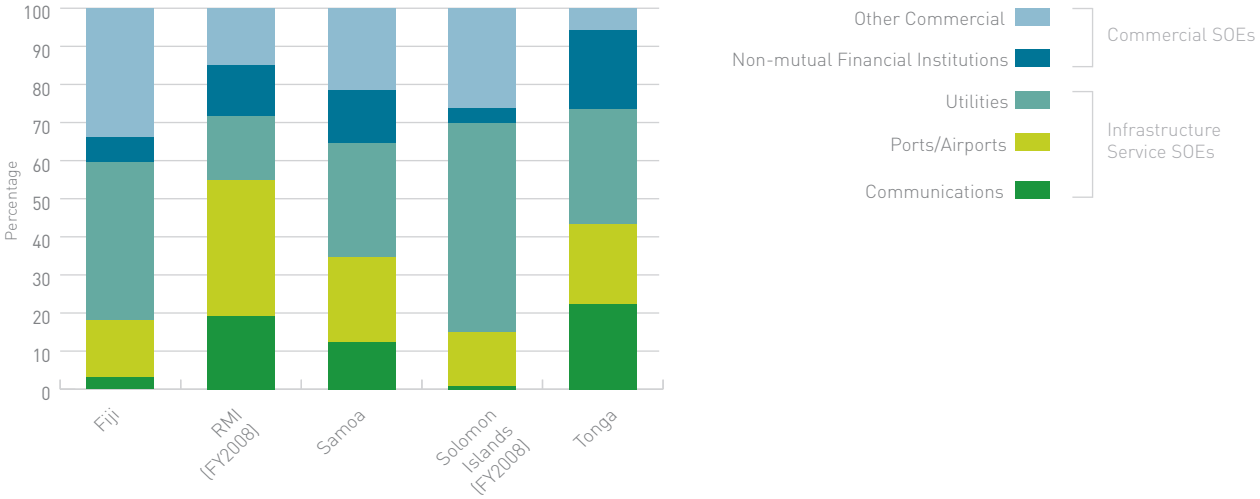
The SOEs in the countries participating in this study are engaged in two broad categories of activities: the delivery of core public infrastructure services—most notably airports, broadcasting, postal services, power, sanitation, seaports, telecommunications, and water—and a range of purely commercial activities such as air transport, banking, food processing, property development, retailing, and shipping.[15] In each of the five countries, the SOE portfolios are composed of a similar mix of activities, with infrastructure SOEs accounting for 59% to 77% of total portfolio assets (Figure 6).

All infrastructure services SOEs combine a mix of commercial and non-commercial activities. Their non-commercial activities (also known as CSOs) typically focus either on delivering core services to remote populations or providing services at a reduced cost to selected customer groups. If properly contracted and funded, the delivery of these CSOs should not have an adverse impact on the SOEs' profitability. The reality, however, is that CSOs are not properly identified, costed, contracted, or funded. Poor CSO management depresses the SOEs' profitability, contributes to inefficient resource allocation, and impairs the government's ability to assess whether the CSOs provide value for money or achieve the outcomes sought.

Important progress has been made, however, with the contracting of private companies to provide subsidized air and shipping services in Fiji, Solomon Islands, and Tonga and the implementation of new legal requirements in Samoa, Solomon Islands, and Tonga requiring the transparent management of CSOs.[16] These initiatives demonstrate the feasibility and benefits of robust CSO management and provide a sound basis for applying these practices to all of the SOEs.

During FY2002–FY2009, the ROEs of the infrastructure SOEs averaged 2.0% in Fiji, -13.3% in Marshall Islands, 1.4% in Samoa, -13.5% in Solomon Islands, and 5.8% in

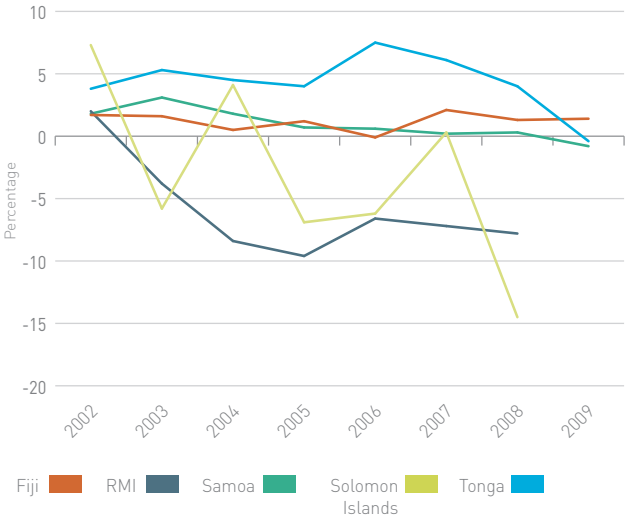
Figure 6: **State-Owned Enterprise Portfolio Composition** (Percent of Total Assets, FY2009)



Sources: Annual Economic Statistics Tables (RMI), Annual SOE Audit Reports (RMI), Ministry of Finance (Solomon Islands), Ministry of Public Enterprises (Fiji), Ministry of Public Enterprises and Information (Tonga), State-Owned Enterprise Monitoring Unit (Samoa).

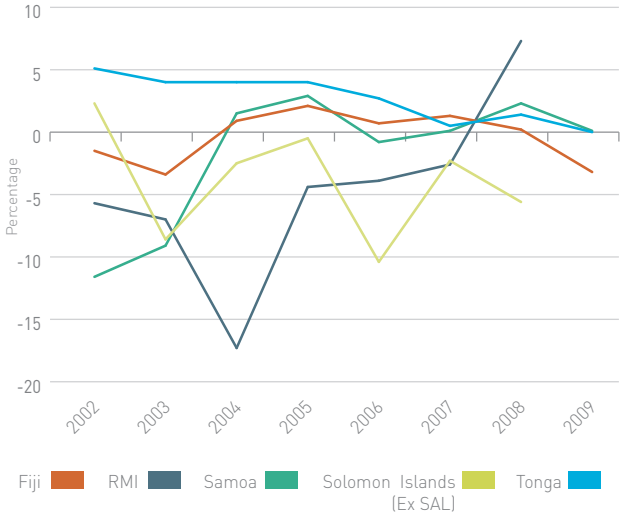
[15] A list of the SOEs classified as "commercial" and "infrastructure services" in each country is provided in Appendix 1.
[16] Fiji, Solomon Islands, and Tonga organized competitive tenders and awarded CSO management contracts to the bidders requiring the lowest subsidies. The existence of multiple bidders allowed the governments to assess the true market cost of providing the services and created efficiency incentives for the bidders.

Figure 7: **Infrastructure State-Owned Enterprise Return on Assets** (FY2002–2009)



Sources: Annual Economic Statistics Tables (RMI), Annual SOE Audit Reports (RMI), Ministry of Finance (Solomon Islands), Ministry of Public Enterprises (Fiji), Ministry of Public Enterprises and Information (Tonga), State-Owned Enterprise Monitoring Unit (Samoa).

Figure 8: **Commercial State-Owned Enterprise Return on Assets** (FY2002–2009)



Sources: Annual Economic Statistics Tables (RMI), Annual SOE Audit Reports (RMI), Ministry of Finance (Solomon Islands), Ministry of Public Enterprises (Fiji), Ministry of Public Enterprises and Information (Tonga), State-Owned Enterprise Monitoring Unit (Samoa).

Tonga. ROAs were also low, averaging 1.2% in Fiji, -5.9% in the Marshall Islands, 1.0% in Samoa, -3.1% in Solomon Islands, and 4.3% in Tonga (Figure 7). These returns would have been even lower if the SOEs had paid commercial, rather than subsidized, rates of interest on their debt. If that had been the case the ROEs for FY2002–FY2009 would have averaged 0.8% in Fiji, -15.5% in Marshall Islands, -1.6% in Samoa, -48.8% in Solomon Islands and 4.8% in Tonga.

Continued government support for and ownership of commercial SOEs, in particular, should be questioned.

Results for the commercial SOEs in three of the five counties are even more disappointing. During FY2002–FY2009, their ROEs averaged -1.0% in Fiji, -11.2% in the Marshall Islands, -8.2% in Samoa, and 7.1% in Tonga. In Solomon Islands, the negative equity of the commercial SOE portfolio in FY2003 and FY2007 does not allow a comparable average to be calculated. ROAs were also low, averaging -0.4% in Fiji, -4.9% in Marshall Islands, -1.8% in Samoa, -7.9% in Solomon Islands, and 2.7% in Tonga (Figure 8). If these SOEs had paid commercial, rather than subsidized, rates of interest on their debt, their ROE for this same period would have been even lower, averaging -1.9% in Fiji, -22.2% in the Marshall Islands, -15.5% in Samoa, and -2.8% in Tonga. In addition, many of these SOEs received substantial capital contributions from their government owners during FY2002–FY2009.

Given these poor results (Table 3), the governments' continued support for and ownership of the commercial SOEs must be questioned. In all five countries, the commercial SOEs' returns were lower than the returns offered by local commercial banks for low-risk deposits. Since these SOEs are not providing any specific public service or achieving any government policy objective, taxpayers in these countries are likely to be better off economically if these SOEs were divested and the proceeds invested in low-risk bank deposits or—even better—in high-yielding education and health programs.

Table 3: **SOE Performance Indicators**	Fiji	RMI (2002-2008)	Samoa	SOL (2002-2008)	Tonga
Net contributions by government (all SOEs) FY2002–FY2009 ($million)	42	80	97	52	15
Actual earnings (all SOEs) FY2002–FY2009 ($million)	33	-42[a]	6	-24[b]	26
Target earnings (all SOEs) FY2002–FY2009 ($million)	406	33	106	12	50
Average ROE, all SOEs FY2002–FY2009	0.7%	-13.2%	0.2%	-13.9%	6.0%
Average ROA, all SOEs FY2002–FY2009	0.4%	-5.9%	0.1%	-4.5%	3.6%
Commercial SOEs					
% of total SOE assets 2008	46%	23%	35%	27%	33%
ROE FY2002–FY2009	-1.0%	-11.2%	-8.2%[c]	NA[d]	7.1%
ROA FY2002–FY2009	-0.4%	-4.9%	-1.8%	-7.9%	2.7%
Average actual cost of debt FY2002–FY2009	6.0%	0.5%	5.2%	4.7%	3.3%
ROE adjusted for commercial debt rates FY2002–FY2009	-1.9%	-22.2%	-15.5%	NA	-2.8%
Infrastructure Services SOEs					
% of total SOE assets 2008	54%	77%	65%	73%	67%
ROE FY2002–FY2009	2.0%	-13.3%	1.4%	-13.5%	5.8%
ROA FY2002–FY2009	1.2%	-5.9%	1.0%	-3.1%	4.3%
Average actual cost of debt FY2002–FY2009	4.5%	8.4%	2.7%	5.9%	6.1%
ROE adjusted for commercial debt rates	0.8%	-15.5%	-1.6%	-48.8%	4.8%

NA = not available.
[a] This figure includes $34.7 million of total government subsidies during 2002–2008.
[b] This figure does not include the more than $216 million in debt forgiveness in 2008 booked as extraordinary income by Solomon Islands Electricity Authority, Solomon Islands Water Authority, and Soltai Fishing and Processing Limited, or the $62 million in extraordinary charges booked by SIEA in 2007 as a result of a Solomon Islands Government request to write-off accounts receivable.
[c] In Samoa, the restructuring of Polynesian Airlines had a material impact on the performance of the group of commercial SOEs over the period analyzed; if Polynesian Airlines is excluded, the average ROE and ROA of the commercial SOEs for FY2002–FY2009 is 0.4% and 0.2%, respectively.
[d] In Solomon Islands, the average ROE for the consolidated and infrastructure portfolios does not include data for FY2007 because the portfolios had a negative net worth in that year. The ROE of the commercial SOE portfolio is not provided because this portfolio had negative equity in both FY2003 and FY2007, resulting in figures which would not be directly comparable to those of the other countries. The restructuring of Solomon Airlines had a material impact on the performance of the group of commercial SOEs over the period analyzed; if Solomon Airlines were excluded the average ROE and ROA for FY2002–FY2008 is -20.9% and -4.0%.
Sources: ADB Staff Estimates, Annual Economic Statistics Tables (RMI), Annual SOE Audit Reports (RMI), Ministry of Finance (Solomon Islands), Ministry of Public Enterprises (Fiji), Ministry of Public Enterprises and Information (Tonga), State-Owned Enterprise Monitoring Unit (Samoa).

III. Sector Focus: Comparative Performance of Water and Port SOEs

A closer analysis of the performance of selected SOEs in similar lines of business in each of the five participating countries provides an insight into the impact of management and governance practices, investment strategies, and CSO frameworks. SOEs in the water and port sectors were reviewed with a range of financial and non-financial indicators so that core performance drivers could be identified. The analysis reveals that the SOEs in the port and water sectors suffer from the same lack of commercial discipline and accountability as the SOEs in other sectors. Beyond this general observation, there are issues unique to the SOEs in each sector; the low cost-recovery levels in the water sector contribute to SOEs' inability to finance needed capital investments; and the weak governance arrangements in the port SOEs in Samoa , RMI, and Solomon Islands have led to their underperforming the Ports Authority of Tonga, which handles significantly less cargo volume than Samoa and Solomon Islands.

Chronic lack of commercial orientation results in poor financial and operational performance among water utilities.

Four of the countries participating in this study have water utilities that provide reticulated water to the main urban centers, and in some cases maintain rainwater or other wells and pumps for non-reticulated water supply.[17] In all four cases, the utilities cross-subsidize low residential customer tariffs with higher commercial customer tariffs, which is standard practice in the water sector. Residential tariffs are approved by the governments. Notably, only one of the four utilities, Tonga Water Board (TWB), is able to generate a positive return on investment due to low operating costs and a tariff rate that comes close to full cost recovery. This allows that utility to have a stronger commercial orientation than the other water companies, although it is still not profitable enough to cover its cost of capital or to reinvest back into the company.

Like all of the utilities studied, TWB relies on grants for all of its capital investment. It has the lowest non-revenue water (NRW)[18] ratio, in part due to a focus on reducing leaks in its piped network. Billing and collections are comparatively efficient, and TWB operates with enough autonomy to encourage payment by discontinuing service to delinquent account holders. Despite its strong performance on collections, TWB has resisted recommendations from its management and the Ministry of Public Enterprises (MPE) to raise tariffs to cost-recovery levels, look for opportunities to contract out some services, and create a shared service with TPL for metering and billing to further reduce costs. This may be due in part to TWB's conflicted role as both the operator and regulator of the sector. The presence of a minister and public servants on TWB's board likely leads to the promotion of the regulatory function at the expense of commercial objectives. As a result, the benefits generated by TWB's performance enhancing reforms are muted by non-commercial decision-making.

The operating efficiency of water utilities can be measured in part by the staffing levels as well as by the levels of NRW. Water companies in larger and more developed markets are typically able to operate with fewer than four staff per 1,000 connections. In the Pacific, only Vanuatu's privately run Union Electrique du Vanuatu achieves these efficiency targets.[19] The four utilities in this study have 8–12 staff per 1,000 connections (Table 4). NRW levels are also comparatively high in the study countries, ranging from 36% to 60% of total system input volume

[17] The Water Authority of Fiji is not included in this analysis because it was formed in early 2010.
[18] Non-revenue water is measured as the difference between the total system input volume and the billed or authorized consumption of water; it includes unbilled consumption, illegal connections, and technical losses from leaks and overflows.
[19] It is recognized that Union Electrique du Vanuatu distributes water only to densely populated urban areas, which helps to improve this efficiency ratio.

Table 4: **Selected Water Indicators** (2008)	RMI (MWSC)	Samoa (SWA)	Solomon Islands (SIWA)	Tonga (TWB)	Rodney District Council (Auckland)
Number of service connections	5,313	17,000[a]	9,830	10,638	18,352
Volume of water distributed (cubic meters)	1,457,380	7,200,000	4,565,000	3,740,000	3,809,384
Cost per cubic meter of water distributed ($)	$1.03	$0.87	$0.95	$0.69	$0.78
Average commercial tariff per cubic meter ($)	$1.0	$0.60[b]	$1.3	$1.0	$1.1[c]
Average cost-recovery rate without subsidy[d] (FY2002–FY2008)	88%	59%	83%	88%	140% (2008 only)
Non-revenue water (% of total)	NA	60%	58%	36%	18%
% of total receivables which are 90 days or more overdue	89%	29%	70%	6%	NA
Average subsidy payments as % of total revenue (2002–2008)	45%	53%	0&	0%	0%
Average ROE FY2002–FY2009	NA[e]	-2.61%	-26.99% (2005–2008)	0.49%	NA
Average ROA FY2002–FY2009	-22.62%[f] (2003-2007)	-2.53%	-18.33% (2005–2008)	0.44%	NA
Total employees	52	210	83	107	NA
Employees per 1,000 connections	10.2	12.4	8.5	10.1	NA
Revenue per employee ($)	$20,924	$26,238	$35,106	$21,692	NA

NA = not available.
[a] The total water customer base comprises 12,000 metered customers and 5,000 flat-rate (i.e. unmetered) customers.
[b] In Samoa, the commercial tariff is the lower block rate and is applicable to the first 40,000 liters per month consumption.
[c] The residential tariff is used for this comparator.
[d] The cost recovery ratio, which is the ratio of operating revenue to operating expenses, indicates the total amount of operating costs that are covered by operating revenue from water distribution; where the ratio is less than 100%, the utility is not able to collect enough revenue to offset costs, even if commercial tariffs are comparatively high, residential tariffs and NRW depress the overall cost recovery ratio.
[e] MWSC was insolvent in FY2002–FY2007 with a negative equity balance; a large recapitalization in FY2008 has returned the company to solvency, although it is still structurally loss-making.
[f] For MWSC, the average ROA is calculated for FY2003–FY2007 because substantial non-core operations income in 2002 and a large recapitalization in 2008 do not allow a comparable ROA to be calculated for those years.
Sources: Pacific Water and Waste Association, SOE financial statements, SOE management.

as compared to 20-30% in better performing emerging market water sectors.[20]

The Rodney District Council (RDC), which supplies water to one of the smaller districts of Auckland, New Zealand, is included in this comparator as a further benchmark, given its large rural coverage (247,500 hectares) and relatively small population served (96,400), thus making it comparable to a Pacific island. Despite the challenges of its market, the RDC has managed to maintain a high level of operational efficiency due to its consistent commercial focus. NRW is kept to 18%, and the company maintained a healthy 140% cost/revenue ratio in 2008, allowing it to reinvest into its network.[21]

The performance of the Samoa Water Authority (SWA) and the Solomon Islands Water Authority (SIWA) are of particular concern, with NRW levels of 60% and 57%, respectively. System leaks, metering inaccuracies, and illegal connections account for the high levels of NRW,

[20] For example, according to a 2006 study performed by the South East Asian Water Utilities Network, NRW levels of 47 water utilities across Indonesia, Malaysia, Thailand, the Philippines, and Vietnam averaged 30 percent.
[21] A number of indicators of profitability are not available for RDC as the water services functions have not been corporatized as a separate service entity and therefore RDC does not have its own balance sheet.

which in Solomon Islands results in lost revenue of approximately $3.8 million per year. Compounding this lost revenue are the poor collection rates on billed customers, as evidenced by the high levels of receivables (70%) that are 90 days or more overdue. This precarious financial position has forced SIWA to finance its operations by defaulting on its payables, most notably to the power utility to which it has accumulated a debt of about $160,000 per month.

In Samoa, high NRW levels have been largely due to the combined effects of a large, free water allocation of 500 cubic meters per month for each metered customer and technical losses through leaks in the pipe system. Low tariffs and high operating costs leave the company dependent on annual subsidies and grants to maintain the network to minimum standards, and without investment capital, progress on reducing system losses has been slow. In 2010, the free water allocation was discontinued, and a new tariff was introduced, which should help to improve SWA's financial performance.

On a smaller scale, the Majuro Water and Sewerage Company (MWSC) provides an interesting comparator to the TWB. TWB is approximately twice the size of MWSC and services twice the number of connections with twice the volume of water. Average commercial tariffs are the same, as is the number of employees per 1,000 connections, but the cost of distributing a cubic meter of water is twice as high for MWSC as it is for TWB. This is even more striking given that TWB operates on four islands and provides service 24 hours per day while MWSC provides water only 3 days a week for only 8 hours per day and only in Majuro. MWSC's comparatively high salary and energy costs—which TWB avoids by using gravity systems to reduce energy consumption—account for much of the difference in operating results. Moreover, a very poor recovery rate on receivables forces MWSC to rely entirely on government subsidies to maintain operations.

While the Water Authority of Fiji (WAF) is not included in this comparative analysis due to its very recent formation in 2010, it is encouraging to see that the government established WAF by corporatizing the Water and Sewerage Division of the Ministry of Public Utilities with an unambiguous commercial mandate. In its first 9 months of operations WAF has already produced impressive results, with revenue collections increasing from an average of F$1.1 million per month in 2009 to over F$2 million per month in 2010.

In summary, the varying financial performance of the utilities is largely attributable to their ability to reduce technical losses, improve collections, and negotiate equitable service provision contracts with government to allow full cost recovery.

Diversification into non-core activities adversely affects financial performance of port sector SOEs.

The performance of the port sector SOEs in the five countries participating in this study varies widely, with the Ports Authority of Tonga (PAT) achieving the best results in terms of the average ROE (3.74%) and average ROA (2.50%) (Table 5). The Fiji Ports Corporation Limited (FPCL) comes a close second in terms of ROE and ROA, but generates the highest revenue per employee. In infrastructure businesses such as ports, it would be expected that the benefits of economies of scale and size would have a significant impact on financial performance, but that does not appear to be the case. PAT is 26 times smaller than FPCL. Wellington's CentrePort Limited, which is an efficiently run port with 31 times the asset size of PAT, showed only a slightly healthier 4.34% ROA in 2007–2008.

Both Wellington's CentrePort and the Port of Napier provide useful benchmarking data for the PIC ports. While these two New Zealand ports handle greater volumes of cargo than PIC ports, their operational and financial ratios remain instructive. CentrePort and the Port of Napier achieved ROEs of 7.16% and 9.52%, respectively, compared to 3.56% for FPCL, less than 1.0% for Marshall Islands Ports Authority (MIPA), Samoa Ports Authority (SPA), Solomon Island Ports Authority (SIPA), and 3.74% for PAT. From this comparative review, size does not appear to have a significant impact on profitability. Other factors such as the degree of private sector participation, the level of asset utilisation and governance arrangements play a larger role.

The degree of contracting out of port operations varies among the five PICs. In Samoa, SPA is a pure landlord port

Table 5: **Selected Port Indicators** (2008)	Fiji (FPCL)	RMI (MIPA)	Samoa (SPA)	Solomon Islands (SIPA)	Tonga (PAT)	CentrePort Wellington, New Zealand[a]	Napier Port, New Zealand
Total container throughput (TEU)	93,789	2,174	24,487	18,182	11,937	91,490	160,479
Total general cargo processed (tons)[b]	1,605,670	NA	320,553	382,648	184,053	NA	NA
Total bulk cargo processed (tons)[c]	263,503	68,907	11,418	325,636	3,040	10,700,000[d]	3,117,500[e]
Cost per unit of cargo processed ($)	$11.33	$19.05	$14.08	$6.85	$16.17	$2.64	$7.52
Receivables as % of total revenue (average 2002–2008)	13.8% (2005–2008)	156.4%	9.6%	25.1%	14.2%	13.9%	8.2%
Asset utilization	24.5%	5.50%	10.0%	55.40%	30.50%	16.85%	37.04%
Average ROE FY2002–FY2009	3.56% (2005–2009)	-0.02% (2002–2008)	0.97%	-0.59% (2002–2008)	3.74%	7.16%	9.52%
Average ROA FY2002–FY2009	2.50% (2005–2009)	0.15% (2002–2008)	0.40%	-0.19% (2002–2008)	2.50%	4.34%	7.45%
Total employees	413	58	190	202	187	200	NA
Revenue per employee ($)	$46,137	$37,818	$26,401	$32,531	$18,946	$162,288	NA

NA = not available.
TEUs: Twenty-foot equivalent units, a standardized maritime industry measurement used when counting cargo containers of varying lengths.
[a] Figures for CentrePort and Napier port are not 2008 but an average for 2007–2008.
[b] Since ADB uses the metric system, "ton" equals 1,000 kilograms.
[c] Since ADB uses the metric system, "ton" equals 1,000 kilograms.
[d] Total cargo throughput.
[e] Total cargo throughput.
Sources: SOE management and accounts, CentrePort and Napier Port websites and annual reports.

with all of the stevedoring, container handling, and major maintenance contracted out to the private sector, with SPA retaining pilotage and dredging as core services. FPCL, however, undertakes many functions at its port, including stevedoring and pilotage, and it will soon own and operate several replacement pilot boats. In Tonga, PAT undertakes all port-related services, although it is in the process of moving to the landlord port model. While prudent levels of contracting out would be expected to improve port performance, this study does not reveal a clear causal link. From observation, where contracting out is undertaken within a weak management and accountability framework, the beneficial impacts are muted.

Underutilization of the significant asset base held by these port authorities clearly has an adverse impact on performance. SIPA, the port with the highest asset utilization rate, however, is the worst performer in terms of ROA with -0.19%. SIPA's high asset utilization is explained by its comparatively low asset value, which is just $11 million, smaller even than PAT. Setting aside the case of SIPA, it is noted that the port companies with the lowest asset utilization rates—MIPA with 5.5% with SPA at 10%—are also the two with the lowest ROAs at 0.15% and 0.40%, respectively. MIPA's comparatively poor performance is explained by the fact that they also own and operate the Majuro airport, which accounts for 74% of net assets, but only 39% of revenue.

From a review of SPA's business plan and annual accounts, its comparative underperformance is clearly driven by poor management practices and weak commercial drivers. The target ROA in the business plan is just 0.5%, and is the rate that is used to support the decision to invest in such non-core activities as a floating restaurant, marina, and wharf located on the southern side of Upolu Island, despite strong objections from the Ministry of Finance.

All of the port companies suffer the negative effects of poor governance. FPCL, which appears to have robust governance practices, has high director turnover rates, which may adversely impact board performance. In both Samoa and Tonga, the port boards have allowed management to undertake investments in non-core activities at investment rates well below the target ROE set by shareholders. In the Marshall Islands and Solomon Islands, there is no effective ownership monitor, no performance targets set by the shareholder ministers, and generally weak governance practices. It is, therefore, not surprising that operational and financial performance of the port SOEs in these two countries has been comparatively poor.

Because the economies in all of the PICs depend on trade with other countries for virtually everything they consume and much that they produce, the impact of high-cost and inefficient ports negatively impacts every sector of the economy and can create a significant drag on growth and productivity. Reform, which is therefore crucial, will require a combination of initiatives: improved governance; improved accountability; a greater commercial focus with hard budget constraints; sale of non-core assets and business lines; better asset utilization; and clearer management goals and consequences for non-achievement.

IV. SOE Reform in the Pacific: Progress and Lessons

While the governments of all five countries participating in this study have long recognized the need to improve the performance of their SOEs, the pace and extent of reforms have been directly correlated to the political commitment of successive governments. This reality underscores both the vital nature of political commitment and the sensitivities surrounding SOE reform. Because the benefits of SOE reform are often realized only after costs have been incurred, SOE reform can have negative political consequences. In PICs, political opposition to SOE reform stems from concern about: (i) the potential loss of patronage; (ii) the loss of direct control over SOEs, which are perceived to be important policy implementation tools; and (iii) potential job losses as SOEs are restructured and made more efficient. In some cases, opposition to SOE reform is also rooted in a distrust of the private sector and a belief that in small economies, like those in the Pacific, market forces and competition erode consumer welfare rather than enhance it. Section VI of this report addresses these and other common objections to SOE reform.

The pace of reforms in the each of the five countries participating in this study has differed markedly, with Tonga continuing to make steady progress in restructuring the boards, as well as the businesses of its SOEs, while Fiji, RMI, Samoa, and Solomon Islands struggle to address the key governance weaknesses and take steps to discontinue unviable business lines.

A. Fiji: Stalled Reform Overshadows Past Progress

Fiji has been an early implementer of SOE reform and a leader in the areas of public–private partnerships and contracting out, but progress has slowed since December 2006.

The SOE reform program in Fiji has been underway for more than 2 decades, although it was only formalized with adoption of the 1996 Public Enterprise Act. In 2001, the Government of Fiji established a policy framework for SOE governance, management, and privatization. A corporate governance framework followed in 2003. In August 2006, the cabinet approved a program to accelerate SOE reforms, although implementation of this program was suspended with the change of government in December 2006.

Fiji has been a leader in adopting a public-private partnerships (PPP) framework and in contracting out CSOs to the private sector, yet only limited progress has been made on these fronts since 2006. While the merger of Fiji Ships and Heavy Industries with the Fiji Ports Corporation, the successful corporatization of the Water and Sewerage Division of the Ministry of Public Utilities into the WAF, and the increase in electricity tariffs to facilitate future private sector participation in the electricity sector are notable achievements, little progress has been made in restructuring the chronically underperforming SOEs. The MPE, which has been focusing on improving monitoring and compliance since 2008, has undertaken performance assessments on four SOEs, in some cases at the instigation of the SOE boards. Other reform initiatives under active discussion are: modernizing the Companies Act, which is expected to be completed in 2010, strengthening the Public Enterprise Act, improving compliance monitoring and accountability structures, introducing incentives for SOEs to achieve performance targets, removing non-performing directors, and reviewing the merits of outsourcing the SOE monitoring function. Only a small number of divestments have been completed since 1998, but the government has indicated that it is looking to increase private sector participation in several SOEs in the coming year.

While Fiji's Public Enterprise Act is generally sound, it lacks specific guidelines for appointing directors as well as details on their duties and obligations. This should be addressed as part of a broader SOE reform program.

Prior to 2008, no public servants or ministers had served as directors on Fiji's SOE boards; however, staff from the MPE often sat as observers, which complicated the

accountability framework.[22] Recently, the government commenced the practice of appointing public servants as SOE directors, a practice explained on the basis that, given the risk of SOE board members' being subject to travel bans placed on government representatives by foreign governments, there are fewer private sector directors willing to serve on SOE boards. As of mid-2010, 14 public servants served on the SOE boards, and six of these as board chair. This represents nearly 25% of all directors of SOEs in Fiji.[23]

The loss of momentum in the SOE reform program has had an impact on the portfolio's performance. The wholly owned SOEs paid a total dividend of only F$15.8 million in the period from FY2007 to FY2009. Since FY2007, 14 of the 20 SOEs in the portfolio showed reduced profitability, with the largest decline recorded by the Fiji Sugar Corporation, which also experienced a production decline and a 30.9% price reduction on sales to its principal customer, the European Union. This deterioration in profitability, combined with a difficult FY2009 for Air Pacific and a devaluation of the Fiji dollar in April 2009, resulted in a drop in the consolidated ROE from 3.18% in FY2007 to -0.82% in FY2009. While the four SOEs that dominate the portfolio in terms of asset size and impact on consolidated profit—Airports Fiji Limited, Air Pacific, Fiji Electricity Authority, and Fiji Sugar Corporation—are making efforts to improve efficiencies, the policy environment does not appear favorable to the more substantive governance and structural changes, which are required to yield sustainable performance improvements.[24]

B. Marshall Islands: Absence of SOE Policies Fuels Poor Performance

As shown in the Marshall Islands, lack of effective monitoring and legislative framework encourages poor performance.

In the Marshall Islands, the lack of an effective ownership monitor and legislative framework has been compounded by the absence of political commitment to reform, although this now appears to be changing. Efforts to reform SOEs over the past 2 decades have had little sustained impact because these efforts have not addressed the fundamental issues of the absence of a true commercial orientation; the ability to recover full costs of service delivery; and the lack of hard budget constraints, accountability, and independence to pursue commercial objectives.

While the Marshall Islands does have legislation governing the establishment, operation, and governance of its individual SOEs, this framework deals inadequately with "ownership" interest, which is distinct from regulatory or "user" interest.[25] As a consequence, the government's relationship with its SOEs tends to be one-dimensional and focused on meeting short-term political expectations relating to SOE operations and impacts on its constituents, rather than ensuring sustainability and generating sufficient profit to reinvest back into the business.

In the absence of incentives to generate sustainable financial returns and the political commitment to enable SOEs to operate as commercial businesses, SOEs incurred operating losses in every year during FY2002–FY2008. Rising levels of accounts receivable within the portfolio, which averaged 66% of revenue in FY2002–FY2008, and the SOEs' failure to collect debts from each other or from other government clients are clear indicators of a persistent lack of political commitment to reform. Two of the largest SOEs—Marshalls Energy Company and Marshall Islands Ports Authority—accounted for 59% of the portfolio's assets in FY2008 and generated 61% of its total losses in that year. Only one SOE achieved a net positive contribution during FY2002–FY2008: the National Telecommunications Authority, the sole provider of fixed and mobile telecommunications services in the country. In aggregate, during FY2002–FY2008 the SOE portfolio accumulated total losses of $42 million, net of government subsidies, debt forgiveness, and capital contributions totaling $39 million. Accumulated losses and government contributions for FY2002–FY2008 totaled $81 million, or 170% of the average equity. The recurring losses have been so large that the portfolio consumes its own equity every 4.3 years.

[22] While the presence of MPE staff on SOE boards has the advantage of improving information flow from the SOE to the MPE, it has two significant disadvantages: (i) MPE staff sitting as observers could be "deemed" directors if they contribute to board discussions, which exposes them to all of the risks and duties of a director and could also compromise their ability to give free and frank advice to the responsible minister; (ii) The fact that MPE staff can have significant influence over board discussions, particularly when the board is new or in times of high uncertainty, creates a conflict for the MPE staff member and undermines board accountability.
[23] This is based on data from the 18 SOEs monitored by the Ministry of Public Enterprises.
[24] These four SOEs accounted for 76% of the SOE portfolio's revenue in FY2008, 65% of its assets, and 40% of its net profit.
[25] A number of RMI's SOEs have been created through their own establishing legislation.

The situation is clearly not sustainable. The cabinet, recognizing the need to reform the SOEs and reduce their fiscal strain on the budget, recently implemented a series of good practice principles applicable throughout the SOE portfolio and approved a restructuring plan for the Marshalls Energy Company. The good practice principles, which address key governance, disclosure, corporate planning, and tariff matters, are an important step towards placing the SOEs on a commercial footing. Their implementation, together with a proposed new SOE policy and future SOE act, will require concerted and unambiguous political support. If this support is forthcoming and sustained, there should be a dramatic improvement in the financial and operational performance of the SOE portfolio.

C. Samoa: Weak Political Consensus Slows Progress

The waning pace of Samoa's SOE reforms signals weakening political support.

With the restructuring and/or divestment of more than half of its SOE portfolio since the mid-1980s, Samoa has long been considered one of the most aggressive SOE reformers in the Pacific. During 2001–2004, SOEs in Samoa adopted accounting policies based on international accounting standards, and the cabinet formally endorsed the policy of SOE Ownership, Performance, and Divestment, which called for the divestment of all SOEs not considered strategic.[26] Samoa also adopted the Public Bodies (Performance and Accountability) Act in 2001, which at the time not only represented best practice in the Pacific but also improved on the New Zealand SOE Act on which it is based. With these elements in place since 2001, Samoa's framework for reforming its SOEs is robust enough to place them on a sound commercial footing.

Nevertheless, progress in implementing both the SOE policy and act has been slow due to the persistent lack of political support for governance reforms and much needed SOE restructuring. While Samoa has had some very high profile successes, such as the 2006 restructuring and privatization of the loss-making Polynesian Airlines and the 2008 sale of a controlling interest in the Samoa Broadcasting Corporation—both of which have generated service quality improvements—it appears unable to address the problems in its more chronically underperforming SOEs.

The country's SOE portfolio continues to perform poorly, with an average ROE of 0.18% and ROA of 0.11% for FY2002–FY2009. Moreover, dividends paid in the period from FY2007 to December 2009 were just ST3.98 million, of which 88% was contributed by SamoaTel. The majority of SOEs continue to submit—and receive cabinet approval

Box 4: Samoa Broadcasting Corporation Demonstrates Quick Wins from Privatization

In 2008, the Government of Samoa completed the privatization of the Samoan Broadcasting Corporation, which operated AM/ FM radio and a TV station in competition with private sector providers. Despite a history of profitability, the company recorded losses and a negative return on equity in 2006 and 2007, the two years preceding the sale.

The company was offered for sale via a competitive tender, which was awarded to a consortium led by the company's management. Four major shareholders, including the pre-sale chief executive officer, now own 90% of the company's equity, with the balance held by the staff. The government opted to retain the AM channel for public announcements and public emergency broadcasts.

A little over 1 year after the completion of the sale, the new owners reported improvements in almost all aspects of the business. In the first year after the acquisition, the company earned sufficient profit to pay the new owners a dividend. In the second year, the directors elected to retain the profits in the business as they embarked on a reinvestment program.

Radio coverage has increased from 85% of the population to 98%; TV broadcasting hours have been extended; the company has expanded its TV program offering and invested an estimated ST400,000 into broadcasting infrastructure; and staff morale and commitment have improved.

This sale demonstrates not only that privatization can bring immediate operating benefits and improved profitability, but also that state-owned enterprises can be sold for fair value even when they are making losses. Purchasers will value a business based on how they will manage it and the business opportunities they can identify; not on the success or failure of the previous owners' business strategies.

[26] The SOEs that are considered strategic in this policy document are: Electric Power Corporation, Samoa Airports Authority, Samoa Ports Authority, Samoa Shipping Corporation, and Samoa Water Authority.

for—corporate plans with profitability forecasts well below the government's 7% target ROE rate. Shortly after the publication of the Finding Balance study in February 2009,[27] the cabinet issued a directive demanding improved financial performance from the SOEs and compliance with the 2001 Public Bodies Act; in particular, the requirements to: (i) remove ministers and public servants from SOE boards, (ii) hold SOE management and boards accountable for poor performance, and (iii) eliminate informal, politically mandated CSOs. As of July 2010, however, little progress had been made to restructure or close down loss-making or insolvent SOEs, and the amending legislation required to facilitate the restructuring of the SOE boards had not yet been formulated. Consequently, the performance of the SOE portfolio has further deteriorated, with the SOEs recording a consolidated ROE of -0.7% in FY2009.

Looking forward, however, there are signs that progress can be made in improving the governance arrangements for SOE boards in 2011; Samoa has established an independent director selection committee, the first of its kind in the Pacific.[28] This committee has also been tasked with preparing the amending legislation required to facilitate SOE compliance with the governance provisions of the 2001 Public Bodies Act. Once the committee is operational and the supporting legislation enacted, the committee should facilitate the strengthening of the SOE boards. Further, since 2007, the percentage of SOE chief executives employed on performance based contracts has increased from 47% to 100%. These developments, together with the privatization of SamoaTel, which is scheduled for 2011, and pending legislation to open up the electricity sector to competition, could give a much-needed boost to the SOE reform agenda in Samoa.

D. Solomon Islands: Weak Implementation of Sound Legislation Yields Poor Results

Solomon Islands has suffered from decades of poor SOE performance, as SOE management has been driven by political rather than commercial imperatives.

As in all countries, SOE reform in Solomon Islands has largely been driven by fiscal necessity, which is often the catalyst for the needed political commitment. In the late 1990s, as part of its structural adjustment program, the government undertook an aggressive restructuring and divestiture program for its 21 SOEs, preparing several for sale and completing two privatization transactions before tensions erupted in 1999. Following a change in the government in 2000, the privatization program was halted, and efforts to restructure SOEs effectively abandoned. SOE performance deteriorated; the Development Bank of Solomon Islands was put under the administration of the Central Bank of Solomon Islands in 2005; and the balance of the portfolio generated net losses in every year except 2004.[29]

Attempts to improve the performance of the SOEs over the past decade have delivered mixed results. A new SOE Act, passed in 2007, and its accompanying regulations issued in 2010, provide a robust framework for the governance and monitoring of the SOEs, but important provisions have yet to be implemented. SOEs still fail to prepare and publish timely annual reports and statements of corporate objectives; directors continue to be appointed by ministers largely on the basis of political rather than skills-based considerations; and board directors who are public servants continue to receive compensation and other benefits from their roles as directors, in direct violation of the SOE regulations. With neither governance nor competition creating pressure to achieve good performance, the SOEs have failed to develop the commercial focus required for effective management.

The net result is that the Solomon Islands SOE portfolio is one of the poorest performers in the Pacific in terms of ROE, with an average return of -13.9% for FY2002–FY2008 and accumulated losses of SI$184 million ($24 million) during the same period. A financial restructuring of the SOE portfolio in FY2008 cost the Ministry of Finance an estimated SI$220 million, bringing the total government contribution to at least SI$398 million ($52 million) for FY2002–FY2008. This restructuring, which was intended to reduce the debt levels and financing costs, is likely to have only a temporary impact on improving the profitability of the portfolio because high levels of receivables, poor

[27] ADB. 2009. *Finding Balance: Making State-Owned Enterprises Work in Fiji, Samoa, and Tonga.* Manila.
[28] The committee comprises three independent members from the private sector, who select preferred director candidates and make recommendations to cabinet that they be appointed.
[29] It should be noted that during this period Solomon Islands National Provident Fund, which is not included in this study, underwent governance reforms that have protected it from political interference and allowed it to operate profitably.

recovery practices, and high operating costs lock many SOEs into loss-making cycles.[30] In FY2008, the most recent year for which financial statements are available, 6 of the 12 SOEs were insolvent.

Beyond the fiscal strain created by the SOE portfolio's poor financial performance, many of the SOEs are also failing to meet minimum service delivery standards in such key infrastructure sectors as power, water, and transport. This poor performance reinforces one of the key lessons of this study: that continued government investment in SOEs does not improve performance unless it is accompanied by operational restructuring measures and robust governance reforms. This lesson has been applied to two SOEs—Solomon Islands Electricity Authority (SIEA) and Soltai Fishing and Processing Limited—and their success should serve to demonstrate the importance of wholesale restructuring to ensure performance improvement. Indeed, the new Government of Solomon Islands has an opportunity to leverage the experience of SIEA and Soltai Fishing and Processing and launch a broader set of reforms across the SOE sector, carefully building on successive improvements in governance practices.

E. Tonga: Reform Continues at a Steady Pace

Tonga's political commitment to SOE reform may have hit some speed bumps, but reforms are beginning to show results.

Tonga continues to pursue a broad-based SOE reform program, which began in 2002 and picked up considerable pace after 2006. Reforms have slowed somewhat in the past year, however, due to the more politically sensitive nature of the next phase of the reforms, which includes removing politicians from SOE boards and navigating the legal and operational complexity of restructuring the remaining SOEs. While the government did not meet its own target of removing all politicians from the SOE boards by the end of 2008, it did successfully restructure five SOE boards in 2009 and a further five in 2010, whereby independent directors have replaced all of the politicians and public servants on those boards. The government also was the first PIC to increase public disclosure by publishing notices in local newspapers highlighting the financial and operational results of its SOEs in FY2008 and FY2009.

Box 5: **Competition Spurs Reform**

In addition to efforts to restructure and privatize SOEs, Fiji, Samoa, Solomon Islands, and Tonga have made notable progress introducing competition in sectors previously dominated by SOEs. These efforts have resulted in dramatic improvements in service coverage and substantial reductions in cost.

For example, by opening the mobile telecommunications sectors to competition, Tonga (in 2002) and Samoa (in 2007) were able to rapidly increase coverage and reduce calling costs by 20% to 50% in the first year. In 2008 and 2010, Fiji and Solomon Islands, respectively, followed suit and opened their mobile telecommunications sectors to competition, with similar drops in calling costs. In the power sector, Fiji created competition by allowing private providers to generate power independently; Samoa is currently restructuring its power sector to eventually allow the same; and Tonga has recently developed an Energy Roadmap that will also lead to increased competition.

After the Ministry for Works introduced competition for road maintenance services, Samoa saw a 400% increase in productivity in a 4-year period. These examples illustrate the powerful role competition can play in creating efficiency incentives for SOEs; and consequently, lowering SOEs' cost of doing business, particularly in cases in which SOEs compete on an equal basis with the private sector. Competition creates welfare benefits for consumers as well as for taxpayers, who are the ultimate owners of SOEs.

Other notable reforms include the implementation of a detailed CSO policy, development of job descriptions for all SOE directors and chairs and development of a director performance and evaluation process to assist in further training and development, whereby an SOE director's performance will be evaluated on an annual or biannual basis. In mid-2009, the cabinet directed that an amendment bill be drafted to address key shortcomings in the Tonga SOE Act, including establishing a profit requirement for SOEs, workable CSO provisions, clear guidelines on the selection and appointment of directors, strengthened directors' duties, and improved reporting requirements. The amendment bill was enacted in October 2010. The law now makes it clear that no minister or member of the legislative assembly can be appointed as an SOE director, and a public servant who is appointed can

[30] This was certainly true of SIEA, whose average receivables balance was 51% of total revenue in FY2002–2008; but recent changes in its management and board, together with operational restructuring measures, should help to place the company on a more sound and sustainable commercial footing.

Box 6: **Proper Establishment is Critical to SOE Success**

Many SOEs are created through a process of carving out their activities and associated assets from existing government departments. The purpose of this corporatization process is usually to increase the efficiency and cost-effectiveness of the activities; and as such, the SOE should be established with only the assets and resources needed to efficiently deliver these activities.

Problems arise, however, when SOEs are burdened with excessive or overvalued assets; are undercapitalized; or are set up in a way that is favorable to the ministry or department from which its assets are being transferred rather than one that is based on commercial drivers; in the best interests of the new SOE, its customers, and its owner (the government).

The recent establishment of Tonga Airports Limited and Tonga Post Limited is a case in point, as both were corporatized with overvalued assets. In the case of Tonga Airports, land valued at T$10 million was placed on the balance sheet while the title to the land was not transferrable to the SOE. In the case of Tonga Post, the opening balance sheet recorded stamps valued at T$10 million while the stamps had no real commercial value. In both cases, the SOEs had to write-off the overvalued assets in their first 2 years of operations.

The Government of Tonga has now begun using establishment boards to ensure that that new SOEs have a reasonable chance of operating as successful businesses. An establishment board was recently used to set up a new SOE to take over operation of the biosecurity heat treatment facility from the Ministry of Agriculture. The establishment board negotiated the commercial value of the assets to be transferred, performed due diligence, developed a business plan, negotiated employment contacts, and ensured that all proper commercial arrangements were in place.

serve neither as chair nor on more than one SOE board contemporaneously.

While there have been no further privatization transactions or asset sales since 2008, the government has prepared and is implementing rationalization strategies for eight SOEs, which should lead to further improvements in their performance. Overall, the SOE portfolio showed a marked reduction in average ROE for FY2007–FY2009 (3.1%) compared to FY2002–FY2006 (7.7%). This decline is due to five principal factors: (i) the FY2007–FY2009 addition of four SOEs to the portfolio, which had relatively low returns in their first years of operation;[31] (ii) a sharp reduction in profitability at the Tonga Communications Corporation, which contributed an average of 67% of the portfolio's consolidated net profit in FY2002–FY2009;[32] (iii) significant losses by the Shipping Corporation of Polynesia in FY2007 and FY2009; (iv) the global financial crisis, which resulted in a contraction of the Tongan economy in FY2009; and (v) the privatization of Leiola Duty Free in 2007, an SOE which averaged an ROE of 16% in FY2002–FY2007. The overall portfolio result hides improvements since FY2006 in individual performance of some SOEs—Tonga Broadcasting Corporation, PAT, and TWB—and the positive impact of the privatization of Tonga Machinery Pool. Further, in the period FY2007–FY2009, Tonga's SOEs paid T$18.8 million in dividends. In FY2010, the average ROE is likely to rise with a significant improvement in TPL's profitability, which in its first full year of operation demonstrated the benefits of successful reform by achieving an 8% return on equity. Stronger commercial practices, improved governance, and tighter accountabilities will lead to improved performance in a number of other SOEs in the years to come, provided continued political commitment for reform.

F. Core Lessons from Reform Experiences

Nine core lessons emerge from the SOE reform experiences in Fiji, Marshall Islands, Samoa, Solomon Islands, and Tonga:

(i) Political commitment to reform is paramount.

(ii) Robust legislation and governance frameworks will not improve SOE performance unless there is political will to enforce them.

(iii) There is a clear link between the lack of effective ownership monitoring and poor SOE performance.

(iv) Successful reform programs are driven from within, not imposed from outside.

(v) Successful SOE reform explores all available restructuring mechanisms, including but not restricted to privatization.

[31] The four new SOEs are Tonga Waste Limited, Tonga Post Limited, Tonga Power Limited, and Tonga Airports Limited. Tonga Power and Tonga Airports have significant assets, but, in Tonga Airport's first year of operation (FY2009), poor returns. Tonga Power also had poor returns in 2009, but operated for only part of the fiscal year.

[32] Tonga Communications Corporation incurred an 11.4% drop in revenue and 18% increase in expenses in FY2009, resulting in a 94% drop in net profit. Intensifying competition, increases in salaries and wages, write-offs of overvalued assets, and provisions for doubtful receivables all contributed to the decline in profitability.

(vi) Incomplete corporatization of SOEs depresses operational and financial performance and complicates later reform.

(vii) Competition is a powerful driver for improved SOE performance. The most efficient SOEs are those that compete with the private sector on an equal footing.

(viii) Continued financing of poorly performing SOEs does not result in improved performance, but rather encourages continued poor performance.

(ix) The private sector is mature enough to invest in SOEs in most PICs, and should be given the opportunity to do so.

V. Commercialization Delivers Results

The performance of the SOEs reviewed in this study illustrates the consequences of managing SOEs on non-commercial terms. While all of the SOEs reviewed are corporatized, few operate with management independence, profit orientation, hard budget constraints, or accountability for results. These characteristics are essential for improved SOE efficiency. This study and international experience have shown that the key to successful reform is to infuse SOEs with private sector discipline and competitive market pressures. This forces SOEs to meet their costs of capital and divest any activities that are not commercially viable.

The comparative performance of the five SOE portfolios is driven by two major factors: the robustness of the initial corporatization process and the extent to which SOEs have undertaken commercialization. In order for real benefits to materialize, corporatized SOEs must be required to operate with the same performance incentives and accountability for results as private enterprises. This is true at both a country level and at an SOE level.

At a country level, Tonga's portfolio is the best performing among the five countries in this study largely as a result of its efforts to develop and implement comparatively strong commercial practices, improved governance, and tighter accountabilities within its SOE portfolio. In the Marshall Islands—where there is no clear commercial mandate underpinning SOE performance requirements, no supporting SOE legislation establishing board responsibilities and accountabilities, no minister responsible for the SOE portfolio, nor concept of ownership monitoring—SOE performance is poor. Similarly, in Solomon Islands, weak implementation of these supporting mechanisms has facilitated poor SOE performance.[33]

At an SOE level, the performance of TPL, Samoa Shipping Corporation and the recently restructured Soltai Fishing and Processing in Solomon Islands also demonstrates the gains that can be achieved with greater commercialization.

Box 7: Lessons Learned from New Zealand

In July 1984, New Zealand's incoming Labour Government inherited an economy on the verge of fiscal bankruptcy. Within the government, a core group of key ministers—supported by senior officials within the reserve bank, the treasury, and the Prime Minister's office—realized the need for economic reform. These ministers identified solutions and adopted a number of new policies, one of which was to corporatize and commercialize non-core and predominantly commercial activities that were being carried out by the government. This initiative established New Zealand's SOEs.

The 14 SOEs corporatized in 1987 achieved spectacular gains in productivity and profitability. During 1987–1990, for example, Telecom New Zealand reduced staffing levels by 47%, increased productivity by 85%, and increased profits by 300%. New Zealand Railways Corporation cut its freight rates by 50% in real terms during 1983–1990, reduced its staff by 60%, and made an operating profit in 1989–1990, the first in 6 years. In the decade following its corporatization, New Zealand Post reduced its workforce by 40%, increased its volume of business by 20%, and turned a NZ$40 million net loss into a NZ$48 million net profit without increasing the nominal postage rates. Coal Corporation increased productivity by 60% and cut its real prices by 20%.

Privatization also began in 1987. By mid-1995, a total of 27 privatization transactions had raised NZ$13.2 billion in asset sales, freeing up much-needed capital. This capital was either reinvested back into core government services or used to repay debt.

The success of the commercialization and privatization initiative created momentum that crossed party lines—subsequent governments, led by the opposition National Party, continued the SOE reforms. It is only in the last 9 years, as New Zealand's economy has improved and the government has run significant, successive fiscal surpluses that the reform process has slowed. As the fiscal necessity for SOE reform has waned, so, too, has political commitment to it, leading to deteriorating SOE performance.

[33] Solomon Islands introduced an SOE Act in 2007 and SOE regulations in 2010, but most of these provisions have not yet been implemented.

Table 6: **Composition of SOE Boards** (2010)	Fiji	RMI	Samoa	Solomon Islands	Tonga
Number of SOEs	18[a]	11	19[b]	13	13[c]
Number of directors	58	69	176	71	59
Number of elected officials serving as directors	0	22	20	11	2
Number of public servants serving as directors	14	13	66	19	4
Percentage of elected officials/public servants on boards	24%	51%	48%	42%	10%
Number of SOEs that have elected officials/public servants as chairmen of the boards	6	10	17	6	2

[a] This number includes only SOEs monitored by the Ministry of Public Enterprises.
[b] This number includes mutuals.
[c] This number includes Tonga Post Limited and Tonga Power Limited, which were established in 2009, and excludes Tonga Machinery Pool Limited, which was privatized in 2010, and Tonga Investment Limited.
Sources: Ministry of Finance (RMI and Solomon Islands), Ministry of Public Enterprises (Fiji), Ministry of Public Enterprises and Information (Tonga), SOE Monitoring Unit (Samoa).

A. Accelerate Commercialization

Renewed emphasis should be placed on accelerating and completing the commercialization process in each country, through the implementation of the existing legal and regulatory frameworks for the SOEs in Fiji, Samoa, Solomon Islands, and Tonga, and the establishment of a new framework in RMI.

This process will provide SOEs with an operating environment and performance incentives similar to those of private sector firms, protect them from inappropriate political interference, and ensure that they are fully accountable for their financial results. Key elements of the process include:

(i) strengthening corporate governance,

(ii) implementing robust frameworks for CSOs, and

(iii) imposing hard budget constraints.

1. Strengthening Corporate Governance

SOEs should be managed by skilled and experienced directors who make decisions that are clearly in the best commercial interests of the SOE, its owners, and key stakeholders.

When ministers and public servants serve as SOE directors, they face conflicts of interest that impede their ability to act in the SOE's best interest. Despite these conflicts, ministers and public servants continue to serve on SOE boards in four of the five countries participating in this study.[34] The poor performance of SOEs in these countries is an indication that the current governance arrangements are not working. Solomon Islands has made a commitment to accelerate the implementation of the SOE legislation, which should substantially reduce the presence of ministers and public servants on boards. In Samoa, progress is being made to enforce the provisions of its 2001 SOE Act, which restricts the appointment of ministers and public servants to SOE boards, and in Tonga, the boards of 10 of the current 13 SOEs, which were restructured during 2009–2010, no longer have ministers or public servants serving as directors.

2. Implementing Robust Frameworks for CSOs

CSOs should be delivered only on a full cost-recovery basis.

SOEs in Fiji, RMI, Samoa, Solomon Islands, and Tonga are often charged with delivering CSOs, even though in many cases they are not adequately compensated for the cost of these services. This practice complicates the SOEs' resource planning and distorts their performance incentives. It also distorts the government's ability to calculate the actual cost of the CSOs and determine whether or not the benefits justify the costs. All countries should adopt international best practices for managing

[34] In Samoa, for example, it is common practice to appoint ministers to SOE boards as chairs and senior public servants as chairs or directors. In 2010, ministers serve as chairs on 13 out of the 16 commercial SOE boards, and a senior public servant also chairs one. Of the 149 director positions on the 16 commercial SOEs, 75 positions are filled by ministers or ex officio appointments. Fiji has no ministers or public servants serving as SOE directors, but staff from the monitoring agency may act as observers on the boards.

Box 8: **Does Political Interference Impact SOE Performance?**

Yes. Political interference can make it very difficult for SOEs to meet their financial performance targets. When SOEs are directed by politicians to undertake activities that are not commercially viable, and are not specifically compensated for these activities, their financial performance suffers. The portfolios of Fiji, RMI, Samoa, Solomon Islands, and Tonga contain many examples of political interference in the management decisions of SOEs.

In Fiji: As a government commercial company, Rewa Rice Ltd is required to achieve a 10% return on equity (ROE), yet the government has also mandated that it continue to operate the Dreketi rice mill to support the local rice farming community, without a corresponding CSO payment. The mill is not commercially viable and represents a drain on the company's profitability.

In Tonga: The Tongan Development Bank is required to achieve a target ROE of 10% while also maintaining a branch network that is not commercially sustainable and for which the bank does not receive direct compensation. The Tonga Water Board and the Waste Authority Limited were discouraged by their politically led board from instigating improved collections systems due to the perceived public good nature of their services.

In Marshall Islands and Solomon Islands: SOEs, particularly infrastructure SOEs, are prohibited from disconnecting defaulting customers; especially where those customers are other SOEs and government ministries. The prohibition can also extend to private sector customers.

In Samoa: The investment decisions of the Samoa National Provident Fund (SNPF) also appear to be subject to political influence. The SNPF is owned by its contributors, although its board is appointed by the government. It manages a high-risk, low-return portfolio in which loans to local organizations and individuals make up 62% of total assets. Many of the SNPF's borrowers are SOEs that are in arrears and have demonstrated a limited ability to repay. In recent years, the fund's return on assets has averaged under 6% per year (net of administrative fees). It is likely that the SNPF would make different investment decisions and generate higher returns if it were managed on a purely commercial basis, with a focus on maximizing returns to contributors.

CSOs, including: (i) rigorously identifying, costing, contracting, financing, and monitoring the delivery of CSOs; and (ii) delivering CSOs only on a full cost-recovery basis. Among PICs, Samoa and Tonga have taken the lead in adopting these best practices, having developed CSO guidelines and mandated that all CSOs must be formally negotiated between the requesting ministry and the SOE.[35] This has resulted in a reduced number of applications for CSOs and an increased scrutiny of the costs and benefits associated with each approved CSO. In Samoa, the strict application of the CSO guidelines has resulted in the approval of CSO payments to only three SOEs. All other non-commercial services provided by SOEs (e.g. airports, non-commercial ports, and remote bank branches), should be discontinued, unless formally approved and financed under the guidelines. This has proved difficult to implement, however, and the fines and penalties, for which violators of the CSO provisions in the SOE Act and regulations are liable, are rarely enforced. Further, in Solomon Islands, detailed CSO guidelines do not yet exist but are planned for 2011.

Fiji's CSO framework is not as robust, but Fiji is the first of the PICs to effectively outsource CSO provision to the private sector. The government has contracted out remote air and shipping services to private providers, who bid for the routes in a competitive tender. This has significantly reduced the cost of service provision and has given the government a market-based assessment of the CSOs' true cost. Similar CSO outsourcing has also been completed in Tonga.

The most effective mechanism for CSO delivery is through an entity that is operating commercially, with the objective of generating a commercial ROA and an appropriate risk-adjusted return to its shareholder. This creates a healthy tension between the SOE, as the provider of the CSO, and the government, as the purchaser and funder, to ensure that they look to optimize the decisions relating to how that CSO is funded, costed, contracted, implemented, and monitored. Suboptimal outcomes arise when SOEs are allowed or directed to undertake non-commercial activities through some informal process without sufficient scrutiny, control, and oversight.

It may take more than one budget cycle to fully implement robust CSO frameworks, since governments will need to agree upon costing methodologies, develop assessment skills, and—where feasible—organize competitive tenders for the delivery of the CSOs. Some rationalization costs may also be incurred, particularly if there is excess

[35] In Samoa, these guidelines elucidate the precise rules in the Samoa Public Bodies Act and the regulations dealing with the application and approval process for CSOs.

Box 9: **Best Practices for Delivering Community Service Obligations**

International best practice for delivering CSOs is to treat them as commercial activities—structured with performance incentives and financed on a fee-for-service basis. This best practice involves six core principles:

Identify. Clearly define the CSO's planned output or outcome. The degree of specification must enable the funder and the performance monitoring agency to confirm that they are getting what they paid for in terms of cost, quality, and volume.

Cost. Cost the CSO in a manner that considers the true costs of delivery. Costs should always include the capital cost or the CSO provider's profit margin, to ensure cost neutrality with other commercial activities.

Contract. Cover all CSOs by a contract that establishes key terms, duration, price, performance measures, and penalties for non-performance.

Tender. Competitively tender the CSO whenever feasible; this will usually result in better prices and higher-quality services.

Monitor. Monitor the delivery of the CSO on an ongoing basis. Undertake a cost–benefit analysis before granting the CSO contract and at regular intervals to ensure that the provider is delivering the CSO as intended.

Finance. Fund the CSO in a manner that creates the greatest level of transparency and facilitates competitive tendering.

employment that is not recognized as a CSO and must therefore be discontinued. Governments can mitigate these displacement costs through measures such as redundancy payments and retraining programs, which have been successfully used in all five countries.

Over time, CSO reform will result in significant cost savings, as governments gain a clearer understanding of the costs and benefits of the CSOs and as SOE managers gain freedom to pursue their mandates to operate SOEs as successful businesses.

3. Imposing Hard Budget Constraints

Commercialized SOEs should operate under the same hard budget constraints as private sector firms.

Most private businesses have only one chance to achieve sustainable profits. Firms that have never made a profit, or those whose profit has declined substantially in recent years, typically find it impossible to raise funds to maintain unprofitable operations. In contrast, the SOE portfolios in the five countries participating in this study contain many examples of enterprises that have continued to receive government support after years of losses or declining profits.[36] Ongoing support for such loss-making SOEs creates negative performance incentives.

To impose hard budget constraints on SOEs, governments will need to: (i) eliminate all subsidized credit, guarantees, debt forgiveness, asset donations, and tax exemptions; (ii) discontinue unfunded CSOs; and (iii) restructure/divest any SOE or SOE business line that does not meet its cost of capital. Since most SOEs in the study countries are failing to meet their costs of capital, their respective governments should immediately assess their overall commercial viability and undertake either substantive restructuring or divestiture.

Hard budget constraints benefit most stakeholders: SOE managers, who gain the freedom to operate on purely commercial terms; taxpayers, who no longer need to prop up inefficient SOEs; and the private sector, which no longer competes against subsidized SOEs and faces the prospect of being crowded out. If hard budget constraints had been imposed on SOEs in Fiji, RMI, Samoa, Solomon Islands, and Tonga years ago, insolvent SOEs would no longer be trading, other low-return assets would have been divested, and the remaining SOEs would have been motivated to significantly improve their productivity.

Strengthened governance practices and hard budget constraints will increase the transparency and independence of SOEs, allowing governments to better assess their contributions and hold them accountable for performance.

Statements of corporate intent and corporate plans (also called business plans) should play an important role in setting out the SOEs' strategies and performance targets. Contracts for CSOs should ensure that any non-commercial activities are undertaken on a full cost-recovery basis. With these tools in place, stakeholders will be able to measure the performance of SOE boards and management, in particular by regularly reviewing financial and non-financial outcomes against targets. In addition, increased transparency will enable the government and—

[36] Support has been provided through asset donations, debt forgiveness, guarantees, tax exemptions, and subsidized loans.

Box 10: **SOE Subsidies Create Negative Performance Incentives**

All five countries participating in this study have poorly performing SOEs that continue to receive government subsidies while failing to achieve their performance targets. Evidence suggests that continued funding of these SOEs without substantial restructuring does not improve their performance but rather serves as an incentive for them to underperform. Examples of continued funding of SOEs without restructuring include:

Fiji. In the 8 years since 2002, Fiji Hardwood Corporation Limited has provided an average return on equity of -1.5% per year, well under the government's 10% benchmark. Despite these poor results, government contributions have continued. In 2004, an F$15.9 million loan was forgiven, yet the company continued to generate losses totaling F$17 million during FY2002–FY2009.

RMI. The Marshalls Energy Company has represented a major fiscal risk to the government for many years. The company has been generating operating losses since 2003, despite ongoing subsidy payments totaling $5 million since 2003. The company has been technically insolvent since 2004, with negative equity reaching $11 million in FY2008. Little effort has been made to address the poor recovery rates and weak governance arrangements, which are at the heart of MEC's poor performance, and this in turn has encouraged a "bailout culture" at the company. The government has recently agreed to a restructuring plan, however, which should help turn around the situation as long as key governance issues are addressed.

Samoa: The Public Trust Office has been generating losses in every year tracked since FY2002, accumulating losses of ST7 million during FY2002–FY2009 and forcing the government to recapitalize the company several times, most recently in FY2009. These losses, together with government recapitalization costs, total an estimated ST19 million.

Solomon Islands: Solomon Airlines has struggled to remain solvent during FY2002–FY2009, with negative shareholders equity in 5 of these 7 years. The government has had to provide budget support and loan guarantees to keep the airline operating, but little has been done to address the fundamental viability of the airline, which continues to generate losses.

Tonga: Tonga Timber Limited has generated an average return on equity of 0.8% per year since FY2002, falling well short of the government's 10% benchmark. During this period, the government has injected an estimated T$1.8 million—19 times TTL's total profits for the period. Despite these subsidies, the company's most recent return on equity (in FY2009) was -8.12%.

more importantly—the media and the general public to monitor SOE performance. This scrutiny will encourage greater accountability of SOEs, especially among their key decision makers. Regular reporting of SOE performance should, in turn, compel governments to restructure or divest SOEs that cannot cover the cost of their capital.

Statements of corporate intent, corporate plans, and CSO contracts would all enhance SOEs' transparency and accountability. Another valuable tool would be regular publication of detailed reports on SOE financial and non-financial performance. These reports would provide an overview of the performance relative to targets set in the SOE's statement of corporate intent and would also list all government and interagency transactions with each SOE. These reports would enable both the SOE monitoring unit and the public to assess overall performance and the degree to which SOEs continue to receive support from the government, the extent to which this support distorts the SOEs' true financial performance and whether the support is achieving the outcomes sought. This information would significantly improve the ability of SOE monitoring units to determine which additional reform measures would be most effective and to allow the public to judge how well the SOEs are achieving the objectives for which they were established.

Among the five countries participating in this study, Tonga was the first to publicly report on the performance of its SOEs by publishing notices in the local press highlighting the financial results of its SOEs in FY2008 and FY2009. The practice of public disclosure of SOE performance is now mandated in the Solomon Islands SOE Act and the 2010 amendment to the Tongan SOE Act.

B. Promote Private Sector Participation

Partial privatization and public–private partnerships can help to accelerate commercialization.

When full privatization is not politically feasible or desirable, partial privatization can help to accelerate commercialization and improve SOE performance. One of the most common forms of partial privatization is the joint venture, where the public and private sectors collaborate in forming a company to provide specific services (e.g., PolyBlue in Samoa). Another option is the PPP, which in certain circumstances can be more suitable than full

privatization for attracting private investment. A PPP is not a joint venture; it is a shared-risk contract between the public and private sectors to deliver a specific output over a period of time.

PPPs have been used extensively throughout the world, and increasingly in PICs. PPPs are most commonly used in the infrastructure sectors, particularly where large capital investments are required to produce a specific output. PPPs can take a number of different forms, but the most common include:

(i) **Service contracts.** The private sector provides a service, such as road maintenance or transport, for a fee.

(ii) **Management contracts.** The private sector manages, but does not own, public assets.

(iii) **Concessions.** The private sector modernizes public assets to deliver a specific output.

(iv) **Build–own–lease or build–operate–transfer.** The private sector builds a new asset (such as a hospital or power generation unit). The asset is then either leased back to the public sector (e.g., a hospital) or its output (e.g., power) is sold to the public sector or directly to consumers.

Partial privatization concepts are not new to PICs. Fiji, for example, has developed PPP guidelines and a PPP unit within the MPE. It already has in place several PPP contracts for electricity generation, and is currently seeking even greater private investment into the power sector. Samoa has successfully contracted out road maintenance services, which resulted in a 400% increase in productivity, and most recently developed a wastewater treatment facility on a build–operate–transfer basis. In Tonga, PPPs have been used to encourage investment in tourism infrastructure, and the private sector has been contracted to provide onshore services for the government-owned ferry operator. TPL is working with a New Zealand-based company to provide solar power generation through a PPP structure.

Fiji, RMI, Samoa, Solomon Islands, and Tonga should continue to actively explore PPP opportunities within the SOE portfolio, so that bankable PPP projects can be implemented and new opportunities identified. Critical to the success of PPPs or joint ventures with SOE participation, however, will be robust governance arrangements, full transparency, and arms-length relationships with government shareholders. These measures will ensure that SOEs operate on a fully commercial basis.

C. Allow Privatization to Lock in the Gains from Commercialization

Decades of international experience with SOE reform have shown that privatization is the most effective mechanism for bringing about long-term improvements in SOE performance. (Box 11.) Although some privatization transactions have failed (most notably when they have not been properly prepared or when a public monopoly has been transferred to a private monopoly without any corresponding improvements in the regulatory framework), in most cases private ownership brings much-needed commercial discipline, capital, and expertise, as well as access to new markets.

Privatization locks in the gains achieved through commercialization, in contrast to SOEs held in continued public ownership, which—even after reform—are often subject to increasing political interference. Political interference makes SOEs more likely to undertake activities that are not commercially justified and that reduce shareholders' returns. Over time, SOEs can again become mechanisms for delivering political solutions rather than commercial outcomes. This trend can be seen in New Zealand where—despite aggressive reform efforts that substantially improved efficiency—the ROE for the SOE portfolio declined from 7.89% during FY2000–FY2005, to 4.31% during FY2005–FY2010.[37] In smaller economies this "clawback" risk is likely to be even higher.

As shown by the experiences of Fiji, Solomon Islands, Samoa, and Tonga, privatization transactions are successful when they are properly prepared. Proper preparation includes prequalifying bidders, making adequate provisions for potential employee redundancies, and introducing competitive tension in the sales process.[38] Where privatization involves an effective or natural

[37] Source New Zealand Treasury. Significant railway assets were acquired by Ontrack and added to the SOE portfolio, which had a negative impact on returns for FY2007 and FY2008. The impact of Ontrack has not been discounted from these numbers because it was a government decision to reacquire the assets and add them to the SOE portfolio.
[38] Given the small size of these economies, opening up bidding to international investors typically increases the likelihood of a competitive process.

Box 11: Studies Demonstrate the Benefits of Private Ownership

Many international studies have shown that SOEs do not perform as well as private sector companies. A 2004 study by the Norwegian Institute of International Affairs, for example, concluded that "using return on assets as the measure of performance and carefully controlling for market structure and a range of factors that may have an impact on company performance; we find that the performance of SOEs is indeed inferior to that of private companies."[a] The same study also concluded that SOEs perform badly even where they have a favorable market structure and little competition.

Empirical evidence demonstrates that privatization improves business efficiency, enhances the competitiveness of markets, and increases overall economic welfare. In a recent survey, 20 out of 22 published academic studies on the effects of privatization observed that businesses performed better after they had been privatized. Ten of the studies compared the performance of public and private enterprises operating in the same industry; eight concluded that private sector enterprises performed better.[b] The survey also found that privatization increased the competitiveness of the markets in which former SOEs operated, as previously state-subsidized or state-favored businesses were forced to succeed (or fail) on their own.

Three surveys by the Organisation for Economic Co-operation and Development[c] and the World Bank[d] contain similar findings. These surveys, which reviewed over 50 published empirical studies examining hundreds of privatization transactions, showed that

(i) private firms tend to be more efficient than their state-owned counterparts, and

(ii) privatizing an SOE usually leads to a more efficient enterprise and a more open, more competitive market (thus benefitting consumers, taxpayers, and the economy as a whole).

The evidence does not show that private ownership is always more efficient. What it does show is that—on average and over time—the private sector is likely to run commercial enterprises more efficiently than the public sector.

[a] E. Goldberg, L.A. Grunfeld, and G.R.G Benito. 2004. *The Inferior Performance of State-Owned Enterprises: Is it Due to Ownership or Market Structure?* Paper No 663. Oslo: Norwegian Institute of International Affairs, p. 20.
[b] P. Barry. 2004. *Does Privatisation Work?* Policy Backgrounder No. 5, Wellington: New Zealand Business Roundtable.
[c] M. Gonenc, M. Maher, and G. Nicoletti. 2000. *The Implementation and the Effects of Regulatory Reform: Past Experience and Current Issues.* Working Paper No. 251. Paris: OECD Economics Department.
[d] M. Shirley and P. Walsh. 2000. *Public versus Private Ownership: The Current State of the Debate.* Research Working Paper No. 2420. Washington DC: World Bank.

monopoly, regulatory frameworks must provide adequate protection for consumers' interests.

Fiji, Marshall Islands, Samoa, Solomon Islands, and Tonga should consider full privatization for all commercial SOEs. The infrastructure SOEs, in contrast, may be better suited for partial privatization or for PPPs. CSOs, which are often found in infrastructure SOEs, can continue to be provided under private ownership (as demonstrated in both Fiji and Tonga).

D. Leverage SOE Reform to Develop the Private Sector

Where governments are committed to private sector growth, the SOE portfolio can be used as a powerful tool to support this policy. SOE reform creates both market and investment opportunities for the private sector. When SOEs that compete with the private sector are divested, it often results in a more level competitive playing field. Where full privatization is not feasible or desirable, the contracting out of selected services by SOEs to the private sector can enable smaller local firms, either on their own or in joint venture with offshore parties, to bid for the new services.

Domestic investors have actively participated in partial or full privatization transactions in the Pacific.

Both partial and full privatization of SOEs presents investment opportunities for the private sector. While it is often believed that privatization results in the sale of important state assets to foreign investors, the reality in the five countries participating in this study is that 11 out of 15 full or partial divestitures of SOEs since 1998[39] were acquired by domestic investors. Domestic investors have therefore demonstrated their capacity for and interest in participating in SOE divestments, and should be expected to continue to do so wherever SOE reform programs are actively pursued.

[39] No privatization transactions have been recorded in RMI during this period, but there have been 10 in Samoa; 2 in Tonga; 2 in Fiji; and 1 in Solomon Islands.

VI. SOE Reform: Common Myths

The fact that SOEs generally underperform comparable businesses in the private sector is neither new nor disputed by most observers. What is often debated, however, is whether this poor performance is balanced by other benefits provided by the SOEs and/or whether there are broader justifications for continued state ownership in these underperforming assets. Should reform even be attempted, or should we accept and embrace the status quo? Reform is complex and often controversial, regardless of where it is undertaken. Over the years, a number of myths, which have specific resonance in the Pacific, have evolved to argue against reform. Critically testing these myths is an important step in securing broad-based commitment to reform.

Common Myth #1: SOEs should not strive to provide a commercial return; they should instead focus on delivering essential services to the people.

Most SOEs are created through a process of corporatizing government departments or agencies, and this is undertaken to provide more transparency, accountability, and better efficiency incentives for the delivery of goods or services. To argue that SOEs should not strive to provide a commercial return is therefore to argue against the efficiency incentives that corporatization is designed to provide. This argument also implies that SOE profitability is incompatible with public service delivery, which is incorrect. Without the objective of providing a commercial return, it is very difficult for SOE management and directors to exercise their responsibilities in a fiscally responsible way. This is precisely why the SOE legislation in Fiji, Samoa, Solomon Islands, and Tonga clearly establishes the commercial objective for all SOEs as the primary objective. Without a clear commercial focus, decisions will be made that destroy value and progressively compromise the ability of the SOE to provide the goods or services that it has been mandated to deliver. These negative consequences can be seen in many of the SOEs reviewed in this study, which have become dependent on regular cash injections from their shareholder governments in order to maintain operations.

Common Myth #2: Only SOEs can fulfill CSOs; if SOEs are commercialized or privatized, CSOs will be discontinued.

It is often argued that because CSOs are by definition non-commercial activities, only the government (including SOEs) can provide them. This is flawed thinking. There is a difference between the government financing CSOs and the government delivering CSOs. The fact that CSOs cannot be financed solely through user fees does not mean that they cannot be provided by the private sector; it only means that they cannot be provided by the private sector without a public sector subsidy. Because SOEs are also required to operate as commercial enterprises, they, too, would require a subsidy to provide CSOs. It is in government's best interest to contract the delivery of CSOs to the most efficient provider, which may or may not be an SOE. The competitive tendering of CSO provision, where feasible, is most likely to result in a more cost-effective outcome. In Solomon Islands, for example, the recent tendering of contracts for interisland shipping services resulted in multiple bids and the successful awarding of the contracts to private providers. In Fiji, private companies already provide both subsidized shipping and air transport services under contract to the government; this process has allowed the subsidy to be reduced over time as the volume of users increase, making the services more commercially viable.

Common Myth #3: The process of commercialization is not achieving the benefits promised.

The continued poor performance of SOEs is often cited as evidence that the process of corporatization and commercialization is not working in PICs. This

is misleading, however, because the benefits of SOE corporatization and commercialization have been well demonstrated throughout the world. In New Zealand, for example, case experience strongly suggests that "there were major gains in efficiency from corporatization that were distributed among customers and owners. The movement in real prices and service levels show that customers were major beneficiaries from the changes. The swing from making no return to the government as owner and making substantial payments in dividends and taxes meant that citizens as owners were a major beneficiary also."[40]

While there are also examples in the Pacific of the gains that can be achieved through an effective commercialization process (e.g., NBV, Samoa Broadcasting Corporation, and TPL), there are unfortunately many more instances where the establishment of an SOE has failed to result in the level of improved performance that was sought.

Why are the gains from SOE commercialization not being seen in every case in the Pacific? In many instances SOE commercialization is still incomplete. Simply transferring a set of activities from a ministry or government department into an SOE corporate structure will not result in improved efficiencies and service delivery unless a conducive policy and regulatory framework exists and is implemented. This framework would include:

(i) an SOE policy setting out the government's expectations on how the SOE portfolio and individual SOEs will be managed to maximize shareholder value and achieve all of the benefits sought from the corporatization process; and

(ii) an SOE act establishing a commercial focus for SOEs, governance principles, under which they will be managed, and reporting and accountability structures. The act should also identify a minister who will be responsible for the "ownership" interest in the SOE and establish effective "ownership" monitoring oversight.

While four of the five countries participating in this study have SOE policies and enabling legislation, their provisions are not being fully implemented. Consequently, while SOEs have been corporatized, many do not operate with management independence, a profit orientation, hard budget constraints, or accountability for results. The commercialization process has been started but not completed, leading to the negative performance outcomes observed. A core finding from this study is that SOE performance is a function of how quickly and completely governments have implemented robust SOE policy and regulatory frameworks.

Common Myth #4: SOEs are vital generators of employment.

It is often suggested that the privatization or reform of SOEs will result in layoffs and a reduction in employment. This argument is flawed on a number of grounds:

(i) SOEs actually employ a relatively small proportion of the formal workforce: 2.6% in Fiji, 8.5% in Marshall Islands, and 5.8% in Tonga. Data constraints do not allow a similar calculation for Samoa and Solomon Islands, but it should be noted that in Samoa, a country that has close to twice the population of Tonga, SOEs employ 1,992 workers, approximately double the number as the SOE sector in Tonga. It would therefore be expected that the SOE sector in Samoa would employ about the same proportion of the formal workforce as in Tonga. In Solomon Islands, however, SOEs employ 1,877 workers, about the same number as in Samoa, yet the formal workforce is almost twice the size, so the percentage of the formal workforce in the SOE sector will be well under 5%;

(ii) If the SOE is providing valuable goods or services, those goods or services will still be required post-privatization, and employees will therefore continue to be required. While there may be some restructuring resulting in a rationalization of the workforce, this should result in the SOE being more competitive and therefore able to sustainably grow and expand its workforce in the future;

(iii) The SOE portfolios in all of the countries taking part in this study are failing to achieve a reasonable return on their equity. They are therefore not

[40] G.C.Scott: 1996. *Government Reform in New Zealand*. Occasional Paper No. 140. Washington, DC: International Monetary Fund.

contributing to overall economic growth, but are in fact destroying economic value. Continued government ownership in underperforming SOEs is actually limiting the opportunities for job creation; and

(iv) It is widely accepted that the private sector is the engine for economic growth. It is the private sector that will generate sustainable growth in employment. As this study shows, government's continued ownership of commercial SOEs can have the effect of crowding out the private sector and stifling growth, thereby stifling employment generation.

In New Zealand, during 1988–2004 when significant privatization activity occurred, total employment in the economy grew by 22%.[41] This suggests that while privatization may lead to reductions in employment within individual SOEs, the broader impact of SOE reform and privatization in New Zealand was to support economic expansion and employment growth.

Common Myth #5: Privatization results in increased tariffs for public services.

It is often thought that increased private participation in the provision of public services will result in increased prices for those services. While in some cases tariff increases do follow privatization or SOE reform, such as in PPP arrangements, there is no evidence to suggest that there is a direct cause and effect. Services cost money. When they are provided by an SOE at a tariff that does not allow the SOE to recover the full costs of delivery, as is often the case in the Pacific, the SOE is unable to make the investments required to maintain infrastructure, improve service quality, and expand access. This does not result in a cost savings, but rather a deferred cost because money will need to be invested to maintain these services at some future time. Often, the longer it takes to make this investment, the greater the actual cost.

If the private sector is contracted to provide (and in some cases expand) the services, it will only do so if it can cover its costs of delivery and make a profit. If tariffs are capped at rates that do not allow this full cost recovery, then a CSO subsidy will be required. This would be the same whether these services are provided by the private sector or an SOE operating under a commercial mandate. Where tariffs have undergone sharp increases following privatization, this has almost always been due to a concurrent change in the government's tariff policy, where a decision has been made to reduce the level of subsidy provided to consumers.

Extensive analysis of the impact of private participation in public service delivery internationally over the past 2 decades, particularly in utilities, reveals increased efficiencies and lower costs of delivery, resulting in improved value for money for government funders. These savings can then be passed onto consumers. It is therefore a myth that private participation drives increased tariffs for public services.

Common Myth #6: Public servants play a vital role on SOE boards.

Public servants serve as directors on the boards of SOEs in the Marshall Islands, Samoa, Solomon Islands, and Tonga, and in Fiji public servants are appointed as directors and sit as observers to SOE boards. Two reasons are often given to justify this practice: public servant board members or observers play a useful role in keeping the responsible minister fully informed on what is happening within the particular SOE and public servants bring vital skills and knowledge to the boards, particularly where they are employed by the ministry responsible for the economic sector in which the SOE operates.

While it is certainly true that public servants can bring very useful knowledge to an SOE board, there are a number of important risks associated with this practice, which make it undesirable:

(i) **Conflicts of interest:** Ministers who are both SOE chairs and responsible ministers[42] violate a basic principle of good governance: SOE ownership responsibilities (as exercised by the responsible or shareholding minister) should be kept separate from SOE management responsibilities (as undertaken by the board of directors); senior public servants who serve on an SOE board also violate the principle of separation between ownership and management, particularly if they have any public service

[41] P. Barry. 2004. *Does Privatisation Work?* Policy Backgrounder No. 5, Wellington: New Zealand Business Roundtable.
[42] The "responsible minister" is the minister responsible for SOEs generally or for a specific SOE.

responsibility for the area in which the SOE operates; it is impossible for public servants to monitor SOEs effectively if they report to ministers or more senior public servants who serve on the boards of those SOEs.

(ii) **Time constraints:** Public servants are full-time employees, and serving on an SOE board requires a reasonable time commitment—up to 3 days a month for directors and 5 days a month for a chair. Multiple board appointments place an unreasonable burden on the public servant. In Samoa, the chief executive officer of the Ministry of Finance sits on 10 boards; 3 as chair. These responsibilities alone would require a commitment of up to 36 days per month, on top of his/her full-time role.

(iii) **Liabilities:** The practice of having staff from the monitoring ministry as observers on SOE boards creates special complications because the public servant is caught in the middle; while they are not legally directors, they could be seen as "deemed" directors and thereby carry all the risks and responsibilities of directors.

All of the SOE acts reviewed as part of this study have very effective statutory mechanisms that allow and empower the shareholding or responsible minister to exert an appropriate and reasonable degree of influence over the strategic direction of the SOE. In a well-functioning ownership monitoring and governance regime, it is unnecessary to have a public servant sitting on a board to pass on information to the minister or provide guidance to the board of the SOE. If a public servant has special skills or knowledge that could assist an SOE, it is better that those skills be "contracted" to the SOE rather than making them available through an appointment as a director.

Common Myth #7: There is insufficient depth in the private sector to populate SOE boards.

A reason often given to justify the continued appointment of politicians and public servants to SOE boards is that there is a shortage of experienced, qualified directors in the private sector. While a limited pool of experienced private sector directors is often a reality, the assumption should be tested. In Samoa, for example, a call for expressions of interest to serve on SOE boards yielded many more qualified candidates from the private sector than were expected.

The pool of qualified directors can and should be expanded over time, with ongoing director training programs and—where the critical mass exists—institutes of directors, as is the case in Samoa and Fiji. In addition, expatriate directors can be used to mentor boards and develop directors for a set period of time, often in a cost-effective manner. This practice is currently in place in Samoa, Solomon Islands, and Tonga.

Common Myth #8: Only profitable SOEs can be successfully privatized; SOEs must be restructured before sale so that they can generate maximum proceeds.

The sale of an SOE generates cash for the government equivalent to the value of the asset sold, whether the divestment is a full or partial privatization or an asset sale. In very simple terms, the value of the asset is equivalent to its ability to generate cash over its expected economic life. The sooner the government sells the SOE, the sooner it can realize that cash value and reinvest it back into core social services or repay government debt. The sale of an SOE does not result in the loss of an asset, but the realization of its cash value.

The recent privatization of the Samoa Broadcasting Corporation and Tonga Machinery Pool Limited demonstrate that unprofitable SOEs can be sold successfully. Both of these SOEs were loss-making at the time they were sold, but the new private sector investors have been able to establish viable businesses post acquisition. Had the governments invested in restructuring the SOEs prior to sale, there is no guarantee that the companies would have fetched a higher sales price. The market price of an SOE, or its assets, is based on the future revenues the new investor believes can be generated from the SOE's assets, not on what the previous owner thought could be generated post restructuring or had generated prior to restructuring. International experience has shown that pre-privatization restructuring rarely returns the sought-after premium in the sales price.

Common Myth #9: Governments need to establish and own SOEs to deal with market failure.

Market failure occurs when a market, left to itself, does not allocate resources efficiently. This is usually caused by one of four factors; the abuse of market power, which can occur when a single buyer or seller can exert significant influences over prices or output; in the case of externalities, where the market does not take into consideration the impact of an economic activity on outsiders; the provision of public goods, such as defence; and where there is incomplete or asymmetric information or high uncertainty.

Except perhaps in the case of the provision of public goods, in most cases the government can address market failure through enhanced regulation and the introduction of policies that encourage private sector investment. As the experience of PICs has demonstrated, creating and maintaining commercial SOEs is not an efficient or even effective means to address market failure.

Box 12: **Turning Losses into Profits: Tonga Machinery Pool Limited**

Tonga Machinery Pool Limited (TMPL), an SOE that hired out tractors to farmers, had been generating losses for a number of years when the government decided to divest its ownership interest. In FY2005, FY2006, and FY2007 the company's return on equity was -11.35%, -4.76%, and -13.01%, respectively. The first privatization attempt, which was conducted as a competitive tender for the company as a whole, was unsuccessful. Understanding that there was more investor appetite for the company's assets than for the company as a going concern, the government successfully retendered the company's assets. The winning bidders were the existing TMPL employee–operators who determined that they could operate successful businesses by individually and directly contracting with local farmers. Without TMPL's heavy overheads, and with a strong profit motive, the individual contractors have been able to establish sustainable businesses. To reduce costs they have developed a shared service, using the old TMPL premises as a central customer contact and dispatch point.

The successful sale of the TMPL assets shows that there are different means of achieving a successful privatisation, which can be achieved even when the company has a poor profit history.

VII. Conclusions

This study benchmarks the progress of SOE reform in Fiji, Marshall Islands, Samoa, Solomon Islands, and Tonga. SOEs represent 12%–31% of total fixed assets within their respective economies, yet contribute less than 6% to GDP. SOEs often crowd out the private sector and, due to continued government support, compete unfairly for scarce capital and skilled labor.

Reform is essential, and to be effective it must address the key areas leading to poor SOE performance: weak governance arrangements, conflicting mandates, the absence of hard budget constraints, and a lack of transparency and accountability.

This study draws on the experiences of the five participating countries to identify successful strategies and demonstrate the tangible gains that can be achieved through reform. While each country is at a different stage of the reform process, their individual approaches to SOE restructuring, privatization, governance, and monitoring offer important lessons to any country wishing to improve the performance of its SOEs. A key finding of the study is that the best performing SOEs have a solid commercial orientation, operate independently of political interference, and are held accountable for results.

This commercialization process can be facilitated through greater private sector participation in SOEs through a variety of approaches such as contracting out, public-private partnerships, and privatization. The commercialization of SOEs is also fully compatible with the government's commitment to delivering CSOs; indeed, it is designed to encourage greater efficiencies in CSO delivery.

SOEs in four of the five study countries are required by law to be as efficient and profitable as comparable private sector firms. The experience of these countries amply demonstrates that in the case of individual SOEs, where the political directive is to achieve this mandate, it is well within reach.

Appendix 1: State-Owned Enterprise Key Performance Indicators

Table A1.1 Fiji Key Performance Indicators (F$ '000, Fiscal Year 2009)		% State-owned	Infrastructure Services SOEs	Commercial SOEs	Return on Equity (ROE)	Return on Assets (ROA)	Total Assets	Total Revenue	Asset Utilization	Total Liabilities	Liabilities / Total Assets	Cash Ratio	# Staff	Average ROA FY2002 –FY2009[a]
FEA	Fiji Electricity Authority	100%	X		0.7%	0.3%	880,933	189,168	21%	478,509	54%	0.66	531	0.0%
PRB	Public Rental Board	100%		X	NA	16.2%	8,579	4,097	48%	8,630	101%	0.43	36	14.0%
HA	Housing Authority	100%		X	-0.3%	-0.1%	151,433	14,812	10%	96,617	64%	0.07	130	0.8%
AFL	Airports Fiji Limited	100%	X		4.6%	3.3%	174,336	46,407	27%	48,878	28%	1.23	471	1.2%
FPCL	Fiji Ports Corporation Limited	100%	X		4.0%	2.2%	161,755	42,321	26%	71,890	44%	1.7	413	2.0%
UTOF	Unit Trust of Fiji (Management) Ltd	100%		X	-42.0%	-25.4%	1,146	1,462	128%	453	40%	0.26	11	3.6%
PFL	Post Fiji Limited	100%	X		7.7%	3.3%	30,998	29,025	94%	17,712	57%	0.43	407	2.1%
FSHIL	Fiji Ships and Heavy Industries Limited	100%		X	2.7%	1.8%	8,132	2,777	34%	2,850	35%	0.52	77	-3.8%
FPFL	Food Processors (Fiji) Limited	100%		X	3.9%	2.3%	3,963	2,717	69%	1,605	40%	0	30	1.0%
RRL	Rewa Rice Limited	100%		X	NA	-2.8%	1,867	543	29%	6,814	365%	1.5	19	-12.6%
VCCL	Viti Corps Company Limited	100%		X	NA	NA	NA	NA	NA	NA	NA	NA	NA	-29.3%
YPCL	Yaqara Pastoral Company Limited	100%		X	1.5%	1.3%	13,005	284	2%	1,399	11%	2.44	22	7.9%
FPTCL	Fiji Public Trustee Corporation Limited	100%		X	5.4%	4.9%	12,158	1,574	13%	1,123	9%	0.13	19	3.7%
FHCL	Fiji Hardwood Corporation Limited	90%		X	-2.0%	-1.7%	157,272	14,284	9%	23,199	15%	0.2	321	-1.3%
FP	Fiji Pine (FY 2008)	100%		X	-5.9%	-2.7%	119,063	49,802	42%	64,905	55%	0.03	724	-4.6%
FSC	Fiji Sugar Corporation	68%		X	-33.1%	-11.8%	212,128	169,274	80%	136,628	64%	0	1729	-4.7%
PAFCO	Pacific Fishing Company Limited	100%		X	12.3%	8.3%	33,038	29,489	89%	10,083	31%	0.01	797	3.6%
AirPac	Air Pacific	51%		X	-6.5%	-1.5%	241,243	333,346	138%	184,578	77%	0.32	959	2.7%
FinTel	Fiji International Telecommunications	51%	X		13.7%	11.9%	39,887	24,225	61%	5,240	13%	1.54	90	17.6%
FBCL	Fiji Broadcasting Corporation Limited	100%	X		10.6%	2.2%	16,142	4,253	26%	12,709	79%	2.71	114	0.2%
Portfolio					-0.8%	-0.4%	2,267,078	959,861	42%	1,173,823	52%	0.44	6,900	0.4%

NA = not available.
[a] Calculation of average ROA of FPCL based on data for FY2005-FY2009, RRL for FY2003-FY2009, VCCL for FY2002-FY2005, FPTCL for FY2006-FY2009, FP for FY2002-FY2004 and FY2006-FY2008.
Source: Ministry of Finance, Ministry of Public Enterprises (Fiji).

Table A1.2 Marshall Islands Key Performance Indicators (USD '000, Fiscal Year 2008)		Infrastructure Services	Commercial SOEs	Return on Equity (ROE)	Return on Assets (ROA)	Total Assets	Total Revenue	Asset Utilization	Total Liabilities	Liabilities / Total Assets	Cash Ratio	# Staff	Average ROA FY2002 – FY2008
KAJUR	Kwajalein Atoll Joint Utility Resource Corporation	X		-63.9%	-46.3%	6,683	4,030	60%	1,846	28%	17.0%	65	-36.8%
MAWC	Majuro Atoll Waste Corporation (FY07)	X		11.5%	10.7%	152	417	275%	11	7%	223.2%	22	NA
MEC	Marshalls Energy Company	X		NA	-22.1%	18,553	19,955	108%	29,532	159%	9.4%	161	-9.2%
MIPA	Marshall Islands Ports Authority	X		-4.0%	-3.8%	40,885	2,268	6%	2,437	6%	40.0%	58	0.2%
NTA	National Telecommunication Authority	X		10.2%	3.8%	22,778	8,414	37%	14,400	63%	23.4%	160	1.7%
MWSC	Majuro Water and Sewer Company[a]	X		-155.9%	-83.3%	401	1,088	271%	187	47%	29.5%	52	-6.5%
MRI	Majuro Resort Inc		X	-52.8%	-23.4%	2,229	2,258	101%	1,242	56%	4.4%	101	-39.5%
TOBOLAR	Tobolar Copra Processing Plant		X	44.0%	40.9%	2,822	6,019	213%	197	7%	421.4%	30	11.8%
AMI	Air Marshall Islands		X	40.5%	3.3%	5,032	3,803	76%	4,624	92%	1.7%	74	-23.2%
MIDB	Marshall Islands Development Bank		X	11.0%	7.0%	16,687	3,288	20%	6,119	37%	NA	51	1.1%
MISC	Marshall Islands Shipping Corp (FY07)		X	-172.2%	-115.9%	801	1,032	129%	262	33%	90.3%	87	NA
Portfolio				-9.00%	-4.30%	116,070	52,382	45%	60,583	52%	15.7%	860	-5.9%

NA = not available.
[a] MWSC received a capital infusion of $1.2m in FY08 which gave the company a positive net worth for the first time in the FY02-08 period; this infusion is not counted as part of revenue in this table.
Source: Annual SOE Audit Reports (Marshall Islands).

Table A1.3 Samoa Key Performance Indicators[a] (ST '000, Fiscal Year 2009)		Infrastructure Services SOEs	Commercial SOEs	Return on Equity (ROE)	Return on Assets (ROA)	Total Assets	Total Revenue	Asset Utilization	Total Liabilities	Liabilities / Total Assets	Cash Ratio	# Staff	Average ROA FY2002 –FY2009[b]
EPC	Electric Power Corporation	X		0.2%	0.2%	202,754	91,062	45%	42,121	21%	0.25	505	0.6%
SWA	Samoa Water Authority	X		-3.4%	-3.3%	89,245	14,960	17%	2,810	3%	0.06	146	-2.5%
SAA	Samoa Airport Authority	X		-0.4%	-0.2%	65,347	10,261	16%	29,762	46%	0.52	198	-1.8%
SPA	Samoa Ports Authority	X		3.2%	0.8%	150,390	11,651	8%	111,124	74%	6.78	190	0.4%
SamTEL	Samoa Tel	X		-3.8%	-2.8%	122,472	50,254	41%	33,824	28%	2.33	271	5.9%
SSC	Samoa Shipping Corp		X	18.1%	9.8%	20,201	16,620	82%	9,299	46%	2.02	135	4.3%
DBS	Development Bank of Samoa		X	-3.5%	-1.5%	122,291	11,515	9%	70,655	58%	0.43	112	-0.4%
SHC	Samoa Housing Corp		X	2.7%	1.8%	21,461	2,932	14%	7,226	34%	0.48	26	1.7%
ASC	Agricultural Store Corp		X	-8.8%	-5.5%	10,941	4,903	45%	4,070	37%	2.43	40	2.5%
PTO	Public Trust Office		X	-11.8%	-7.0%	5,276	490	9%	2,137	41%	4.51	14	-22.6%
SLC	Samoa Land Corporation		X	-0.5%	-0.4%	89,009	6,933	8%	17,198	19%	0.02	70	0.2%
STEC	Samoa Trust Estates Corp		X	-2.1%	-1.9%	52,657	286	1%	4,786	9%	0.00	24	1.8%
SSS	Samoa Shipping Services		X	-12.7%	-3.7%	4,134	6,362	154%	2,919	71%	0.22	120	-3.6%
PAL	Polynesian Airlines Ltd		X	42.6%	9.3%	26,466	13,445	51%	20,688	78%	0.41	141	-16.4%
Portfolio				-0.70%	-0.45%	982,645	241,673	25%	358,619	36%	0.97	1,992	0.1%

[a] All SOEs listed are 100% state-owned.
[b] Calculation of average ROA of SAA based on data for FY2005-FY2009, SLC for FY2003-FY2009, SSS for FY2004-FY2009.
Source: State-Owned Enterprise Monitoring Unit, Ministry of Finance (Samoa).

Table A1.4 Solomon Islands Key Performance Indicators[a] (SI$ '000, Fiscal Year 2008)		% State Owned	Infrastructure Services SOEs	Commercial	Return on Equity (ROE)	Return on Assets (ROA)	Total Assets	Total Revenue	Asset Utilization	Total Liabilities	Liabilities / Total Assets	Cash Ratio	# Staff	Average ROA FY2002 – FY2008[d]
DBSI	Development Bank of Solomon Islands[b]	100%		X	NA	NA	NA	NA	NA	NA	NA	NA	NA	-6.1%
SML	Sasape Marina Ltd[c]	100%		X	NA	NA	NA	NA	NA	NA	NA	NA	NA	-0.7%
SAL	Solomon Airlines Limited	100%		X	NE	-6.1%	63,382	176,241	278%	95,551	151%	0.03	154	-11.0%
SIPR	Solomon Islands Printers Ltd	100%		X	NE	-18.8%	2,369	1,617	68%	6,744	285%	0.01	23	-20.2%
SFPL	Soltai Fishing and Processing Ltd	51%		X	-13.2%	-5.2%	73,722	124,972	170%	44,554	60%	0.43	1,000	-2.2%
SIBC	Solomon Islands Broadcasting Corporation	100%	X		NE	0.3%	2,970	5,471	184%	4,479	151%	0.11	52	-24.4%
SIEA	Solomon Islands Electricity Authority	100%	X		-18.0%	-17.0%	288,863	232,980	81%	20,349	7%	0.11	213	-0.5%
SIHF	Solomon Islands Home Finance Ltd	100%		X	-5.9%	-5.3%	18,918	1,661	9%	2,027	11%	1.90	15	-1.8%
SIPA	Solomon Islands Ports Authority	100%	X		28.2%	19.8%	91,238	50,548	55%	27,006	30%	0.37	232	-0.2%
SIPC	Solomon Islands Postal Corporation	100%	X		NE	-102.7%	16,319	18,010	110%	54,734	335%	0.02	91	-67.6%
SIWA	Solomon Islands Water Authority	100%	X		-79.5%	-56.4%	26,277	22,877	87%	7,637	29%	0.14	97	-18.3%
Portfolio					-22.1%	-12.1%	584,058	634,377	109%	263,080	45%	0.13	1,877	-4.5%

NA = not available, NE = negative equity.
[a] Investment Corporation of the Solomon Islands is not included as it is a holding company; CEMA is not included as it is a regulatory body.
[b] DBSI has been under receivership since 2005; no financial accounts have been prepared since that year.
[c] SML has not prepared financial accounts since FY2004.
[d] Calculation of average ROA of DBSI based on data for FY2002-FY2005, SML for FY2002-FY2004, SIPC for FY2005-FY2008, SIWA for FY2005-FY2008.
Source: Economic Reform Unit, Ministry of Finance (Solomon Islands).

Table A1.5 TONGA[a] Key Performance Indicators (T$ '000, Fiscal Year 2009)		Infrastructure Services	Commercial SOEs	Return on Equity (ROE)	Return on Assets (ROA)	Total Assets	Total Revenue	Asset Utilization	Total Liabilities	Liabilities / Total Assets	Cash Ratio	# Staff	Average ROA FY2002 – FY2009[b]
TCC	Tonga Communications Corporation	X		0.6%	0.5%	55,176	22,670	41%	8,266	15%	1.42	296	8.3%
TBC	Tonga Broadcasting Commission	X		4.3%	3.0%	3,568	2,517	71%	1,090	31%	0.22	81	-3.1%
TWB	Tonga Water Board	X		2.6%	2.5%	18,851	5,633	30%	1,086	6%	0.70	109	0.4%
PAT	Ports Authority Tonga	X		3.6%	2.6%	20,784	7,042	34%	5,722	28%	0.13	179	2.5%
TTL	Tonga Timber Limited		X	-8.1%	-6.6%	5,405	1,133	21%	1,029	19%	0.00	32	0.7%
TPrint	Tonga Print Limited		X	-2.8%	-2.6%	1,594	998	63%	112	7%	1.14	29	2.8%
TML	Tonga Market Limited		X	-3.3%	-1.1%	4,130	569	14%	2,730	66%	65.13	23	3.2%
SCPL	Shipping Corporation of Polynesia		X	-1788.5%	-101.4%	1,079	1,151	107%	1,018	94%	0.45	21	-23.0%
TDB	Tonga Development Bank		X	9.4%	2.9%	54,227	8,983	17%	37,557	69%	1.56	110	3.4%
WAL	Waste Authority Limited		X	-18.3%	-17.0%	3,802	1,635	43%	266	7%	0.01	23	-2.1%
TPost	Tonga Post Limited		X	-6.5%	-6.4%	1,836	434	24%	42	2%	10.88	23	NA
TAL	Tonga Airport Limited	X		-0.7%	-0.7%	37,446	6,646	18%	1,662	4%	0.73	144	NA
TPower	Tonga Power Limited	X		-2.0%	-1.3%	57,635	36,823	64%	20,952	36%	0.33	115	NA
Portfolio				-0.4%	-0.3%	265,532	96,234	36%	81,533	31%	1.01	1,185	3.6%

NA = not applicable.
[a] Tonga Post Ltd and Tonga Power Ltd were established in 2009. In 2009, Tonga Machinery Pool Ltd was privatized and in 2010, the management of Tonga Investment Ltd was contracted out to the private sector; no accounts were prepared for Tonga Investments Ltd in FY09.
[b] Calculation of average ROA of TPrint based on data for FY2005-FY2009, TML for FY2004-FY2009, SCPL for FY2003-FY2009, WAL for FY2007-FY2009; no averages are presented for TPost, TAL and TPower as they were established after 2007 and as such their average ROA is not strictly comparable.
Source: Ministry of Public Enterprises and Information (Tonga).

Appendix 2: Notes on Methodology

Selection of SOEs. The financial analysis has focused on the "for-profit" SOEs within the respective portfolios. In Fiji there are two SOEs that are "not-for-profit" but whose functions are similar to commercial SOEs in the other portfolios; therefore, they are included in the analysis for comparative purposes.[43] The other two not-for-profit SOEs in Fiji have been excluded from the financial analysis.[44] All not-for-profit SOEs in Samoa are likewise excluded. In Samoa, the National Provident Fund and two insurance companies that are classified by the government as public trading bodies are not included in the analysis, since their shares are owned by their contributors, not by the government. In Solomon Islands, two SOEs that are listed under the SOE Act are not included in the analysis: (i) the Commodities Export and Marketing Agency is excluded because it is a regulatory agency with no real commercial functions, and (ii) and the Investment Corporation of the Solomon Islands is excluded because it is a holding company whose assets are composed either of other majority-owned SOEs or minority holdings and including it would distort the results by double-counting the results of the majority-owned SOEs and counting the results of minority-holdings, which is not done for the other SOE portfolios. Soltai Fishing and Processing, which is not an SOE under the SOE Act but is majority-owned by the Investment Corporation of the Solomon Islands, is included as a separate SOE in this study. In summary, unless the context otherwise requires, the terms "SOE portfolio" and "trading SOEs" used in this report relate to the for-profit SOEs only.

There are also some SOEs that are minority-owned within the respective portfolios; however, these have been excluded because they are not effectively controlled by the governments, and the scope of this report is to assess the impact of government control on SOEs. Where SOE are majority but not 100% owned, they have been included in the report, and where consolidated financial results are presented, portfolio financial results are calculated as the simple proportional addition of each SOE in the portfolio.

Source Data. The source data for the financial analysis are primarily the audited financial statements of each SOE, as provided by the SOE monitoring units of each country, augmented by quarterly reports where audited financial statements were not available. Where some SOEs have recorded debt forgiveness as extraordinary income, an adjustment has made to remove this impact on the income statement. No further adjustments have been made to the financial statements, but some line items have been reclassified to provide a finer distinction among core, non-core, and extraordinary items. Where SOEs are reporting to different financial years (e.g., one SOE in the portfolio ends its year in September, while the rest do so in December, and another SOE has a 9-month financial year) then these were simply summed on a calendar year basis. Thus, portfolio results for FY2004 include financial results summed for all SOEs with any financial year end occurring in calendar 2004.

[43] These are Fiji Electricity Authority and Housing Authority.
[44] These are Public Rental Board and Meat Industry Board.


SOLOMON ISLANDS
TUVALU
SAMOA
VANUATU
FIJI IS.
TONGA
Suva

Finding Balance 2011: Benchmarking the Performance of State-Owned Enterprises in Fiji, Marshall Islands, Samoa, Solomon Islands, and Tonga

State-owned enterprises (SOEs) place a significant and unsustainable strain on the economies of Fiji, Marshall Islands, Samoa, Solomon Islands, and Tonga. They absorb large amounts of scarce capital on which they provide very low returns. This study reveals the core drivers of SOE performance, illustrates how rapid progress can be made in placing SOEs on a sound commercial footing, and demonstrates the importance of political will for successful SOE reform. While the study focuses on five countries with broadly similar SOE portfolios, the core lessons from their experience are applicable throughout the Pacific region.

Pacific Private Sector Development Initiative

The Pacific Private Sector Development Initiative (PSDI) is a regional technical assistance project cofinanced by the Australian Agency for International Development. PSDI is designed to support efforts by ADB Pacific developing member countries to encourage private sector-led, sustainable economic growth. PSDI focuses on the following key reform areas: SOE reform and public-private partnerships, improved access to financial services, and reform of the legal and business regulatory environments in the region.

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