

Legitimacy of the agreement for privatising 66% of the shares of AS Eesti Raudtee and the shareholders' agreement

As a member of INTOSAI and of the Privatisation Audits Working Group of INTOSAI the SAO has monitored the progress of privatisation and all the major privatisation cases and it will continue its monitoring activities also in the future. Traditionally the national audit offices focus mainly on the privatisation of companies, undertakings or enterprises with great economic and social importance. Also the SAO has applied a similar principle and audited the privatisation of major infrastructure companies like AS Eesti Telekom,¹ AS Narva Elektriijaamad² and AS Eesti Raudtee.³ The privatisation of the latter two has such economic and social importance that auditing the effect of privatising these two companies shall certainly remain a priority for the SAO for the next few years.

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The SAO is competent to audit the legitimacy of economic transactions by virtue of § 133 of the Constitution. In this context it is important to note that the assessments by the SAO of the legitimacy of transactions are not court judgements as regards their legal nature. This cannot be interpreted as adopting the functions and role of a court of law, but the performance of the functions of the SAO as defined in § 6 of the State Audit Office Act. By virtue of § 31 of the said Act the SAO has, inter alia, the right to make proposals for eliminating the violations whereby these proposals are subject to examination, as appropriate, by the management body of an institution, company or other organisation or by a local government, a Ministry or other government agency or the Government. The same § 31 provides that the measures taken must be notified to the SAO in one month after the day when the relevant decision of proposal was received. If a violation entailing the elements of a criminal offence is detected, the SAO is required to communicate the relevant materials to an investigative body.

The SAO assessed the legitimacy of the agreement for privatising AS Eesti Raudtee and the shareholders' agreement in the light of the legal bases set out above, the internationally recognised working principles and the scope of auditing powers. The SAO considered it necessary to focus the audit on the said agreements, because these constitute the very outcome of the preparation and implementation phases of the privatisation process and largely determine the effectiveness of privatisation. Pursuant to the principles of result-based management it is essential to audit the actual results and not the process itself. It is also important to examine the different outcomes from the aspect, which is most influential as regards public money flows or the greatest possible number of persons. Therefore the SAO focused its attention on the essential aspects influencing the final outcome of the privatisation in financial terms and looked into the legitimacy of those terms and conditions of agreements imposing financial obligations on the state. The SAO could have audited and still may audit the different aspects of privatising AS Eesti Raudtee endlessly, but in order to make the best use of taxpayers' money we analyse only the most important ones.

1. Essential proposals

The essential proposals of the SAO are set out below.

- The decision of a Chief Auditor of the SAO included a proposal to the Director General of the Privatisation Agency to abstain from performing obligations stemming from those contractual terms which are contrary to the law and the requirement to submit a written confirmation to this end. In a situation where the SAO has drawn attention to the fact that the transaction partially violates the applicable laws the SAO finds that disregarding the proposal implies that the officers in charge have intentionally caused damage to the state.

¹ Public Limited Company Estonian Telecom.

² Public Limited Company Narva Power Plants.

³ Public Limited Company Estonian Railways.

- Considering the gravity of the detected violation and the need to ensure the legitimacy of the further activities of the Privatisation Agency, the SAO made a proposal to the Chairman and the Members of the Board of the Privatisation Agency to call a meeting of the said Board in three weeks in order to review the illegitimate obligations assumed with the aforesaid agreements and to provide the Director General of the Agency with guidelines for ensuring the legitimacy of the privatisation in the future. The SAO does not have the power or interest to suspend the privatisation process, but it is interested in ensuring the transparent and legitimate completion of this process.

2. Essential conclusions

The essential conclusions drawn by the SAO are set out below.

- The Director General of the Privatisation Agency and the Minister of Transport and Communications were, within the limits of their statutory powers, competent to sign the agreement for privatising AS Eesti Raudtee and the shareholders' agreement as the representatives of the Republic of Estonia. Furthermore, the judicial decisions applicable at the time of signature of the agreements did not directly prohibit their signature. However, the Agency signed the privatisation agreement knowing that the signature was contrary to judicial decisions already made but not yet effective. Considering the situation and the need to ensure the transparency and legitimacy of transactions of major importance to the state and given the need of the officials to respect judicial authority and to foster law-abiding management in the public sector the SAO finds that it would have been reasonable not to sign the agreement before the final court judgement. Privatisation that serves the sole purpose of privatisation itself and disregards the economic and social impact and sense of justice of the public cannot possibly be a good practice in the modern society.
- According to § 65(10) of the Constitution and § 29(1) of the State Budget Act a public department can assume financial obligations only if the relevant budgetary appropriations have been made or if this right stems from a specific law. The Director General and the Minister acted *ultra vires* by assuming such obligations on behalf of the state with the privatisation and shareholders' agreements for which they had no right under the Privatisation Act or any other law. § 10(5) of the Privatisation Act provides that debts which are related to the privatised assets and which are not the objects of sale may, on the decision of the organiser of privatisation, be covered from the privatisation proceeds pursuant to § 2 of the Use of Privatisation Proceeds Act. The regulatory framework specifies in a sufficient detail the debts which can be covered from the privatisation proceeds and which the organiser of privatisation can therefore exclude from the assets to be privatised.
- The important potential financial obligations of the state include: the obligation to compensate for up to 100 million kroons of loss that AS Eesti Raudtee may incur by selling or leasing 5 Russian locomotives and the obligation to keep 50 million kroons to this end on the government's bank account for up to 7 years; a potential obligation in case the Tax Board requires AS Eesti Raudtee to pay the income tax on the payments to the railway organisations of Russia or other participating countries under the agreements for pooling carriages before the shares are transferred to OÜ Baltic Rail Services; the obligation to compensate for the earlier environmental damage caused by AS Eesti Raudtee. The relevant clauses of the privatisation and shareholders' agreements imposing financial obligations on the state are contrary to the law and therefore null and void. According to the General Part of the Civil Code Act the Privatisation Agency is not required to and may not perform obligations stemming from contractual terms which are null and void.
- For a number of obligations assumed by the state the maximum amount of government liability has not been set out in the agreements and therefore reference can be made only to the fact that according to the agreement the liability can in no case exceed 1 billion kroons. Theoretically and in the worst case it means that the government loses its sales proceeds of 1 billion kroons, 66% of the shares of AS Eesti Raudtee and the right to govern an important transit channel.

- According to the privatisation program AS Eesti Raudtee was to be privatised to a strategic investor. Performance guarantees provided by the privatising entity are essential to ensuring the achievement of the intended goals of privatisation. Guarantees provided by OÜ Baltic Rail Services conform to the requirements set out by the Agency in and pursuant to the tender documents. The said requirements and the guarantees that the Agency has accepted in the light of these requirements are insufficient to allow making any claims against strategic investors in case the privatising entity infringes its obligations.
- Although the privatisation agreement has been signed, the shares are yet to be paid for and the performance guarantees are yet to be lodged. This may jeopardise the successful completion of the privatisation process. The government would incur a loss of at least 60.9 million kroons even if the privatisation would fail due to reasons attributable to the buyer. In this case the government could claim a compensation of 25 million kroons, but the costs of organising the privatisation of AS Eesti Raudtee amount to a minimum of 89.5 million kroons.
- The privatisation of AS Eesti Raudtee has not been sufficiently transparent and violated the principle of equal treatment of bidders. The SAO is particularly unhappy with the fact that before the submission of tenders the bidders did not know for sure which financial obligations the government would assume under the privatisation agreement. Since several important contractual terms were not included in the competition phase and were inserted in the agreement later on as a result of negotiations between the Agency and the buyer, it cannot be said that the government managed to reach an agreement on the most favourable terms possible. Competition between the bidders is an important mechanism that ensures the impartiality of the privatisation competition.
- On the one hand the privatisation of the shares of AS Eesti Raudtee can be seen as a normal sales transaction. On the other hand the technical and financial plans of the privatising entity which signed the privatisation agreement provide that 50 locomotives of American origin and conforming to American standards shall be used for railway transport in Estonia. This requires a number of substantial changes in the technical regulations, the work of the officials of the Railway Administration, the activities of AS Eesti Raudtee and in the Regulations of the Minister of Transport and Communications. In this regard the SAO is astonished that the representatives of the Railway Administration as experts who know the local conditions and requirements were not involved in analysing the technical and financial plans and providing expert opinions to the Minister of Transport and Communications in charge of privatisation. This may lead to a situation where the aforesaid agreements require the government to facilitate the implementation of the privatising entity's business plan in the best possible manner, although it is not technically and effectively prepared to do so.

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