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INTOSAI WORKING GROUP ON THE AUDIT OF PRIVATISATION

THE ROLE OF THE STATE AS MINORITY SHAREHOLDER IN PRIVATE BUSINESSES

QUESTIONNAIRE

INTRODUCTION

The purpose of this questionnaire is to gather information from Members of the Group about the issues the state needs to address where it is a minority shareholder in private businesses, the challenges faced by the SAI in examining how the state addresses these responsibilities, and the impact of the SAI's work.

BACKGROUND

The topic 'The Role and Responsibility of the State as Minority Shareholder in Privatised Businesses' was discussed at the sixth meeting of the INTOSAI Working Group on the Audit of Privatisation (Warsaw, October 1999).

The discussion examined both the role of the state and key issues that SAIs are likely to have to address in examining how effectively that role is carried out. It was agreed that this subject merited further examination by the group.

Issues Affecting the State

- The state needs to protect the taxpayer's interests, even though it is not in control of the business.
- The state will have objectives in being a minority shareholder, and it needs to ensure these objectives can be met.
- The state may have taken special powers (e.g. a golden share). Such powers are however usually not general, but closely defined e.g. the right to approve changes in ownership of the business. As regards the general running of the business, such special powers are unlikely to afford the state any greater protection than that enjoyed by any other minority shareholder.
- Unlike a private minority shareholder, the state may not in practice be able to dispose of its investment if it is dissatisfied with the way the business is being run by those in control. For example, where the state's minority shareholding is retained for strategic economic reasons the state may be in double jeopardy: the actions of others could create additional obligations for the state, going beyond its original investments and the concept of limited liability, resulting in the moral hazard of implicit guarantees.

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- The state may not have access to sufficient market-focused skills necessary to understand the nature of the business, and the risks to which the state is exposed. And even if it is able to monitor the business's performance intelligently, it may not be able to influence those in control.
- Has the state been able, in practice, to protect its interests as a minority shareholder?

Issues Affecting the SAI

- The SAI is likely to be the auditor of the government body which holds the minority stake.
- Does the SAI also have audit access to the private business for the purpose of monitoring how the government body responsible for the state's shareholding is exercising its rights and responsibilities?
- If the SAI does not have audit access to the business, how can it effectively examine these arrangements?
- Does the SAI have access to the market-focussed skills necessary to check whether the state is doing all it can to protect the taxpayer's interests in relation to the minority shareholdings?
- Has the work of the SAI assisted the state in protecting the taxpayer's interests?

The questionnaire is divided into two parts

Part 1: The Role of the State

Part 2: The Role of the SAI

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Part 1: The Role of the State

General Information

1 Is the state a minority shareholder in any private business established in your country?

Yes (go to Q2)

No (no further responses necessary)

Any additional comments?

The UK government's minority shareholdings fall into two categories: firstly, there are some shareholdings that have been retained as a result of the major privatisations, mostly in order to provide bonus share entitlements to individual shareholders or to confer powers on the government in certain circumstances (golden shares); secondly, there are shareholdings that have arisen from the government's increasing efforts to exploit the state's physical and intellectual property in wider markets, through partnerships and joint ventures with the private sector. The government also plans to move to a position of shared or minority ownership in major businesses that are currently 100%-owned by government, such as the National Air Traffic Service and British Nuclear Fuels.

2 What proportion of your country's Gross Domestic Product (GDP) is represented by such businesses?

0 - 5 per cent

over 5 per cent

Any additional comments?

The government are encouraging departments (for example, scientific research establishments) to enter into joint ventures with private sector partners to maximise public benefits from under-utilised state assets. Such ventures are expected to increase in number over the next 2 to 3 years, but they are unlikely to take the overall government minority shareholding over 5 per cent of Gross Domestic Product.

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3 How are the state's minority shareholdings defined?

- ✓ percentage of shares owned (all types of share)
- percentage of voting rights owned
- other (please detail below)

4 In approximately how many companies does the state have minority shareholdings (including minority holdings which enjoy special status, e.g. with a 'golden share')?

- i) **As at March 1999 the Government held substantial minority holdings in 12 public companies, most residual holdings as a result of privatisation.**
- ii) **The Government also had "golden" or special shares in about 25 privatised companies.**

Any additional comments?

The "golden" shares confer special, defined rights on the government, typically for their consent to be necessary for a change of ownership or control of the company. Such shares do not attract dividends.

5 Are the minority shares held in (tick all that apply):

- ✓ stock exchange companies?
- ✓ unquoted companies?
- ✓ other e.g. partnerships (please detail below)

As regards partnerships, the National Audit Office recently reported on an early example of a minority shareholding arising from a government agency entering into a partnership with a private sector entity. The partnership involves the establishment of a joint venture company between the RadioCommunications Agency and CMG, a UK IT services company, in which the Agency have a minority shareholdings. The partnership seeks to achieve the commercial exploitation of the agency's skills by selling consultancy services and IT systems to overseas governments (see NAO report of December 2000 *The Radiocommunications Agency's joint venture with CMG*, available on the NAO website at www.nao.gov.uk).

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6 Does the state maintain a register listing the details of all the state holdings in privatised businesses?

- Yes
- No

Any additional comments?

Shareholdings in new joint ventures and other forms of partnership will be reported in the National Asset Register when it is re-issued.

Rights as a minority shareholder

7 What are the rights of a general minority shareholder under the laws of your country? (Tick all that apply, but do not include any rights which are specific to the state, as special state rights are addressed in subsequent questions.)

- powers to veto decisions (e.g. a 75% (or 2/3) majority may be needed to pass certain resolutions, so a minority shareholding greater than 25% (or 1/3) can be used to block these resolutions)
- any powers to require that the company should be wound-up (likely to need support from a majority of the shareholders e.g. 2/3)
- any powers to block a share redemption by the majority shareholder (such blockage might need only minority support e.g. 1/10)
- powers to request certain types of shareholder meeting
other (please detail below)

Any additional comments?

Company law in the UK is built around the concept of protecting the rights of minority shareholders. These laws apply equally when the minority shareholder is the state itself.

8 Does the state have the same rights for its minority shareholdings as those detailed in Question 7 above?

- Yes, it has the same rights (go to Q10)
- No, it has fewer rights (please detail below and go to Q10)
- No, it has more rights (please detail below and go to Q9)

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Objectives of the minority shareholding(s)

10 Has the state become a minority shareholder as a part of a process of (tick all that apply):

acquiring private sector businesses or shareholdings in them [see comment below]?

- privatising formerly state owned businesses?
- setting up joint ventures with private businesses?
- other (please detail below)?

Acquisitions by state-owned businesses are rare in the UK. Two notable acquisitions in recent years were the purchase of German Parcel by the Post Office (see NAO report *The Acquisition of German Parcel of August 2000*, available on the NAO's website at www.nao.gov.uk) and the purchase of Westinghouse's nuclear businesses by BNFL. Both of these were 100% purchases and therefore involved no minority shareholdings.

11 Has the state set any specific objectives with regard to its minority shareholdings e.g. to (tick all that apply):

- protect the taxpayer's investments?
- ensure the business is soundly run on a commercial basis?
- pursue strategic economic goals?
- promote growth in employment?
- increase international investment?
- obtain taxes and dividends from the efficiency of the private sector?
- promote shareholding by the general public?
- raise money for the state through the sale of shares?
- other (please detail below)?

Those ticked were the key objectives; the considerations set out in the unticked boxes were also of incidental relevance, depending on the nature of the transaction.

Any additional comments?

The UK government is also encouraging universities and publicly owned laboratories to set up "spin-off" companies in the "knowledge economy" and high-tech sectors.

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12 Has the state sold any of its minority shareholdings?

Yes

No

Any additional comments?

The government has an on-going programme of sales of residual shareholdings in privatised businesses.

13 Is the state likely to sell its remaining minority shareholdings?

Yes, all of them

Yes, some of them

No

Don't know

Any additional comments?

The government is likely to sell most, if not all, of its residual shareholdings in privatised businesses. The National Audit Office has reported on several of these sales of residual holdings in its report *Sales of the Government's Residual Shareholdings in BP, BAA and in other privatised companies* (published March 1997).

Responsibility for the minority shareholding(s)

14 Who is responsible for looking after the state's rights as minority shareholder?

government ministry

privatisation agency

other (please detail below)

Any additional comments?

On behalf of the UK government, the Treasury (ie the Ministry of Finance) holds most residual shareholdings in privatised companies. The Treasury also has overall policy responsibility for government participation in partnerships and joint ventures but the individual shareholdings in such enterprises are held by the relevant department. For example, the government's minority shareholding in the joint venture between CMG and the RadioCommunications Agency, an executive agency of the Department of Trade and Industry, is held by the Secretary of State for Trade and Industry.

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15 Does the responsible body (Q14) have representation on the Boards of the private companies?

Yes, on all

Yes, on some

No

Any additional comments?

For example, the proposed public-private partnership for the National Air Traffic Service will include two government board appointees.

16 Does this body have access to the expertise it needs to monitor the shareholdings and the achievement of the state's objectives?

Yes

No

Any additional comments?

The Treasury recognise that, as departments with little experience of commercialisation set up joint ventures with private sector companies, there is need for more guidance and transfer of experience across government. The Treasury see the recently-formed body Partnerships UK (a public body with some private funding, and with commercial expertise in the partnerships area) as a key vehicle for delivering this knowledge transfer.

17 Has the state introduced any measures in relation to its exposure as a minority shareholder, to reduce the moral hazard it faces (implicit guarantees or additional obligations for the state going beyond its original investment and the concept of limited liability) e.g. distancing the state by use of a holding company?

No

Yes (please detail below)

Treasury guidance emphasises that such arrangements should be limited to the commercial exploitation of under-utilised state assets. The Treasury hope that by limiting the state's contributions in this way, the government is unlikely to face demands from the private sector to go beyond its original investment.

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Competition Issues

18 Are there any indications that minority shareholdings by the state in privatised companies are distorting competition?

Yes (go to Q19)

No (go to Q20)

Any additional comments?

Concern is however expressed by private sector entities that commercial use of publicly-funded assets could run the risk of competing with private sector provision on unfair terms (eg cross subsidy) so this issue needs watching as the number of minority shareholdings grow.

20 Has the state taken any measures to reduce the risk of such distortions of competition?

No

Yes (please detail below)

Treasury guidance emphasises that departments should not seek to displace but to supplement private sector provision of services.

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Part 2: The Role of the SAI

This part of the questionnaire is in three sections:

Section A: the SAI's audit access to the government body which is responsible for the state's minority shareholding, and to the business in which the shares are held

Section B: the issues addressed by the SAI in examining the government body and/or the business

Section C: the outcome of the SAI's work

Section A - Audit Access

22 Is the shareholder (ministry, agency etc) audited or reviewed by the SAI as regards this shareholder role?

- annually
- occasionally
- never

23 Does this audit access extend to an examination of the prices for state sales or acquisitions of minority shareholdings?

- Yes (go to Q24)
- No (go to Q26)

24 If yes, please give one or two firm examples.

The National Audit Office reported on the price obtained for the sales of minority shareholdings in privatised companies in its report *Sales of the Government's Residual Shareholdings in BP, BAA and in other privatised companies (March 1997)*.

25 If yes, when is this review carried out?

- prior to the sale
- subsequent to the sale
- both

26 Does the SAI have audit access to any of the businesses in which the state is a minority shareholder?

- Yes (go to Q27)
- No (go to Q31)

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31 Where the SAI does not have audit access rights to the private business, does the SAI nevertheless attempt to establish how far the state has been able to protect/promote its interests as minority shareholder?

No

Yes (please detail below)

Our annual financial audit considers whether the government maintains complete and accurate records of its shareholdings. In our separate value for money/performance audit work, we shall also increasingly consider how well departments are discharging their responsibilities as minority shareholders in joint ventures and partnerships. And in such studies we may well invite comments and evidence from the private sector participants in these deals. Experience suggests that they are willing to co-operate, even though we do not have formal audit access to them.

Section B - Issues Addressed by the SAI

32 What areas does the SAI examine in relation to (a) how effectively the government body has discharged its responsibilities as a minority shareholder and (b) the operations of the business in which the shares are held?

(a) The government body responsible for the state's minority shareholding (tick all that apply)

action to protect the taxpayer's interests

achievement of objectives in relation to the shareholding

reasonableness of the state's investment return, measured by:

dividend yield

return on capital employed

the performance of similar companies?

other (please detail below)?

other (please detail below)

Our financial audit considers whether departments have maintained proper records of shareholdings. As part of our regular monitoring, our performance audit teams consider departments' management of their minority shareholdings. If we had any concerns about this management, we would consider examining the matter and reporting our findings to Parliament.

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- (b) The business (tick all that apply)
- compliance with general company law and regulations
 - compliance with specific government regulations
 - compliance with relevant audit and accounting standards
 - achievement of the business plan
 - any conflicts of interest vis a vis the state
 - other (please detail below)

None of the above.

Section C - Outcome of the SAI's Work

33 Does the SAI's examination result in a report?

- Yes
- No

34 To whom does the SAI report?

- Government
- Parliament
- other (please specify)

We also clear the reports with government: a primary objective of our value for money work is to identify recommendations that government departments will find beneficial as they carry out their responsibilities.

35 Is the report published?

- Yes
- No

36 Please provide one or two examples of the impacts of SAI's audit work, in particular where these have led to measurable improvements in the way in which the state's interest in the company is protected, or ways in which the company is run.

- 1. On the financial audit side, audit tests for completeness have identified shareholdings that government had not recorded properly in its own asset registers, leading to an increase in stated assets of £600,000.**
- 2. On the value for money side, we recently reported on the RadioCommunications Agency's partnership with CMG to provide IT services and to sell its expertise in**

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radio spectrum management in international markets. The Agency has a minority shareholding in the joint venture company that it formed with CMG. Our report has been recognised in the press and in government as an example of NAO supporting – and promoting – well thought-out innovation in government. The NAO recommended:

- the need for departments to have clear objectives at the outset of the process of seeking a partnership. This will help minimise the risk of delay and encourage positive responses from potential bidders.
 - wherever possible, departments should enter into contracts following a competitive bidding process. If this is not possible, departments should ensure that they have adequate mechanisms for addressing the risk that, in the absence of competitive tension, the contract does not represent value for money. Possible mechanisms include the establishment of benchmarks to measure value for money.
 - departments should recognise the importance of aspects such as alignment of business interests, trust-based relationships and effective collaboration, but should also build in adequate contractual protection to address the risk that the partnership does not turn out to be as successful as hoped.
 - departments should carefully consider the size of the shareholding, in percentage terms, that they propose to take in a joint venture, bearing in mind the need to protect the government's interest in the assets it is contributing to the joint venture. In some circumstances, departments will seek a minority shareholding. In others, a majority stake may be more appropriate.
3. The NAO has emphasised, both in the RadioCommunications Agency report and through presentations and informal advice, that departments should ensure that they are not exposed to the risk of having to increase their commitment – in terms of cash, assets, or staff time – should the partnership perform below expectations.
 4. The NAO has encouraged departments to consider what share of returns – for example in terms of dividends or through contractual agreements – they require to secure an appropriate share of the proposed benefits of the joint venture.

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37 Please provide one or two examples of audit methodology good practice which you have developed in the process.

- 1. The audit can obtain information on the completeness of government records of minority shareholdings by contacting Share Registrars to identify all shareholdings held by an audited body (financial audit).**
- 2. The auditor should obtain a full understanding of the commercial objectives and potential risks of a joint venture or a partnership in which a government entity holds a minority shareholding (performance audit).**
- 3. The auditor should consider what commercial expertise, whether in-house or through advice, is available to the department in negotiating and managing its contribution to entities in which it holds a minority shareholding (performance audit).**
- 4. Auditors should confirm that departments are legally empowered to enter into minority shareholdings, and that in each case the department has ensured that licences and assets it contributes to a joint venture or partnership are in a proper legal form (performance audit).**
- 5. Auditors should consider whether the department has properly valued any state assets it has contributed to entities in which it holds a minority shareholding, bearing in mind that under-utilised assets or intellectual property may often have minimal book value (performance audit).**
- 6. Auditors should analyse the reasonableness of returns expected by the state from its minority shareholdings, bearing in mind the riskiness of the project and the size of the state's contribution (performance audit).**
- 7. Auditors should examine the incentives on the public sector officials responsible for entering into and managing deals to exploit government assets commercially. Good practice is that incentives should be transparent (eg in cash rather than in kind); should be proportional; and should be aligned with the interests of the department (eg not just with the interests of the commercial partner or the individual scientists/officials involved in the deal) (performance audit).**