

# Georgia: Technical Assistance Report-Draft Public Corporation Reform Strategy



# GEORGIA

## TECHNICAL ASSISTANCE REPORT—DRAFT PUBLIC CORPORATION REFORM STRATEGY

December 2021

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# **Georgia**

## **Draft Public Corporation Reform Strategy**

John Zohrab and Avril Halstead



**Technical Assistance Report**

**October 2021**

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# CONTENTS

<b>GLOSSARY</b>	<b><a href="#">4</a></b>
<b>PREFACE</b>	<b><a href="#">5</a></b>
<b>EXECUTIVE SUMMARY</b>	<b><a href="#">6</a></b>
<b>I. BACKGROUND</b>	<b><a href="#">8</a></b>
<b>II. KEY ELEMENTS OF THE DRAFT STRATEGY</b>	<b><a href="#">10</a></b>
A. International and European Models and Experience	<a href="#">10</a>
B. Five Pillars of the Reform	<a href="#">10</a>
C. Applicability to Public Corporations	<a href="#">10</a>
D. Commercial Objective	<a href="#">11</a>
E. Corporate Governance	<a href="#">11</a>
F. Shareholder Functions	<a href="#">12</a>
G. Ownership Policy	<a href="#">13</a>
H. Performance Framework	<a href="#">14</a>
I. Competitive Neutrality	<a href="#">15</a>
J. Interdependencies	<a href="#">15</a>
K. Auditing, Reporting and Disclosure	<a href="#">16</a>
L. Framework Public Corporations Law	<a href="#">16</a>
M. Pilot	<a href="#">16</a>
<b>III. NEXT STEP AND RECOMMENDATION</b>	<b><a href="#">17</a></b>
<b>BOX</b>	
1. April 2021 MEFP Statement on SOE Reform	<a href="#">9</a>
<b>APPENDIX</b>	
I. Georgia Draft Public Corporation Reform Strategy	<a href="#">18</a>

## GLOSSARY

ADB	Asian Development Bank
CD	Capacity Development
EFF	Extended Fund Facility
EU	European Union
FAD	Fiscal Affairs Department
FRMU	Fiscal Risks Management Unit
FRS	Fiscal Risks Statement
GFSM	Government Finance Statistics Manual
GSE	Georgia State Electrosystem
IMF	International Monetary Fund
JSC	Joint Stock Company
LLC	Limited Liability Company
KPI	Key Performance Indicator
LEPL	Legal Entity of Public Law
MEFP	Memorandum of Economic and Financial Policies
MoF	Ministry of Finance
MoESD	Ministry of Economy and Sustainable Development
NASP	National Agency for State Property
OECD	Organization for Economic Cooperation and Development
PFM	Public Financial Management
PIE	Public Interest Entity
QFA	Quasi Fiscal Activity
SCI	Statement of Corporate Intent
SOE	State Owned Enterprise
UWSC	United Water Supply Company

## PREFACE

In response to a request from the Ministry of Finance (MoF), a Fiscal Affairs Department (FAD) mission assisted the authorities in developing a draft public corporation reform strategy. The mission was conducted remotely during January to March, 2021 and comprised John Zohrab (FAD regional PFM advisor) and Avril Halstead (FAD expert). The mission was financed partly by the government of Japan and partly by the European Commission DG for International Cooperation and Development.

The mission met from the MoF: Mr. N. Gagua, Deputy Minister; and Mr. S. Gunia.

The mission team is grateful to the authorities for the frank and open discussions and close cooperation. The mission also expresses its appreciation to Mr. S. Cakir, IMF Resident Representative in Georgia, for his invaluable support for its work.

## EXECUTIVE SUMMARY

State-owned enterprises (SOEs) are a key part of Georgia's economy, accounting for a significant portion of GDP, employment and public investment. They deliver critical services in important economic sectors, including gas, electricity, water and transportation. Improving their performance is a critical step in the path to becoming a high income country.

Since 2012, the authorities have been taking concrete steps to address challenges arising from the SOE sector. Substantial progress has been achieved in disclosing fiscal risks arising from SOEs in the Fiscal Risk Statement; increasing the monitoring capacity at the Ministry of Finance (MoF) by establishing a Fiscal Risk Management Unit (FRMU); rationalizing the number of SOEs; sectorizing them in line with international statistical standards; partially unwinding the role of the Partnership Fund; and restructuring some specific SOEs.

Notwithstanding the improved transparency and monitoring of SOEs in recent years, their financial performance has continued to be unsatisfactory. It is therefore clear that, while being critical factors, better disclosure and monitoring cannot by themselves improve SOE performance to the extent necessary. Comprehensive legal and institutional reform is also required.

Drawing on established international models and good practice guidelines for the supervision of public corporations in a market economy, a reform strategy has been developed for those SOEs in Georgia that are, or could become in the near future, public corporations. The MoF has identified these SOEs on the basis of the international standards for defining a public corporation i.e. an SOE that operates on an essentially commercial basis.

The strategy has 5 interdependent pillars: commercial objectives; corporate governance; ownership policy; performance framework; and competitive neutrality. The key provisions under each pillar are as follows:

- Commercial objective: the primary objective of the public corporations should be to operate commercially.
- Corporate governance: public corporations will be required to apply good international corporate governance practices. Importantly, all supervisory board members would be required to be independent and they would be appointed through a well-structured, merit-based and transparent process. No politicians or civil servants would be permitted to serve on public corporation boards.
- Ownership policy: an ownership policy statement is to be developed and published by the central government and each local government that has responsibility for supervising public corporations. The statement will articulate the principles that will inform the public corporations' supervision and the institutional arrangements for doing so.

- Performance framework: Each year, the public corporations will be required to develop a Statement of Corporate Intent (SCI), defining the financial and non-financial objectives to be achieved within the specified risk thresholds. This will be submitted to the Ministry of Finance or local government finance department and Parliament and used to hold the public corporation supervisory boards accountable.
- Competitive Neutrality: public corporations will be required to operate on a competitively neutral basis, i.e. they should not enjoy any competitive advantages or face competitive disadvantages as a result of their ownership or control by the central or local government. Specifically, public corporations will be prohibited from undertaking public policy activities that may negatively impact on their finances, i.e. quasi-fiscal activities (QFAs)) unless explicitly mandated and fully compensated for doing so.

The strategy makes provision for the responsibility for exercising the shareholder functions of public corporations to be centralized under the MoF. This is in line with international good practice as it would ensure a clear separation between the state's shareholder and policymaking functions, as per the OECD's recommendations. However, in order to comply with the European Union (EU) unbundling directive, the MoF will be the ownership entity for the state-owned electricity transmission company whereas the MoESD will be the ownership entity for the electricity generation companies.

Nevertheless, in order to reduce the impact of the MoESD's conflict of interest between its ownership entity role and its policy/regulatory role, additional measures will be taken to separate these roles within the MoESD.

The strategy provides that a framework public corporations law be put in place that will provide a clear statutory foundation for the implementation of the principles and procedures set out in the strategy. It will also provide for reporting and disclosure requirements by both public corporations and their ownership entities to be brought in line with international good practice.

The strategy will be used to initiate a process of wider discussion in Georgia that would assist the Government to decide on how best to implement the strategy. The interdependencies between the five pillars will require careful design, sequencing, and implementation of the reform.

Implementation will be informed by pilots to be conducted in a few selected public corporations.

# I. BACKGROUND

**1. State-owned enterprises (SOEs) are a key part of Georgia's economy, accounting for a significant portion of GDP, employment and public investment.** They deliver critical services in important economic sectors, including gas, electricity, water and transportation.

**2. Improving the performance of Georgia' SOEs is a critical step in the path of becoming a high income country.** Poor performance of SOEs results in high fiscal and economic costs. In particular, the materialization of fiscal risks results in higher sovereign debt levels, delaying credit rating upgrades. As SOEs provide services in key sectors of the economy, their poor performance hampers the international competitiveness of existing and potential businesses in Georgia, constraining economic growth.

**3. Since 2012, the Georgian authorities have been making concerted efforts to address SOE performance.** They have made outstanding progress in disclosing fiscal risks from SOEs and taken some initial steps towards improving SOE performance. Key areas of progress relate to:

- *Disclosure by the Ministry of Finance (MoF) of fiscal risks from SOEs.* Since 2017, the MoF has included in the Fiscal Risks Statements (FRSs), published together with the annual draft state budgets, assessments of the fiscal risks from SOEs. The authorities have gradually increased fiscal transparency on SOEs. Disclosed information is regarded internationally as being of high quality and has encouraged a more realistic attitude towards SOE fiscal risks in Georgia;
- *Monitoring and capacity building by the MoF.* A fiscal risks management unit (FRMU) was established in 2017 in the MoF, reporting directly to a Deputy Minister. The capacity of the FRMU has been enhanced substantially, in terms of both the number and the skills and experience of its staff. In turn, this has fed through to improved monitoring of SOE fiscal risks by the MoF, both quantitatively and qualitatively, which is also evident in the analysis and advice that it has been providing on SOE fiscal risks;
- *Rationalization of SOEs.* Over the last several years, the National Agency for State Property (NASP) under the Ministry of Economy and Sustainable Development (MoESD) has reduced the number of SOEs under its control from over 1,300 in 2009 to 92 by June 2020. This has been achieved by liquidations and mergers of small SOEs;
- *Restructuring of SOEs.* The restructuring of three large SOEs is under way. The Partnership Fund is being restructured to align its activities with its essentially non-commercial nature. Georgia State Electrosystem (GSE) and the United Water Supply Company (UWSC) are being restructured to enable them to operate on a fully commercial basis.
- *A sectorization exercise has been completed by the MoF, in March 2020.* A first in the region, this exercise has identified, according to international standards,<sup>1</sup> those SOEs that are essentially commercial in nature (i.e. public corporations) and those SOEs that are essentially

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<sup>1</sup> As set out in the *Government Finance Statistics Manual (GFSM) 2014*.

non-commercial in nature (i.e. general government entities). Sectorization is important for improving the SOE performance, because a framework to monitor and promote improved performance of public corporations would not be appropriate for general government entities, and vice versa. The sectorization identified 52 out of the 235 SOEs as being public corporations.

**4. Notwithstanding the improved transparency and monitoring of SOEs in recent years, their financial performance has continued to be unsatisfactory.** While being important factors, better disclosure and monitoring can only go so far in improving SOE performance. It has become clear that a comprehensive legal and institutional reform is required to deliver the desired improvements in SOE performance.

**5. In the most recent Memorandum of Economic and Financial Policies (MEFP) associated with the Government's IMF-supported macroeconomic program, the authorities confirmed their intention to pursue comprehensive SOE reform.** This reform would be focused initially on public corporations, i.e. SOEs that are essentially commercial in nature (see Box 1).<sup>2</sup> The MEFP statement reiterates the intention expressed in the Government Program 2021-2024.<sup>3</sup>

#### **Box 1. April 2021 MEFP Statement on SOE Reform**

We are formulating a reform strategy for SOEs that would bring SOE governance consistent with best international practices. Locking in benefits from fiscal transparency in SOEs requires moving from risk disclosure to risk management and mitigation. Hence, we are committed to developing a new governance framework that defines:

- (i) The commercial objectives of public corporations.
- (ii) The corporate governance of public corporations to be implemented based on the Organization for Economic Cooperation and Development (OECD) recommendations.
- (iii) The rationale and policy guiding the ownership of public corporations.
- (iv) The performance management framework for public corporations, based on medium-term objectives defined by financial and non-financial key performance indicators (KPIs).
- (v) Principles of competitive neutrality.

We have agreed on a comprehensive SOE reform strategy, in consultation with IMF technical assistance, and will explore the options for its implementation.

**6. In line with the MEFP's intentions, the mission assisted the authorities in the preparation of a comprehensive draft strategy for public corporations.** It is attached as the Appendix to this report. The draft strategy does not, as yet, include an action plan, because the

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<sup>2</sup> Associated with the 8<sup>th</sup> review of Georgia's Extended Fund Facility (EFF) with the IMF, published in April 2021.

<sup>3</sup> Article 56 of the Constitution requires each new Government to present a Government Program, which is a strategy document, to Parliament at the time it receives its vote of confidence.

authorities are still in the process of considering options for its implementation, as stated by the MEFP.

## II. KEY ELEMENTS OF THE DRAFT STRATEGY

### A. International and European Models and Experience

**7. The draft strategy draws on established international models and good practice guidelines that have been developed in recent decades for the supervision of public corporations in a market economy.** Key documents capturing the critical principles include: (i) *G20/OECD Principles of Corporate Governance* by the G20 and Organisation for Economic Cooperation and Development (OECD); (ii) *Guidelines on Corporate Governance of SOEs and Competitive Neutrality: Maintaining a Level Playing Field between Public and Private Business*, both by the OECD; (iii) *How to Improve the Financial Oversight of Public Corporations*, by the IMF's Fiscal Affairs Department; (iv) *Corporate Governance of SOEs. A Toolkit*, by the World Bank; and (v) *Reforms, Opportunities and Challenges for SOEs*, by the Asian Development Bank (ADB).

**8. The Association Agreement between Georgia and the European Union (EU) is also an essential reference.**<sup>4</sup> It would be difficult for Georgia to comply with its provisions on competitive neutrality and state aid without a comprehensive reform of the SOE sector.

### B. Five Pillars of the Reform

**9. The draft strategy has 5 pillars: commercial objectives; corporate governance; ownership policy; performance framework; and competitive neutrality.** These reflect the main elements set out in the Government Program 2021-2024 and the MEFP statement.

**10. There are important interdependencies between these pillars.** The draft strategy is integrated, and therefore failure to adequately implement any one pillar would undermine the others. Key interdependencies are discussed later in this document.

### C. Applicability to Public Corporations

**11. The strategy will apply in its first stage of implementation to the 24 public corporations that are Public Interest Entities (PIEs) plus selected other SOEs that could realistically become public corporations in the near future.** The strategy will be applied to the 28 smaller public corporations at a later stage. There are three main reasons for limiting the strategy to public corporations:

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<sup>4</sup> *Association Agreement between the EU between and the European Atomic Energy Community and their Member States, of the one part, and Georgia, of the other part.*

- SOEs that are public corporations require a governance framework that allows them to operate at arms' length from the central or local government, given that they have the capacity to operate commercially, generate their own revenues to cover the majority of their expenditure, and require experienced professional management. On the other hand, general government entities should be supervised in a manner similar to budget organizations, as they are responsible for fulfilling public policy mandates on a non-commercial basis;
- There are clear international models and experience as well as good practice guidelines to inform the public corporations framework; and
- The SOEs that are classified as public corporations account for most of the assets, liabilities, revenues and expenses of the SOE sector, and therefore for most of the fiscal risks and economic efficiency problems associated with it.

**12. Nevertheless, the future framework for SOEs that are general government entities will need to be addressed at some point.** In aggregate, these SOEs are contributing to fiscal risks and economic efficiency problems. How and when they are addressed could be influenced by the implementation of the strategy for public corporations.

## **D. Commercial Objective**

**13. The draft strategy provides that the primary objective of public corporations should be to operate commercially.** This is logical in terms of their status as public corporations and has two components:

- First, public corporations should achieve, on average over the business cycles, financial performance that is comparable with the financial performance of comparable private sector commercial enterprises. Their non-financial objectives should also be comparable with those of comparable private sector commercial enterprises; and
- Secondly, public corporations should not engage in activities that are not in their commercial interest. In this regard, public corporations should identify and eliminate quasi-fiscal activities (QFAs), i.e. non-commercial activities, both explicit and implicit.<sup>5</sup> If, in clear circumstances and as a secondary objective, the central or local government would like public corporations to conduct QFAs, it should compensate them fully for their costs. QFAs should be maintained only where the most efficient ways of conducting the particular activities are via public corporations; otherwise, they should be eliminated.

## **E. Corporate Governance**

**14. The draft strategy provides for public corporations to apply good international corporate governance practices.** Corporate governance refers to the structures and processes for the direction and control of corporations. It specifies the distribution of powers and responsibilities

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<sup>5</sup> Examples of implicit QFAs include excess staffing and other inefficiencies driven by Government requests.

among the corporation's stakeholders, including owners, supervisory boards, and full-time executives, and articulates the rules and procedures for making the decisions in the name of the corporations. The Georgian authorities have adopted a Corporate Governance Code, intended to be annexed to the draft strategy, that is consistent with international good practice and that would be applied to public corporations.

**14. An independent supervisory board should take full responsibility for each public corporation company.** In particular, the supervisory board should be fully responsible for:

- The appointment of the full-time executives of the public corporation, including the chief executive officer, without any kind of interference from the ownership entity;
- Monitoring and holding accountable the full-time executives of the public corporation in the implementation of the its strategic and business plans and policies approved by the supervisory board, including the achievement of performance targets;
- Overseeing the integrity of the public corporation's accounting and financial reporting systems and its formal disclosures and communications; and
- Agreeing the public corporation's Statement of Corporate Intent (SCI) with the ownership entity and be accountable for the public corporation's performance against the SCI.

**15. Thus, at the core of corporate governance is the role of the public corporation's supervisory board.** Duties of care and loyalty on the part of the supervisory board members towards their public corporations need to be established. Key elements associated with the public corporations' supervisory boards relate to how members are appointed and what are their duties.

**16. Supervisory board members should be appointed through a well-structured, merit-based and transparent process and should not include any politicians or civil servants.**

Members would only be considered for appointment if they had relevant skills, sufficient experience and no conflicts of interest. They should not be former politicians or former civil servants without a sufficient cooling off period. The Government should establish a transparent mechanism for the selection of supervisory board members by establishing a selection committee with the representation from business or civil society groups.

## **F. Shareholder Functions**

**17. With the exception discussed in paragraph 18, the draft strategy makes provision, in line with international good practice, for the responsibility for exercising the shareholder functions of public corporations to be centralized under the MoF.** This would ensure a clear separation between the state's shareholder and policymaking functions, as per the OECD's recommendations, and would be logical in terms of the public corporations' commercial mandate. This centralization would not apply to the large majority of SOEs that are general government entities. Key shareholder functions for public corporations, as provided for in the Corporate Governance Code, include appointing and dismissing the supervisory board members, setting their

remuneration, agreeing the Statement of Corporate Intent (SCI) and exercising the state's voting rights on fundamental corporate decisions.

**18. The exception is that the MoESD will be the ownership entity for the electricity generation companies.** This is to comply with the EU's Directive<sup>6</sup> requiring the ownership of state-owned electricity and transmission companies to be unbundled. The MoF will retain ownership of the transmission company, Georgia State Electrosystem (GSE). In order to reduce the impact of the MoESD's conflict of interest between its ownership entity role and its policy/regulatory role, additional measures will be taken to separate these roles within the MoESD.

## **G. Ownership Policy**

**19. The draft strategy provides that the ownership entity for the central and each local government should develop, update and publish an ownership policy statement on its public corporations.** As necessary, the MoF would lead this process for local governments. This statement would set out clearly the rationale for retaining the public corporations and the related policy objectives.

**20. The ownership policy statement should include a well-argued rationale for the ownership of each public corporation and for the size of the central or local government's shareholding.** The rationale for ownership should be based on the justification that central or local government ownership is the best way for achieving public objectives related to economic development. The ownership policy statement should be transparent and well communicated.

**21. The ownership policy statement should also set out how the ownership entity should exercise its shareholder functions.** In this regard, the statement should also include:

- How the central or local government intends to exercise its ownership or control rights;
- The organization of the central or local government ownership or control function;
- The main functions carried out by the central or local government as owner or controller of the public corporations; and
- The basis of financial and nonfinancial oversight.

**22. The draft strategy includes the criteria for establishing a public corporation and that the ownership of each existing public corporation should be reviewed periodically.** For the purposes of these reviews, the draft strategy sets out criteria for liquidating the corporation, converting it into a Legal Entity of Public Law (LEPL), privatizing it, or retaining it as a public corporation.

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<sup>6</sup> 2019/944 of 5 June, 2019.

## H. Performance Framework

**23. The draft strategy provides that the performance framework should replicate the performance discipline that equity markets, including the market for corporate control, apply to private corporations.** It should be the central mechanism through which the ownership entity sets out its expectations of each public corporation's performance and holds the public corporation's supervisory board accountable for achieving the performance. Within the performance framework provision is made that the following be defined:

- The mandate, objectives, performance targets and risk tolerance thresholds for each public corporation;
- The monitoring and evaluation of performance; and
- The appropriate rewarding of good performance and sanctioning of poor performance.

**24. Each year, each public corporation should develop a SCI.** It should be submitted for approval, which should also include a strategic plan for delivering on the objectives and targets set out in the SCI, to the MoF or local finance department before the start of the financial year. The MoF or local finance department should assess the ambitiousness and relevance of the SCI and based on this assessment approve it. The approved SCI should then be submitted to the national or local parliament for information. The SCI should:

- Define the scope of the public corporation's business, outside which it is not authorized to operate;
- Define the public corporation's objectives, including its financial and non-financial KPIs and targets and dividend policy, consistent with its forecast financial statements;
- Define the limits of the risks that the public corporation is authorized to bear;
- Define any transfers the public corporation shall receive from, or pay to, the state or local budget to compensate for competitive disadvantages and advantages;
- Define any QFAs and the transfers the public corporation shall receive from, or pay to, the state or local budget to compensate for undertaking such activities at the central or local government's direction;
- Include reconciliations between financial and non-financial data and other information provided in it and the corresponding data and information included in the management report for the previous year and the previous SCI;
- Include a statement outlining the public corporation's corporate governance framework; and
- Define the consequences of the public corporation's failure to achieve its objectives or comply with its risk limits or other obligations, including those contained in its SCI.

## I. Competitive Neutrality

**25. The draft strategy provides that public corporations should operate on a competitively neutral basis.** This means that they will not enjoy competitive advantages or face competitive disadvantages as a result of their ownership or control by the central or local government. The application of competitive neutrality principles helps to ensure that public corporations use scarce economic resources – capital, assets, labor and intermediate goods and services – efficiently, to enhance their positive impact on economic productivity and growth.

**26. Public corporations should therefore:**

- Be subject to general laws, regulations, and taxes. The framework Public Corporation Law and associated subsidiary legislation, discussed below, will not undermine competitive neutrality but will enhance it;
- Face market conditions for access to, and the cost of debt. They will be required to obtain debt finance on commercial terms from financial markets where possible. Any on-lending from the central or local government will be on standard commercial terms, using market interest rates matching the maturity and risk profile of the debt;
- Face market conditions for access to, and the cost of equity. In respect of the cost of equity, they will be required to earn rates of return on equity consistent with those obtained by comparable private sector commercial enterprises. Similarly, public corporations will be subject to private sector norms with respect to their dividend policies and capital structures;
- Not benefit from indirect financial support from the central or local government that confers an advantage on them over comparable private sector commercial enterprises. They should be fully and transparently compensated financially for any QFAs they are required to undertake; and
- Be subject to the financial reporting, disclosure, auditing, and corporate governance requirements that are similar to those of comparable private sector firms, enhanced in certain respects because of the particular requirements of ownership by the central or local government.

## J. Interdependencies

**27. The draft strategy notes that the interdependencies between the five pillars make the design, sequencing, and implementation of the reform more challenging than would otherwise be the case.** However, they also mean that the reform, when implemented, would be robust as the five pillars will reinforce one another.

**28. Notable interdependencies include:**

- *Between competitive neutrality and commercial objectives and the performance framework.* Without competitive neutrality, commercial objectives have little meaning, as the

performance of a public corporation in this situation could not be compared meaningfully with the performance of otherwise comparable private sector enterprises. Conversely, competitive neutrality would be unachievable without commercial objectives and a performance framework that held public corporations accountable on a basis comparable with private sector enterprises competing with them; and

- *Between the performance framework, corporate governance framework and ownership policy.* In order for the performance framework to be meaningful, the corporate governance framework and an ownership policy that are comparable with those applicable in the private sector would also need to be implemented. Otherwise, the performance framework would be undermined by the roles of the ownership entity, supervisory board and full-time executives of the corporations not being clearly distinguished, making it difficult for them to be held accountable. In addition, the principles set out in the ownership policy should inform the performance targets the public corporation should be required to achieve.

## K. Auditing, Reporting and Disclosure

**29. The draft strategy provides for the reporting and disclosure requirements by both public corporations and their ownership entities should be brought in line with international good practice.** The requirements for annual reporting and disclosure by public corporations will be enhanced to close the remaining gaps. Over and above the annual reports, public corporations will be required to report regularly intra-year to the MoF and local government finance departments. The MoF and local government finance departments will be required to produce, publish and submit aggregate reports on public corporations. Requirements for all the public corporations' annual reports as well as the aggregate reports to be submitted to parliament are included in the draft Strategy.

## L. Framework Public Corporations Law

**30. International experience suggests that comprehensive, robust and enduring reform of Georgia's public corporations would require a framework public corporations law.** This is because Georgia's *Law on Entrepreneurs* and *Law on Accounting, Reporting and Auditing* do not take into account sufficiently the particular circumstances and requirements of government ownership, and therefore need to be enhanced. However, good international practice is that a framework public corporations law should complement the general law applying to all commercial enterprises. The draft Strategy provides that a framework public corporations law would be approved by Georgia's national parliament on this basis. It would cover the key elements of the Strategy that require a clear statutory foundation for their proper and consistent application.

## M. Pilot

**31. The draft strategy provides that it should be piloted in a few selected public corporations.** The main purpose of the pilot would be to test the Strategy to ensure that it is

appropriately and efficiently designed for the Georgian context. In particular, this would inform the development and fine-tuning of the framework Public Corporation Law and its subsidiary legislation. The public corporations proposed for the pilot are GSE, Georgian Oil and Gas Corporation (GOGC), and UWSC.

### III. NEXT STEP AND RECOMMENDATION

**32. The mission understands that the authorities intend to publish the draft strategy.** This would initiate a process of wider discussion in Georgia, including with civil society, that would assist the Government to decide on how best to implement the Strategy.

**Recommendation.** Consider *Georgia's Public Corporation Reform Strategy* contained in the Appendix to this report for publication and discussion as a draft.

# **APPENDIX I. GEORGIA DRAFT PUBLIC CORPORATION REFORM STRATEGY**

## **Georgia's Public Corporation Reform Strategy**

**April 2021**



## Contents

<b>APPENDIX I. DRAFT PUBLIC CORPORATION REFORM STRATEGY</b>	<b><u>18</u></b>
<b>A. BACKGROUND TO THE STRATEGY</b>	<b><u>21</u></b>
<b>B. PURPOSE OF THE STRATEGY</b>	<b><u>22</u></b>
<b>C. OBJECTIVES OF REFORM</b>	<b><u>22</u></b>
<b>D. FIVE PILLARS OF THE REFORM</b>	<b><u>23</u></b>
Pillar 1. Commercial Objectives	<u>23</u>
Pillar 2. Corporate Governance	<u>24</u>
Pillar 3. Ownership Policy	<u>28</u>
Pillar 4. Performance Framework	<u>30</u>
Pillar 5. Competitive Neutrality	<u>32</u>
<b>E. REFORM INTERDEPENDENCIES</b>	<b><u>33</u></b>
<b>F. OWNERSHIP ENTITY</b>	<b><u>34</u></b>
<b>G. COVERAGE OF THE REFORM</b>	<b><u>36</u></b>
<b>H. QUASI-FISCAL ACTIVITIES</b>	<b><u>36</u></b>
<b>I. AUDITING, REPORTING AND DISCLOSURE</b>	<b><u>38</u></b>
<b>J. PILOTS</b>	<b><u>40</u></b>
<b>K. FRAMEWORK PUBLIC CORPORATION LAW</b>	<b><u>41</u></b>
<b>Annex I. State Public Corporations Corporate Governance Code</b>	<b><u>43</u></b>
<b>Annex II. Key Reference</b>	<b><u>43</u></b>

## GLOSSARY

ADB	Asian Development Bank
CEO	Chief Executive Officer
CSO	Commercial Service Obligation
EU	European Union
GOGC	Georgian Oil and Gas Corporation
GSE	Georgian State Electrosystem
IMF	International Monetary Fund
JSC	Joint Stock Company
KPI	Key Performance Indicator
LEPL	Legal Entity of Public Law
NCSO	Non-Commercial Service Obligation
OECD	Organization for Economic Cooperation and Development
PIE	Public Interest Entity
QFA	Quasi-Fiscal Activity
SCI	Statement of Corporate Intent
SOE	State-owned Enterprise
UWSC	United Water Supply Company

## A. BACKGROUND TO THE STRATEGY

The Government Program 2021-2024 has committed the Government to implement the reform of State-Owned Enterprises (SOEs). The first stage of the reform will focus on public corporations, i.e., those SOEs that are defined as essentially commercial in nature according to international standards by the sectorization conducted by the Ministry of Finance, that are Public Interest Entities (PIEs) following the criteria set out in the *Law of Georgia on Accounting, Reporting and Auditing*. There are 24 public corporations that currently meet these criteria.

The Government Program 2021-2024 further provides that the reform will be based on five pillars:

1. The commercial objectives of public corporations will be prioritized.
2. Corporate governance of public corporations will be implemented based on the Organization for Economic Cooperation and Development (OECD) recommendations.
3. There will be a formal rationale and policy guiding the ownership of public corporations.
4. The performance management framework for public corporations will be based on medium-term objectives defined by financial and non-financial key performance indicators (KPIs).
5. Public corporations will not distort competition in the sectors in which they operate.

Since 2015, the Government has improved the transparency of SOEs by publishing assessments of their financial performance and fiscal risks in an annual *Fiscal Risks Statement* accompanying the draft state budget submitted to parliament. This improved transparency, which is recognized internationally as high quality, has produced some tangible benefits in terms of improved performance and reduced fiscal risks as a result of improving the accountability of public corporation managers and supervisory board members. However, it has not been sufficient to ensure satisfactory financial performance overall; indeed, there has been an overall deterioration of financial performance in recent times.. Without suitable legal and institutional arrangements, transparency alone cannot ensure that public corporations will deliver their full potential benefits to Georgia.

The last five years of improved transparency have highlighted the scale of these potential benefits, both financial and non-financial, as has the public corporation reform implementation experience of many other countries. The last five years of improved transparency, as well as international experience, have also clarified the reforms that need to be undertaken. It is therefore the right time now to begin to implement them on a comprehensive basis.

The fact that SOEs are generating only marginal revenues for central and local government budgets in the form of dividends, with large SOEs making almost zero contributions, represents a materialization of fiscal risks. However, the main objective of the reform is not to increase budget revenues but to increase efficiency in the economy, improve the business environment and contribute to the economic growth of the country.

## B. PURPOSE OF THE STRATEGY

The purpose of this Strategy is to:

- Define a vision for the planned reforms for public corporations. This vision will help to ensure that the policy, legal and institutional changes contribute to achieving the aim of the reforms.
- Create a basis for communicating with stakeholders, including the general public, members of parliament and public corporations, to maximize co-operation in executing the Strategy, thereby easing the transition to the reformed legal and institutional arrangements.

## C. OBJECTIVES OF REFORM

The objectives of the reform of public corporations are to:

- **Increase economic growth.** In 2018, the 16 largest public corporations accounted for 18 percent of Georgia's GDP, and so improvements in the efficiency of the use of public corporation resources – capital, assets, labor, and intermediate goods and services – would significantly and directly increase economic productivity and growth. In addition, improved economic efficiency of public corporations would have significant indirect economic growth benefits, by improving the efficiency of other sectors that use their products, e.g. energy and transport services, and by stimulating Georgia's business environment and domestic capital market generally.
- **Strengthen public finances.** Public corporations have been a drain on Georgia's public finances since independence. Just in the period between 2014 and 2018, central government public corporations have received capital injections of GEL 1.3 billion but their net worth has still declined by GEL 0.7 billion. Improvements in their financial performance would help to ensure that they deliver critical services effectively, their burden on public finances and fiscal risks are controlled, their assets are properly managed, and they are integrated into Georgia's overall strategy for improving public financial management.
- **Improve the business environment.** Large SOEs in Georgia are predominantly in the energy and logistics sectors. Efficiency in these SOEs will have a positive impact on their sectors and therefore on the business environment in the country as a whole.
- **Develop the capital market.** SOE reform will also be conducive to capital market development objectives of the country. This impact of SOE reform has been demonstrated internationally.<sup>1</sup>

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<sup>1</sup> See World Bank, *Corporate Governance of SOEs. A Toolkit*, p. 17.

## D. FIVE PILLARS OF THE REFORM

The five pillars of the reform, set out in the Government Program 2021-2024, are: commercial objectives; corporate governance; ownership policy; performance framework; and competitive neutrality. They are based on well-established international principles for public corporation ownership and corporate governance that are appropriate for a country like Georgia adopting European standards of corporate governance, notably via its Association Agreement with the European Union (EU). These principles have been developed and refined over several decades and are appropriate for public corporations operating in a market economy.

The principles have been elaborated by Georgia's development partners, including the OECD, the International Monetary Fund (IMF), the World Bank and the Asian Development Bank (ADB). Annex 1 of this Strategy provides references to key publications by these organizations.

The five pillars are interdependent. To achieve the standards and the associated improvements in the public corporation corporate governance and performance all five pillars must be implemented.

The IMF, World Bank and ADB, all of which Georgia is a member, have committed to support the implementation of various aspects of the Strategy.

### Pillar 1. Commercial Objectives

The primary objective of public corporations will be to operate commercially. They should achieve a comparable financial performance to that of similar private sector commercial companies, on average over time. Benchmarking their performance against private sector comparators will ensure that public corporations are not held to higher or lower standards than their private sector competitors and thus that *Competitive Neutrality* is achieved. International experience shows that such benchmarking is possible even where public corporations do not have direct private sector competitors. The *Performance Framework (pillar 4)* will ensure that public corporations are held accountable for achieving their financial and non-financial commercial objectives.

The non-financial objectives of public corporations will also be comparable with those of comparable private sector commercial companies. These include:

- Limits on the risks that public corporations should be permitted to take.
- Quality standards for the supply of goods and services by public corporations, e.g. maximum levels of service interruption.
- Standards of corporate responsibility by public corporations, e.g. towards employees, customers, the communities in which they operate and the physical environment.

If, as a secondary objective, the central or local government wishes public corporations to conduct non-commercial activities, also known as *quasi-fiscal activities* (QFAs), it will compensate them fully for their costs.

### Key Reform Action Points for Pillar 1

Incorporate in a framework Public Corporations Law:

- The primary commercial objective for public corporations
- The approach to handling their secondary non-commercial objective.

Ensure that *Ownership Policy* is consistent with the prime responsibility of public corporations to operate commercially.

Ensure that the *Commercial Objectives* are defined comprehensively and consistently with *Corporate Governance*, *Ownership Policy*, *Performance Framework* and *Competitive Neutrality*.

## Pillar 2. Corporate Governance

*Corporate Governance* refers to the structures and processes for the direction and control of corporations. It specifies the distribution of powers and responsibilities among the corporation's stakeholders, including owners, supervisory board members, and full-time executives, and articulates the rules and procedures for making the decisions in the name of the corporations.

*Corporate Governance* is essential for achieving the other pillars of the Strategy, helping to build an environment of trust, transparency, and accountability necessary for fostering long-term investment, financial stability, and business integrity.

*Corporate Governance* for public corporations requires expanding on the existing requirements of Georgia's *Law on Entrepreneurs* and extending its provisions to public corporations that are not joint stock companies (JSCs). The need to strengthen the corporate governance provisions applicable to all corporations in Georgia, without undermining *Competitive Neutrality*, is a clear lesson from international experience and is the result of the particular ownership and public policy context of public corporations.

Regardless of its legal form, each public corporation will have a supervisory board. It will comprise members with the appropriate skills, knowledge, experience, independence and time to exercise independent oversight over the day-to-day activities of the corporation's full-time executives, in particular the chief executive officer (CEO). Supervisory board members will be held accountable for the performance of their duties.

The framework Public Corporation Law will stipulate that the number of supervisory board members is in line with international good practice, depending on the size and complexity of the corporation.

The public corporations ownership entity, i.e., the entity assigned responsibility to exercising the state's shareholder or ownership rights in respect of the public corporations (see section F below), in association with other shareholders in the case of corporations with less than 100 percent central or local government ownership, will have the right to:

- Obtain relevant information about the public corporation on a timely and regular basis.
- Participate and vote in a general meeting of shareholders.
- Appoint and dismiss supervisory board members and determine their remuneration.
- Agree to, and monitor the implementation of, the mandate, objectives and performance targets as specified in the *Statement of Corporate Intent* (SCI), which is a key element of the *Performance Framework*.
- Approve decisions to amend the charters of public corporations, the issuance of additional shares and major and extraordinary transactions. The central or local government will be responsible for developing the ownership policy, which will specify how it intends to perform these functions.

Duties of care and loyalty on the part of supervisory board members towards their public corporations will be established. This means that they will be required to exercise appropriate care and professionalism in undertaking their responsibilities. They will be required to manage conflicts of interest and not use any information for their personal gain. Should they fail to uphold these duties of care and loyalty, they will be held accountable.

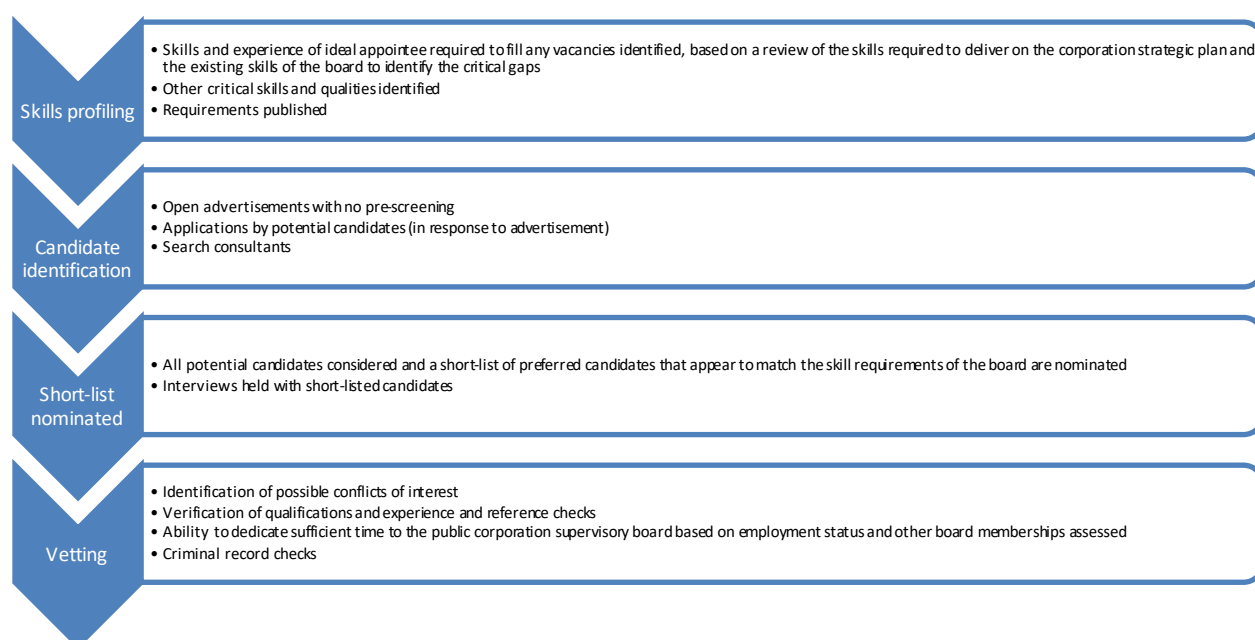
Further key responsibilities of a public corporation's supervisory board will include:

- Agreeing the SCI, adopting the corporation's strategic plan to deliver on its mandate and KPIs, and monitoring implementation of the corporation's strategic plan by the CEO and other executives.
- Setting the corporation's policies.
- Appointing and dismissing the corporation's CEO and other senior executives and setting their remuneration in line with the remuneration policy approved by the ownership entity.
- Overseeing the integrity of the corporation's accounting and financial reporting systems and compliance with all applicable legislation.
- Approving the corporation's formal disclosures and overseeing its communications.

Supervisory board members will be prohibited from involvement in the day-to-day management of the public corporation, to ensure that they are able to perform effectively their monitoring responsibility. The CEO will be responsible for day-to-day management of the public corporation, including the implementation and execution of the SCI, strategic plan and policies approved by the supervisory board. The CEO, together with the other senior executives, will also be responsible for undertaking any functions delegated to them by the supervisory board.

A special committee will be appointed by the Prime Minister or mayor on the recommendation of the Ministry of Finance or local finance department to nominate candidates for supervisory board membership. This approach will promote transparency and independence in the formation of supervisory boards. Members of the special committee should desirably be experienced actual or former supervisory board members of public or private sector corporations.

The process to be followed by the special committee is set out below. The candidates to be appointed to each supervisory board will be appointed by the applicable public corporation ownership entity from among those nominated by the special committee.



Public corporation supervisory board members will serve terms of three years and a maximum of two terms on each supervisory board.

Candidates will be required to meet a number of criteria to be considered for a position as a supervisory board member of a public corporation, including:

- Having industry, financial, business, legal and/or corporate governance skills.
- Having more than 10 years' experience in senior management or on supervisory boards, a portion of which should have been in the private sector.
- Being individuals of proven ethics and integrity, having exhibited the capacity to think critically and be independently minded, and having demonstrated the soft skills necessary for working effectively as part of a supervisory board.

Certain individuals will be disqualified from serving on the supervisory board of a public corporation, including:

- Ministers and other elected central and local government officials as well as civil servants, or persons who have occupied such posts within the preceding two years;
- People that have been removed from a position of trust due to misconduct or dishonesty.
- People that have been convicted of theft, fraud, misrepresentation, dishonesty, perjury, corruption, or a securities-related complaint.
- People that are unrehabilitated bankrupts.

Members of the supervisory boards of public corporations may be dismissed at the discretion of the ownership entity, but reasons need to be provided. However, before supervisory board members are dismissed, they must be given an opportunity to make representations to the ownership entity. Normally, supervisory board members will only be dismissed if they have become one of the following:

- Ineligible or disqualified.
- Incapacitated so that they are unable to perform their functions.
- Negligent or derelict in performing their duties

The ownership entities will determine the remuneration of supervisory board members. It will be competitive, taking into account the size and complexity of the public corporation and the industry in which the public corporation operates, and will be consistent with a remuneration policy approved by the central or local government, which will form a component of the *Ownership Policy*. The ownership entities will also establish and implement processes for assessing the performance of supervisory board members.

There will be a number of other key corporate governance provisions:

- Each public corporation supervisory board will, as a minimum, be required to establish an Audit Committee and will be encouraged to also establish a Risk Management Committee and a Remuneration Committee.
- Supervisory boards will be required to undertake annual evaluation of their effectiveness as part of the ownership entities' board evaluation process.
- The public corporations will be required to adhere to the national Corporate Governance Code.
- Each public corporation will be required to have a Code of Ethics that applies, as a minimum, to supervisory board members and all employees and contractors of the public corporation, including the CEO and other senior executives, as well as to the corporation as a whole. Each Code will include a requirement for the corporation to act as a responsible corporate citizen and have procedures in place for preventing corruption and money-laundering.

- Whistleblowing mechanisms that allow any person to report misconduct at a public corporation will be established and legal protection will be provided to whistleblowers provided that their claims are not found to be frivolous or vexatious.
- Minority protections contained in the *Law on Entrepreneurs* will be extended to all public corporations in which the central or local government does not have 100 percent ownership.

### Key Reform Action Points for Pillar 2

Incorporate in a framework Public Corporations Law the:

- Requirement for public corporations to have a supervisory board.
- Powers and responsibilities of public corporation shareholders and supervisory board members.
- Procedures for the appointment, removal and remuneration of supervisory board members.

Develop secondary legislation to elaborate the Law's requirements in greater detail.

Develop a Corporate Governance Code to be applicable to all state public corporations.

Ensure that *Corporate Governance* is defined comprehensively and consistently with the *Commercial Objectives, Ownership Policy, Performance Framework* and *Competitive Neutrality*.

## Pillar 3. Ownership Policy

A public corporation will only be established if this is clearly the most efficient option for meeting a relevant and significant public policy objective, after the costs and benefits of each option have been assessed. Other options for meeting the policy objective could include regulation, targeted taxation and expenditure measures, or establishment of a non-commercial government unit.

An existing public corporation will be:

- Liquidated if it is: (i) not commercially viable; and (ii) no longer the most efficient option for meeting the policy objective.
- Converted into a Legal Entity of Public Law (LEPL) if it is: (i) not commercially viable; but (ii) remains the most efficient option for meeting the policy objective.
- Privatized if it is (i) commercially viable; but (ii) no longer the most efficient option for meeting the policy objective.
- Retained as a public corporation if it is: (i) commercially viable; and (ii) remains the most efficient option for meeting the policy objective. International examples of the circumstances in which public corporations have been the most efficient option for meeting significant and relevant policy objectives include:
  - National security.
  - Natural monopolies where market regulation is insufficiently effective.

- The delivery of public goods or services where public ownership is more efficient or reliable than contracting out to private operators.
- Investments that are too large for the private sector to undertake.

The status of each existing public corporation will be reviewed according to these criteria at least every five years.

Both the cases for the establishment of new public corporations and the reviews of existing public corporations will be subject to independent assessments, which will be published.

Public corporations may be wholly owned by the state. The state may also have a majority stake in a company, or a minority stake. The extent of public ownership required to achieve the identified policy objectives most efficiently will be scrutinized as part of the assessments of their establishment or retention.

The central and each local government will develop, update and publish an ownership policy statement on its public corporations. As necessary, the Ministry of Finance will lead this process for local governments. This statement will set out clearly the rationale for retaining the public corporations and the related policy objectives. The statement will also convey:

- How the central or local government intends to exercise its ownership or control rights.
- The organization of the central or local government ownership or control function.
- The main functions carried out by the central or local government as owner or controller of the public corporations.
- The mandate and financial and non-financial objectives of each public corporation.
- The basis of financial and nonfinancial oversight.
- The main principles and policies to be followed, such as ensuring *Competitive Neutrality*.

The ownership policy statement will also refer to the constitution, statutes, subsidiary legislation and other documents that define the ownership or control rights of the central or local government. On financial oversight, the policy will explicitly address:

- Planning and budgeting requirements.
- Approval of major transactions.
- Reporting requirements.
- Pricing and tariffs.
- Dividend policy.
- Financial assistance or compensation from the central or local government, including guarantees and contractual commitments.

All these elements will be included in the *Performance Framework*.

### Key Reform Action Points for Pillar 3

Incorporate in the framework Public Corporations Law:

- The criteria for establishing or retaining a public corporation
- The requirement to develop, update and public corporation ownership policy statements.

Develop secondary legislation to give effect to these provisions in the Law.

Ensure that the *Ownership Policy* is defined comprehensively and consistently with the *Commercial Objectives*, *Corporate Governance*, *Performance Framework* and *Competitive Neutrality*.

## Pillar 4. Performance Framework

The *Performance Framework* should replicate the performance discipline that equity markets, including the market for corporate control, apply to private corporations. It will be the central mechanism through which the central or local government sets out its expectations of each public corporation's performance and holds the public corporation's supervisory board accountable for achieving the performance. Thus, the *Performance Framework* will define the mandate, objectives, performance targets and risk tolerance thresholds for each public corporation; the monitoring and evaluation of performance; and the appropriate rewarding of good performance and sanctioning of poor performance.

Each year, public corporations will develop a SCI to be submitted by the supervisory board to the Ministry of Finance or local government finance department for review. The Ministry of Finance or local government finance department will provide comments on the SCI, which will be finalized taking these comments into account. The finalized SCI will be submitted, together with a strategic plan for delivering on the objectives and targets set out in the SCI, to the Ministry of Finance or local government finance department before the start of the financial year. The Ministry of Finance or local government finance department will then submit both documents to the national or local parliament for information.

Amendments of the SCI may be initiated by the supervisory board or the Ministry of Finance or local government finance department. However, amendments will be limited to exceptional circumstances to avoid significantly changing the accountability framework during the year and thereby undermining accountability. Amendments to the SCI or to the strategic plan will be submitted to the national or local parliament for information.

Both the SCI and strategic plan should cover the four-year period of the central government's medium-term budget framework and be updated annually on a rolling basis. The SCI should include the following elements:

- Define the scope of the public corporation's business, outside which it is not authorized to operate.
- Define the public corporation's objectives, including its financial and non-financial KPIs and targets and dividend policy, consistent with its forecast financial statements.
- Define the limits of the risks that the public corporation is authorized to bear.
- Define any transfers the public corporation shall receive from, or pay to, the state or local budget to compensate for competitive disadvantages and advantages.
- Define any QFAs and the transfers the public corporation shall receive from, or pay to, the state or local budget to compensate for undertaking such activities at the central or local government's direction.
- Include reconciliations between financial and non-financial data and other information provided in it and the corresponding data and information included in the management report for the previous year and the previous SCI.
- Include a statement outlining the public corporation's corporate governance framework.
- Define the consequences of the public corporation's failure to achieve its objectives or comply with its risk limits or other obligations, including those contained in its SCI.

The strategic plan shall, as a minimum, include the following elements:

- A business plan containing the strategic initiatives for delivering the objectives agreed in the SCI.
- Forecast financial statements as well as borrowing and capital expenditure plans aligned to the SCI and business plan.
- Quarterly breakdown of the financial forecasts and performance targets for the upcoming financial year to facilitate quarterly monitoring.
- An assessment of strategic risks and a risk management plan consistent with it.

The SCI should be an agreement between the ownership entity and the public corporation on the results the public corporation needs to achieve, whereas the strategic plan should be the plan for how the public corporation will achieve the results specified in the SCI which the Supervisory Board takes responsibility for. If the two documents were combined, the ownership entity would become responsible for the strategic plan and therefore would have difficulty in holding the Supervisory Board accountable for achievement of the results.

Supervisory boards will submit quarterly reports to the Ministry of Finance or local government finance department. They will cover:

- Actual financial performance versus the financial projections or budget.

- Actual performance against quarterly targets in the SCI.
- Reasons for any deviations and actions to be taken to get performance back on track.

At the end of each year, the supervisory board will include in the public corporation's annual report the actual performance against each of the objectives and targets set in the SCI. This performance will be independently audited to ensure the reliability of the information, as they will form the basis for evaluating the performance of the public corporation. The Ministry of Finance or local government finance department will evaluate the performance. The corporation risk assessments in a public corporation's annual report will normally be consistent with the fiscal risks assessments in the annual Fiscal Risks Statement prepared by the Ministry of Finance, as the two types of risks are related to each other.

The *Performance Framework* will be codified in the framework Public Corporations Law as well as in subsidiary legislation.

#### **Key Reform Action Points for Pillar 4**

Incorporate in the framework Public Corporations Law:

- The key contents of public corporations' SCIs and strategic plans and the procedures for submitting and approving them.
- The requirement for public corporations to submit regular reports and their key contents.
- Essential procedures for evaluating public corporation performance.
- The role of the Ministry of Finance or local government finance department in the Performance Framework.

Develop secondary legislation to specify the Law's requirements in greater detail.

Ensure that the *Performance Framework* is defined comprehensively and consistently with the *Commercial Objectives, Corporate Governance, Ownership Policy, and Competitive Neutrality*.

## **Pillar 5. Competitive Neutrality**

Public corporations will operate on a competitively neutral basis. This means that they will not enjoy competitive advantages or face competitive disadvantages as a result of their ownership of control by the central or local government. The application of competitive neutrality helps to ensure that public corporations use scarce economic resources – capital, assets, labor and intermediate goods and services – efficiently, and therefore to enhance their positive impact on economic productivity and growth.

Public corporations compete not only with those private sector commercial firms actually in their market, but also those potentially competing in their market as well as those offering substitute product or services. For example, Georgian Railway's competition is not only in the rail market, but in the market for transport services and its competitors include both actual and potential providers of

transportation services. Public corporations also compete with all Georgia's public and private sector firms in the markets for inputs such as capital, labor, materials and services.

Public corporations will:

- Be subject to general laws, regulations, and taxes, and will not be granted exemptions or be subject to special laws, regulations and tax arrangements that undermine competitive neutrality. The applicable general laws will include general company, labor, environmental and consumer protection laws. The framework Public Corporation Law and associated subsidiary legislation will not undermine competitive neutrality but will enhance it.
- Face market conditions for access to, and the cost of debt. They will be required to obtain debt finance on commercial terms from financial markets where possible. Any on-lending from the central or local government will be on standard commercial terms, using market interest rates matching the maturity and risk profile of the debt. Similarly, any inter-public corporation lending or other transactions will be on market terms. Any debt raised by the public corporations will not be guaranteed by central or local government, and this will be stated explicitly in all debt documentation.
- Face market conditions for access to, and the cost of equity. In respect of the cost of equity, they will be required to earn rates of return on equity consistent with those obtained by comparable private sector commercial firms. On any new investments of equity, there should be a reasonable expectation that the public corporations will be able to generate such a rate of return. Benchmarking of market returns on equity will be done using standard corporate finance tools. Similarly, public corporations will be subject to private sector norms with respect to their dividend policies and capital structures.
- Will not benefit from indirect financial support from the central or local government that confers an advantage on them over comparable private sector commercial firms. Thus, public corporations will not be eligible for special guarantees or subsidies from the central or local government beyond those required to achieve competitive neutrality; instead, they should be treated the same as private sector companies. They will be fully and transparently compensated financially for any QFAs they are required to undertake.
- Will be subject to the financial reporting, disclosure, auditing, and corporate governance requirements that are similar to those of comparable private sector firms, albeit enhanced in certain respects because of the particular requirements of ownership by the central or local government.

## **E. REFORM INTERDEPENDENCIES**

The five pillars of the reform are interdependent. Therefore, in order to ensure that the reform succeeds in achieving its objectives, all the pillars will be implemented consistently with a high level of compliance with international and European standards. Modifications of these standards to reflect

the practical realities of Georgia today and in the foreseeable future will be necessary but will be minimized.

### Key Reform Action Points for Pillar 5

Incorporate in the framework Public Corporations Law the requirement for public corporations to operate under conditions of competitive neutrality in the markets for both their outputs and inputs.

Review the legal, regulatory and taxation frameworks of public corporations and develop a plan to remove any elements of them that are inconsistent with competitive neutrality.

Develop secondary legislation to give effect to the competitive neutrality provisions in the Law.

Develop amendments to other statutes.

Ensure that Competitive Neutrality is defined comprehensively and consistently with the Commercial Objectives, Corporate Governance, Ownership Policy, and Performance Framework.

For example, *Competitive Neutrality* would be unachievable without a *Performance Framework* that holds public corporations accountable on a basis comparable with private sector firms competing with them. Conversely, a *Performance Framework* would have limited meaning and enforceability if the public corporations involved enjoyed significant competitive advantages or suffered significant competitive disadvantages, by virtue of their ownership by central or local government.

Although the interdependencies between the five pillars make the design, sequencing, and implementation of the reform more challenging, they also mean that the reform, when implemented, will be robust as the five pillars will reinforce one another. This is the clear lesson from European and international experience and good practice.

## F. OWNERSHIP ENTITY

In line with OECD recommendations, responsibility for exercising the shareholder rights of public corporations in Georgia will, with one exception, be centralized in single ownership entities for each local government and the central government. To ensure that there is a clear separation between the state's shareholder and policymaking functions, the Ministry of Finance will be the central ownership entity for central government, and local government finance departments will be the central ownership entities for local governments, with the Ministry of Finance as necessary acting for local finance departments. Line ministries and departments will continue to be responsible for policymaking and regulation of the sectors in which the public corporations operate.

The one exception is that, in order to comply with the European Union unbundling directive, the Ministry of Finance of will be the ownership entity for the state-owned electricity transmission company whereas the Ministry of Economy and Sustainable Development will be the ownership entity for the electricity generation companies. However, in order to reduce the impact of the Ministry of Economy

and Sustainable Development's conflict of interest between its ownership entity role and its policy/regulatory role, additional measures will be taken to separate these roles within the Ministry of Economy and Sustainable Development.

The centralized model of public corporation ownership will ensure that ownership is exercised consistently for all public corporations, i.e. it will ensure consistency in the way the state and local government give effect to their ownership policy. It will facilitate aggregate reporting on public corporations, which is an established good practice internationally.

As the Ministry of Finance and local government finance departments are not involved in sector policymaking, they will be able to serve as relatively unconflicted centralized ownership entities in line with the OECD recommendations. In contrast, line ministries and line departments decide on policies for the sectors in which some of the public corporations operate, which could give rise to significant conflicts of interest. Such conflicts could make it more difficult to maintain *Competitive Neutrality* and therefore the *Performance Framework*, *Corporate Governance* and *Commercial Objectives*.

Assigning the public corporation ownership powers to the Ministry of Finance and local government finance departments will improve their ability to control the fiscal risks that arise from the activities undertaken by public corporations. This will also help the Ministry of Finance and local government finance departments to strengthen aggregate reporting on the public corporations, building on the reports they currently produce.

It is preferable to assign the ownership powers to the Ministry of Finance and local government finance departments than to autonomous agencies or holding companies. An agency or holding company structure can be opaque, creating difficulties in overseeing the use of public resources. Moreover, there is scope for cross-subsidization between public corporations within an agency or holding company structure that would be difficult to monitor and manage. Also, holding companies can have considerable power to determine how resources generated from dividends and divestments are reinvested, which could complicate the exercise of ownership powers over individual public corporations.

#### **Key Reform Action Points for Ownership Entity**

- Incorporate in the framework Public Corporations Law provisions defining the institutional arrangements for the exercise of ownership powers.
- Transfer the ownership of public corporations to the Ministry of Finance and local government finance departments.
- Enable the Ministry of Finance to act for local finance departments.
- Define the separation between the policy/regulatory and ownership within the Ministry of Economy and Sustainable Development with respect to electricity generation.

## G. COVERAGE OF THE REFORM

The first stage of the reform will apply to:

- The 19 public corporations as currently defined by the Ministry of Finance according to the international standards codified in the IMF's Government Finance Statistics Manual 2014 that are also PIEs.
- 2 other SOEs that are currently classified by the Ministry of Finance as general government units and that the Government deems to have the potential to become public corporations in the foreseeable future.

Thus, the first stage of the reform will apply to: JSC Georgian State Electrosystem; Engurhesi Ltd.; JSC Georgian Oil and Gas Corporation; JSC Georgian Railway; Georgian Land Reclamation Ltd.; United Water Supply Company of Georgia Ltd.; JSC Tam Tbilaviamsheni; JSC Sachkheregaz; Georgian National Center of High Technologies Ltd.; Batumi Water Ltd.; Tbilisi Transport Company Ltd.; Georgian Gas Transportation Company Ltd.; Batumi Seaport Ltd.; Batumi Airport Ltd.; Sakaeronavigatsia Ltd.; Georgian Airports Association Ltd.; Georgian Post Ltd.; Georgian TV and Radio Center Ltd.; Black Sea Flora and Fauna Research Center Ltd.; Service Ltd – 7; and JSC Akura.

The public corporation accountability framework that is the subject of this reform is not suitable for non-commercial entities. Because general government units are essentially non-commercial entities, notwithstanding the fact that SOEs that are general government units have the legal form of companies incorporated under Georgia's *Law on Entrepreneurs*, such SOEs will be subject to a different accountability framework that the Government will develop subsequently.

### Key Reform Action Points for Coverage

Advise the 21 SOEs that will initially be covered by the reform of their status and that they will be required to comply with the reform's principles.

## H. QUASI-FISCAL ACTIVITIES

A QFA is an operation that is undertaken by a public corporation in pursuit of a public policy objective and that is not strictly commercial in nature, for example:

- Its cost is not, or only partially, compensated by revenues from customers or transfer from the central or local government.
- It uses a monopoly position to charge its customers more than would be strictly justified commercially, using the excess profits to cross-subsidize its other activities.

A QFA takes a range of forms, for example:

- *Non-commercial service obligations (NCSOs)*: charging less than commercial prices for the provision of goods and services to the general public or target groups. On the other hand, a *Commercial Service Obligation (CSO)* is a service obligation, the full cost of which (including an appropriate return on capital) is recovered by the public corporation from its customers.
- *Noncore functions*: obligations imposed by the central or local government for the public corporation to provide goods and services, or undertake capital investments, that are unrelated to their core functions.
- *Subsidized purchases*: paying above commercial prices to particular suppliers of goods and services or assets.
- *Super-dividends*: withdrawal of own funds in excess of the distributable income of the accounting year, normally as a consequence of sales of assets or payments out of accumulated reserves.
- *Pricing for short-term budget revenue purposes*: setting a higher price for goods and services so as to increase a public corporation's profits and dividends in the short term, even if this risks reducing the corporation's market share and its profits in the medium term.
- *Abuse of a monopoly position*: charging customers more than would be strictly justified commercially, using the excess profits to cross-subsidize its other activities.

Some QFAs are explicit, i.e., defined in a statute, central or local government decree, or formal agreement, and some are implicit, i.e., public corporations undertake QFAs without explicit direction in statute, decree, or a formal agreement. In either case, public corporations have usually operated on the understanding that they would not be held accountable for the worse financial position caused by the QFAs.

Implicit QFAs and explicit QFAs that are not NCSOs will be prohibited, which will be reflected in:

- Provisions in the framework Public Corporation Law that require public corporations to act commercially and therefore not to undertake QFAs unless they are explicit and their costs or benefits are fully compensated for by transfers between them and the central or local government budgets.
- Provisions in public corporation SCIs prohibiting implicit QFAs.

All CSOs will be included in SCIs, which will also include an explicit statement that such a social obligation is a CSO, and not an NCSO. CSOs will be publicly disclosed in the annual management reports of public corporations, in the section reporting on their performance against their SCIs. The information thus disclosed should include a description of each CSO, an estimate of its full cost, and a description and quantification of how this cost is recovered from customers. Summaries of CSOs will also be disclosed in the fiscal risks statements prepared by the Ministry of Finance, because CSOs have the potential to become NCSOs.

The net cost of NCSOs, including an appropriate return on capital, will be compensated through transfers from state or local budgets to public corporations. These transfers must not exceed the total net costs. The transfers, and their underlying NCSOs, will be considered and prioritized in the state and local budget processes on the same basis as other expenditures. Where funds are not provided to cover the costs, public corporations may not undertake NCSOs.

All NCSOs and their metrics used to assess the effectiveness and efficiency of their performance will be included in the SCIs. NCSOs will also be disclosed in the annual management reports of public corporations, in the section reporting on their performance against their SCI. The information thus disclosed will be audited by the State Audit Office and will include a description of each NCSO, its actual versus budgeted cost, and its associated actual and planned associated non-financial outcome(s). Summaries of NCSOs will also be disclosed in the Fiscal Risk Statements, together with a qualitative discussion of the possibilities for the actual expenditures on them to vary from the budgeted and forecast expenditures amounts.

### **Key Reform Action Points for QFAs**

Incorporate in the framework Public Corporations Law:

- A comprehensive definition of QFAs.
- Principles for handling QFAs, NCSOs and CSOs.

Develop secondary legislation to give effect to the definitions and principles of the Law on QFAs.

Develop methodological guidelines to explain QFAs and how to handle different examples of QFAs.

Ensure that the legal and methodological framework for QFAs is comprehensive and consistent with Competitive Neutrality, Commercial Objectives, and the Performance Framework.

## **I. AUDITING, REPORTING AND DISCLOSURE**

International best practice is that public corporations should, as far as practicable, prepare, have audited and publish their financial statements on the same basis as comparable private sector enterprises, to reinforce competitive neutrality, transparency and accountability. Current practice in Georgia is defined by the *Law on Accounting, Reporting and Auditing*, together with Government Resolution 584 of November 29, 2019, and is largely consistent with international good practice. However, the following enhancements will be made to take into account the particular circumstances of central or local government ownership:

- The financial statements of all public corporations will include disclosures on QFAs and related party transactions, i.e. transactions between the corporations and the government and other public corporations.

- The financial statements should be submitted by the public corporations to the national and local parliaments so that they can be discussed by them formally.

Current practice in Georgia for the preparation and publication of public corporation management reports is also largely consistent with international good practice. However, the following enhancements will be made to take into account the particular circumstances of central or local government ownership:

- The management reports will report against financial and non-financial performance requirements contained in documents, i.e. SCIs, formally approved by the central or local government and accepted by the public corporations.
- The management reports will include disclosure of supervisory board members' qualifications and experience, current employment, other directorships and whether they are considered independent or not. Supervisory board members' attendance of board and committee meetings, and their aggregate and individual remuneration as well as that of the executives will also be disclosed.
- The requirements for management reports will also apply to public corporations in the third and fourth categories.
- The management reports will be submitted by the public corporations to the national and local parliaments together with the financial statements.

In addition, in line with international good practice, public corporations will also be required to report regularly intra-year to the Ministry of Finance and local government finance departments as per the requirements of their SCIs. This should include information that would not necessarily be included in the financial statements or management reports, e.g. information that is sensitive commercially or legally, or for privacy or security reasons; and more detailed and/or wide-ranging analysis or elaboration. The Ministry of Finance and local government finance departments will produce, publish and submit to the central and local governments and parliaments aggregate reports on the corporations for which they are responsible, including aggregate information, summary information on individual corporations and commentary by the Ministry of Finance and local government finance departments on performance and prospects. To the extent practicable, the annual fiscal risk statements produced by the Ministry of Finance and submitted to the national parliament should avoid duplicating the information in these aggregate reports, including by using cross-references.

### Key Reform Action Points for Auditing, Reporting and Disclosure

Ensure that the key requirements for auditing, reporting and disclosure are incorporated in the framework Public Corporations Law or the *Law on Accounting, Reporting and Auditing*.

Develop secondary legislation to give effect to the statutory requirements on auditing, reporting and disclosure.

Ensure that the framework for auditing, reporting and disclosure is comprehensive and consistent with the Performance Framework.

## J. PILOTS

The Strategy will be piloted in a few selected public corporations. The main purpose of the pilots will be to test the Strategy to ensure that it is appropriately and efficiently designed for the Georgian context. This will inform the development and fine-tuning of the framework Public Corporation Law and its subsidiary legislation. Having an opportunity to begin putting into practice the key elements of the Strategy will also allow all stakeholders to begin learning how to perform their new roles and developing the required capacity.

The public corporations selected for the pilots are Georgian State Electrosystem (GSE), Georgian Oil and Gas Corporation (GOGC) and the United Water Supply Company (UWSC). These public corporations have been selected for the pilot as they reflect companies, whose financial positions vary, and which have different levels of complexity and governance challenges.

The UWSC is currently not classified as a public corporation, but as a general government unit, primarily due to the persistent losses. However, it is intended to be restructured and its performance improved with a view to its re-classification as a public corporation in due course.

The main elements of the Strategy that will be tested in the pilot will be:

- *Corporate Governance.* Where it is necessary to appoint or replace supervisory board members or executives in one of the pilot corporations, the process will be aligned to the procedures envisaged by the Strategy. The pilot corporations will also be required to undertake board evaluations as well as to develop and begin implementing a corporate governance code and code of ethics.
- *Performance Framework.* The selected public corporations will be required to develop and discuss with the Ministry of Finance a SCI for 2021-2024, consistent with state budget and public investment management process projections and approvals. They will also need to prepare and approve a strategic plan, consistent with their SCI. The selected public corporations will be required to report quarterly to the Ministry of Finance on performance against their SCI.

- *Competitive neutrality.* As far as possible, steps will be taken so that the selected public corporations operate in a competitively neutral regulatory environment. To the extent that this is not possible (e.g., because of legislation that can only be amended by parliament) transfers to or from the public corporation and the state budget will be made to ensure competitive neutrality.
- *QFAs.* Transfers will be made to the selected public corporations to compensate them for the costs of undertaking the QFAs that have been explicitly mandated in the SCI.
- *Auditing, reporting and disclosure.* Where they do not already exist, the pilot corporations will be required to establish an Audit Committee, which will oversee the internal audit function and the external audit. The procedures for auditing public corporation performance information and QFAs will be piloted. The selected public corporations should attempt to meet the proposed information disclosure requirements. The Ministry of Finance will use the information from the pilot to strengthen the aggregate report that it is already producing as part of the Fiscal Risks Statement.
- *Ownership entities.* During the pilot, the Ministry of Finance will assume the responsibilities of the ownership entity.

#### **Key Reform Action Points for the Pilot**

Selected public corporations to be notified and agree to participate in the pilot.

Pilot corporate governance arrangements with selected public corporations.

Use lessons from the pilots to fine-tune the draft framework Public Corporation Law.

## **K. FRAMEWORK PUBLIC CORPORATION LAW**

International experience suggests that comprehensive, robust and enduring reform of Georgia's public corporations will require the enactment by parliament of a framework Public Corporations Law. This is because Georgia's *Law on Entrepreneurs* and *Law on Accounting, Reporting and Auditing* do not take into account sufficiently the particular circumstances of central or local government ownership, and therefore need to be enhanced. However, good international practice is for a framework Public Corporations Law to build on the foundations of the general law applying to private sector firms. Accordingly, a framework Public Corporations Law in Georgia will complement and enhance the *Law on Entrepreneurs* and *Law on Accounting, Reporting and Auditing*, and will not weaken their application to public corporations.

The framework Public Corporation Law in Georgia will codify in statute the key elements of this Strategy that are not already codified in the *Law on Entrepreneurs* and *Law on Accounting, Reporting and Auditing*. It will include the following:

- Definition of a public corporation and the scope of application of the Law.

- Institutional arrangements and governance procedures at both the ownership and supervisory board levels.
- The rationale for public corporation ownership and its reflection in an ownership policy statement.
- The primary and secondary objectives for public corporations.
- The principles of competitive neutrality, including the treatment of QFAs.
- The requirements for enabling the oversight and control of public corporation performance.
- How major public corporation transactions will be handled.
- The framework for supervisory board member appointments, dismissals, evaluation, remuneration, roles, and responsibilities.
- Disclosure requirements for public corporations and their central and local government owners.
- Requirements relating to auditing of financial and performance information.
- Sanctions for violations.

Consultations will be held with stakeholders on the draft Law, including public corporations, civil society and key donors, as well as the relevant agencies of central and local government, before a draft is submitted to parliament. In addition, the learnings from the pilot will be used to refine the draft.

#### **Key Reform Actions for the Framework Public Corporation Law**

Develop the draft framework Public Corporation Law.

Consult on the draft Law with stakeholders.

Submit the draft Law to parliament.

Develop subsidiary central and local government decrees and Ministry of Finance and local government finance department instructions.

## **Annex I. State Public Corporations Corporate Governance Code**

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## **Annex II. Key References**

*ADB, Reforms, Opportunities and Challenges for SOEs.*

*IMF Fiscal Affairs Department, How to Improve the Financial Oversight of Public Corporations.*

*OECD, Guidelines on Corporate Governance of SOEs.*

*OECD, Competitive Neutrality: Maintaining a Level Playing Field between Public and Private Business.*

*World Bank, Corporate Governance of SOEs. A Toolkit.*

*Association Agreement between the EU between and the European Atomic Energy Community and their Member States, of the one part, and Georgia, of the other part.*

*G20/OECD Principles of Corporate Governance.*