STATE-OWNED ENTERPRISE ASSESSMENT[1]

A. Sector Performance, Problems, and Opportunities

1. Improving the performance of state-owned enterprises (SOEs) and developing public-private partnerships (PPPs) in Papua New Guinea (PNG) will create opportunities for private sector investment, which in turn will enhance income earning opportunities and help foster more inclusive economic growth. Enhancing the efficiency and effectiveness of SOE's through commercialization and expanded private sector involvement will also improve the efficiency of service delivery across a range of sectors of operational relevance to ADB, including transport, energy, telecommunications, and water supply and sanitation.

2. SOEs play a significant role in the economy of PNG, providing a range of services such as power, water, telecommunications, and transport that are vital to commerce and to the livelihoods of all communities. Consequently, the performance of the SOEs has an important impact on PNG's ability to achieve inclusive economic growth. PNG has 9 majority-owned SOEs that are managed by the Independent Public Business Corporation (IPBC)[2], and a further 5 that are under the oversight of other Ministries[3]. Five of these SOEs (PNG Power, PNG Ports, PNG Telikom, Water PNG and Post PNG) are regulated monopolies. From FY2002 to FY2012, the SOE portfolio managed by IPBC generated an average return on equity (ROE) of 5.8% and return on assets (ROA) of 3.3%, well below the standards of commercially risk adjusted rates of return. Moreover, these low returns were achieved after subsidized debt and substantial fiscal transfers to the SOEs. In the 2002-2012 period, an estimated US$178 million was transferred to the SOEs from the government in the form of cash infusions, debt forgiveness and asset donations. Average SOE cost of debt was 5% for the period compared to 11.5% for the private sector.

3. Regulatory contracts for monopoly service providers have helped to ensure strong revenue growth but have not produced expected efficiency gains. PNG's Independent Consumer and Competition Commission (ICCC) regulates the five monopoly SOEs. Regulatory contracts of up to 10 years establish a price path tied to agreed performance standards and investment plans. The regulatory contracts that do not have productivity clauses have allowed some SOEs to increase prices above the inflation rate to generate profits to finance their investment plans. Frustration at the slow rate of improvement in SOE services has encouraged changes in market regulation including enhanced monitoring of SOE performance and increased private sector participation.

4. The Government has moved to promote competition in the power and telecommunications sectors but risks undermining competition in the banking sector through its support for subsided Government financial services. In 2011 the NEC endorsed the Electricity Industry Policy, which supports greater private sector participation in power generation as a key enabler of service improvements and efficiency gains. In 2013 PNG Power was directed to contract with private power suppliers rather than develop new capacity on its own. In the telecommunications sector the Government has established a new SOE, PNG Data Co, to own the government funded national fiber-optic network and make it available on an open access

[1] This summary is based on research prepared for the 2014 PSDI publication *Finding Balance: Benchmarking the Performance of SOEs in Island Economies*

[2] Telikom PNG, PNG Power, PNG Ports Corporation, Post PNG, Water PNG, Air Niugini, Eda Ranu, National Development Bank, Motor Vehicles Insurance Corporation (MVIL)

[3] National Airports Corporation, National Petroleum Corporation, Mineral Resources Development Company, Petromin, PNG Data Co.

basis. At the same time, however, the fully Government owned finance SOE, National Development Bank, was instructed to artificially reduce its lending rate to 6.5% - well below average market lending rates of 10-12%. This direction and the establishment of another Government owned microfinance institution, the People's Microbank[4] in 2013 could harm competition by undermining private banks' sustainability.

5. Deficiencies in the current legal and governance framework for SOE's and problems with compliance have contributed to SOEs' poor commercial performance**.** PNG's SOE portfolio is held in the General Business Trust managed by the IPBC, which performs a dual role of trustee and SOE monitor. Amendments to the IPBC Act in 2012 reversed previous changes that had weakened the legal framework, but some notable deficiencies remain including the absence of an explicit commercial objective for SOEs. Non-compliance with key elements of the Act has been a problem since 2002 leading to weak governance and accountability. The IPBC has consistently failed to publish annual reports with audited financial statements for the IPBC, GBT, and individual SOEs. Greater transparency would strengthen the performance incentives for the SOEs. Certainly, low levels of transparency have contributed to their poor performance. Moreover, many SOEs are directed to provide community service obligations (CSOs) without compensation. This distorts whatever performance incentives may exist and makes it very difficult for the board and management to establish a coherent framework for decision-making.

6. The challenges faced by PNG's SOEs are shared by many countries around the world and illustrate the fundamental flaw in the SOE model: it is not an effective long-term ownership structure. As long as SOEs remain under majority government control, the risk of politicized decision-making will remain high. Undue political intervention in SOE management and operations undermine performance. Recent moves to replace Telikom's CEO, direct the NDB to reduce its interest rates, and overturn an increase in electricity prices approved by the regulator undermine the SOEs' commercial mandate and independence. Decisions motivated by short-term politician gain result in long-term value destruction. International experience has amply demonstrated that privatization, supported by robust regulatory arrangements, is the most effective mechanism for long-term improvements in the productivity of state assets. Full privatization, however, is not always politically feasible nor the most suitable reform mechanism. In these cases partial privatization - such as public listings, joint ventures, and public–private partnerships (PPPs) - can help improve SOE performance.

7. Greater use of PPPs could help improve SOEs efficiency and profitability. If credible partners are chosen and the contracting framework is robust, PPPs can help SOEs to operate more efficiently. PNG adopted a PPP Policy in 2008 and has legislation ready for submission to parliament in 2014. The legislation is strongly supported by the private sector that welcomes the transparent preparation and tendering process that it establishes for PPP contracts. PNG has strong potential to develop a pipeline of PPP contracts for a range of infrastructure services.

B. Government's Sector Strategy

8. The Government has repeatedly stated its plans to improve the performance of SOEs but underlying policy principles remain unclear. A draft policy on SOEs and state investments has yet to be published, and previous drafts have tried to reconcile a push to expand the role of SOEs in the economy with one that also increases competition and private investment. These principles cannot be reconciled. Sustained, inclusive growth and investment can only come if the

[4] People's Microbank is a wholly owned subsidiary of the National Development Bank; it competes directly with private banks and microbanks for market share.

government allows the private sector to drive economic growth. The government's regulatory powers can shape sector outcomes in a much more effective way than direct ownership and operation of assets.

9. While the government's policy on SOEs and state investments is being formulated, plans have been announced to restructure the state's business holdings under a specially created trust. Trusts often lack transparency and suffer from confused accountabilities. A clear policy that encourages commercialization, embeds best practice principles on SOE governance and monitoring, and upholds competitive neutrality, would drive improved performance more effectively than fine-tuning the ownership structure.

10. The NEC adopted a new CSO Policy for SOEs in December 2013, and ADB is supporting its piloting in 3 SOEs in 2014. This policy should help support greater commercialization of the SOEs but the benefits will be greatest if private companies are allowed to bid for CSOs. Many SOEs provide CSOs, mostly funded through cross-subsidies. They are criticized for providing weak incentives for service provision in high cost areas, preventing more efficient providers from entering the market, and undermining SOEs' focus on commercial performance. The CSO policy follows international best practice and when implemented will help to improve outcomes for SOEs, consumers, and the Government.

C. ADB Sector Experience and Assistance Program

11. ADB has been working with the government on SOE reform and PPP issues since 2007. The PPP policy work[5] was ADB's first advisory support provided directly to IPBC, and resulted in a stand-alone TA[6] to support the implementation of the future PPP law, develop a PPP project pipeline and support the implementation of a CSO framework for SOEs. Protracted delays in reviewing the draft PPP law within the government in 2010-2013 created delays in the implementation of the TA, which has now been extended until December 2015.

12. ADB's work with the SOEs expanded rapidly in 2011 when a new Government adopted a policy of increased transparency and accountability. PNG participated in ADB's Pacific SOE benchmarking survey, supported by PSDI, and the accounts of the SOEs were published for the first time in 2012. Since 2011 PSDI has been assisting IPBC with reforms to its governance arrangements, strengthening of monitoring practices, development of a community service obligation policy and identification of opportunities to expand service delivery through public private partnerships.

13. More recently, PSDI has provided targeted technical assistance to IPBC in its review of PPP options for the operation of the new Tidal Basin at Lae Port. The future contracting out of the management of the new container terminal, and possible development and operation of future phases of the port, represents an important opportunity to restructure the port sector as a whole. PNG's ports have the potential to transition from being managed by an inefficient regulated monopoly to being managed by a range of private operators under strong efficiency incentives. The CSO framework now supports the transparent tendering and subsidization of ports that are not commercially viable, eliminating their reliance on a cross-subsidy managed by PNG Ports. The same will apply to the National Airports Corporation and all other SOEs. An increasing number of infrastructure services – including those requiring subsidies – should be made available for private provision.

[5] ADB. 2005. *Technical Assistance to Papua New Guinea for Policies for Private Sector Development. Manila.*
[6] ADB. 2010. *Technical Assistance to Papua New Guinea for Facilitating Public Private Partnerships*. Manila.

14. It is proposed that over the period of the new CPS, ADB will continue to support SOE reform and the preparation of PPP transactions. PSDI will continue its TA support and ADB will ensure that all new infrastructure projects are reviewed for their potential to be delivered directly by the private sector, or via a PPP modality. Wherever feasible PSDI staff should also accompany sector programming missions to ensure consistency between ADB's public sector lending to SOE's and efforts towards promoting greater commercialization in these entities. Consistent with PNG's PPP Policy and ADB's PPP Operational Plan, sovereign lending will only be considered without private sector participation if these options have been thoroughly assessed and determined not to represent value for money for the Government of PNG.