RE-EXAMINING THE FINANCIAL RETURNS FROM NEW ZEALAND'S SOE SECTOR; RE-EVALUATING PRIVATISATION

1. INTRODUCTION

While the privatisation debate is not new (Boycko *et al*., 1996; Sappington and Stiglitz, 1987; Vickers & Yarrow, 1988), renewed interest has emerged, as governments continue to consider privatisation as a public sector policy and management strategy to address financial concerns and public administration challenges. Between 1980 and 1992, more than 8,000 state-owned enterprises (SOEs) in more than 80 countries were privatised (Kikeri *et al.*, 1992). More recently, privatisation has been adopted by Burma, Greece, Russia, and Turkey (Atiyas, 2009). It continues to be promoted by governments in Australia and New Zealand (English and Ryall, 2012; McArdle, 2012).

Examination of public sector and private sector organisations in practice reveals cases of both financial (and operational) success and failure. Poor organisation between government departments following Hurricane Katrina in the United States led some to conclude privatisation would result in better service delivery and outcomes (Calhoun, 2006). Yet lack of investment to maintain privatised assets such as New Zealand's railways by Toll New Zealand Limited [Toll] and ongoing disagreements over appropriate compensation to ensure Toll made sufficient profits, highlight the risks of surrendering ownership and control of strategic national assets, referred to by former New Zealand Finance Minister, Michael Cullen, as "one of the most disastrous privatisations in New Zealand history" (Financial Times, 2008). Thus, it seems there is no all-encompassing solution to the privatisation debate.

An alternative to privatisation is continued government ownership of operations and organisations such as SOEs. Security of "public" assets and interests, versus a financial strategy of asset sales by government - the case for SOEs centres on trade-offs between risk and returns (Guriev and Megginson, 2005). Essentially, the financial and managerial issues central to this debate relate to revenue from the sale of assets to the private sector (thereby eliminating the risk of ongoing investment and losses under public sector management) versus keeping control of strategic national assets (and the associated financial commitments or returns). Given the importance of financial returns to this debate, this paper considers profitability within SOEs through a study of New Zealand's SOE sector.

Examining cases of public sector performance in organisations such as SOEs is fundamental to understanding whether financial success is possible under public sector ownership, and if so, what factors contribute to that success. Given the diverse nature of public sector organisations, lines and boundaries are often blurred within privatisation debates. In the context of specific forms of government organisation such as SOEs, however, lines for separation are somewhat clearer, given their express terms of operation. In the context of New Zealand for example, SOEs are designated as commercial in nature (SOE Act, 1986; State Services Commission, 2002) with expectations of performance comparable to private sector organisations in terms of efficiency and effectiveness (Martin, 2003; Mulgan, 1997; SOE Act, 1986).

Since the mid 1980s New Zealand has successfully implemented and refined its commercial approach to the SOE sector, with SOEs operating as government-owned but commercially focused organisations in deregulated markets (Boston *et al*., 1996; Brash, 1996). Despite a challenging transition (Kelsey, 1993), New Zealand's reforms with respect to SOEs have been recognised as comprehensive in nature, and successful in increasing service efficiency (Easton, 1999; Eggers, 1997; Schick, 1998). Thus, an examination of New Zealand's SOEs from 2001 to 2005 provided a valuable context in which to consider the potential for financial returns within the public sector (Luke, 2008), as part of the privatisation debate. This examination was undertaken during a period when New Zealand experienced solid economic performance and steady growth (New Zealand Treasury, 2006). While findings from that study revealed returns from the SOE sector were viable, a more challenging economic environment raises the question as to whether such returns are sustainable in more difficult economic times.

An initial review of the financial returns from New Zealand's SOE sector indicated financial returns were not only possible, but that consistently strong returns had been realised by a number of SOEs (Luke, 2008). However, in a period involving recession in early 2008 for five consecutive quarters, and the global financial crisis which began to affect New Zealand later that year (New Zealand Government, 2010a), certainly there have been changes and challenges in the economic environment. Accordingly, this paper is the second of a two part study which considers the profitability within New Zealand's SOE sector over an extended period of time to examine how New Zealand's SOEs have performed within this changed environment.

The following sections of this paper consider arguments for privatisation in the context of New Zealand's SOE framework. The research method, involving analysis of SOEs' financial reports and interviews with senior executives in 13 of the (now) 15 SOEs is then outlined, before re-examining the financial performance of New Zealand's SOEs from 2006 to 2010. Findings highlight the continued profitability of New Zealand's SOE sector by comparing findings of the current study with those from 2001 to 2005, and consider the principles which have contributed to this performance. Implications extend to policy-makers and private sector competitors. A broader view of government, however, in the context of a challenging economic environment, highlights SOE performance alone may not determine privatisation policy.

2. EXAMINING THE PRIVATISATION DEBATE IN THE CONTEXT OF NEW ZEALAND'S SOES

Economic changes and challenges, particularly in recent years, have resulted in privatisation reappearing on the political agenda of various countries – developed (e.g. New Zealand (English and Ryall, 2011)), developing (e.g. Burma (Allchin, 2011)), and faltering (e.g. Greece (Petrakis, 2011)). While the arguments for and against privatisation have not changed, economic stability of various countries has (International Monetary Fund, 2010), such that current policy and prior reasoning is being reconsidered under new, often more challenging economic conditions.

Commentary on and analysis of ongoing cases of both success and failure continue to fuel the privatisation debate (Shirley and Walsh, 2000). While empirical studies typically indicate support for privatisation (see Guriev and Megginson (2005) and Boyko *et al*. (1996) for an overview of studies undertaken in numerous countries), analysis beyond the numbers indicates various contextual factors (market development, competition) underlie the success or otherwise of privatisation. Arguments in favour of privatisation are often grounded in the notion that the public sector will always be less efficient in using resources to maximise wealth (Moore, 1992; Savas, 1981), consistent with traditional property rights theory (Alchian, 1987; Coase, 1960; Demsetz, 1967). Views such as this, however, are supported by notions that *market forces* of the private sector demand commercial discipline, require efficient operations, promote competition, and are profit- and customer-focused (Stiglitz, 2008; Vickers and Yarrow, 1988). Similarly, arguments are presented that the private sector demands a *financial discipline* (impacting on competition and costs), not required in the public sector (King and Pitchford, 1998). Specific contrasts include financial government support (e.g. subsidies) available at reduced rates of interest to public sector organisations resulting in unfair competition, and protection from bankruptcy such that non-profitable SOEs continue to be subsidised by government (Guriev and Megginson, 2005).

Other arguments in support of privatisation include public sector firm *performance* being difficult to *evaluate* due to lack of comparability with the private sector, particularly with respect to monopolies. Further, concerns regarding *political influence* or interference in the public sector (Zahra and Hansen, 2000), such that political goals may override commercial ones, have been raised in support of privatisation and private sector markets (King and Pitchford, 1998). A review of these issues, however, suggests many are characteristic not specifically of private sector markets, but rather of deregulated markets open by definition to all organisations – in both the public and private sector. Hence, in order to re-examine these issues in a specific public sector context, the following section considers New Zealand's SOE policy framework and practice.

2.1 Policy and practice within New Zealand's SOE sector

Background to New Zealand's SOE reforms

Since the 1980s, New Zealand has undergone significant government reform with the intention of increasing efficiency and effectiveness within the public sector (Boston *et al*., 1996; Mulgan, 1997). Such reforms were consistent with an international trend in public sector management intended to align management of public sector organisations with that of private sector organisations (Hood, 1995; Martin, 2003). Thus, this new public management approach focused on emphasising results and outcomes, together with effective use of public sector resources.

As part of New Zealand's reforms, government departments with a strong trading function were corporatised and/or privatised, on the premise that such services could be more efficiently provided by commercially orientated organisations, rather than subject to ministerial control and government interference (Palmer, 1988; Scott, 2001). The rationale for such reform was the inefficiency of government as a provider of commercial services, due to protection from the discipline of a free market economy, often operating in a monopolistic environment, with the availability of on-going financial support from central government (Brash, 1996).

Policy and practice within New Zealand's SOE sector

Specifically, New Zealand's SOE reforms involved market deregulation, with express profit-making requirements, resulting in accountability for both competitive services and commercial results. Other features of the reforms included self-funding obligations, separation of SOE management and ownership (such that Government as owners were not to be involved in managing SOEs' operations)[1], the role of Government as purchaser of outputs rather than provider of inputs, and performance based contracts and rewards (Brash, 1996; Mascarenhas, 1993; Taggart, 1992). Thus, corporatisation came with expectations of efficient and profitable operations, consistent with a new public management philosophy (Hood, 1995).

Under Section 4(1) of the State-owned Enterprises Act (1986), the objectives of SOEs are to:

[1] A policy that has at times been questioned based on ministerial practice (see Norman, 2008).

operate as a successful business and, to this extent, to be
(a) As profitable and efficient as comparable businesses that are not owned by the Crown; and
(b) A good employer; and
(c) An organisation that exhibits a sense of social responsibility by having regard to the interests of the community in which it operates and by endeavouring to accommodate or encourage these when able to do so.

Under New Zeland's SOE Act (1986), where SOEs are required to meet non-commercial and social objectives by Government, these services must be purchased from individual SOEs. Hence, any non-commercial activities are to be transparent, and funded on a fee for service basis by the Government. Other commercial activities can be undertaken by SOEs at their discretion, similar to private sector organisations, and are not subject to price controls or rate of return restrictions. Government contracts are regularly made available for tender, such that SOEs bid for projects and fixed term services against their private sector counterparts (Brash, 1996). Similar to private sector organisations, SOEs are subject to various industry regulators and the Commerce Commission, which oversees business activity within New Zealand to ensure unfair or anti-competitive behaviour does not take place[2].

SOEs are expected to pay regular dividends to the Crown, based on the surplus cash balance available (CCMAU, 2007). This payment is negotiated regularly between individual SOEs and the Government. Funding requirements, beyond the amount of capital contributed by Government, are the responsibility of individual SOEs, and typically represented by debt financing from private sector institutions on commercial terms[3]. The Government expects SOEs to have a balance of debt and equity funding, and SOEs' debt to equity ratios are subject to regular Government review. Cases such as Terralink New Zealand Limited and Timberlands West Coast Limited (Mallard, 2008) demonstrate that where SOEs are unable to conduct financially viable operations, SOEs will be placed into receivership, rather than be provided with Government financial support.[4]

Performance of SOEs is reviewed regularly by the Government, New Zealand Treasury and the Crown Ownership Monitoring Unit (COMU). SOEs are required to prepare an annual Statement of Corporate Intent, and six monthly and annual financial statements (CCMAU, 2007; COMU, 2012). In 2009, a review of SOEs' operations by the newly elected National-led Government (Elections New Zealand, 2008) highlighted expectations of increased profits and dividends (English and Power, 2009). This review was followed by requirements for increased disclosure in SOEs' half-year and annual reports (Power, 2010), and the introduction of continuous disclosure requirements for SOEs, similar to private sector firms.

Under the State-Owned Enterprises Act 1986, shares in SOEs are held by the Minister of Finance and the relevant portfolio minister on behalf of the Crown. COMU (formerly Crown

[2] In 2005, Transpower was the only SOE subject to price controls set by the Electricity Commission (Transpower, 2005). Transpower had refused to comply with these requirements, and by 2008 an agreement had been reached such that price control was effectively retained by Transpower (Transpower, 2008).

[3] The establishment of Kiwibank by New Zealand Post Limited in 2001 is one exception, whereby the Government agreed to provide additional capital of $72.2 million as start-up funding (New Zealand Post, 2003). New Zealand Railways is another exception (discussed further in Section 4.2.

[4] New Zealand Railways and more recently Solid Energy are however, exceptions, as detailed in the latter part of this paper (Sections 4.2 and 5).

Company Monitoring Advisory Unit (CCMAU)) within the New Zealand Treasury acts as an advisor to the Ministers on SOE performance. The Treasury also provides advice to the Minister of Finance as a shareholding Minister. The relevant ministries review SOEs' operations, and also appoint a Board of Directors to oversee management of each SOE. Similar to SOE chief executives, directors are appointed based on their business knowledge, skills, and experience (CCMAU, 2008; COMU 2012). Directors are subject to directors' duties outlined in the Companies Act 1993, including the duty to act in good faith and in the best interests of the company (CCMAU, 2008).

While New Zealand's public sector reforms with respect to SOEs are largely viewed as successful (Easton, 1999; Mulgan, 1997), debate continues on the future of New Zealand's SOE sector. In contrast to the prior Labour-led Government, the incumbent National-led Government (elected in late 2008) which had supported a policy of privatisation, noted they would not sell SOEs during their first term in office. On re-election in 2011, however, they proceeded with a policy of partial privatisation (Ryall, 2012). The terms of the privatisation included:

- The Government would maintain a majority controlling stake,
- New Zealand investors would be "at the front of the queue for shareholdings", and the Government would need to be confident of widespread and substantial New Zealand share ownership
- The companies involved would present good investment opportunities for investors
- Freed up capital would be used to fund new public assets and reduce pressures on Government to borrow
- Industry specific regulations adequately protected New Zealand consumers (Prime Minister John Key, 2011).

Issues surrounding the debate include using funds from asset sales to repay Government debt, and providing a boost to New Zealand's share market such that "mum and dad" investors have increased local investment opportunities (English and Ryall, 2011). Questions have been raised, however, as to who will really benefit (Smellie, 2012) given the large investments required suggests the involvement of overseas purchasers. Further concerns relate to the returns from these SOEs being higher than the associated cost of debt (Smellie, 2012). Thus, the proposed sale would represent a net cost rather than a gain to the New Zealand Government. Despite these concerns, the process of partial privatisation for Mighty River Power, the first of New Zealand's SOEs to be sold under John Key's National-led Government, commenced in April 2013 (Financial Markets Authority, 2013).

Returning to the various arguments presented in the case for privatisation, four main categories can be identified: *market forces* (driving efficiency, competition, profits, and economic performance), *funding and financial discipline* (impacting on competition and costs), *performance evaluation* (including comparability difficulties), and *government influence* (e.g. the potential conflict between market and political forces); based on a review of the privatisation literature (Guriev and Megginson, 2005; King and Pitchford, 1998). Re-examination of these issues, however, in the context of New Zealand's SOE sector, suggests many can be mitigated, and thus seem difficult to uphold or substantiate. Market discipline, for example, has been fostered through market deregulation, including those in which SOEs operate, such that SOEs compete openly with private sector firms.[5] Regarding financial

[5] In isolated cases, however, industry or international regulations require that certain services are conducted by government organisations (e.g. inspection of meat for export, undertaken by AsureQuality).

discipline, SOEs are expected to be self-funding, with surplus cash balances distributed to Government in the form of dividends. In relation to performance evaluation, annual Statements of Corporate Intent, regular financial statements, and a range of performance measurement ratios are prepared by SOEs. Last, with respect to Government influence, the structure of New Zealand's SOE sector involves separation of management and ownership, such that SOEs are managed by experienced executives often from the private sector, and Government's role is one of shareholder and advisor (Martin, 2003). Hence, concerns emerge regarding rhetoric versus reality (or at least substance) in the debate for privatisation (Norman and Gregory, 2003).

With respect to financial performance of SOEs in practice, a review of New Zealand's SOEs from 2001 to 2005 showed the sector had developed as commercial and profitable organisations, with solid financial returns. Hence, at a time when privatisation is re-emerging as a policy consideration, it is important to review the arguments underlying this position and re-assess the alternatives based on an examination of practice. Five years on, following a period of substantial change in New Zealand's economic environment, the question examined by this study is have those returns been sustained? An outline of the research method adopted to address this question, incorporating analysis of quantitative and qualitative data, is presented in further detail below.

3. METHOD

Consistent with the first phase of this research, and on the basis that limited research has been conducted in this area, a combination of quantitative and qualitative data was considered necessary to understand both the financial performance of New Zealand's SOE sector and the associated underlying issues (Cohen et al., 2000; Eisenhardt, 1989; Villalonga, 2000). This method effectively provided the opportunity for examination from the outside and inquiry from the inside (Evered and Louis, 1981) - investigating the financial returns of New Zealand's SOEs, and analysing through an interpretivist approach (Putnam, 1983), the broader practical and theoretical implications of New Zealand's SOE framework through case study analysis (Yin, 2003).

Summary financial data were collected and analysed for each of the SOEs from 2006 to 2010, providing an extended longitudinal perspective of financial performance (Low and MacMillan, 1988; Villalonga, 2000; White, 2005). As noted previously, this timeframe reflects a period of economic challenge within New Zealand involving a relatively shallow recession, but also a shallow and slow recovery (New Zealand Government, 2010a).

Triangulated qualitative data collection involved interviews with a senior executive from 13 of the 15 SOEs operating in New Zealand, textual analysis, and observation. Interviews were conducted in late 2010, and involved the same or similar executives from phase one of this study in terms of their roles and responsibilities in each SOE. The semi-structured interviews lasted approximately one hour each, and were recorded, transcribed, and coded for both content and themes (Strauss and Corbin, 1998) central to each SOE's operations and financial performance. Interview data were compared with observation during the interview process and texts, forming the basis of case studies on each SOE. Observations (documented in the form of field notes) enabled the interview data to be more effectively evaluated (Hycner, 1985). Textual analysis of websites, annual reports, and newspaper articles, provided valuable background information on SOEs, detailing the different perspectives of multiple actors (Cortazzi, 2002). Case studies were analysed individually and collectively to explore similarities and differences. Case study findings from 2006 to 2010 were compared across

SOEs, and with the findings from the prior phase (2001 to 2005) of this research, whereby a number of underlying themes were identified and reinforced. The findings are presented below from two separate perspectives: examination from the outside based on secondary financial data, and inquiry from the inside based on interview data and supported by observation and textual analysis.

4. FINDINGS

4.1 Analysis of SOEs financial performance – examination from the outside

As noted previously, organisations designated as SOEs in New Zealand have been recognised for their strong trading function. Collectively, these SOEs represent a wide range of industries which can be broadly classified as energy (five SOEs), agriculture (three SOEs), transport (two SOEs), education, post, property valuation, transmission, and weather services.

The range of industries covered by the SOE sector highlights the diversity of SOEs' operations, and also raises the complexity of comparisons within the sector, given their differences. The commonality within the sector however, is that each SOE has been viewed as commercially viable, with a mandate to operate as a financially independent, profitable organisation (SOE Act, 1986).[6]

The financial performance of the SOE sector over the five year period from 2006 to 2010 is summarised in Table I, the key components of which are explained briefly below. A review of SOEs' revenues over the five year period to consider sustainability and growth in income from commercial operations reveals a decrease in 2007, recovery in 2008, and slight decline to 2010. An examination of profits over the same period to evaluate the commercial success and continuing viability of SOEs reveals a marked decrease in 2007, with a slight recovery in 2009 and 2010. Contributed capital has remained relatively stable, with increases in 2009 relating to investment in New Zealand Railways (discussed further in the following section). Increases in owners' equity are also relatively stable from 2007 to 2010, with changes mainly attributable to increases in retained earnings. The marked increase in 2007 primarily relates to New Zealand Railways' asset revaluation of more than \$10 billion, in preparation for International Financial Reporting Standards (IFRS).[7]

[insert Table I here]

A review of the returns to Government in the form of dividends and tax payments shows a consistent decrease in returns from tax payments from 2006 to 2009 (noted by the New Zealand Government across both the public and private sectors). With respect to dividend payments, a more substantial decrease is noted in 2007 and again in 2009, with a strong recovery in 2010. The percentage of dividend payments, however, is relatively stable between 2006 and 2008, with a noticeable decrease in 2009, and a marked increase in 2010. Such variation is due to variability in profits and regular negotiations between the Government and individual SOEs regarding the availability of surplus cash and the need to reinvest profits (CCMAU, 2007). The marked increase in dividend percentage in 2010 is in part attributable to a number of SOEs considering they were well positioned for future growth at that time (e.g. Airways and Meridian, whose dividend payments both exceeded their calculated profit for the period (detailed in Table II)). The returns generated are compared with the funds employed by Government in the SOEs through the calculation of three ratios:

[6] NZ Railways is one exception, as noted in the following section.

[7] The revaluation increased depreciation from \$2 million to \$157 million, resulting in a \$19 million loss. However, as detailed in Section 4.2, NZ Railways is no currently required to make a profit, given its need for financial assistance and investment.

return on equity (ROE), return on capital invested (ROCI), and return on investment (ROI). Collectively, these ratios present financial measures of SOE performance from three perspectives: a traditional measure, Government as owner, and Government as investor. While ROE figures (3-12%) indicate the SOE sector has achieved modest returns from 2007 to 2010 by conducting commercial operations in deregulated markets, calculation of ROCI (14-32%) and ROI (9-32%) represent increasingly strong returns in this context.

A comparison of SOE sector returns between 2006 to 2010 and earlier findings from 2001 to 2005 provides the opportunity to consider the sustainability of SOEs' financial returns over an extended period, where economic challenges have emerged. As shown in the last two columns of Table I, most notable perhaps is the increase in those returns with respect to a number of different areas. While revenue and profits (with increases of 57%), assets and equity (with increases of more than 200%) have increased substantially, contributed capital (6% increase) has remained relatively stable. The percentage of dividends paid has increased by 27%, with actual dividend payments increasing by 110% over the second phase of this study. Tax payments have also increased substantially (41%). ROE has decreased by approximately half, due to the large increase in equity outweighing what remains a strong increase in profit. In contrast, both ROCI and ROI have increased markedly due to increased profits and payments on a relatively stable base of contributed capital. Thus, in relatively challenging economic times, results may be viewed as modest but positive.

A review of these components, however, raises a number of issues and complexities. As noted previously, individual SOEs operate in a diverse range of industries, thus some variation would be expected within the ratios based on differing industry issues. Further, the introduction of IFRS during the period under review, impacts on the comparability of the figures. While the sector as a whole appears to be achieving positive yet modest returns in a challenging economic environment, more detailed analysis based on an examination of the financial measures for individual SOEs provides an enhanced understanding of the similarities and differences among SOEs with respect to financial performance. These findings are presented in Table II, summarising average figures over the five years from 2006 to 2010 for each of the 15 SOEs operating in New Zealand as at 2010.

Results have been coded under three categories by reference to the traditional measure of ROE. Arbitrary cut-offs have been imposed as follows: *high performance* being identified as ROE $\geq$ 15%, *medium performance* for ROE of more than 5% but less than 15%, and *low performance* as ROE $\leq$ 5%. While these benchmarks may be viewed as challenging targets given the prevailing economic environment, they were adopted in the first study and are maintained in this second study for consistency and comparability. The high-low variation noted within the findings shown in Table II is summarised in Table III, highlighting the range of results for each measure within the SOEs examined.

With respect to individual SOEs' performance in the first and second phase of this study, findings reveal consistency in terms of individual SOEs being ranked as high, medium, and low. Very little change has occurred within each classification, with one SOE being reclassified from high to medium, and two SOEs being reclassified from medium to low. Similarly, a comparison of high-low variations between the two time periods examined also reveals a number of similarities, in terms of the individual SOEs which have contributed to the highs and lows, and the value of the 'lows' recorded in the second phase of this research being largely consistent with the 'lows' recorded in the first phase of the research. As detailed in the last three columns of Table III however, a comparison of 'highs' reveals marked increases in revenue (69%), profit (118%), assets (179%), dividends paid (more than 300%) and total payments (more than 200%). The three figures which have decreased are percentage dividend payments (down 4%), ROE (down 22%), and ROCI (down 9%).

[insert Tables II & III here]

While an overview of individual SOEs' financial performance highlights the similarities (Table II) and differences (Table III), inquiry from the inside provides the opportunity to understand some of the issues underlying the financial outcomes of the respective SOEs. These issues are considered below, based on data from interviews with senior executives from 13 of the 15 SOEs (as at 2010), supported by observation and textual analysis.

4.2 Analysis of SOEs' financial performance – inquiry from the inside

An internal perspective of SOEs suggests New Zealand's public sector reforms continue to operate effectively. Senior executives' comments indicate SOEs operate in deregulated markets, competing openly against private sector firms, and facing similar challenges.

> It's essentially performance [expectations] consistent with listed company equivalence. We operate the business as you would expect anybody else to (Senior executive, SOE G, 2010).[8]

> We have key financial metrics that have to be met and they're just the basic hurdle rates and if you don't meet those then your idea doesn't go forward, your project stops, etcetera. So we are absolutely focussed (Senior executive, SOE D, 2010).

The model under which SOEs operate and the explicit accountability for profitable operations provide a clear operating framework for all SOEs, despite changes in Government.

> I think that [SOE] model has worked well for us. The way the government has handled us as a model, I think, is a real credit to - and this is nothing to do with parties, this goes from National to Labour - they are hands off, they understand their government's role, they understand where the board sits in terms of representing the owner. I think that's a real credit to them, and I'm sure if we were a government department, for example, it would be quite different, - it would be a totally different situation (Senior executive, SOE H, 2010).

Revenue from Government is minimal[9], and in each case services provided to Government are won (and lost) through commercial tender. Interview comments typically show SOE executives believe there is freedom of commercial choice, and a high awareness of responsibility for commercial results. Further, SOE executives expressed an acceptance that as shareholder, Government has the right to set expectations and give direction on certain issues.

> Yes [freedom of commercial choice exists]; we have a commercial board and we're looking to make investment decisions that are rational and economic and create shareholder value. Government's role as a shareholder has been to drive us to a more commercial focus, and that's very, very explicit, so they communicate to us formally around what their expectations are every year, and they lay that out (Senior executive, SOE G, 2010).

Of the four SOEs classified as having high returns, three have contributed capital of less than $10 million. Commonalities which emerge among SOEs in this category include a clear understanding of how to utilise the SOE's core asset base in a commercial context, and a

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[8] Individual executives and SOEs have generally not been identified with respect to interview data, due to requests for confidentiality from executives in three SOEs.

[9] The one exception to this statement is MetService, whose service contract with the Ministry of Transport represents approximately 50% of the SOE's revenue.

strategic direction founded on those assets. Expertise has been developed in the SOE's core business area, and opportunities to leverage from this expertise have been identified and realised in a range of markets, and recognised through industry awards.

> I think we've got very good at working out value from our existing asset base that we started some 10 years ago...we've extracted more value from those [assets] and we've stuck to what we're good at...built a really strong team and got a strong pipeline of projects (Senior executive, SOE G, 2010).

> Part of the long term strategy is to identify other opportunities which are consistent with the core business. The nature and scope of activities in terms of our strategy is pretty clear (Senior executive, SOE L, 2010).

Despite their success, however, SOEs in this category seem acutely aware of the challenges ahead, managing growth, and continuing to leverage from core skills and resources in a challenging economic environment.

> We're still a business in a very volatile environment, being New Zealand and what it is (Senior executive, SOE L, 2010).

Of the seven SOEs in the medium ROE category, two are in the business of energy generation. Findings from interviews with SOEs in this category indicate these SOEs have established a clear strategic direction, but continue to refine and develop their asset base (e.g. leveraging from core skills, investing in related business areas), while being conscious of limitations.

> We've built up [our core capabilities] so now we're extending them through leveraging. We've taken a small number of significant bets rather than a large number of less significant bets. We have a clear purpose and try not to muddy that with running after every opportunity. You need to focus and you need to specialise, you can't afford to try and do everything (Senior executive, SOE I, 2010).

> We look for niche opportunities where we can deliver what customers are looking for but using our particular expertise. We try and stay away from anything that's a commodity because we don't have the scale to do it (Senior executive, SOE D, 2010).

Four SOEs are included in the low category, with ROE $\leq$ 5%. Inclusion in this category may be partly an industry issue, with SOEs in this category representing a range of industries, including farming (Landcorp) and transport (New Zealand Railways) - each of which has relatively low profit expectations, based on comments from interviewees. The remaining two SOEs, Genesis and Learning Media, represent organisations which have established and subsequently reviewed their strategy and strategic direction in view of their asset base.

> The board has purposely brought in [the CEO] to get that growth and change and grow the shareholders' value and contribute to [our industry] in a wider sense than just [one part of the] market...[understanding] what we're good at, [adopting] a different risk model (Senior executive, Learning Media, 2010).

> We've [continued to diversify], that's public now. It's a development project...and once again this is part of [the] strategy of having a pipeline of opportunities and developments (Senior executive, Genesis, 2010).

Such developments reveal modifications to strategy where returns are not considered satisfactory, and a re-examination of risks and returns. However, these developments remain in the relatively early stages.

While New Zealand Railways is included in this group, it is the one SOE which remains largely reliant upon the Government for financial assistance, and thus provides valuable insight into a case of corporatisation and privatisation which has not resulted in commercial success. New Zealand Railways was privatised in 1993, purchased by Toll, and subsequently rebranded. In 2004, New Zealand Railways repurchased New Zealand's railway infrastructure from Toll, noting the infrastructure had not been maintained, and that significant funding (in the range of $200 million) would be required for its restoration and upgrade (New Zealand Railways, 2005). Toll continued to use the railways under an access agreement; however a dispute relating to the amount payable under this agreement resulted in the Government compensating New Zealand Railways for the amount Toll refused to pay in 2005. This ongoing dispute was addressed by the Crown purchasing New Zealand's rail and ferry operations from Toll in 2008, now part of New Zealand Railways (New Zealand Railways, 2008). While revenue is generated from a range of activities, New Zealand Railways remains largely dependent on the Government for financing significant operating and capital maintenance expenditure.

> You get some [models] which didn't work, we privatised the railways and they fell to pieces (Senior executive, SOE J, 2010).

In 2010, New Zealand Railways received $122.3 million in Government grants (New Zealand Railways, 2010), with Government commitments of future investments for $250 million and $500 million in the next three years. Given the task faced by New Zealand Railways to restore and upgrade the rail network, an agreement was made between the Government and the SOE, such that it was not required to make a profit. This arrangement directly opposes the intention of the SOE reforms, and is the only agreement of this kind which has been made with a New Zealand SOE.

> As a Board, we now face the challenge of investing wisely to generate revenue while operating a safe and efficient transport business. Our goal is to grow the business to a point where it is financially self-sustaining in 10 years (New Zealand Railways Chairman, John Spencer, 2010, p. 4).

Hence, in an industry acknowledged internationally for its commercial challenges (Shaoul, 2006; Stiglitz, 2008), significant variation in the financial independence and performance of SOEs is noted. Analysis of both the similarities and differences within these findings, however, raises a number of issues for discussion, and are considered below.

5. DISCUSSION

An analysis of financial performance based on the tables and SOE executives' comments above provides an overview of New Zealand's SOEs, highlighting the financial outcomes of the SOE sector, and the demonstrated potential for successful financial performance within SOEs. Such performance extends both over time (taking into account the two phases of this research), and through challenging economic times (with reference to the economic environment in the second phase). These findings provide insights into a number of issues such as the potential for financial returns from SOEs, the elements contributing to successful performance, and the notion that SOEs will *always* fail (Moore, 1992). Each of these issues is considered below.

While findings (refer Table II) show a significant range of financial performance outcomes for the 15 SOEs examined as at 2010, cases of financial success are clearly evident. Four of the SOEs examined were classified as high performers based on ROE, yet results for ROCI and ROI show significantly higher returns based on the amount of capital invested (ROCI) and the cash returns received (ROI). The notably lower, yet sustainable returns for the sector during 2006 to 2010 (refer Table I) indicate SOEs can represent reliable sources of revenue even in a challenging economic environment. The very high returns generated by SOEs which have developed strong businesses with relatively modest amounts of contributed capital, further indicates public sector organisations are not necessarily lacking in market discipline or capital intensive (Guriev and Megginson, 2005).

With respect to the context of the SOE reforms, a number of elements may be identified as important factors contributing to the financial success of SOEs in general. A clear regulatory framework has ensured a strong awareness of accountability for self-funding operations and profit within each SOE. Where profitability was unlikely, clear communication and agreements were in place outlining the operational issues and financial implications (e.g. New Zealand Railways). Such findings highlight the understanding by SOE executives of the importance of performance expectations and outcomes. While debate exists regarding the role of accounting and financial measures with respect to performance evaluation in the public sector (Carlin, 2005), the express requirements on New Zealand's SOEs highlight the potential for solid returns where expectations are clear and accountability express (SOE Act, 1986). As noted by Lapsley (1999), an emphasis on profit effectively makes the invisible *visible,* and can be an important motivator of change. Hence, accounting's role as a means of communication underpins effective performance monitoring and evaluation, provided the information is available (Shaoul, 1996) and reliable (Jacobs, 2009). This is reinforced by external reports (Ernst and Young, 2011), which benchmark New Zealand SOEs' financial performance against private sector firms. Despite the difficulty in finding appropriate benchmarks[10], based on a review of financial performance within the respective industries, eight of the 15 SOEs' performance was ranked in the upper quartile. A comparison of the report with this study's findings reveals SOEs ranked as not only as 'high' performing (ROE $\geq$ 15%) but also 'medium' performers (ROE between 5% and 15%) compare favourably with their private sector counterparts.

Another factor contributing to the New Zealand SOE sector's financial performance is it new public management foundations. The commercially viable nature of New Zealand's SOE sector has attracted interest from overseas governments and previously been recognised as an exemplar of new public management (Easton, 1999; Eggers, 1997; Khalegian and Das Gupta, 2005; Polidano, 1999 Schick, 1998). While contention exists regarding the ongoing application of new public management (Dunleavy *et al*, 2005), arguably its legacy prevails in various countries' public sector management frameworks (Pollitt and Bouckaert, 2011), including New Zealand (Chapman and Duncan, 2007; Duncan and Chapman, 2010). Thus, new public management principles appear to have played an important role in establishing commercial and competitive foundations within New Zealand's SOE framework.

The long-term hold strategy of New Zealand's former Labour-led Government (CCMAU, 2007) confirmed the intention not to sell any of the SOEs, on the basis that they were

[10] In several cases the report acknowledges consideration of companies which are 'only broadly comparable' (e.g. p. 22).

valuable national assets providing core services with the potential for commercial operations. An evaluation of New Zealand's SOEs reinforces the case for competitive, commercial, and successful operations within the public sector. Further, despite numerous empirical studies which find support for privatisation over state ownership (see Guriev and Megginson (2005), which provides both an overview of these studies and commentary on the associated methodological limitations), it is increasingly accepted that the outcomes of privatisation are largely dependent on several factors. These include appropriate market institutions (Guriev and Megginson, 2005) and "how badly the state enterprise was performing to begin with" (Ramamurti, 1997, p. 1973). Hence, questions have been raised as to whether competition is more important than ownership (Guriev and Megginson, 2005; Shirley and Walsh, 2000; Villalonga, 2000).

Importantly, however, an examination of New Zealand's SOEs also reveals that not all SOEs have achieved financial independence or success (e.g. Terralink New Zealand Limited, Timberlands West Coast Limited) and some industries in particular require ongoing support (e.g. New Zealand Railways). Further, business and industry risks present ongoing challenges.[11] Thus, the traditional view of public sector organisations as non-commercial, capital intensive and costly 'investments' to maintain, is not without support. Yet, while public sector organisations and operations underpinned by commercial principles may not consistently result in profits, the opportunity for enhancing efficiency and the potential for profit should not be dismissed.

6. CONCLUSION AND IMPLICATIONS

The implications of this study include the potential for SOEs to be profitable investments. The broader economic implications of financially successful and sustainable operations of SOEs operating under commercial principles indicates the potential for this sector to be a viable investment, even in challenging economic environments (albeit with lower returns). While this study focuses on SOEs operating in New Zealand, findings are not considered specific to the New Zealand context. A growing number of countries have adopted new public management principles in some form (Pollitt and Bouckaert, 2011), and with the appropriate regulatory framework, arguably enhanced financial performance and sustainable financial returns are achievable elsewhere. This outlook presents an interesting alternative to privatisation policies, with the opportunity to review the extent of government reliance on more traditional funding sources (e.g. taxation). In 2010, revenue from SOEs represented 13% of the New Zealand Government's total revenue for the year. By comparison, tax revenue (typically the Government's largest revenue source) represented 67% of the New Zealand Government's total revenue for the same year (New Zealand Government, 2010b). These percentages were similar in 2005, being 15% and 70% respectively (New Zealand Government, 2005), and highlight the importance and relative consistency of SOE revenue as a source of central Government funds. Thus, throughout both strong and challenging economic times, revenue contributions from New Zealand's SOEs have remained relatively stable.

Interestingly, however, returns from SOEs may not alone be justification for a policy of corporatisation. In the case of New Zealand, for example, multiple asset sales are planned despite solid financial performance of the SOE sector, due to challenges in other aspects of

[11] While Solid Energy was classified as having 'high' returns in the current and previous study (2001 to 2005), in early 2013 it was reported to be in significant financial distress due to increasing debt and losses resulting from decreasing coal prices. The Government advised they would not let Solid Energy be placed into receivership, and appointed a new Chairman in an attempt to rescue the SOE (English and Ryall, 2013).

government performance (e.g. growing national debt, concerns from international investors and credit-rating agencies regarding New Zealand's debt levels, investment and disaster recovery needs following the Christchurch earthquakes beginning in early 2011). Thus, sale of state assets or SOEs remains a potential strategy for government to address issues other than SOE performance.

Several limitations should be noted with respect to this study. First, while this study specifically focuses on the financial returns of SOEs, non-financial performance measures are outside the scope of this paper and have therefore not been examined. Although the Government and relevant authorities (e.g. CCMAU, 2005; New Zealand Treasury, 2000) have previously indicated a favourable view of SOE performance overall, certainly areas for improvement have been noted (English and Ryall, 2012). However, a review of these issues will invariably raise some of the concerns previously identified in the literature (e.g. difficulty of performance evaluation in the public sector). With respect to the classification of individual SOEs' financial performance, arbitrary classifications of high, medium, and low, were made taking a portfolio approach to examine the financial returns. Complexities arise, however, due to the introduction of IFRS during the period under examination (predominantly in 2007). While comparisons with industry benchmarks would perhaps provide a more suitable basis for comparison, such benchmarks are difficult to establish given the small size of New Zealand in general, as well as the small-sized industries (and, at times, natural monopolies) in which SOEs often operate. International comparisons raise further complexities due to the different contextual and environmental variables to be taken into consideration (Villalonga, 2000).

Regarding areas for further research, a more detailed understanding of individual cases within the context of New Zealand's SOEs would provide further insight into the operational elements which contribute to financial success and failure. Consideration of SOE frameworks and financial performance in other counties will provide important comparative data. Further, the future of New Zealand's SOEs post-privatisation will no doubt be monitored with interest.

New Zealand's policy of partial privatisation, commencing with SOEs in the electricity industry, is consistent with the OECD's (2010, p. 3) observation of a "new privatisation landscape" whereby privatisation is increasingly being undertaken without fully transferring ownership to the private sector. This approach seeks to take advantage of returns through market discipline while managing risk via partial ownership and control. Given market discipline is considered a feature of New Zealand's existing SOE framework, it will be interesting to observe the changes that unfold.

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Table I Financial performance of New Zealand's SOE sector ($m)

	Current study						Prior study	
	2010	2009	2008	2007	2006	**Ave 2006 - 10**	**Ave 2001-05**	**Increase**
Revenue	9,622.6	9,654.7	9,808.0	7,715.1	8,401.1	9,040.3	5,748.3	57%
Net profit after tax	669.2	653.0	601.3	780.2	1,402.2	821.2	523.1	57%
Total assets	49,099.5	44,903.9	39,690.4	33,657.7	19,445.8	37,359.5	12,285.4	204%
Contributed capital	4,804.9	4,804.9	4,431.6	4,397.4	4,397.4	4,567.2	4,300.6	6%
Equity	25,665.2	24,937.7	23,541.4	23,332.5	11,474.8	21,790.3	6,709.2	225%
Dividends %	112%	32%	71%	62%	73%	71%	56%	27%
Dividends paid	751.2	210.6	427.9	480.8	1,028.2	579.7	276.1	110%
Tax paid	274.1	213.3	228.1	362.3	371.4	289.8	204.8	41%
Total payments	1,025.3	423.8	656.0	843.1	1,399.6	869.6	480.9	81%
ROE	3%	3%	3%	3%	12%	4%	8%	-51%
ROCI	14%	14%	14%	18%	32%	18%	12%	47%
ROI	21%	9%	15%	19%	32%	19%	11%	75%

*SOEs operating in New Zealand as at 2010[12]

1. Revenue - reflects income from commercial services provided to government and non-government organisations
2. NPAT - net profit after tax
3. Total assets - based on financial year end values
4. Contributed capital – the amount of capital contributed by the New Zealand Government
5. Equity – total equity, including contributed capital, retained earnings, and reserves
6. Dividends % - the amount of dividends paid compared to the amount of profits recorded in a particular financial year
7. Dividends paid – the amount of dividends paid during the financial year, based on negotiations between individual SOEs and the Government, in view of profits, future plans, and capital investment requirements
8. Tax paid– the amount of tax paid during the financial year
9. Total payments – sum of dividend and tax payments made during the financial year, being the two main forms of cash returns to Government from SOEs
10. ROE – return on equity, calculated as net profit after tax/equity
11. ROCI – return on capital invested, calculated as net profit after tax/contributed capital
12. ROI – return on investment, calculated as total payments (cash returns) to Government/contributed capital

[12] Changes in SOEs from 2006 include the merger of AgriQuality Limited and Asure New Zealand Limited In late 2007 to form AsureQuality (due to overlapping interests and potential synergies), and the reclassification of Timberlands West Coast Limited to a Crown entity, with Timberlands (failing to be commercially viable) subsequently prepared for liquidation. Names changes include Transmission Holdings Limited becoming Kordia Group Limited, and New Zealand Railways Corporation Limited (Ontrack) becoming New Zealand Railways Corporation Limited (Kiwirail).

Table II Financial performance of individual SOE ($m)

	Genesis	Landcorp	Learning M	NZ Railways	Airways	AsureQuality	Meridian	Mighty Rv Pw	NZ Post	Korida	Transpower	Animal Ctl	MetService	Quotable V	Solid Energy
Industry	energy generation	farming	educational services	transport	air traffic control	biosecurity, food safety	energy generation	energy generation	postal services	transmission services	energy infrastructure	pesticide manufacturer	weather forecasting	property valuation	energy resources
Revenue	2,018.9	155.4	24.3	534.7	137.8	116.4	2,111.1	1,037.2	1,211.5	243.5	661.5	6.4	34.2	44.5	671.2
Net profit after tax	35.5	22.3	0.2	86.7	6.1	2.4	291.7	113.7	67.8	4.8	107.8	1.1	2.7	4.6	78.6
					-			-	-	-	-	-	-		
Total assets	2,409.7	1,546.9	12.6	9,925.1	136.6	57.2	7,019.5	3,786.3	8,332.4	245.5	3,109.0	6.1	21.6	25.5	687.1
Contributed capital	540.6	125.0	1.2	300.3	41.1	18.0	1,600.0	377.6	192.2	87.7	1,200.0	0.0	5.0	4.6	60.9
Equity	1,440.7	1,273.8	4.7	9,486.5	46.4	27.9	4,667.8	2,365.5	628.2	100.3	1,324.9	5.0	9.1	16.4	361.5
					-			-	-	-	-	-	-		
Dividends %	64%	7%	22%	0%	101%	79%	132%	85%	37%	108%	2%	84%	58%	38%	34%
Dividends paid	22.7	1.6	0.0	-	6.2	1.9	385.7	96.9	25.1	5.2	2.0	0.9	1.6	1.7	26.8
Tax paid	24.3	0.0	0.2	2.6	2.8	2.2	82.7	62.5	25.1	4.7	44.2	0.5	1.3	0.8	35.3
Total payments	47.0	1.6	0.3	2.6	6.9	4.1	468.4	102.2	50.2	9.9	46.2	1.4	3.0	2.6	62.1
					-			-	-	-	-	-	-		
ROE	2%	2%	4%	1%	13%	9%	6%	5%	11%	5%	8%	22%	30%	28%	22%
ROCI(1)	7%	18%	15%	29%	15%	13%	18%	30%	35%	5%	9%	1098312%	55%	100%	129%
ROI(2)	9%	1%	23%	1%	17%	23%	29%	27%	26%	11%	4%	1410404%	59%	56%	102%

□ Low ROE ≤ 5%
□ Medium 5% < ROE < 15%
■ High ROE ≥ 15%

Table III High-low range of individual SOE performance ($m)

	Current study				Prior study	
	Company	Low	Company	High	High 2001-05	Increase
Revenue	Animal Control	6.4	Meridian	2,111.1	1,246.7	69%
Net profit after tax	Learning Media	0.2	Meridian	291.7	133.9	118%
Total assets	Animal Control	6.1	NZ Railways	9,925.1	3,559.5	179%
Contributed capital	Animal Control	0.0	Meridian	1,600.0	1,600.0	0%
Equity	Learning Media	4.7	NZ Railways	9,486.5	2,090.2	354%
Dividends %	NZ Railways	0%	Meridian	132%	137%	-4%
Dividends paid	Learning Media*	0.0	Meridian	385.7	97.1	297%
Tax paid	Landcorp	0.0	Meridian	82.7	48.5	71%
Total payments	Learning Media	0.3	Meridian	468.4	145.5	222%
ROE	NZ Railways	1%	MetService	30%	39%	-22%
ROCI	Kordia	5%	Animal Control	1098312%	1213559%	-9%
ROI	NZ Railways	1%	Animal Control	1410404%	1302018%	8%

Nb. Animal Control Products' contributed capital is $100 (rounded down to 0).