

Special rights of public authorities in privatised EU companies: the microeconomic impact

**Report prepared for
The European Commission**
November 2005



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Executive summary

A common feature of privatisations in Europe during the privatisation wave of the 1980s and 1990s was the retention of special rights by public authorities in the privatised companies. The rights—also referred to as ‘golden shares’—preserve the influence of governments over the companies they privatised and grant the governments powers that are otherwise only available to, or go beyond those of, a majority shareholder.

The compatibility of special rights with the EC Treaty has long been contested by the European Commission, and the European Court of Justice (ECJ) has reached several judgments confirming that, in most cases, the measures are infringements against the freedom of capital movement. Many special rights have since been abolished.

Oxera was commissioned by the European Commission to provide a systematic overview of special rights retained by public authorities in privatised companies in the EU, and an evaluation of their economic impacts on the performance of affected companies, direct and portfolio investment, and EU financial market integration more generally. The study does not assess in any detail the wider social benefits or costs that may arise from special rights.

The findings contained in this report can be summarised as follows.

Classification of special rights

Special rights include all legal arrangements with the purpose of preserving the influence of a public authority on a privatised company beyond the extent to which such influence would be afforded under general company law. They take many different forms and, depending on their nature, vary in their likely impact. Using as examples the special rights that are, or were, observed in EU companies and that were the subject of infringement proceedings by the Commission, the report provides a systematic classification of special rights along several relevant dimensions, including the following.

- **Direct or indirect investment restrictions**—special rights can give a public authority the rights to control changes in ownership and influence the shareholder structure of a company. Alternatively, they can grant the authority influence over a company’s management decisions. While the former presents a direct restriction on investment in the company, the latter influences investment decisions only indirectly (eg, by making the investment less attractive). Examples are shown in Table 1.

Table 1 Examples of special rights

Direct investment restrictions	Indirect investment restrictions
Caps restricting substantial blockholdings	Requirements for approval of, or rights to veto, certain strategic management decisions
Requirements for approval of, or rights to veto, changes in ownership by the government	Rights to approve or appoint members of the company board
	Limitations of other shareholders’ voting rights

Source: Oxera.

The two types of special rights differ not only in their likely impact on investment decisions, but also in the way they affect company performance.

- Direct investment restrictions in the first instance shelter the company from being taken over. This in turn may affect company performance if a lower likelihood of takeover increases managerial slack or prevents the realisation of synergies.
- The performance impact of indirect restrictions comes from, and depends on the quality of, public intervention in management decision-making.
- **Discriminatory and non-discriminatory restrictions**—among the direct investment restrictions, a distinction can be drawn between those that explicitly discriminate against foreign investment and those that do not. The former are likely to have a more significant impact on cross-border investment. However, even restrictions that are not discriminatory on paper can be applied in a discriminatory manner to prevent takeovers by foreign bidders.

Other dimensions for classification include the severity of a restriction, the stated public policy justification for maintaining the rights, whether the rights are time-limited or permanent, and whether they have been exercised in practice.

Impact assessment based on the existing literature

The assessment of the economic impacts of special rights can draw from existing empirical research findings. Although direct evidence is limited, academic studies have addressed questions that are relevant when evaluating the impact of special rights on company performance and investment decisions.

- Existing research documents significant improvements in company performance following the transfer of ownership (and control) from the state to the private sector. These improvements relate not only to share prices and the financial performance of companies following privatisation, but also to productivity and operating performance.

One study explicitly examines the impact of golden shares on performance, and presents findings that are consistent with the view that failure to transfer complete control to the private sector, combined with uncertainty surrounding the exercise of golden shares, has a detrimental effect on performance.

- A prominent motive for the retention of special rights in the form of direct investment restrictions is to block hostile takeovers. There is a large body of literature establishing a negative relationship between anti-takeover provisions and company performance—ie, when managers are insulated from takeovers, overall performance tends to decline.
- It is well established that shareholders in firms that become takeover targets receive large premia relative to the pre-announcement share price. Special rights that prevent takeovers therefore have a negative impact on shareholders in potential target companies who would otherwise have been able to realise premium returns on their investment.
- There is widespread evidence that voting rights and control powers carry significant market value, with higher share prices being observed for shares with increased voting rights and in acquisitions of control blocks. Special rights grant disproportionate control to the public authority and hence can be expected to have an adverse impact on market valuation.
- Special rights that restrict the free movement of capital across borders are likely to have effects that are similar to those examined in the literature on international investment restrictions. Such restrictions have been found to impose costs on affected companies and investors. They segment financial markets and distort the allocation of savings and capital across markets.

Impact assessment based on empirical analysis

The report contains new empirical evidence on the impact of special rights on privatised EU companies, to complement the existing evidence. The first set of evidence is obtained from a detailed case study analysis for a sample of six companies affected by recent Commission infringement proceedings.¹

- Evaluating the impact of special rights on company performance requires an assessment of the counterfactual—ie, what would the performance have been if the companies had not been subject to special rights? One approach is to compare performance of the same company before and after the abolition of special rights and to assess any resulting performance improvements. However, in the case study sample, most special rights were abolished only very recently or were still in place (eg, because infringement proceedings were ongoing at the time of analysis). It was therefore too early to assess the longer-term impact of the abolition of special rights.
- Instead of using before-and-after comparisons, the case study analysis therefore focuses on benchmarking the companies' performance against that of comparable companies not subject to special rights. Other things being equal, any observable difference between the case study firm and comparators may be attributed to the existence of special rights.

The results of the benchmarking analysis show some underperformance of case study firms relative to their chosen comparators, in particular in operating performance. However, the results are disparate and overall not conclusive—while some of the case study firms tended to underperform consistently, others outperformed the benchmarks at least along specific dimensions of financial performance.

The lack of conclusive evidence may be largely due to data and methodological problems. In particular, given the nature of the industries in which the case study firms operate, the choice of comparators was restricted to companies operating in other countries, subject to a different regulatory regime, or indeed still partly state-owned. Any differences in these or other company-specific factors are likely to influence comparative performance, thereby clouding the measured performance impact of special rights. Conclusions that can be drawn from case study analysis are necessarily limited. More conclusive results might be obtained if the impact assessment were based on a larger sample of firms and applying techniques that control for other factors influencing company performance, and allow the impact of special rights to be isolated from these other factors. Notably, one study in the existing literature adopts such techniques and, for a large sample of international companies, reports a statistically significant negative impact of golden shares on long-term share price performance.

- The case study analysis also considers share price reactions around the dates when it was announced that the special rights in the companies were to be removed. If the special rights were considered binding by the market, a positive share price reaction upon announcement of abolition would be expected. This approach critically relied on the identification of dates when the market learned, for the first time, that the special rights would be abolished. The event dates available, however, related to official announcements of infringement proceedings, ECJ rulings or actual abolition, which may have long been anticipated by the market. This is likely to explain the general lack of

¹ Cimpor (Portuguese cement manufacturer); Volkswagen (German automobile manufacturer); Repsol YPF (Spanish oil and gas company); KPN (Dutch telecoms company); Portugal Telecom; and British Airport Authority (BAA, the UK airports operator).

share price responses. Overall, no evidence was available to conclude that the market reacted positively to the official measures taken to abolish special rights.

- Evidence was available from the case study analysis to suggest that special rights have a negative impact on investment decisions—eg, a takeover bid which was made conditional on the government abolishing the special right in the target and which triggered a significant share price appreciation.

The second set of new evidence is obtained from an event study analysis around the abolition of golden shares held by the UK government in privatised companies in the water and electricity sectors until 1995. The golden share constituted a direct restriction on investment in the companies; it effectively meant that no shareholder was allowed to control more than 15% of voting shareholdings and so prevented hostile takeovers.

- The golden share redemption triggered a surge in takeover activity in both sectors. Within two years of redemption all but one of the 12 regional electricity companies had been merged or acquired, in most cases by foreign companies. In water, the first takeover bid for a water and sewerage company occurred just two months after the golden share redemption. This provides support for the view that special rights in the form of direct investment restrictions restrict the market for corporate control and have a binding, negative impact on takeover activity in the market.
- The takeovers announced as a result of the golden share redemption were associated with significant takeover premia. It therefore appears that special rights of this type prevent shareholders in target companies from realising large premium returns.
- The event study analysis does not allow conclusions to be drawn about the impact of the golden share redemption on the longer-term performance of UK water and electricity companies. Nonetheless, the positive share price reactions—not just of the target companies but also of the other companies in the sector—are consistent with the hypothesis that the market expected significant synergies or other benefits from takeovers in the sectors. To the extent that these benefits would have been prevented if the golden shares had not expired, special rights of the UK type are likely to have adverse long-term consequences on the performance of companies.

Conclusions

Special rights held by public authorities tend to have a negative impact on the longer-term economic performance of EU privatised companies. The new empirical analysis conducted as part of this study provided some evidence consistent with a negative performance impact, although further research would be required to allow stronger conclusions to be drawn from the data. Importantly, existing research in the academic literature supports the conclusion of a negative impact of special rights on the financial and operating performance of companies.

Both existing and new empirical research provide strong evidence that special rights can constitute important barriers to direct investment. They have an adverse impact not only on the market for corporate control, by restricting takeover activity and distorting the level playing field in the market, but also on portfolio investors. To the extent that they restrict the free movement of capital across EU borders, they impede further financial market integration.

Despite these negative impacts, it could be argued that maintaining public control of companies might be justified in some circumstances. In particular, governments may deem it necessary to impose special rights following privatisation, given concerns about a divergence between social objectives and the private goals of unconstrained private companies. Such concerns apply in particular to enterprises providing public services, where there may be considerations of security of supply or universal access to a service. These are of little relevance for companies in other industries where special rights have been observed.

Moreover, the public policy argument may be relevant when justifying the need to maintain control over certain company decisions that would risk the public policy objectives, but it provides little justification for special rights that constitute a direct investment restriction and an outright blocking of a takeover of utilities.

Special rights are only one of a number of mechanisms that can be employed by public authorities to retain control in companies following privatisation. In particular, regulation that addresses economic efficiency and often wider aspects such as security of supply and universal access is now an essential part of most governments' approach to privatised companies in the public utility sectors, often underpinned by Community secondary legislation. Regulation may be seen as a potentially less restrictive and more transparent means of achieving public policy objectives, especially if carried out by an arm's-length regulatory authority.

An alternative would be not to relinquish ownership in the first place. Indeed, in some instances governments may be less likely to sell their ownership stakes and fully privatise a company if they did not have the possibility of retaining special control rights. This is important since, despite the significant privatisation wave in the last two decades, many EU governments still retain large stakes in companies and, as major shareholders, can use that ownership power to block acquisitions or influence management decisions. This provides more reason to continue work on refining alternative methods of control that would safeguard public policy concerns without directly interfering in corporate control and restricting direct investment.

