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ECFIN Country Focus

ECONOMIC ANALYSIS FROM EUROPEAN COMMISSION'S DIRECTORATE-GENERAL FOR ECONOMIC AND FINANCIAL AFFAIRS

HIGHLIGHTS IN THIS ISSUE:

- *State-owned enterprises in Romania dominate important sectors such as railway transport and energy.*
- *They carry large stocks of payment arrears and tend to be more heavily indebted and less profitable than their privately-owned peers.*
- *Implementation of restructuring efforts, including privatisations, and adherence to corporate governance principles would upgrade SOEs' operational performance and limit the risk they represent to public finances.*

The role of state-owned enterprises in Romania

*By Helena Marrez**

Summary

Under the successive EU Balance-of-Payments (BoP) assistance programmes to Romania, state-owned enterprises (SOEs) have been identified as an area to be revamped. Improving performance of SOEs, including through privatisations, had a twofold purpose: (i) increase the potential of the Romanian economy, and (ii) reduce the risk to the government's budget.

Generating 8% of total output of non-financial corporations and employing close to 4% of the Romanian workforce, the absolute size of the portfolio of SOEs is markedly above average but not exceptional compared to other EU Member States. However, SOEs play an important role in the Romanian economy, as they dominate in particular the energy and rail transport sectors, which provide crucial inputs to the overall economy. SOEs perform suboptimally compared to counterparts in the private sector. They have higher debt-to-earnings ratios and lower profitability levels. This suboptimal performance affects both public finances and the private sector, with SOEs accounting for 50% of total tax arrears owed by companies and accumulated payments past due date on their books, owed to suppliers, employees, financial institutions and the government, standing at the equivalent of 3.4% of GDP at end-2013. Moreover, enforcement of the current corporate governance legislation for SOEs is weak.

Overall, reforms are lagging behind, with privatisation processes being postponed and cost-cutting restructurings being delayed. There has been limited progress regarding the corporate governance of SOEs. Pursuance of privatisations, implementation of restructuring efforts and enforcement of corporate governance principles would upgrade SOEs' operational performance, limit risks to the government budget and improve their functioning in the economy. This would be especially important in the energy and rail transport sectors.

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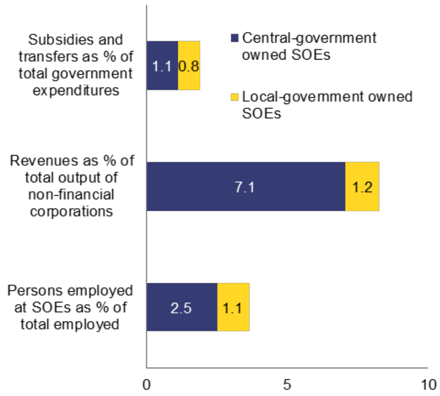
- *While the size of the SOE portfolio is not exceptional, SOEs dominate important sectors such as railway transport and energy.*

Importance of SOEs in the Romanian economy

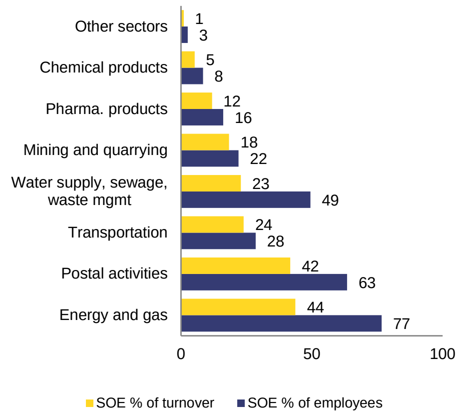
State-owned enterprises play an important role in the Romanian economy. They generate 8% of total output of non-financial corporations and employ close to 4% of the total workforce, whereas government subsidies and transfers to these entities account for 2% of total government expenditure or 0.7% of GDP (Graph 1). Moreover, these companies dominate in particular the energy and transport sectors (Graph 2), which provide crucial inputs to the overall economy.

Graph 1: Importance of SOEs in the Romanian economy



Source: Ministry of Public Finance data end-2013, Commission analysis

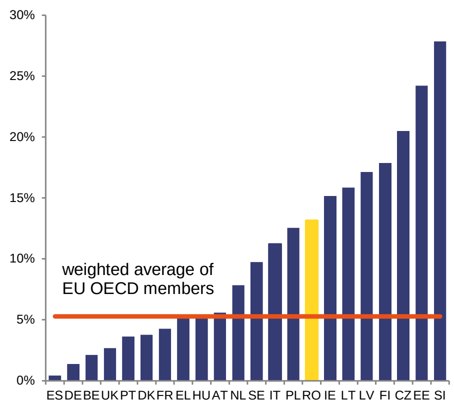
Graph 2: Importance of SOEs by sector[1]



Source: Ministry of Public Finance data end-2013, Commission analysis

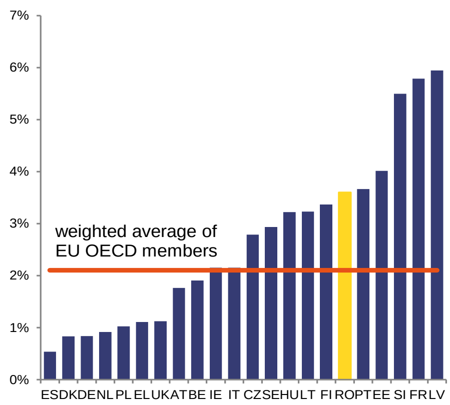
Combining OECD data on SOEs with data on Romania, which is not an OECD member, allows for basic cross-country comparison of the share of the SOE sector in the national economies and the number of employees as a share of total employment.[2] Although these ratios are imperfect proxies for measuring the importance of SOEs in the respective countries, they show that the equity valuation of Romanian SOEs in proportion to GDP and the Romanian workforce employed in SOEs are markedly above average but not exceptional compared to other EU countries (Graphs 3 and 4).

Graph 3: Equity valuation of SOEs expressed relative to GDP



Source: OECD dataset on the size and composition of national state-owned enterprise sectors, Bureau Van Dijk Orbis database, Commission analysis, end-2012 data.

Graph 4: Employment at SOEs as a share of total employment



Source: OECD dataset on the size and composition of national state-owned enterprise sectors, Ministry of Public Finance data, Commission analysis, end-2012 data.

A headcount of SOEs reporting to the Ministry of Public Finance reveals a total of 247 central-government-owned SOEs and a total of 1,177 local-government-owned SOEs at end-2013 (Table 1 and Table 2).[3] These entities range from as tiny as 1 employee to large companies employing over 20,000 persons and generating a turnover of 260 million euros (Compania Naţionalã Poşta Românã SA). Small and large players can be found at both local and central government levels. Overall, more than 300,000 workers are employed by state-owned enterprises. 27 SOEs each employ over 2,000 workers. Most entities are commercial companies, subject to company law. Less than 10% of all entities are "regii autonome", a specific legal form not subject to regular company law and used for those entities considered as "not for privatisation". These include e.g. district heating and regional public transport entities. Another specific category includes research institutes, with a legal framework closer to that of public institutions rather than that of commercial companies.

Table 1: Central-government-owned SOEs by type

Type of entity	Total	Of which operational	Of which under insolvency or other legal procedure
Commercial companies	101	87	14
Subsidiaries fully or majority-owned by parent companies	72	69	3
Companies fully or majority owned by multiple SOEs	13	13	
Research institutes	45	44	1
Regii Autonome	16	15	1
Total	247	228	19

Source: Ministry of Public Finance data end-2013, Commission analysis

Table 2: Local-government-owned SOEs by type

Type of entity	Total	Of which operational	Of which under insolvency or other legal procedure
Commercial companies	1,080	926	154
Regii Autonome	97	92	5
Total	1,177	1,018	159

Source: Ministry of Public Finance data end-2013, Commission analysis

Limited restructuring and privatisations of SOEs under the BoP programmes

- *Restructuring and privatisation processes, although a commitment under the successive Balance-of-Payments assistance programmes, have been delayed.*

In view of the large number of SOEs[4] and their dominance in the energy and rail transport sectors, their suboptimal operational performance and the room for improvement with regards to corporate governance, restructurings and privatisations became an important pillar in the successive Balance-of-Payments (BoP) assistance programmes to Romania. In the Memorandum of Understanding sustaining the 2011-2013 precautionary BoP programme, the government committed to: (i) improving performance through corporate governance reforms and a focus on reduction of outstanding payments past due date[5] and operational losses; (ii) selling minority or majority stakes in selected SOEs without public-service obligation, mainly in the energy and the transport sector, thereby bringing in fresh capital and know-how, as well as improving transparency of the decision-making process; and (iii) closing down those companies without public-service obligations that could not be restructured into profit-making entities. These commitments were reiterated in October 2013, under the 2013-2015 Balance-of-Payments assistance programme.

Under the programmes, first steps were taken with the introduction of corporate governance legislation for SOEs in 2011, the reduction of outstanding payments past due date from 5% of GDP in 2010 to 3.4% in 2013 and 5 concluded tenders for the sale of stakes in SOEs.[6] However, out of the 20 companies selected over the course of 2011 for minority or majority privatisation or liquidation under the BoP programme, 11 procedures are still pending. Only one majority privatisation procedure has been completed, despite a selection of 13 companies for majority privatisation. Consequently, there remains ample room for further operational improvements, restructurings and privatisations.

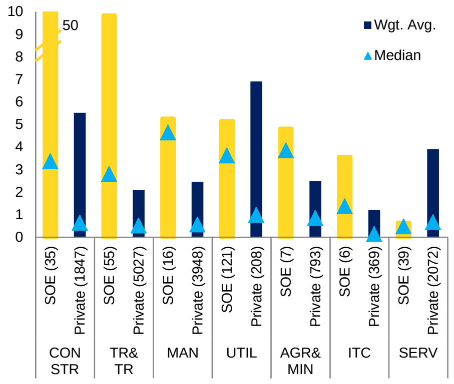
Suboptimal operational performance

- *On average within sectors, SOEs are more heavily indebted and less profitable than their privately-owned peers.*

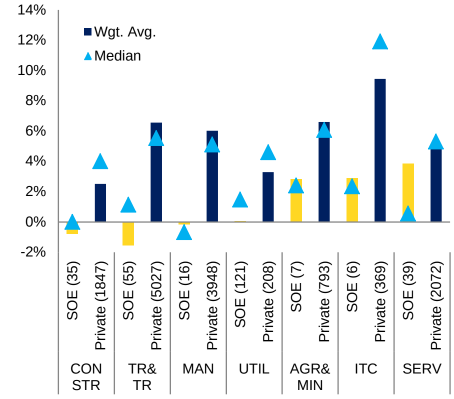
The aggregate financial situation of Romanian SOEs is worrisome, in particular when compared to private sector companies operating in the same sector. First, SOEs are more heavily indebted, with their median debt-to-earnings[7] ratio (a measure of indebtedness) higher than the same ratio for private sector companies in each sector apart from other services (Graph 5). Second, SOEs are less profitable than their privately-owned peers (Graph 6). Third, SOEs also seem over-staffed compared to privately-owned companies, as the latter generate a higher turnover per employee (Graph 2). A comparison across EU member states of the operational performance of SOEs could further complement this analysis. Country-specific evidence suggests SOEs perform below potential also in Croatia, Italy, Latvia, and Slovenia.[8] Contrary to the case of Croatia and Slovenia, the Romanian banking system is not heavily exposed to SOEs, e.g. through loans and other bank products.

The companies generating the largest profits are all in the energy sector: Romgaz (gas extraction and power generation), Hidroelectrica (hydro power), Nuclearelectrica (nuclear power), Transgaz (gas transmission) and Electrocentrale Bucuresti (cogeneration power plant). The companies generating the largest losses are in the transport sector: CFR Călători (passenger rail transport), Regia Autonomă de Transport Bucureşti (Bucharest public transport), CFR Infrastructură (rail infrastructure manager), Metrorex (Bucharest subway), CFR Marfă (freight rail transport), and Tarom (national airline carrier). Oltchim (chemicals producer) and Radet (district heating Bucharest) also generate substantial losses. Some of these companies are performing a public service obligation for which it could be argued that, apart from the need to improve operational performance, they should be entitled to government transfers to cover related operational costs. Other companies, notably CFR Marfă, Tarom and Oltchim operate in a competitive environment where EU law strictly regulates the conditions under which they can receive state support. In these cases, there is clear scope for improvements in operational performance.

Graph 5: Debt-to-earnings ratios across sectors[9]



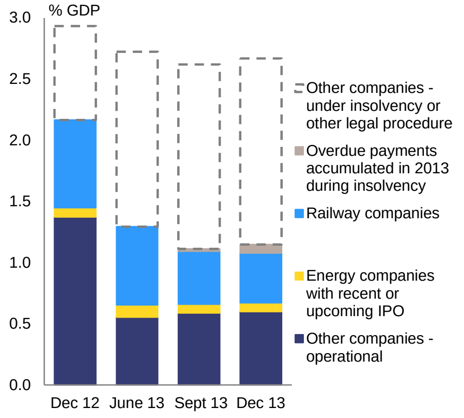
Graph 6: Return-on-assets across sectors



Source: Bureau Van Dijk Orbis database 2012 data, Commission analysis
Note: # companies per sector in brackets

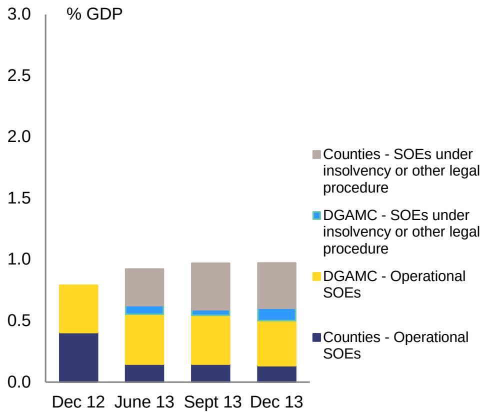
High indebtedness and low rates of return generate payment problems for SOEs. In 2012, the total debt of SOEs amounted to 45 bn lei or 7.7% of GDP. The stock of payments past due date on the balance sheets of all SOEs (including those under an insolvency or liquidation procedure) amounted to 3.4% of GDP at end-2013 (Graph 7 and Graph 8), down from about 5% of GDP in 2010. The reduction in overdue payments has been achieved through a mix of debt restructuring, including cancellations of overdue tax liabilities, ad-hoc increases in transfers from the government budget, restructuring of companies and liquidations. Further reductions could still be possible given that two thirds of payments past due date are owed by only 10 companies.[10] Overall, SOEs do not generate sufficient profits to pay off the remaining overdue payments: the total operational profit of all SOEs combined was 0.4% of GDP in 2013.

Graph 7: Payments past due date of central-government-owned enterprises



The energy companies with recent or upcoming IPO's are Electria, Nuclearelectrica, Hidroelectria, Oltenia and Romgaz.
The railway companies are CFR Cai Ferate, CFR Calatori, CFR Marfa and their respective subsidiaries.
Source: Ministry of Public Finance data end-2013, Commission analysis

Graph 8: Payments past due date of local-government-owned enterprises



DGAMC represents those largest local-government-owned SOEs that fall directly under the responsibility of the DGAMC unit within the tax administration.
Source: Ministry of Public Finance data end-2013, Commission analysis

In summary, many SOEs produce suboptimal profits or outright losses and do not pay their bills on time. Comparisons with the private sector could be unfair in some cases, if public-service obligations of state-owned companies are not adequately covered by corresponding subsidies. Nevertheless, the current size of debts and losses has negative effects on both the Romanian economy and the state budget.
In 2012, SOEs accounted for 17% of overdue payments to suppliers (state-owned and privately-owned combined) weighing on the smooth functioning of the economy.[11] Out of the 3.4% of GDP stock of overdue payments in 2013, 40% were payments due to suppliers.

Inefficient SOEs are a burden on public finances

- *SOEs account for 50% of total tax and social security arrears owed by companies.*

Loss-making SOEs constitute a liability to the general government budget. First, while generating only 8% of total output of non-financial corporations, at end-2013, state-owned enterprises accounted for 50% of all tax arrears of companies (Table 3). One explanation for the high share of total tax arrears could be that SOEs on average are much more loss-making than private sector companies and therefore encounter more difficulties in paying tax liabilities. Another explanation could be that payments of tax obligations are less enforced in the case of SOEs compared to private companies. Such preferential treatment would put SOEs at an advantage vis-à-vis their private sector competitors. Loss-making SOEs might not be forced to restructure or close down, as would happen in the case of private companies. Social motives, i.e. preventing job losses, and political motives, such as maintaining well-remunerated board positions or influence in a specific industry, may be at play here. Hence, these companies continue accumulating losses and arrears.

Table 3: Tax arrears at end-2013 (m lei)

	Tax arrears end 2013 (m lei)	Share of total
Private	1,302	50%
Central-gov owned SOEs	783	30%
Local-gov owned SOEs	514	20%
Total	2,600	

Source: Tax administration (ANAF) data end-2013, Commission analysis

Second, also several SOEs classified outside general government represent contingent liabilities for the state budget. Although there are no large outstanding government guarantees for SOEs at the moment, these SOEs can represent a contingent liability in an indirect way. When sales of a publicly-owned entity drop below 50% of production costs, the entity is classified into the general government sector (as defined in ESA) and its financial situation impacts directly the government's deficit and debt levels. State-owned enterprises classified outside general government carried debt levels equivalent to 5.4% of GDP in 2012, more than two thirds of total SOEs debt, and a stock of payments past due date equivalent to 1.9% of GDP in 2013, more than half of the total stock of payments past due date.[12]

Finally, in order to avoid job losses through liquidation or restructuring, the Romanian authorities are inclined to support certain loss-making entities through foregone tax liabilities and through government subsidies or transfers. Recent examples in 2013 and 2014 include support to the state-owned rail freight operator, the rail passenger operator and the defence industry, amounting in total to 2.8 billion lei or 0.5% of GDP.

Weak corporate governance framework

- *The applicable corporate governance legislation for SOEs is not fully enforced due to ample vested interests. Its provisions can be further improved.*

Because of the underperformance of Romanian SOEs, the corporate governance framework is an important aspect in transforming these companies. The management of SOEs is currently dispersed across different government entities. Some companies are managed by line ministries or entities in central government and some are managed by local government (local administrative units organized at different local levels: municipalities, cities, counties). In both cases, the ownership rights are exercised by the relevant tutelary public authority: either the competent line ministry, or the competent local authority. Each line ministry has a department supervising the SOEs under its responsibility. Such a governance structure is not an ideal setup for avoiding political interference in the day-to-day management of the companies, or guaranteeing a separation between the authorities' ownership and policy-making functions. Adherence to sound corporate governance principles is therefore of the utmost importance. Moreover, there is no asset management strategy laying down which assets the authorities consider strategic and which assets could be privatised over time, although this could help in reducing the opportunities for vested interests to influence the privatisation process.

Corporate governance principles, as defined by the OECD in 2005, were incorporated in the Romanian legislation on commercial companies in 2006,[13] and are also applicable to most SOEs as most are organised as commercial companies. Corporate governance rules specific to SOEs in Romania, including the regii autonome, were systematically introduced for the first time in 2011 through the government emergency ordinance (GEO) 109/2011. The main corporate governance principles are (i) the separation between the ownership and policy-making function of the government, (ii) full transparency on strategic decisions, related-party transactions and audited financial information, (iii) clarity on public-service obligations versus competitive operations, and (iv) professional and transparent board and management nomination and remuneration processes. Above all, company board members and management need to be able to operate independently from direct government interference, within only the overall strategy set out by the government as the sole or main shareholder. The Romanian ordinance benefitted from inputs by stakeholders such as line ministries, minority shareholders, business associations, the IMF, the World Bank and the European Commission. Its provisions focus inter alia on: (i) selection procedures, appointment and responsibilities of board members and management; (ii) transparency; and (iii) oversight by a dedicated unit within the Ministry of Public Finance. Ceilings for the remuneration levels of state representatives participating in general shareholder meetings and board members are defined in separate government ordinances.[14] Ordinance 109/2011 did not attempt to modify the state ownership setup, currently dispersed over multiple line ministries and local governments, nor does it lay down detailed rules for the functioning of boards. Shielding off SOEs from interference of line ministries is also not tackled through the ordinance. Performance monitoring is included, while rules for the enforcement of this monitoring and the improvement of performance are weak. There is thus ample room for improving corporate governance legislation for SOEs, along the domains spelled out in the World Bank Toolkit of 2014. Further implementation is also required, as the rules laid down in 2011, although straightforward, are still not fully adhered to. When implemented, selection procedures for managers and board members often adhere to the letter but not to the spirit of the law. One such example is the dismissal of management and board members upon the arrival of a new minister, only to appoint interim managers and board members while a new lengthy selection procedure is started. The monitoring unit within the Ministry of Public Finance lacks proper enforcement tools as line ministers do not feel accountable to this unit. As a result, enforcement rules laid down in the emergency ordinance are not applied to companies not adhering to transparency provisions.

In the current BoP programme context, the Romanian authorities committed to complying with the prevailing corporate governance rules, including replacing interim board members with members selected according to the ordinance and full compliance with the transparency obligations regarding companies' annual reports, line ministries' consolidated reports and the aggregate report on SOE performance by the monitoring unit in the Ministry of Public Finance.

The government emergency ordinance 109/2011 is already binding but will be amended and adopted by the Parliament,[15] which provides an opportunity to improve its provisions and to reinforce implementation. The Romanian authorities, together with the World Bank, are currently performing an assessment of the current text in order to identify potential revisions to enhance transparency, compliance monitoring and enforcement. The Romanian government's aim is to submit a new draft to Parliament in early 2015.

Conclusion

While the size of the SOE sector in Romania is not exceptional compared to other EU Member States, these companies dominate important sectors such as railway transport and energy. Compared to the private sector, Romanian SOEs are performing poorly, with higher debt levels, lower profitability and payments past due date piling up. As a result, loss-making SOEs constitute a burden on the government budget, while profit-making-but-inefficiently-managed SOEs do not reach their full value-creation potential. Moreover, overdue restructuring and privatisation processes have been delayed over the past years, even though these were a commitment under the successive Balance-of-Payments assistance programmes. Looking forward, corporate governance principles will need to be better enforced if SOEs are to improve their contribution to the economic and social development of Romania. Recently, the successful listings of Romgaz, Nuclearelectrica and Electrica illustrate investors' increased appetite for state-owned companies with upward potential. Such transactions illustrate the scope for success if the authorities are fully committed to the restructuring or privatisation process.

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[1] Central- and local-government-owned SOEs combined. Other sectors comprises NACE R2 categories C, G, I, J, L, M, N, P, and Q. The graph does not include NACE R2 categories A (108 SOEs), F (141 SOEs) and R (27 SOEs).
[2] Data are not fully comparable, due to exclusion from the dataset of state-owned enterprises at local-government level for some OECD members.
[3] Ownership rights of central-government-owned SOEs are exercised by the competent line ministries, while ownership rights of local-government-owned SOEs are exercised by the competent local authority (e.g. municipality).
[4] All companies in which the state or an administrative-territorial unit is the single shareholder, has the majority stake or controls the company. This includes companies in which one or several SOEs hold a majority stake or participation granting them the control right. It also includes the "regii autonome" and research institutes (see further). The analysis contained in this Country Focus excludes state-owned banks, insurance companies and financial institutions. The analysis comprises both market producers, thus classified outside general government, and non-market producers, included in general government.
[5] Payments past due date are defined as all overdue payments that are one day overdue. This is a stricter definition than arrears, which usually covers all payments overdue by more than 90 days.

[6] 15% SPO in Transelectrica in March 2012, 15% SPO in Transgaz in April 2013, 10% IPO in Nuclearelectrica in September 2013, 15% IPO in Romgaz in November 2013, and 51% IPO in Electrica in June 2014.
[7] Total debt of the company divided by Earnings Before Interest, Taxes, Depreciation and Amortisation (EBITDA). The EBITDA is a proxy for the operational profitability of a company, allowing comparisons between companies while excluding the effects of interest payments, tax treatments and depreciation and amortisation rules.
[8] See for example Georgieva, S. and Riquelme, D. 'Slovenia: state-owned and state-controlled enterprises' Country Focus. European Commission, 3. June 2013. Brussels. PDF. 8pp. and European Commission, ' IDR Macroeconomic imbalances - Croatia 2014', European Economy. Occasional Papers. 179. March 2014. Brussels. PDF. 92pp.
[9] Categories are Agriculture and Mining, Construction, Utilities, Information and Communication, Manufacturing, other Services, Trade and Transport.
[10] Huilei (oil refinery), Oltchim, RADET Bucuresti, CFR Infrastructura, CFR Călători, RAAN (heavy water production), CNADNR (road company), Carbunelui (coal mining), CET Iasi (thermal power plant), Uzina Mecanica Cugir (defence industry)
[11] Based on data in the 2013 Stability Report by the National Bank of Romania.
[12] Including the tax and social security arrears mentioned above.
[13] Law 441/2006 amending law 31/1990 on commercial companies and law 26/1990 on trade registry.
[14] Government ordinance 26/2013 and government emergency ordinance 51/2013.
[15] Under Romanian legislation, government emergency ordinances enter into force as of government approval, but need to go through parliamentary approval afterwards to be converted into law.