

Erkki Raasuke
Regina Raukas
Antti Perli

**Proposals for reorganisation of the governance of state-owned companies in the
Republic of Estonia**

Discussion document

August 2013

TABLE OF CONTENTS

SUMMARY	4
1. PURPOSE OF THE WORK	6
2. BACKGROUND INFORMATION.....	8
2.1. WORKING GROUP	8
2.2. COMPANIES WITH STATE PARTICIPATION IN THE REPUBLIC OF ESTONIA.....	8
2.3. LEGAL BACKGROUND.....	9
2.4. PREVIOUS WORK AND RESEARCH.....	11
2.5. THE NORDIC EXPERIENCE.....	14
3. OVERVIEW OF THE PROBLEMS AND BOTTLENECKS	16
3.1. INTRODUCTION.....	16
3.2. THE SHAREHOLDER’S OBJECTIVES AND EXPECTATIONS HAVE NOT BEEN SUFFICIENTLY DEFINED	16
3.3. OWNER SUPERVISION IS INSUFFICIENT; SUPERVISORY BOARDS OF COMPANIES ONLY SERVE THEIR ROLES PARTIALLY	17
3.4. AS A SHAREHOLDER, THE STATE SERVES SEVERAL ROLES SIMULTANEOUSLY	19
3.5. THE STATE IS SLOWER AND LESS FLEXIBLE THAN A PROFESSIONAL PRIVATE-SECTOR SHAREHOLDER	20
3.6. RESPONSIBILITY FOR THE PERFORMANCE OF THE DUTIES OF THE STATE AS A SHAREHOLDER IS FRAGMENTED.....	21
4. THE PATH TOWARDS A SOLUTION.....	22
5. THE EXPECTED ECONOMIC IMPACT OF THE CHANGES.....	25
6. LEGAL FORM OF THE OWNERSHIP ENTITY: THE ALTERNATIVES	26
6.1. BASIS FOR COMPARISON.....	26
6.2. LEGAL FORMS OF PUBLIC ENTITIES	27
6.3. LEGAL FORMS GOVERNED BY PRIVATE LAW.....	32
7. PROPOSAL FOR THE ESTABLISHMENT OF AN OWNERSHIP ENTITY IN THE FORM OF A COMPANY	38
8. ACTIVITIES OF THE OWNERSHIP ENTITY	41
8.1. DEFINING OF THE SHAREHOLDER’S EXPECTATIONS OF THE COMPANIES	41
8.2. APPOINTMENT OF SUPERVISORY BOARD MEMBERS	42
8.3. ORGANISATION OF THE EVALUATION OF THE ACTIVITIES OF THE SUPERVISORY BOARDS OF COMPANIES	43
8.4. OWNER SUPERVISION OF THE CORPORATE PORTFOLIO.....	44
8.5. ANALYSIS OF THE CORPORATE PORTFOLIO AND REPORTING	44
8.6. ACQUISITION AND DISPOSAL OF PARTICIPATIONS IN COMPANIES.....	45
9. MANAGEMENT, ORGANISATION AND FINANCING OF THE OWNERSHIP ENTITY	47
9.1. MANAGEMENT OF THE OWNERSHIP ENTITY	47
9.2. ORGANISATION OF THE OWNERSHIP ENTITY	48
9.3. FINANCING.....	49
10. DECISION-MAKING COMPETENCE IN THE GOVERNANCE OF PARTICIPATIONS	50
10.1. DECISION-MAKING COMPETENCE IN THE MANAGEMENT OF THE OWNERSHIP ENTITY	50
10.2. ESTABLISHMENT OF SHAREHOLDER’S OBJECTIVES AND EXPECTATIONS FOR THE COMPANIES GOVERNED....	53
10.3. APPOINTMENT AND REMOVAL OF MEMBERS OF THE SUPERVISORY BOARDS OF THE COMPANIES GOVERNED	54
10.4. ADDITIONAL FINANCING OF THE COMPANIES GOVERNED	55

10.5. DISTRIBUTION OF DIVIDENDS IN THE COMPANIES GOVERNED.....	55
10.6. ESTABLISHMENT OF NEW COMPANIES; ACQUISITION AND TRANSFER OF PARTICIPATIONS	57
10.7. REPORTING	58
ANNEX 1: PRINCIPLES FOR STATE PARTICIPATION IN COMPANIES (DRAFT)	60
ANNEX 2: SHAREHOLDER’S EXPECTATIONS OF EESTI ENERGIA AS (DRAFT).....	77

SUMMARY

The objective of this work has been established by the Minister of Economic Affairs and Communications of the Republic of Estonia. The purpose of the work is to analyse and make proposals for reorganisation of the governance of companies with state participation in the Republic of Estonia, with the aim of ensuring efficient, purposeful and professional management of such companies by the shareholder.

The work was performed by a three-member working group, who relied on OECD recommendations, the Nordic experience, analysis of the current arrangement of corporate governance, and expert opinions. The working group finds that the bottlenecks of the current system provide sufficient incentive for weighing the option of introducing changes in the current model for governance of state participations. The ambiguity of state objectives and expectations, inadequate owner supervision and the work of the supervisory boards, as well as simultaneous performance of different functions, fragmentation of liability and inflexibility of state structures do not allow governance of state companies with the necessary effectiveness and efficiency.

As a solution, the working group proposes a plan of action, consisting of four elements. The plan of action includes: (a) verbalisation of the principles for participation in state companies – i.e. specification of the participation policy; (b) specification of the state expectations with regard to particular companies; (c) improvement of the procedure for designating supervisory board members of companies, and (d) centralisation of the governance of state participations into a single entity, focused on a specific task.

The working group finds that, in order for the solution to be implemented, the state needs to work out participation policies for state companies, and set up a professional entity for governance of participations (ownership entity).

The working group performed a comprehensive analysis of the different forms of operation. A comparison of the alternatives revealed that, based on the established criteria, an ownership entity established in the form of a public limited company would be best suited for effective and efficient performance of the functions. Consequently, for operative governance of the state's majority holdings, the working group proposes to establish a consolidating company (ownership entity) which would take over as many of the state's majority holdings as possible, especially in companies having mainly commercial functions. Certain companies, which mainly serve a public function, would be left under the governance of the ministry in charge of the corresponding area. In such cases, the ownership entity would provide consulting services to the governing ministry when necessary, thus ensuring governance of all companies with state participation on the basis of similar principles and practice.

According to the working group's calculations, the potential benefits of the proposed changes would amount to an annual 75-100 million euros. This result is achievable within a period of three years after initiation of the changes. Benefits would arise, above

all, from strategic certainty, prudent and professional corporate governance, investment optimization, contemporary risk management and focused management by results.

1. PURPOSE OF THE WORK

This objective of this work has been established by the Minister of Economic Affairs and Communications of the Republic of Estonia. The purpose of the work is to analyse and make proposals for reorganisation of the governance of companies with state participation in the Republic of Estonia, with the aim of ensuring efficient, purposeful and professional management of such companies by the shareholder.

The working group has been assigned with the task of analysing and ascertaining whether or not the current organisation of the governance of companies with state participation is adequate, and whether or not it should be changed. Should the work reveal the need to introduce changes, the working group must propose a solution which would differ from or complement the current solution.

The key input for the work consists of the evaluations of the persons currently involved in the governance of companies with state participation in the Republic of Estonia, feedback from companies with state participation, audit findings of the State Audit Office, the OECD code of best practice of corporate governance of state-owned enterprises, interviews with the key corporate governance experts in Nordic countries, as well as previous analyses and reports prepared by the Ministry of Economic Affairs and Communications.

Should the work reveal the need to introduce changes in the current organisation, the proposals must include a comparison of the alternatives, division of responsibilities and competence, the resources required, as well as a description of the new organisation. The proposals must present a carefully planned, future-looking solution, which is not limited to current affairs, and which complies, to the extent possible, with the most progressive practice for governance of state companies.

Where the proposals require amendment of legal acts, a general mention must be made of the changes, whilst bearing in mind that the purpose of the work is not to discuss such changes in detail.

The purpose of the work is not to analyse and evaluate the operational management of individual companies. Neither will the work give an evaluation on whether or not it is reasonable for a state to participate in entrepreneurship. The starting point of this work is the fact that the Republic of Estonia holds a stake in nearly 40 different companies, and that the governance and management of these companies by the shareholder must be organised in an efficient and professional manner.

In public debate, the topic of governance and management of state companies has often been associated with the potential listing of shares on the stock exchange. Nevertheless, this work will focus solely on the role of the state as a shareholder and governor of state property, and will not provide an analysis of the options for or impact of listing shares.

The proposals made as a result of the work should be applicable to as wide a range of companies with state participation as possible. Nonetheless, the restrictions established by EU legal acts (e.g. EU directives that prohibit control and governance of a power-producing or power-selling company and a transmission network operator by the same person) shall apply.

2. BACKGROUND INFORMATION

2.1. Working group

The working group has three members:

- **Erkki Raasuke** – adviser with the Ministry of Economic Affairs and Communications. Nearly 20 years of experience in commercial banking in the Baltic States and Scandinavia. Has been accountable to the supervisory board of an international publicly traded company as chairman of the management board and financial director for over 15 years. Has participated, as a member or chairman, in the work of the supervisory boards of numerous companies. Directly involved in issues related to Estonian state companies for the past 18 months.
- **Regina Raukas** – chief specialist with the Economic Analysis Division of the Ministry of Economic Affairs and Communications. 13 years of accounting and budgeting experience, gained as chief accountant in insurance and construction companies; responsible for preparation and co-ordination of the budgets of all penitentiary institutions in the Republic of Estonia. Has participated in the work of the supervisory board of a state-owned company and a state foundation.
- **Antti Perli** – legal adviser with AS SmartCap (state venture capital fund management company). Over 10 years of service as an attorney with law office Raidla, Lejins & Norcous, advising companies with state participation and other customers in large-scale acquisitions, restructuring and financing transactions, listing of shares on the stock exchange, and issues related to daily management of companies. Has previously participated in the analysis of matters concerning governance of state-owned companies.

In preparing proposals for enhancing the efficiency of the governance of companies with state participation, members of the working group have examined the best practice of various countries. All members of the working group have met with Kari Järvinen, CEO, and Tapani Varjas, legal adviser of Solidium OY, ownership entity of Finnish companies with state participation. In addition, members of the working group have met with Pekka Timonen, CEO of the ownership entity established with the Prime Minister's Office of the Republic of Finland. Furthermore, the working group has also examined the work in the ownership entity established under the Ministry of Trade and Industry of the Kingdom of Norway to obtain an overview of the organisation of management and supervision by the state as a shareholder. To understand the corporate perspective, members of the working group also met with *Flytoget* (management of express trains between Oslo airport and city centre) and *Avinor* (management of 45 airfields all over Norway).

Two members of the working group have also participated in supervisory board member training conducted by the *Baltic Institute of Corporate Governance (BICG)*.

2.2. Companies with state participation in the Republic of Estonia

As at 23 April 2013, the Republic of Estonia held a stake in 38 companies. The state was a 100% owner of 26 companies, and held a stake of less than 50% in 5 companies. In other companies, the state participation fell between 51% and 90%.

The management of companies with state participation has been divided between seven governing ministries. One company is governed by the State Forest Management Centre.

The largest number of companies lies within the governing area of the Ministry of Economic Affairs and Communications. The Ministry of Finance governs 11 companies and the Ministry of the Environment 4 companies, with the Ministry of Justice, Ministry of Social Affairs, Ministry of the Interior and the Ministry of Agriculture each governing one company.

In 2012, the consolidated equity of companies with state participation amounted to approximately 2.7 billion euros, EBITDA to 496 million euros and net profit to 167.3 million euros. Companies with state participation employed a total of nearly 17,300 people in 2012.

2.3. Legal background

State participation in companies is regulated by the State Assets Act, which stipulates the rules of procedure for governance of state assets. To all intents and purposes, the State Assets Act provides the “internal rules of procedure”, regulating the division of state competence, the procedure for passing decisions and other procedural matters in the governance of state participations as a form of state property.

The State Assets Act focuses, above all, on the internal relationship between the state and its representatives in participation in companies as a shareholder. Albeit the State Assets Act establishes specific requirements, which need to be implemented in companies with state participation (above all, through the introduction of the corresponding provisions in the articles of association), the main objective of the State Assets Act is not to establish specific rules for the general operation and management of companies with state participation. Rather, such companies are governed by rules applicable to all enterprises: the Commercial Code, the Law of Obligations Act and other provisions of private law, as well as Estonian and EU legal acts on competition and state aid, legal acts regulating specific business areas and other provisions of public law applicable to all enterprises.

The management structure and main rules (competence of management bodies, foundation procedure, procedure for passing decisions, liability of management bodies) of companies with state participation can thus be derived from the general rules of company law – above all, the Commercial Code. The State Assets Act merely specifies the division of functions and the rules of procedure for participation in the management structures of companies. This approach is in line with the need to secure equal treatment of companies with state participation and other companies.

Pursuant to the State Assets Act, in line with the OECD recommendations, the state participates in the management of companies, above all, via exercising the shareholder's rights, and is not allowed to intervene in the management of companies on any other level, thus respecting the autonomy of supervisory boards and granting the supervisory boards and management boards full autonomy in daily business activities pursued for the achievement of the goals established.

The governor of state participation, who holds the shareholder's rights and obligations provided by law, thus plays a key role in the management of a company. A governor of state participation is the ministry or profit-making state agency designated by the Government of the Republic or, in case of a minority holding, by the Ministry of Finance.

By exercising shareholder's rights, the **governor of participation** must mainly serve the following functions:

- (a) specify, for each company governed by the state, the reason for the state's participation in the given company on the basis of the objectives stipulated in the State Assets Act – above all, seeking a profit or pursuing a public objective (section 10 of the State Assets Act);
- (b) specify the strategic objective of the company in accordance with national development plans and other documents, and check and evaluate their achievement (section 9 of the State Assets Act);
- (c) evaluate the purpose and feasibility of the governance of participations, and make proposals for transfer of participations that are not needed by the state (subsection 8 (3) of the State Assets Act);
- (d) appoint a half of the supervisory board members whom the state has the right to appoint, with the Minister of Finance appointing the rest of the members;
- (e) adopt decisions and vote in issues that lie within the competence of a shareholder pursuant to the Commercial Code and the State Assets Act;
- (f) ensure the exercising of the shareholder's rights (above all, by introducing the corresponding provisions in the articles of association), so as to implement the special requirements stipulated in the State Assets Act in the companies governed by the state;
- (g) submit to the Ministry of Finance an annual report on the objectives of state participation and the governance of participations.

The governor of participation needs the authorisation of the **Government of the Republic** for deciding or voting on certain issues that lie within the competence of shareholders:

- (a) merger, division, transformation or dissolution of a company, except for merger with a company incorporated in the same consolidation group;
- (b) increase or decrease in the share capital of a company or issue of convertible bonds;
- (c) acquisition of new shares through the increase of capital, waiver from pre-emptive subscription or acquisition right or exercising of the pre-emptive right in a smaller volume than actually allowed;
- (d) amendment of the articles of association, if this involves a change in the rights related to the participation;
- (e) entry into, amendment of or termination of contracts between the shareholders of a company;
- (f) establishment of or acquisition of a stake in a company with state participation (section 76 of the State Assets Act).

The **Ministry of Finance** is the central co-ordinating entity for the management of companies with state participation. Every year, the Ministry of Finance submits to the Government of the Republic a consolidated report on the governance of state participations, together with the proposals for pursuing the state's interests in the companies, where necessary, and an opinion of the feasibility of transfer of state participations in accordance with the objectives of state participation (subsection 99 (2) of the State Assets Act).

2.4. Previous work and research

Among other things, the working group has used the following work and analyses as source material for conducting the analysis and making proposals:

- (a) OECD publications, including “OECD Guidelines on Corporate Governance of State Owned Companies” (2005), “Balancing Commercial and Non-Commercial Priorities of State-Owned Enterprises” (2013), “Board of Directors of State Owned Enterprises: An Overview of National Practices (2012)”;
- (b) State Audit Office report No. OSIV-2-1.4/07/4, 5 April 2007 “Owner supervision in public undertakings and foundations”;
- (c) Erkki Raasuke, Ott Pärna and Antti Perli. Discussion paper “Management and development of companies of the Republic of Estonia“ (January 2012);
- (d) Baltic Institute of Corporate Governance. Report “Governance of State-Owned Enterprises in the Baltic States” (May 2012);
- (e) Erkki Raasuke, Ruslan Mahhov. Analysis “Development dynamics of state-owned

companies 2005-2016” (July 2012);

- (f) Report prepared by the Swedish expert group led by Hans Dalborg: “*Ekonomisk värde och samhällsnytta – förslag till en ny statlig ägarförvaltning*” (*Proposal for a new state ownership and administration*) (2012). The report is intended for official use only, and has been made available to members of the working group;
- (g) State Audit Office audit “Organisation of the management of companies with state participation” (draft; 2013).

In 2005, OECD prepared the guidelines “OECD Guidelines on Corporate Governance of State-Owned Enterprises”¹. These guidelines are based on the practice of several countries, and contain recommendations for the management of companies with state participation. The guidelines emphasise that the state needs to act as an informed and active shareholder, establishing a clear and sustainable participation policy with the aim of insuring transparent, responsible, professional and efficient management of companies with state participation.

Similarly, the OECD guidelines advise states to exercise shareholder’s functions through a central ownership entity or efficiently co-ordinated entities which should act independently and adhere to the participation policy established by the state. The terms “co-ordinating entity” and “ownership entity” are used in the guidelines for referring to units governing companies with state participation. The corresponding entities are accountable to the parliament and/or the government, and have clearly defined relations with other public institutions (ministries, audit and supervisory bodies).

In its report of 5 April 2007 (“Owner supervision in public undertakings and foundations”)², the State Audit Office has admitted that the state has no policy for participation in companies and thus lacks a clear understanding of the reasons why the state participates in companies or foundations or a vision of what the state, as an owner or founder, is aspiring to and how the participation in companies or foundations relates to public interest and the state's strategic objectives. The State Audit Office fears that this may lead to companies not being governed, in their activities, by the interests of the state as a shareholder. Similarly, the report of the State Audit Officer draws attention to the fact that the activities of ministries in the government of companies are non-transparent, with deficiencies evident in the work of the supervisory boards of companies.

At the beginning of 2012, a discussion paper “Management and development of companies owned by the Republic of Estonia” was prepared, on the order of the Secretary General of the Ministry of Economic Affairs and Communications, by a working group led by Erkki Raasuke. The discussion paper proposed to establish a

¹ OECD (2005). “OECD Guidelines on Corporate Governance of State Owned Companies.” (<http://www.oecd.org/daf/corporateaffairs/soe/guidelines>).

² State Audit Office report No. OSIV-2-1.4/07/4, 5 April 2007 “Owner supervision in public undertakings and foundations”.

central entity which would focus on the management and supervision of companies with state participation and would serve as a consolidating company on the basis of the group model.

A trend analysis was prepared in 2012 by Erkki Raasuke and Ruslan Mahhov, analysing the development dynamics of companies with state participation in the governing area of the Ministry of Economic Affairs and Communications in the period 2005-2010 and the growth plans up to 2016, and making proposals for enhancing the efficiency of the state's role as a shareholder.

A Swedish expert group led by Hans Dalborg prepared a report on enhancement of the efficiency of owner supervision for the Swedish parliament (*Riksdag*) in 2012 ("*Ekonomisk värde och samhällsnytta – förslag till en ny statlig ägarförvaltning*"). The task of the Swedish expert group was to map and evaluate alternative means for organising the management of companies with state participation, and to study the experience and best practice of other shareholders in the area. The expert group was assigned with the task of weighing whether the model for and organisation of the management of companies with state participation should be changed and reorganised into a new or existing executive agency or company.

In its report, the Swedish expert group made proposals for the organisation of the management of companies through the Government Office in order to ensure efficient and professional management by the shareholder, as well as increase the transparency of state participations to the parliament and the general public. The report also analysed the proposed model for organisation of, distribution of competences and responsibilities of, management and financing of companies, and presented an activity plan for the implementation of the proposals.

Among other things, the expert group deemed it necessary to separate the role of the state as a shareholder from its other duties, leaving the issues related to operative management of companies outside government competence, and finding the means for separating political management from business management and ensuring the compliance of political objectives with business logic.

In its report, the expert group proposed to hand the government of state participations over to an independent ownership entity outside government structures. The expert group deemed it practical to establish the ownership entity in the form of a public limited company, as this provides the best foundation for efficient and professional performance of the role of the shareholder.

Scheduled to be completed in August 2013, the audit of the State Audit Office "Organisation of the management of companies with state participation" focuses on the analysis of the efficiency of owner supervision and its progress, compared to the "Owner supervision in public undertakings and foundations" audit published in 2007. Within the framework of initial conclusions submitted to the working group, the State Audit Office notes that the state currently has no participation policy and no clear vision of why and

when the state should participate in entrepreneurship. In addition, the State Audit Office points out in the draft report that no objectives have been established for the activities of companies; the tasks of supervisory board members are not clearly defined or coordinated with the governor of participation; the involvement of relevant officials is arbitrary and depends on the discretion of supervisory board members; ministries lack resources to take initiative and effectively monitor the activities of companies.

2.5. The Nordic experience

In the Kingdom of Sweden and the Republic of Finland, companies with state participation are governed based on the so-called dual model. This means that the key input with regard to the tasks and objectives of companies is provided by the ministry governing the participation, with the entire portfolio coordinated by a separate ownership entity.

In the Republic of Finland, management of companies has been divided between an entity established with the Prime Minister's Office and the state-owned company Solidium OY.

The task of the entity established with the Prime Minister's Office is to coordinate the management of nearly 30 companies in which the Finnish state has a majority holding. The corresponding entity is responsible for the preparation and implementation of the state's participation policy in the particular companies.

Solidium OY was established with the aim of allowing the state to adopt smaller-scale investment decisions without parliamentary approval in companies where the state has a minority holding. The biggest investments require the consent of the minister responsible, as well as the approval of the Cabinet. Solidium actively uses its available funds with the aim of ensuring the state's (minority) holding in companies listed on the Helsinki Stock Exchange. As at the end of 2012, Solidium had a minority holding in 14 companies listed on the stock exchange, with a total value of 7.6 billion euros. In portfolio management, Solidium is governed by the guidelines presented in the state participation policy.

In Sweden, state participation in companies has been coordinated by the Ministry of Finance since 2010. The governance of state participations in companies has been divided between different ministries, which had a total of 60 companies in their governing areas as at 2012, with a total participation value of approximately 620 billion euros.

In Norway, a majority of companies with state participation lie within the governing area of the Ministry of Trade and Industry, which accommodates a central coordinating entity assigned with the task of managing the companies with state participation. Governance of state participations in companies has been divided between ten different ministries, which had a total of 52 companies in their governing areas as at 2012, with a total participation value of nearly 600 billion Norwegian kroner.

In addition to the dual model, the Kingdom of Norway uses state pension funds for portfolio-based management of companies. These funds manage 85% of state participations in companies. The key institutions involved in investment of state assets in companies are the *Government Pension Fund Global (SPU)* and the *Government Pension Fund Norway (SPN)*. Direct management of state-owned companies has been organised through different ministries.

According to the OECD, the management models implemented in the Nordic countries are the most advanced and sophisticated of the lot. Nonetheless, progress has not ceased – all countries are actively involved in further development of the area in pursuit of efficiency. Private-sector shareholders always have advantages over the state – the state needs to make efforts for closing the gap.

3. OVERVIEW OF THE PROBLEMS AND BOTTLENECKS

3.1. Introduction

The working group has evaluated the management and supervision of companies with state participation by the shareholder in accordance with the requirements stipulated in the State Assets Act and the best practices of other countries (OECD). The conclusions mainly rely on the observations of the members of the working group and officials of the Ministry of Economic Affairs and Communications, as well as the initial positions expressed by the State Audit Office within the framework of the ongoing audit.

In general, several deficiencies are evident in the performance of the functions of the state as a shareholder, hindering the exploitation of the full potential of the companies with state participation by the shareholder or the society at large. The following shortcomings are evident:

- (a) the shareholder's objectives and expectations have not been sufficiently defined;
- (b) "owner supervision" is insufficient; supervisory boards of companies only serve their roles partially;
- (c) the state, as a shareholder, serves several roles simultaneously;
- (d) the state is slower and less flexible than a professional private-sector shareholder;
- (e) responsibility for the performance of the duties of the state as a shareholder is fragmented.

3.2. The shareholder's objectives and expectations have not been sufficiently defined

Pursuant to both the State Assets Act and the best practices of other countries, the state should specify the reason for participation in any company³. Similarly, the state should regularly evaluate whether or not and give explanation of why a particular participation continues to be necessary for the state⁴.

The state must specify the strategic objectives of a company⁵. The legal acts also oblige the state to analyse the achievement of the activity goals and financial objectives of a company⁶. In turn, this means that the state must previously define its expectations with regard to the corresponding objectives, at least on a very general level. The

³ Section 10 of the State Assets Act.

⁴ Subsection 8 (3) and subsection 98 (2) of the State Assets Act.

⁵ Section 9 of the State Assets Act.

⁶ Regulation No. 46 of the Government of the Republic, 8 April 2010, "Requirements for the contents of, procedure for submission of and forms of state participation governance and members' rights execution reports", sections 4 and 5.

determination and establishment of such objectives and expectations is common practice for professional shareholders in the private sector.

The working group believes that the state (governors of participations) has failed to define the above objectives and expectations in an adequate manner, in substance and detail, and to specify the reason for the state's participation in companies. Nonetheless, this does not mean that the role of state companies is unknown or that the general public does not recognise their purpose. For example, in case of companies with a significant public purpose (Elektriraudtee AS; AS Saarte Liinid; AS Tallinna Lennujaam), expectations with regard to the state as a shareholder and the companies themselves are quite obvious. Albeit the expectations have not been documented and made available to the public, we cannot claim that there are no expectations of the companies. In case of predominantly profit-seeking companies, however, there is greater uncertainty and lack of information.

As the objectives and expectations are non-existent or have been inadequately defined, we cannot measure or direct the efforts towards their achievement. Consequently, the companies lack long-term strategies or the established strategy has no apparent correlation with the development plans and the policies established in the area. Pursuits relying on business considerations, management ambitions and political trends alone might not correspond to the long-term expectations and needs of the state as a shareholder.

The establishment of business strategies is complicated for supervisory boards of companies – in addition to the problems described in the next clause, supervisory boards have inadequate information on the expectations and objectives of the state as a shareholder.

The negative consequences of the state's inactivity could include strategic management errors, lack of trust between the company and its shareholders and inefficient use of resources, e.g. investments that are unjustifiable or infeasible from the state's point of view.

3.3. Owner supervision is insufficient; supervisory boards of companies only serve their roles partially

The defining of objectives and expectations alone is not sufficient for prudent and appropriate management of state participations in companies – the state also needs to ensure efficient supervision over achieving the objectives and meeting the expectations. On the operational level, the task of performance of supervision lies with the supervisory boards of companies.

The work of supervisory boards has been discussed only briefly in previous analyses. At the same time, the experience of some of the members of the working group gained within a period of more than 18 months indicates that significant problems exist in this

area specifically. Albeit the problems described below are not widespread or massive, they appear to be recurrent and have a significant negative impact.

- (a) **Bases for appointment of supervisory board members are ambiguous, with no explanation provided** It is unclear for the general public as well as the company's staff members, cooperation partners and other interested parties, why a particular person has been appointed to the supervisory board. Where a person is not a recognised expert in the particular area, questions may arise as to whether the choice was made on the basis of the person's skills and knowledge, or whether other considerations were involved.

Where the appointment of supervisory board members is non-transparent and without basis, the supervisory board will not be recognised as a professional and skill-based management body outside the company. Where the supervisory board appoints a management board for the company, the same will apply to the management. Any doubts with regard to the professionalism of the supervisory board and management board are bound to have a negative impact on the company's economic activities, and undermine its competitive ability. The work culture of the company will suffer significantly, along with the ability to recruit top-level employees.

- (b) **The tasks of supervisory boards are unclear** The efficiency of the supervisory board in obtaining the objectives and meeting the expectations of the shareholder is very difficult to measure, if the objectives and expectations have not been defined, or have been defined in a vague and contradictory manner. In such an environment, the supervisory board fails to focus its attention and energy on the achievement of common goals, facilitating pursuit of different, often incompatible directions. Any contact and exchange of information between supervisory board members and the governing ministry is random and inadequate.
- (c) **Supervisory boards represent conflicting interests or interests which restrict economic activity** Conflicts of interests, corruption or any suspicion thereof, are the worst that can happen in top management of a company. This is bound to lead to non-economic decision-making, overselling, leakage of business secrets and advantages of informed suppliers/buyers. Counterparties who follow good business practice are scared away, with the company's economic results thus suffering. Such circumstances may have a significant negative impact on the company's organisational culture, resulting in the loss of ability to recruit new top-level employees.

A problem to be noted is the fact that the minutes of the meetings of supervisory boards are laconic, complicating ex post facto identification of the information and bases for making the corresponding decision. Among other things, such non-transparency may add to suspicions of conflicts of interests and corruption.

- (d) **“Competing” parties are represented in supervisory boards** The regulation of

the State Assets Act and the inter-party division of minister seats in the Government of the Republic has created a situation where in a majority of companies, a half of the supervisory board members are appointed by a minister of a particular party, and the other half by a minister of a different party. In some cases, this may lead to a supervisory board that is unable to cooperate. Such a supervisory board may adopt non-economic and inconsistent decisions, with any liability dispersed. Negative examples include large-scale investment decisions in AS Tallinna Sadam, AS EVR Cargo and Eesti Energia AS – cases where the supervisory board was far from consensus, sensitive information leaked out and the reputation of the shareholder, supervisory board and management board was damaged.

- (e) **Supervisory board members fail to invest sufficient time and resources in the performance of their functions** Strategic management and supervision functions require in-depth knowledge in the particular field, critical frame of mind, attention to details and advanced skills of analysis. To produce a high-quality result, members of supervisory boards of companies pursuing complicated fields of activity must make a considerable effort and dedicate significant amount of time on processing the materials and acquiring additional knowledge. This will be added to the time spent on the meetings of the supervisory board and participation in various committees.

Where the state requires high-quality contribution by supervisory board members, the state must be ready to compensate for the efforts accordingly. The remuneration principles stipulated for supervisory board members in currently valid legal acts do not provide supervisory board members with sufficient motivation for appropriate performance of their tasks. Underpaid supervisory board members will not sufficiently prioritise their service in the supervisory board. Superficial work by supervisory board members will pose significant risks to the state as a shareholder.

3.4. As a shareholder, the state serves several roles simultaneously

The OECD recommendations for governance and management of state-owned enterprises require a clear separation of the state's functions as a shareholder from any other function which may affect the activity of companies with state participation, especially the market regulation function.

For example, the Ministry of Economic Affairs and Communications is, on the one hand, governor of a large number of companies with state participation and, on the other hand, the developer and regulator of the policies concerning the activities of such companies. The Ministry of Finance serves, on the one hand, as governor of the participation in Riigi Kinnisvara AS, and, on the other, the coordinator and implementer of the state budget policy planning, whilst the daily activities of Riigi Kinnisvara AS affect the budget balance. Both of the above examples indicate an overlapping of the state's functions in the governance of companies. This does not comply with the good management practice.

We can presume that the above situation is mainly conditioned by practical considerations. We also have to admit that, despite the OECD recommendations, many states have brought the regulation of the area and the governance of companies operating in the area under a single ministry. We can thus conclude that, in such situations, cooperation and information is deemed to be of higher value than the risk of triggering a conflict of interests. The analysis performed by the working group revealed no single event of significance, where the overlapping of the role of the regulator and the role of the governor of participation within a ministry would have had a direct negative impact on the activities of the corresponding company/companies. At the same time, the working group admits that continuation of the current government model will sustain the exposure to risk.

In Estonia, the conflicting roles of the state as a shareholder are evident in the case of intervention in the economic activities of a company due to short-term political considerations, affecting the activities in a way which does not comply with the company's strategy or activity plans. A good example is that of Eesti Energia AS, where the state has taken dividends from a company for budget balance considerations (increasing budget revenue) and increased the share capital (not a state budgetary expense item) in the same financial year. Such practice can hardly be considered economically justifiable. On the negative side, we have also seen cases where the governing minister affects the price policy of a company through public communication. Political expectations with regard to state-owned companies are quite relevant and justified, but only if implemented in accordance with the legal acts and good management practice, and if defined and implemented via development plans and resolutions of management bodies in a way which is understandable to all parties involved.

3.5. The state is slower and less flexible than a professional private-sector shareholder

The state's internal processes and work models in the performance of the shareholder's functions differ largely from the procedures and models applied in the private sector. The state's activities in the performance of the shareholder's duties are subject to extensive rules and restrictions, with less flexibility in the design of work processes. A good example is the planning and payment of owner's income, recapitalisation, acquisitions and take-overs, and management of confidential business information. Similarly, due to public sector remuneration principles and the corresponding restrictions, it may prove difficult for the state to recruit the necessary professional competence, competing with the private sector in the process.

In the conditions of active competition, these differences provide private sector companies with certain competitive advantages over companies with state participation. The state always needs to make an effort to close the gap.

The fact that the state's activities as a shareholder have been organised in a manner which differs from the private sector, also means that the state as a shareholder is

unable to serve as a professionally equal counterparty/partner to the management boards of companies. There is no “balance” between the supervisor and the supervisee, when it comes to organisation, basis and level of responsibility, professionalism and motivation.

3.6. Responsibility for the performance of the duties of the state as a shareholder is fragmented

Pursuant to the State Assets Act, duties and responsibility are divided, in the management of companies by the shareholder, (a) between different ministries as governors of participations, (b) between the Ministry of Finance as a coordinating entity and (c) the Government of the Republic as the competent authorities for passing the most important decisions.

The competences and responsibilities related to the governance of participations in companies have not been adequately defined within ministries. The statutes of the Ministry of Economic Affairs and Communications stipulate that responsibility for the monitoring of the development of and for the provision of analytical support to state companies governed by ministries lies with the Economic Development Department. At the same time, it is unclear whether the particular department has been assigned with the task of protecting the state’s interest in all companies in the governing area (the terms “monitoring” and “provision of analytical support” do not indicate such general competence).

Similarly, the responsibility of the Ministry of Finance as the coordinating entity is unclear. For example: even though the ministries as governors of participations have failed to define the motives for and objectives of state participation in companies in sufficient detail, the Ministry of Finance, in turn, has failed to demand this of them, even though the ministry considers itself responsible for the development of the policy of participation in companies.

The fact that the state organisation lacks a clearly structured and focused single entity with clearly defined liability for the governance of participations will eventually lead to inefficient supervision and the following negative results:

- (a) lack of portfolio view on companies with state participation; danger of failure to notice potential synergies or seize economic and financial opportunities;
- (b) shareholder management practice and procedures may be different in different ministries, and be applied in different manners (including with different intensity and consistency);
- (c) experience gained in shareholder management might not accumulate and not be conveyed.

4. THE PATH TOWARDS A SOLUTION

The State Assets Act stipulates that governors of state assets are obliged to govern state assets in a purposeful, expedient, sustainable and prudent manner. The Republic of Estonia holds participations in companies in public interest as well as for seeking a profit.

Further to the analysis and assessments provided in the previous article, we can claim that the current bottlenecks provide sufficient incentive for weighing the option of introducing changes in the current model for governance of state participations. The proposed solution for governance of participations should help solve the following issues:

- (a) separate business management from political management more clearly; leave the operational management to the company level and raise the long-term strategy establishment more clearly to the political level;
- (b) separate the state's regulatory and supervisory activities from business management; ensure that the regulatory objectives are achieved via the establishment of regulations and the activities of state supervisory authorities;
- (c) ensure that the supervisory boards of companies are set up of professionals, with membership determined based on the candidates' abilities, knowledge and experience; the principles for setting up supervisory boards, and the corresponding appointment of supervisory board members must be transparent and well-explained to the public;
- (d) ensure consistency, coherency and long-term stability of the shareholder management of companies, avoiding any rash changes of direction and one-off decisions which do not correspond to the general and/or long-term strategy;
- (e) ensure a continual and consistent shareholder control over companies in order to support the achievement of the established goals and avoid deviations and crises in the early stage;
- (f) implement the best practices for contemporary corporate management developed by the Nordic countries and the OECD;
- (g) implement the active shareholder management methods developed in the private sector, contributing to the enhancement of the output and value of companies.

The working group finds that, in order to develop and enhance the efficiency of the governance of state companies, a complex solution must be implemented, incorporating four elements:

- (a) **Verbalisation of the principles for participating in state companies – i.e. specification of the participation policy** Principles serve the purpose of ensuring efficient shareholder management of companies, allowing the state to operate as a cognisant and responsible shareholder. Principles establish a framework which allows deciding why the state should hold participations in companies in the first place, laying down the general expectations with regard to the companies and organising the governance of participations and management of the companies.
- (b) **Defining of the state’s expectations with regard to particular companies** Strategic and financial objectives will be established for companies where the state has a majority holding in accordance with the participation policy and the peculiarities of the particular company. The objectives will provide the basis for the establishment of a competent supervisory board, which will, in turn, appoint the management board members. The same objectives and expectations will form the basis for the evaluation of the activities of the supervisory board and the management board.
- (c) **Improvement of the procedure for designating supervisory boards of companies** The working group proposes to change the current procedure for designating supervisory boards, and improve the procedure based on the contemporary practice of developed nations. The proposed changes focus on the obligation to specify the qualification expected of each member of the supervisory board prior to his/her selection, to make sure that the selection is professional and fact-based, and to ensure transparency of the entire procedure and the underlying principles.
- (d) **Centralisation of the governance of state participations into a single entity focused on a specific task** The state’s corporate portfolio is quite extensive and the related topics complicated enough to merit the establishment of a separate entity. A focused entity forms a part of good corporate governance practice in a contemporary state – the establishment of such an entity has been recommended by the OECD and implemented in Nordic countries, which serve as a role model for Estonia in many respects.

The above complex solution can be implemented via two initiatives:

- (a) **establishment and approval of the state participation policy;**
- (b) **establishment of a professional entity for governance of participations (hereinafter the ownership entity)**

Participation policy will establish a much more detailed framework to the governance of participations, compared to the State Assets Act. The approval of the participation policy should lie within the competence of the Government of the Republic, with the Riigikogu granting the corresponding authorisation (establishing a provision delegating authority in the State Assets Act). The working group has prepared an initial draft of the policy (see Annex 1). Future work should broadly involve all interested and related parties.

In turn, the ownership entity will implement the activities required for purposeful governance of participations. The establishment of a new entity does not mean the creation of a new management level or a rise in the level of complexity. Quite to the contrary – centralisation of governance into a single professional entity is expected to significantly increase the output of state companies, and release the human resources of different ministries currently engaged in governance.

5. THE EXPECTED ECONOMIC IMPACT OF THE CHANGES

Considering the current bottlenecks in the governance of companies with state participation and their negative impact on one hand, and relying on the best international practice and long-term experience of the private sector on the other hand, the working group estimates the potential benefit of the proposed solution to amount to 15-20% of the total EBITDA of the state's corporate portfolio. The total EBITDA of the state's corporate portfolio amounted to 454 million euros in 2010, 468 million euros in 2011 and 496 million euros in 2012.

The working group believes that competent and consistent implementation of the proposed changes will raise the EBITDA by 75-100 million euros over the next three years. Through dividends and tax revenue, this could be direct additional revenue for the state budget. The estimated result is not a one-off benefit, but will persevere in the upcoming years.

Strategic clarity, establishment of objectives and professional performance management would be the greatest contributor to the improvement of the results. The second crucial positive change would be investment-making on the basis of contemporary risk and feasibility analyses as well as termination of the current practice of over-investment. Broad-based enhancement of management quality through the creation of professional supervisory boards would be the third major contributor. Enhancement of the efficiency of the work performed by supervisory boards will raise the quality of management decisions and minimise the damage caused by conflicts of interests and inability to cooperate.

6. LEGAL FORM OF THE OWNERSHIP ENTITY: THE ALTERNATIVES

6.1. Basis for comparison

This analysis is based on the understanding that governance of participations held by the state is a function of executive power, and that the competence for the organisation of governance lies (and should, indeed, lie) with the Government of the Republic and government agencies. The roles of other constitutional institutions in the governance of participations is (and should, indeed, be) limited and more indirect. For example, the functions of the Riigikogu in this particular issue are limited, above all, to the establishment of a legal framework and legal bases (e.g. the State Assets Act), deciding on the financing of companies from state budgetary resources via adoption of the state budget and approval of the state's strategic documents, which may assign tasks to companies with state participation.

Although the executive power is exercised, above all, by the Government of the Republic and government agencies, the state may allocate the performance of certain functions of executive power to persons governed by private law.

The ownership entity's potential legal forms under public law and private law have been briefly discussed below, based on their basic suitability for serving the functions of an ownership entity. The working group has considered the following key criteria:

- (a) **Suitability of the legal form for attaining the objectives identified in the path towards the solution** The choice of legal form plays an especially important role in ensuring the segregation of the different functions of the state, and a clear division of responsibility. The legal form should allow separating business management of companies from state policy formation as well as the state's regulatory and supervision activity. An ownership entity must serve as a body responsible for business management of companies, whilst being sufficiently independent from politics and regulatory functions. A clear division of responsibilities would improve the performance of all functions (policy formation, regulatory activity, business management), as each entity would be able to focus on its own area of responsibility. At the same time, such a division of responsibility should allow the ownership entity to exercise, in the extent possible, shareholder's rights in the companies. Otherwise, the ownership entity will be left with responsibility without actual competence. The chain of "owner supervision" would be dragged out.
- (b) **Capacity for value growth and business efficiency enhancement** The legal form should facilitate a growth in the value of the companies and efficiency of their economic activities. The legal form of an ownership entity should not trigger further inefficiency or generate needless red tape for the state. The following factors play an important role here:

- The legal form should be generally accepted in international practice as a form of management of companies. It should allow to directly compare the entity's objectives and their achievement with the activities of other entities of similar form, and to overcome concerns (e.g. competence of management bodies, scope of responsibility) on the basis of existing practice, including judicial practice.
 - The legal form should allow to implement the active shareholder management methods applied in the private sector, as these rely on theoretical and methodological bases that have been developed over a long period of time, have been generally accepted and tested in practice, and are aimed at maximising the growth in value.
 - The legal form should be sufficiently attractive for engaging the required competence, at least on equal footing with the state companies themselves, in order to strike a balance between the supervisor and the supervisee. The legal form should not establish any restrictions which would complicate the attainment of the above objective.
- (c) **Capacity to identify and coordinate the state's strategic and political input**
The location of the entity within the state organisation should facilitate the gathering of strategic and political input from various state authorities for purposes of shareholder management, best exploitation of expertise in the public sector, coordination of the input with the required parties and implementation of a stable and consistent shareholder management system. Among other things, this concerns the specification of the reason for and necessity of participating in entrepreneurship as well as verbalisation of the public objectives of the companies.
- (d) **State control over the activities of the entity** The working group has presumed that the state would prefer leaving the competence of making the shareholder's most important management decisions with the Government of the Republic, as stipulated in the valid State Assets Act. The legal form should thus allow to efficiently implement the division of decision-making competences. The legal form should also allow the state to respond quickly to potential failures and crises, and to hold the responsible persons accountable.
- (e) **Financing options, including issues related to additional capitalisation and dividend distribution** The peculiarities related to the financing of the entity's activities need to be taken into account when choosing the legal form. Within the extent that the ownership entity becomes a governor of state participations and the person exercising the shareholder's rights, the options for additional capitalisation and dividend distribution in the state companies must be analysed.

6.2. Legal forms of public entities

By legal form, public entities can be divided as follows:

- (a) government agencies, e.g. ministries, executive agencies, Government Office;
- (b) legal persons governed by public law;
- (c) other legal forms: state authorities and profit-making state agencies.

6.2.1. Government agencies

- Options for separating business management from politics and regulatory activities

If the ownership entity was to be established as a government agency, it would be difficult to separate the business management of companies from policy formation and regulatory activities, and to ensure a clear segregation of responsibilities in the manner described above.

For instance, we could analyse the operation of an ownership entity as a ministerial department. A department is the key structural unit of a ministry, managed by a head of department appointed by the minister. The structure and competence of a department is established by the minister in the statutes of the department (subsections 47 (1) and (3) of the Government of the Republic Act). As a rule, a department has no independent management function.

In issues related to the management of companies, we can assume that no separate decision-making competence will be granted to a ministerial department. A department can only play a preparatory role in the corresponding issues (e.g. appointment of supervisory board members, deciding on issues in the competence of the general shareholders' meeting). We can also assume that the competence of exercising shareholder's rights will be left with the minister. This means that policy formation would not be sufficiently separated from business management and the division of responsibility in the ministry's management chain could remain ambiguous. Subordination relations within the ministry and coordination relations with other departments may complicate the separation of the management of companies from the state's regulatory activities.

The segregation of functions and responsibilities can, presumably, be better ensured in an executive agency in the governing area of a ministry⁷. Namely, an executive agency

⁷ An executive agency is a government agency which operates within the area of government of a ministry, has a directing function, exercises state supervision and applies enforcement powers of the state on the bases and to the extent prescribed by law (section 70 of the Government of the Republic Act). An executive agency is accountable directly to the corresponding minister who directs and coordinates the activities of the executive agency, and conducts supervisory control over the executive agency, approves the field of activity, principal duties, structure and budget of the executive agency (subsections 41 (1) and (7) and section 42 of the Government of the Republic Act). An executive agency cooperates with and coordinates its activities with the departments of the ministry. The director general of an executive agency is appointed to and released from office by the minister on the proposal of the secretary general on the basis of a public competition (clause 49 (1) 5) of the Government of the Republic Act; subsection 18 (4) of

serves a management function and has a certain degree of autonomy and independence in the performance of its duties. While a ministry serves, rather, as the policy designer of the given area in the Estonian administrative arrangement, executive agencies have been assigned with the task of actual implementation of laws and provision of solution to individual cases, including the conduct of state supervision.

At the same time, an executive agency is, traditionally, a suitable legal form for serving functions that include performance of tasks clearly stipulated in legal acts and conduct of state supervision over adherence to requirements stipulated in legal acts. Operative shareholder management of state companies, however, is not an activity for which comprehensive and general requirements and objectives could be established in legal acts.

- *Capacity for cross-sectoral coordination*

Both of the above forms of operation – a ministerial department and an executive agency – are characterised by their positioning within the governing area of a particular ministry, serving as an internal structural unit or extension of a ministry. Therefore, the ability of such legal forms to ascertain the cross-sectoral strategic input required for management of companies by the state and to fulfil the related tasks of coordination could prove inadequate. In turn, this could mean that inadequate input is provided to the management of public-purpose companies by other ministries or public sectors.

Considering the above criteria, there are certain advantages of establishing the ownership entity as a structural unit of the Government Office.

The main duty of the Government Office is to organise the operations of and provide technical support to the Government of the Republic and the Prime Minister and manage the relations with other constitutional institutions as well as coordinate the formulation of the positions of Estonia in EU affairs (subsection 77 (1) of the Government of the Republic Act). The Government Office is directed by the State Secretary who is appointed to and released from office by the Prime Minister (subsection 70 (1) of the Government of the Republic Act).

The Government Office has several coordinating functions according to its statutes, e.g. coordination of the preparation and implementation of the activity programme of the Government of the Republic and the strategic development plans for competitiveness and sustainable development, coordination of the Estonian positions in EU affairs, coordination of national security and national defence. The Government Office has also been assigned with the task of recruitment, selection and development of top civil servants⁸.

the Civil Service Act).

⁸ Among others, the structural units of the Government Office include the Strategy Unit, EU Secretariat, National Security and Defence Coordination Unit as well as Top Civil Service.

The Government Office thus has long-term experience in cross-ministerial and cross-sectoral coordination, which could facilitate identification and coordination of the state input required for corporate management, and thus the implementation of consistent and coherent participation policy.

As a unit serving the Government of the Republic, the Government Office has a direct contact with the Government of the Republic. This would allow to efficiently share corporate-management-related decision-making competence between the structural unit of the Government Office and the Government of the Republic (considering the working group's presumption of the state's preference of leaving the competence of passing the most important decisions with the Government of the Republic).

At the same time, the operation of the ownership entity as a structural unit of the Government Office would not, in the opinion of the working group, allow to ensure sufficient segregation of the state's different functions. Namely, the traditional function of the Government Office is (and will always be) supporting, helping and consulting the Government of the Republic and the Prime Minister in various issues. This means that the Government Office is primarily involved in policy formation and political management of the country. In addition to the above, we need to consider that the Government Office has historically had no major independent decision-making competence. Both of the above circumstances give reason to question the ability (and possibility) of the Government Office to operatively carry out shareholder management of companies separately from the state's strategic-political guidance and regulatory activities.

- Capacity for value growth and business efficiency enhancement

Were the ownership entity to serve as a ministerial department, executive agency or a structural unit of the Government Office, we could assume that the methods of active shareholder management used in the private sector would be inapplicable, considering that the management, supervision and responsibility structure, work processes and their legal framework differ significantly from those of the private sector.

Civil service regulations (including the established salary guides and wage scale) may hinder the ability to engage the necessary competence from the private sector.

It would be inappropriate to compare (benchmarking) the activities of a ministry, executive agency or a structural unit of the Government Office to the activities of private-sector holding companies managing large consolidation groups or the activities of investment fund management companies administrating large-scale corporate portfolios – the underlying principles and the framework of the corresponding rules are too different.

- Financing options

The activities of an ownership entity as a ministerial department, executive board or a structural unit of the Government Office should be financed from state budgetary

resources. The working group can see no other alternative. The use of the above forms of operation would introduce no major changes of principle with regard to additional capitalisation and dividend payment, compared to the current situation.

- *State control over the activities of the entity*

If the ownership entity was to be established as a government agency, the state would be in the position to exercise control and conduct supervision via hierarchical subordination relations and supervisory control. Economic control over government agencies is exercised by the Government Office.

6.2.2. *Legal person governed by public law*

A legal person governed by public law is an independent subject of law, established in public interests on the basis of a law regulating the activities of the particular legal person. The competence and tasks of a legal person governed by public law are stipulated in the act which serves as the basis for the establishment, as well as the statutes. As a rule, the subjects are established with the aim of decentralising the state authority, i.e. delegating the final decision-making power to independent subjects of law and bringing the decision-making closer to all those affected by the decision. A legal person governed by public law does not form a part of the state's hierarchical administrative arrangement, and operates independently, within the limits of its competence.

Legal persons governed by public law are usually established for the purpose of ensuring the autonomy required for exercising a fundamental right granted by the constitution. Thus, legal persons governed by public law include local governments, the Estonian Bar Association, the Chamber of Notaries, the Estonian Health Insurance Fund and the Estonian Unemployment Insurance Fund.

Shareholder management of state-owned companies forms a part of governance of state assets. The performance of this task is not related to the protection of any fundamental right which should be done autonomously, rather than under the state's subordination. The working group thus finds that, despite potential advantages of the establishment of a legal person governed by public law (sufficient segregation of functions, good foundation for cross-sectoral coordination, sufficient flexibility for implementation of private-sector management models and engaging the required competence on equal footing with the private sector), the particular legal form is unsuitable for serving the functions of an ownership entity.

Furthermore, the use of the particular form would require preparation of a new, comprehensive law.

6.2.3. *Other legal forms*

The legal forms governed by public law in the Estonian legal order also include the profit-making state agency⁹. The only establishment which currently serves as a profit-making state agency is the State Forest Management Centre. Considering that the particular form of operation is unusual and seldom used, the working group has not analysed this form in detail.

The Government of the Republic Act has also listed state agencies governed by government agencies as a form of operation. Pursuant to the Government of the Republic Act, government agencies may administer state agencies which are financed from the state budget and whose principal function is not to exercise executive power. These state agencies provide services to government agencies or perform other state functions in cultural, educational, social or other areas (section 43 of the Government of the Republic Act). Traditionally, such agencies include museums, libraries, etc. In light of the established criteria, the working group can see no advantages of the particular form of operation compared to other government agencies. Thus, the particular legal form has not been analysed by the working group in detail.

6.3. Legal forms governed by private law

6.3.1. Legal persons governed by private law

For the purposes of this document, the operation of an ownership entity in private law means a model pursuant to which the state organises shareholder management of the corporate portfolio (or a part thereof) via a 100%-state-owned legal person governed by private law.

Under the Estonian law, legal persons governed by private law include general partnership, limited partnership, private limited company, public limited company, commercial association, foundation and a non-profit association. A private limited company and public limited company are the most predominant legal forms used in the private sector for performing functions similar to those of the ownership entity – these two types of companies are also the most preferred forms of any business activity in general. Parent companies/holding companies that manage large consolidation groups, or companies that manage corporate portfolios through other means, are often established in the above forms. Thus, these forms can be considered generally recognised forms of shareholder management of companies.

The working group finds that other legal forms described above are not widely used for the performance of similar functions. Thus, a comprehensive analysis of these forms would only be justified, if major deficiencies were to be discovered in adherence to the criteria by private limited company or public limited company. As the working group has discovered no such deficiencies, no in-depth analysis has been conducted on the other forms of operation.

⁹ Pursuant to a previous version of the State Assets Act (currently invalid), a profit-making state agency is a state agency which may render fee-charging services and receive income therefrom within the limits provided by its statutes.

6.3.2. Public limited company and private limited company

Above all, public limited companies and private limited companies are characterised by limited liability – the shareholder is not personally liable for the obligations of the company. These companies have a three-level management, divided between shareholders, the supervisory board and the management board¹⁰. A private limited company is a closed company suitable, above all, for companies with a small number of shareholders, where the circle of owners is not subject to frequent changes. Shareholders may personally participate in the management of a private limited company in a much larger scale than shareholders of a public limited company. For simplification, only the public limited company has been discussed below; however, a majority of the analysis is also true for private limited companies.

Considering the established criteria, the working group finds that a public limited company is best suited for effective and efficient performance of the functions of an ownership entity.

- Options for separating business management from politics and regulatory activities

In shareholder management of state companies, an ownership entity must be governed, above all, by rational business thinking and feasibility. An ownership entity operating in this form “translates” the strategic objectives established by the state into specific owner’s expectations in accordance with business logic.

An ownership entity operating in the form of a public limited company is an independent subject of law, which does not form a part of the state’s hierarchical administrative arrangement and which has independent management bodies. Thus, the state’s options in the management of the ownership entity are largely limited to business measures – above all, exercising of the shareholder’s rights at the general meeting. For instance, in order to implement the strategic objectives established for the companies, the state must present the objectives as shareholder’s expectations at the general meeting of the ownership entity. The ownership entity will then deliver the input received to the particular companies by way of specified expectations. In turn, this means that the state must thoroughly deliberate and work out the corresponding objectives and the expectations to be submitted to the companies, as there will usually only be a limited number of general meetings every year.

¹⁰ The general shareholder’s meeting is the highest management body, competent to pass the most important decisions (e.g. amendment of the articles of association, increase or decrease of share capital, profit allocation). The supervisory board is responsible for the (long-term) planning of the activities of and general organisation of the management of a company, including the conduct of supervision over the activities of the management board. The management board is assigned with the task of representation and daily management of a company. Any transactions which fall beyond everyday economic activities may only be concluded by the management board upon previous consent of the supervisory board. A private limited company may be established without a supervisory board, by transferring the functions of the supervisory board partially to the shareholders.

The above factors should ensure sufficient independence of the business management of state companies from policy formation as well as the state's regulatory activities, using the ownership entity as a "filter".

- Capacity for value growth and business efficiency enhancement

Operating in the form of a public limited company, an ownership entity would have a good foundation for value growth and business efficient enhancement, because:

- (a) the particular legal form allows to directly implement the private-sector management methods designed for enhancing value and efficiency;
- (b) as a rule, the ownership entity has access to as quick and as flexible measures for organising the business management of companies under its management as the managed companies themselves;
- (c) the activity objectives of an ownership entity and their achievement can be directly compared (benchmarking) to the activities of companies operating in the private sector;
- (d) an ownership entity which operates as a public limited company has good foundations for engaging professional competence at least on equal footing with the "supervised" state companies themselves; the potential restrictions on the development of motivation systems, arising from civil service regulations, do not apply to the ownership entity;
- (e) the operation of an ownership entity in the same form as the companies under its management is expected to facilitate communication and cooperation between the entity and the companies under its management; similar basis of operation are expected to improve "mutual understanding";

The following models for governance of participations could be considered in an ownership entity which operates as a public limited company:

- (a) state participations in companies are handed over to the ownership entity, which manages these participations similarly to a parent company managing its consolidation group (the group model);
- (b) state participations in companies are left with the state, and the ownership entity advises the management of companies and provides other assistance and support on the basis of contracts concluded with the state (the advisory model).

The working group finds several advantages of the group model over the advisory model:

- (a) The advisory model would leave the current governors of participation liable for the performance of the duties of the state as a shareholder; the liability of the ownership entity would be limited to standard liability of the mandatory (advisor).
- (b) In case of the advisory model, the ownership entity would be competent to conduct operations with regard to the companies (including voting at the general meeting; election of supervisory board members) only within the extent of specific authorisations granted by the governor of the participation; in practice, the process of applying for and granting authorisations would lead to needless red tape.
- (c) The group model opens the additional business opportunities in the management of the corporate portfolio (management of liquidity, engagement of debt capital, reinvestment of dividends, efficiency from common support services).

We must also take into consideration that, due to the restrictions established by EU legal acts, the transfer of all state participations to the ownership entity might not prove possible. Similarly, the transfer of all participations might not prove feasible for companies that mainly serve a public purpose (see clause 7 for additional information).

- Capacity for cross-sectoral coordination

Although an ownership entity operating in the form of a public limited company is formally located outside the state organisation, the ownership entity can help and support the state in the establishment of strategic objectives for companies, and coordination of the area. An ownership entity can independently check whether, and to which extent, the state has fulfilled its duties on the strategic level and, if necessary, request the adoption of the corresponding decisions and forwarding of information (albeit not by way of mandatory orders).

As the state's other structures outside the ownership entity are released from the obligations and responsibilities related to the business management of companies, they are expected to have more resources to focus on strategic issues.

- Financing options

As an alternative to state budget financing (state-budgetary expense item), the activities of an ownership entity operating based on the group model can be financed from the dividends payable by the companies managed by the ownership entity, allocating a portion of the dividends paid by the shareholders to cover the operating expenses of the ownership entity. Similarly, an ownership entity can be financed through state-budgetary financing transactions (increase of the share capital of the ownership entity).

The dividends of the state companies managed would be paid to the state via the ownership entity which would serve as a parent company, similarly to the increase of the share capital of the state companies managed. Upon payment of dividends to the state by the ownership entity, the ownership entity could allocate a portion to reserves, so as

to be able to meet any unexpected need for additional capital experienced by the companies managed.

The addition of such a “go-between” ownership entity between the state and companies managed by the state would not significantly complicate capitalisation, provided that the state waives the current practice of paying dividends and adding additional capital to the same company in the same year, which constitutes a violation of good management practice. It would be reasonable to leave companies with a sufficient portion of the profit for covering the foreseen need for capital.

- State control over the activities of the entity

Unlike the legal forms governed by public law, the state’s options in controlling an ownership entity which operates as a public limited company are more indirect. Should the state be dissatisfied with the results of the ownership entity, the main option, under company law, is to remove the supervisory board. In theory, a claim for compensation of damage can be filed against the members of the supervisory board.

At the same time, additional measures could be stipulated in legal acts for controlling the activities of an ownership entity – e.g. issues granted into the competence of the shareholder of the ownership entity, rather than the management board or the supervisory board. This includes the option of specifying matters in which any decision of the governor of the participation in the ownership entity require the consent of the Government of the Republic.

Furthermore, the state as a shareholder of the ownership entity may establish internal control and reporting mechanisms for the ownership entity.

Economic control over an ownership entity which operates in the form of a public limited company is also exercised by the State Audit Office.

6.3.3. Other legal forms: investment fund

Major portfolios of companies similar to a set of public companies often function as a part of investment funds in the private sector. Thus, a question may arise with regard to combining the state's corporate portfolio into a single or several investment funds, which would be governed by an ownership entity as a management company of the investment fund.

The management of an investment fund usually means engagement of capital from various investors with the aim of making investments, under a pre-determined investment policy and the principle of dispersing risks, for the benefit of investors for the purpose of seeking profit.

The working group finds that the implementation of the particular form of operation would be unsuitable, as the government of state participations lacks the traditional

features of fund management: (i) there is only a single investor; (ii) the main activity of the governor of participations does not revolve around the search and realisation of new investments but, rather, shareholder management of the existing corporate portfolio; (iii) the state's corporate portfolio has not been set up under the principle of diversification of risks; (iv) seeking profit is not often the main objective of the state as an investor. For the above reasons, the implementation of this form of operation may establish unnecessary requirements and restrictions for the activities of an ownership entity.

7. PROPOSAL FOR THE ESTABLISHMENT OF AN OWNERSHIP ENTITY IN THE FORM OF A COMPANY

The previous analysis indicates that value creation in a company with state participation can be enhanced, and that the positive impact of changes is sufficient for justifying such action. The working group estimates the potential benefit of modernising and developing the model for governance of companies with state participation to amount to an annual 75-100 million euros.

Further to the analysis, the working group proposes to establish an independent professional organisation for operative governance of state participations (ownership entity). The working group deems a consolidating company (public limited company) to be the most suitable form of operation for such an ownership entity.

In principle, the ownership entity may operate based on the group model and the advisory model simultaneously (see clause 6.3.2 for additional information). The selection of the operating model will depend, above all, on the activity objectives of particular companies with state participation. Namely, pursuant to state asset governance objectives stipulated in the State Assets Act, and the state's long-term expectations of each company, companies should be divided into two groups:

- (a) companies mainly pursuing business objectives;**
- (b) companies mainly pursuing public objectives.**

The working group deems it feasible to implement the group model for companies mainly pursuing business objectives. State participations in these companies should be transferred to the ownership entity, and consolidated into a single portfolio. In case of companies with mainly public objectives, the feasibility of the transfer of participations should be carefully considered. The working group presumes that it would be reasonable to continue governing some of these companies in the ministry governing the area. In such cases, the ownership entity would provide consulting services to the governing ministry when necessary, thus ensuring governance of all companies with state participation on the basis of similar principles and practice.

The working group provides the following justification for its proposal:

- (a) Business management will be separated from political management**
Establishment of an ownership entity will allow to clearly separate daily business management and control from political management. In the future, political management will include preparation of development plans and establishment of long-term strategic objectives. Business management will include implementation

of the long-term objectives and organisation of everyday economic activities. The ownership entity will serve as the linkage between political and business management, and operate based on the best practice of professional ownership entities.

(b) **Regulatory activities will be separated from performance of shareholder functions**

The establishment of an ownership entity will clearly separate regulatory activities of governing ministries from the exercise of shareholder's rights (especially in case of the group model). This means that regulatory objectives can be established and implemented only through legal acts and contracts, rather than through the "ministerial short-cut". This separation will help to prevent conflicts of interests between the state's role as a shareholder and regulator. Similarly, it will help to create conditions similar to private-sector companies operating on the free market.

(c) **Company-specific expectations and objectives will be established** The ownership entity will define the shareholder's expectations and objectives for all companies under its governance on the basis of national development plans and long-term objectives and by considering the options available to and restrictions established for companies.

(d) **Supervisory boards of state companies will be established by engaging the required knowledge, skills and experience in a transparent manner and by preventing conflicts of interests** The ownership entity will conduct background research and find the suitable supervisory board member candidates. The criteria for the selection will be publicly explained. Once a year, the ownership entity will assess the performance of the supervisory boards and members of the supervisory boards.

(e) **Consistent and persistent shareholder control will be ensured for the companies** The ownership entity will conduct substantial and professional control over the economic activities of state companies, and monitor attainment of the established objectives. In case of significant deviations or in the event of crises, the ownership entity will be able to respond quickly and decisively and, if necessary, initiate changes or processes for stabilisation of the situation.

(f) **Adherence to OECD guidelines for effective management of state companies** The establishment of an ownership entity and contemporary organisation of its work will help to adhere to a majority of the OECD recommendations. This applies to the establishment of the regulatory framework, performance of the ownership function, equal treatment of shareholders and related parties, and pursuit of transparency and accountability.

(g) **Active shareholder management methods developed in the private sector will be applied** If the ownership entity is established in the form of a company, the methods developed by the private sector over the years can be applied for

professional governance and administration of participations. Management companies, the private equity industry and active capital markets have developed efficient methods for strategic acquisition of companies and facilitation of value growth. The use of the legal form of a company will ensure the necessary flexibility and will provide a better foundation for engaging top-level professional knowledge and experience.

In conclusion, the working group finds that the establishment of an ownership entity and its organisation in the form of a company will provide the best foundations for efficient administration of companies with state participation. It will help to raise the value of the corporate portfolio and enhance the public benefit, strengthen the political impact on the strategic level and create a stable and foreseeable basis for the activities and development of companies. This position correlates to the organisation of the governance of state companies in other developed countries as well as the long-term experience of the shareholders of private-sector companies.

8. ACTIVITIES OF THE OWNERSHIP ENTITY

The main purpose of the ownership entity is to ensure shareholder management of companies where the state has a majority holding in the most efficient manner possible, thus maximising the economic and public benefit. The ownership entity will carry out various activities in pursuit of its objectives. A list of the key activities has been presented below.

8.1. Defining of the shareholder's expectations of the companies

Clear and justified shareholder's expectations must be defined for all companies where the state has a majority holding. This clarity is needed by the state for explaining, in a transparent manner, why the state holds a participation in a particular company. This clarity is also needed by the company for establishing long-term objectives. Furthermore, the clarity is needed by market participants competing with and cooperating with the company, as well as the general public.

By and large, the state has three expectations with regard to all companies, which should be specified for each particular company. The state's expectations:

- (a) to pursue profitable, sustainable and efficient economic activities, ensuring optimal and stable owner's income for the state;
- (b) to attain the strategic and financial objectives established by the state in accordance with the valid legal acts and other regulations;
- (c) to serve as a role model for all Estonian companies, with regard to good management practice, social responsibility and high business culture.

In defining the shareholder's expectations of companies mainly pursuing business objectives, the ownership entity will be governed by the existing development plans and strategies, as well as the input of government agencies and other relevant parties. The management board of the ownership entity will submit the corresponding proposals to the supervisory board of the ownership entity for approval once a year, and present them to the annual general meeting thereafter. We can presume that the established expectations will be quite constant and will not need to be modified very often or very extensively. At the same time, the expectations should be regularly reviewed and adjusted in order to ensure that they are up-to-date and relevant.

The expectations of the shareholders of companies mainly pursuing public objectives will be defined by the ministry governing the participation. The ownership entity can provide support thereof.

As the first step, the Ministry of Economic Affairs and Communications has defined the shareholder's expectations with regard to Eesti Energia AS, and submitted these to the

Ministry of Finance for finalisation. A draft of the shareholder's expectations has been presented in Annex 2.

8.2. Appointment of supervisory board members

After specification of the shareholder's expectation, the establishment of a competent and efficient supervisory board is the shareholder's function that most affects the activities of a company. With the establishment of the supervisory board and appointment of members thereto, the shareholder gives the company's staff members, customers and partners a signal of the shareholder's true ambitions and the core values underlying the management of the company.

The working group believes that the engagement of competent and experienced professionals in the supervisory board and an honest and transparent process of selection of the supervisory board members are of equal importance in the establishment of a supervisory board. A supervisory board will be efficient, if its legitimacy is publicly acknowledged.

The corporate portfolio of the Republic of Estonia is sufficiently extensive and the supervisory boards are subjected to sufficient changes to merit continual attention to the subject. Staff changes in supervisory boards may be conditioned by expiry of the term of office, resignation of a supervisory board member on his/her own initiative, a potential conflict of interests or a negative assessment of the work of a supervisory board member. In order to ensure the existence of a high-quality and sufficiently broad-based group of candidates to the supervisory board, a professional approach should be taken towards the matter.

In case of companies mainly pursuing business objectives, the ownership entity would have the task of organising the selection of the members of the supervisory board. In case of companies mainly pursuing public objectives, the ownership entity would have the task of supporting the governing ministries in the selection of the members of the supervisory board. In companies consolidated by the ownership entity, this process would be carried out as follows:

- (a) the chairman of the supervisory board of the company or the chairman of the supervisory board of the ownership entity identifies the need for a new member of the supervisory board;
- (b) the ownership entity in cooperation with the chairman of the supervisory board of the company define the criteria for the new member of the supervisory board;
- (c) a notice of the job vacancy is published;
- (d) the ownership entity starts preparing a list of potential candidates in accordance with the established criteria;

- (e) the management board of the ownership entity together with the chairman of the supervisory board of the ownership entity prepares a shortlist of candidates (2-3 candidates);
- (f) the ownership entity ascertains the terms and conditions of the job and of the candidate's acceptance of the job offer;
- (g) the chairman of the management board of the ownership entity presents the chosen candidate to the supervisory board of the ownership entity for approval;
- (h) the supervisory board of the ownership entity grants the management board of the ownership entity approval for appointment of the particular candidate;
- (i) the general meeting of the company (the management board of the ownership entity) appoints a new member of the supervisory board;
- (j) the ownership entity publicly comments on the decision, the criteria underlying the decision, and expectations of the member of the supervisory board.

For successful organisation of its work, the ownership entity will keep a database of potential members of the supervisory board. The list includes previous supervisory board members suitable for the job, current supervisory board members, and potential new members. To enhance transparency, maintenance of the database could be outsourced from a professional human resource service provider assigned with the task of finding and monitoring potential new members of the supervisory board. This model is applied, for example, in Finland.

In case of (ministry-governed) companies mainly pursuing public objectives, the ownership entity may provide support to the ministry, when necessary, in defining the profiles of supervisory board members and searching for potential candidates.

To avoid a conflict of interests, staff members of the ownership entity and members of the supervisory board of the ownership entity will not participate in the supervisory boards of companies governed by the ownership entity. Exceptions may be made to the rule, if the company is in a complicated crisis and the shareholder must abruptly take a more active role.

8.3. Organisation of the evaluation of the activities of the supervisory boards of companies

The ownership entity will establish the principles and the framework for evaluation of the activities of the supervisory board, and conduct the annual evaluation. The ownership entity will use a supervisory board member evaluation method which combines the self-assessment of members with the corresponding input from the relevant third parties. The ministry governing the area will provide a significant input to the evaluation, assessing whether or not and to which extent the public objectives established for the company have been attained.

The results of the evaluation of supervisory board members will form the basis for the establishment of the supervisory board and introduction of changes. The results of the evaluation of supervisory board members will not be made public and will only cover a clearly defined list of individuals.

8.4. Owner supervision of the corporate portfolio

Upon defining the expectations, establishing the objectives and setting up a competent supervisory board, a professional shareholder also needs to conduct supervision. The nature of such "owner supervision" conducted by the shareholder is not similar to the supervision conducted by the supervisory board of the company. Shareholder supervision will focus, above all, on the long-term perspective and aims at examining whether a company is able to meet the established strategic and/or long-term expectations. Such supervision will not intervene in the daily activities of a company in any way. The supervisory measures will only be conducted via a general meeting and appointment of supervisory board members.

For the conduct of owner supervision, quarterly meetings will be held between the ownership entity and the company governed, giving an overview of the progress made, challenges faced, as well as the main risks and opportunities. The task of the ownership entity is to assess whether there are any deviations from the path pursued, and the potential impact of the deviations. Upon conduct of quarterly meetings, the ownership entity will give, via the Ministry of Finance, a brief overview of the progress made and the risks involved. Special attention will be paid to developments that may affect the planned dividends (deviations from dividend policy).

At regular meetings, the company will be represented by the chairman of the management board, and the ownership entity will be represented by the corresponding portfolio manager. At least once a year (once a quarter in case of major companies), a meeting will be held between the chairman of the supervisory board and the management board of the ownership entity. If necessary, the supervisory board of the ownership entity may call upon the chairmen of supervisory boards or managing directors of companies to give a presentation at the meeting of the supervisory board of the ownership entity.

The owner supervision of (ministry-governed) companies mainly pursuing public objectives must be conducted by the governing ministry. The ministry may delegate this task to the ownership entity, but will retain the right of final evaluation and judgement.

8.5. Analysis of the corporate portfolio and reporting

The ownership entity will set up a high-quality and transparent reporting system. Among other things, the ownership entity will set up a website for quarterly publication of the financial highlights of all companies where the state has a majority holding, and summarised information on the portfolio of state companies. This must be done by

avoiding duplication of the work conducted by the Ministry of Finance. The ownership entity is expected to be able to ensure high-quality reporting in accordance with the needs of the Ministry of Finance.

Once a year, by June 1 at the latest, the ownership entity will publish a comprehensive consolidated report on the governance of participations, providing a transparent overview of the entire portfolio of state companies and changes in the financial year. The consolidated report of the ownership entity will replace the consolidated report currently prepared by the Ministry of Finance, and cover all companies with state participation. The consolidated report will be approved by the Government of the Republic. The report will be published in both Estonian and English.

The ownership entity will examine the major investment projects of all companies governed by the ownership entity, and submit its opinion to the supervisory board of the ownership entity and, if necessary, to the Government of the Republic via the Ministry of Finance. This concerns, above all, investments which require the engagement of equity or deviations in long-term dividend policy.

The investment analysis of companies (governed by ministries) mainly pursuing public objectives will be conducted by the ministries. Ministries may outsource the analyses from the ownership entity, but will retain the right of final evaluation and judgement.

The ownership entity will analyse the activities of state companies by sectors. Major state companies mainly operate in two sectors – energy and transport. To understand and evaluate the activities of the company, regional progress in the entire sector as well as relative productivity of state companies, compared to competing companies, need to be evaluated.

8.6. Acquisition and disposal of participations in companies

Pursuant to the State Assets Act, the governor of participations must evaluate the purposefulness and feasibility of the governance of participations under its administration, and make proposals to the state for transfer or disposal of unnecessary participations. Further to the state's purpose of participation in a particular company, the ownership entity will formulate a position with regard to the feasibility of the preservation or transfer of the state's participation, and submit the position to the Government of the Republic. The need for changes in the corporate portfolio may also be conditioned by external factors. For example, a market failure may occur in a strategic area, prompting the establishment of a new state-owned enterprise (with the corresponding input provided or order placed by a ministry). Similarly, a key area of governance of state assets may require reorganisation (e.g. Riigi Kinnisvara AS). Companies held by the state may be subjected to a merger (establishment of AS Eesti Teed) or reorganisation (AS Teede Tehnokeskus).

The reasons for acquisition of participations and the proposals for the required changes are submitted to the Government of the Republic as an annex to the consolidated report

on an annual basis. Further to the proposals made, the Government of the Republic may grant the corresponding authorisation for the acquisition or disposal of participations, or for other similar transactions.

The performance of all of the above tasks and entry into transactions require basic knowledge in investment banking. The ownership entity must be able to analyse the economic and public impact of the purchase, sale or reorganisation of companies, and, if necessary, coordinate the activities for implementation of the approved transaction.

9. MANAGEMENT, ORGANISATION AND FINANCING OF THE OWNERSHIP ENTITY

The working group proposes to organise, complete and manage the ownership entity in the form of a public limited company similarly to private-sector holding companies/investment firms. This means that the general shareholders' meeting would serve as the highest management body of the ownership entity. Strategic management and supervision will be conducted by the supervisory board, and daily management by the management board.

9.1. Management of the ownership entity

The ownership entity will be responsible for the management of and provision of strategic guidance to a large number of companies with state participation, representing a significant economic value and serving important public functions. All of the efforts will be made for the benefit of the “beneficial owner” – the people of Estonia. It is crucial for this role and responsibility to be reflected in the staff of the management and the joint knowledge and experience of its members. The chairman of the supervisory board and the chairman of the management board must have comprehensive business knowledge and experience, acquired in sophisticated companies and in complicated situations. Furthermore, the heads of the ownership entity must understand that the role of state companies is somewhat special and somewhat contradictory. The heads of the ownership entity have the huge responsibility of combining business feasibility with political trends and aspirations.

The supervisory board of the ownership entity will be appointed by the Government of the Republic. The supervisory board will consist of 5-7 members, with a recommended term of office of four years. In the opinion of the working group, it would be reasonable to synchronise the term of office of the supervisory board of the ownership entity with the term of the Riigikogu in order to ensure the necessary political impact on the highest level of management of state companies.

The supervisory board of the ownership entity must have at least the following competences:

- (a) experience in the top-level management of sophisticated publicly traded companies or groups of companies;
- (b) experience in international business;
- (c) experience in infrastructure investment planning and execution;
- (d) experience in financial planning and management;
- (e) experience in complex risk management;
- (f) experience in international business law;
- (g) experience in the public sector and in government.

Meetings of the supervisory board will be held at least once a month. Members of the supervisory board must allocate at least 2-3 days for these tasks every month. This would also entail the establishment of an appropriate remuneration for members of the supervisory boards.

The qualification of the chairman of the management board of the ownership entity must equal to that of the chairman of the supervisory board. The skills and knowledge of the chairman of the management board must equal to or exceed those of the chairmen of the management boards of major Estonian state companies. The chairman of the management board of the ownership entity will be appointed by the supervisory board of the ownership entity for a term of three years. In good practice, the candidates to the position of the chairman of the management board should be coordinated with the minister governing the ownership entity. The candidates to the positions of other members of the management board will be presented to the supervisory board by the chairman of the management board.

9.2. Organisation of the ownership entity

The organisation of the ownership entity will be managed by the management board which will, in turn, be headed by the chairman of the management board. The management board will have three members. The main activities of the ownership entity will be carried out by portfolio managers. The chairman of the management board will serve as a portfolio manager himself/herself. Each portfolio manager will be responsible for the administration of the companies in his/her portfolio. Together with the chairman of the management board, there will be a total of four portfolio managers. One of them will focus on companies mainly pursuing public objectives (provided that the ownership entity supports ministries in corporate governance), and the other three on companies mainly pursuing business objectives. The portfolio managers must have extensive experience in finance and investment. Knowledge of investment banking is required, as well, so as to be able to manage capitalisation, acquisition and sales projects.

The portfolio managers will be supported by one or two analysts. The whole team will be supported by one assistant. Support services (IT, accounting, etc.) will be outsourced.

To ensure availability of the necessary competences and experience, the remuneration of the key persons must be comparable with the remuneration of management board members of major state companies. The scale of and challenges provided by the ownership entity should make it a highly attractive employer. Consequently, the planned level of remuneration should remain conservative. Nonetheless, it should not be comparable with the general principles of remuneration in state agencies. The ownership entity has been designed for those who are no longer pursuing a career but are willing to employ their in-depth business knowledge for providing reinforcement to an area of strategic importance for the state. **The values of the ownership entity should make it a beacon for entrepreneurship in Estonia.**

9.3. Financing

The equity of the ownership entity will consist of the consolidated equity transferred to the ownership entity by the companies. Any dividends of companies under its governance will be forwarded by the ownership entity to the state. The amount required for covering the annual expenses of the ownership entity will be withheld from the dividends received. This amount will be budgeted by the ownership entity and approved by the supervisory board. In addition to the coverage of current expenditure, a reserve will be established by the ownership entity in its first year of operation for covering the expenses on the outsourcing of professional services. The need for services of third parties may arise in connection with the acquisition or disposal of shares of companies.

Considering the planned size of the ownership entity, the annual operating expenses are estimated at 800,000-850,000 euros. The 200,000-euro reserve to be established in the first year of operation will be added to the above amount. Upon purposeful use of the reserve, the reserve will be restored to its initial level once a year. An ownership entity must serve as a role model for all other companies. This means that the ownership entity must be **modest, practical, well-planned and transparent**.

A more detailed estimation of the expenses has been provided below (in euros):

Wages and salaries (including taxes)	725,000
Office and administrative expenses	30,000
Support services	25,000
Business trips	20,000
Audit expenses	10,000
Total	810,000

10. DECISION-MAKING COMPETENCE IN THE GOVERNANCE OF PARTICIPATIONS

The working group's vision of the division of decision-making competences in the proposed structure for governance of participations has been presented below. The division is based on the following objectives: (a) to ensure adequate separation of political management from regulatory activities, (b) to ensure control of government agencies over important decisions, (c) to avoid overlapping of decision-making on different levels.

The working group has touched upon the key issues in the organisation of the activities of the ownership entity and management of companies. The proposed division of competences can, above all, be applied to companies with state participation that mainly pursue business objectives, and the shares of which will be transferred by the state to the ownership entity. In case of companies mainly pursuing public objectives, the below functions will be performed by the ministries governing the participations, to whom the ownership entity can provide support on the basis of the advisory model, when necessary.

10.1. Decision-making competence in the management of the ownership entity

Pursuant to the Commercial Code, the general shareholders' meeting is the highest management body of the ownership entity. Pursuant to the State Assets Act, the state's rights as a shareholder will be exercised, at the general meeting, by the governor of the participation – e.g. a ministry or a profit-making state agency.

The working group believes the **Ministry of Finance** to be the most suitable party for governing the participation in the ownership entity and exercising the shareholder's rights. This is due to the fact that coordination of the governance of state assets is currently, and has traditionally always been the duty of the Ministry of Finance¹¹. Considering the governing areas of different ministries established by law, and the need to ensure sufficient separation of the activities of the ownership entity from the activities of the state as the regulator of the area, it would be difficult to assign the ownership entity into the governing area of any other ministry.

At the same time, a majority of the issues within the competence of the shareholder of the ownership entity are of such significance that the corresponding decision should rely, in addition to factors central to the governing area of the Ministry of Finance (e.g. the state budget policy), on the relevant input of other ministries and/or a broad political

¹¹ The structural units of the Ministry of Finance include the State Assets Department charged with the task of formulating policies, preparing draft legal acts, consulting and coordinating the activities of state agencies in the governance of state assets and organising the protection of the state's interests in legal persons governed by private law, in which the state has a holding. Pursuant to the valid State Assets Act, the Ministry of Finance shall give the Government of the Republic an annual overview of the governance of state companies in the previous periods on the basis of the reports submitted by ministries.

consensus, with the decision-making competence thus best left with the **Government of the Republic**. Such matters of key importance include:

- (a) establishment and amendment of the statutes of the ownership entity;
- (b) appointment and removal of members of the supervisory board of the ownership entity;
- (c) increase and decrease of the share capital of the ownership entity, and the related operations;
- (d) dissolution, merger, division and transformation of the ownership entity;
- (e) approval of the annual report of the ownership entity and the consolidated report on the governance of state participations, which forms a part of the annual report, and distribution of dividends in the ownership entity;
- (f) establishment of a new company by the ownership entity, or acquisition or disposal of a significant stake in another company.

A bulk of these issues would also lie within the competence of the Government of the Republic under sections 76 and 77 of the valid State Assets Act. Thus, the above division of competences would not, in the working group's opinion, fundamentally change the regulation on the governance of state assets.

Considering the above, the **Ministry of Finance** would be competent to decide on the following issues:

- (a) appointment of an auditor for the ownership entity;
- (b) ordering of a special audit of the ownership entity;
- (c) deciding on the conclusion of transactions with members of the supervisory board of the ownership entity, establishment of the terms and conditions for such transactions, deciding on legal disputes and appointment of the representative of the ownership entity in such a transaction or dispute;
- (d) deciding on other issues granted into the competence of the general meeting of the ownership entity by law¹².

We must take into account that, pursuant to the valid State Assets Act, the Government of the Republic does not exercise shareholder's rights in issues within its scope of competence. Rather, the Government of the Republic serves as a body which grants the governor of the participation the authorisation to adopt a decision or to vote in a particular issue. Thus, pursuant to the valid State Assets Act, the Ministry of Finance,

¹² Subsection 298 (1) of the Commercial Code.

represented by the Minister of Finance, would formally remain the party exercising the shareholder's rights in these issues. In the opinion of the working group, such a multi-level decision-making system would not be feasible in many cases, especially if the discretion of the Minister of Finance under the authorisation of the Government of the Republic is very narrow or is altogether non-existent. Thus, we should weigh the options of simplifying the system, granting the Government of the Republic the exclusive competence to decide on particular issues.

We must point out that, similarly to the management of other companies with state participation, shareholder management of the ownership entity itself should be carried out **only by exercising the shareholder's rights established by the Commercial Code** and in accordance with the good practice for corporate management and the principles defined by the OECD. This means that the governor of the participation will not be allowed to intervene in the daily activities of the ownership entity, or to give the supervisory board or management board instructions or orders, or to make inquiries. The ownership entity is not a structural unit of the Ministry of Finance as the governor of participation, and is not in any subordination relation within the ministry.

The establishment of the decision-making competence of the **supervisory board of the ownership entity** must be governed, above all, by the Commercial Code, pursuant to which the main duty of the supervisory board is to plan the activities and organise the general management of the public limited company.

The supervisory board is also competent to appoint and remove the management board of the ownership entity, and conduct supervision over the activities of the management board. To ensure the functioning of the management board as a single team, it would be reasonable to organise the establishment of the management board in such a way that the supervisory board would first appoint the chairman of the management board, with the chairman of the management board then selecting the candidates for other members of the management board.

The supervisory board will also be competent to decide on other issues concerning the general planning of the activities of the ownership entity or transactions falling beyond everyday economic activities, for example:

- (a) approval of the annual budget of the ownership entity;
- (b) establishment of the dividend policy of the ownership entity (see clause 10.5 "Distribution of dividends in the companies governed");
- (c) assumption of loans and debt obligations, as well as grant of loans and securing of debt obligations (which should not, as a rule, be allowed in the ownership entity);
- (d) entry into other contracts, which are of significance with regard to the size of the monetary obligations assumed by the ownership entity, duration of the validity period or other conditions.

In addition to the above, the supervisory board of an ownership entity also performs other functions specified below, e.g. granting approval for appointment of supervisory board members of the companies governed.

10.2. Establishment of shareholder's objectives and expectations for the companies governed

The establishment of the shareholder's objectives and expectations will be based on the national development plans approved by the **Riigikogu** and the **Government of the Republic** and other similar strategic documents.

The **policy of participation in state companies**, established by the **Government of the Republic**, is a document which specifically addresses companies and, among other things, stipulates the general expectations of all companies¹³.

The working group deems it feasible to take the following action for the purpose of establishing objectives for the companies:

- (a) The **Ministry of Finance** as the governor of the participation in ownership entity will determine, in cooperation with the relevant ministries, the **reason for the state's participation** in any company – seeking profit or pursuing a public purpose¹⁴. Simultaneously with the establishment of the reason for the state's participation, the above agencies will submit to the Government of the Republic a proposal for division of companies into **companies mainly pursuing business objectives** and **companies mainly pursuing public objectives**. Once a year, the Ministry of Finance, together with the relevant ministries, will review the established objectives and classification of companies, and introduce changes, where necessary. The Ministry of Finance will submit the positions previously coordinated with other ministries to the Government of the Republic together with the consolidated report on the governance of state participations, prepared by the ownership entity on an annual basis.
- (b) The **Government of the Republic** will approve, on the basis of the proposal coordinated by the Ministry of Finance and the relevant ministries, the division of companies into **companies mainly pursuing business objectives** and **companies mainly pursuing public objectives**. Upon establishment of the ownership entity, the state's participations in companies mainly pursuing business objectives will be transferred to the ownership entity.
- (c) The **management board of the ownership entity** as the governor of participations in companies with state participation will specify the shareholder's expectations with respect to each company under its governance, including the company's strategic objectives, and submit these for approval to the supervisory

¹³ The corresponding provision delegating authorisation should be stipulated in the State Assets Act.

¹⁴ Subsections 10 (1), (2) and (6) of the State Assets Act.

board of the ownership entity together with the annual consolidated report on the governance of participations. The management board of the ownership entity will specify the expectations based on the following:

- development plans approved by the Riigikogu and the Government of the Republic and other similar strategic documents;
 - policy of participation in state companies approved by the Government of the Republic;
 - objectives of participation in state companies, specified by the Ministry of Finance;
 - input information from the relevant ministries.
- (d) The **supervisory board of the ownership entity** will approve the above expectations as a part of the annual consolidated report, and submit these for final approval to the Government of the Republic via the Ministry of Finance.
- (e) Upon approval of the consolidated report by the Government of the Republic, the **management board of the ownership entity** will specify the fields of activity and objectives of the companies in the articles of association of the companies¹⁵ and submit the specified shareholder's expectations to the general meeting of the shareholders.
- (f) The **Government of the Republic** will send the approved consolidated report to the Riigikogu and the State Audit Office for information purposes¹⁶.

10.3. Appointment and removal of members of the supervisory boards of the companies governed

In the opinion of the working group, the appointment and removal of members of the supervisory boards of companies governed by the ownership entity should lie within the **competence of the ownership entity**.

In appointment of **new supervisory board members**, the task of the management board of the ownership entity is to ascertain the qualifications required and find potential candidates, while the task of the supervisory board of the ownership entity is to approve or, in justified cases, reject the choices made by the management board. Upon the corresponding approval of the supervisory board, the management board of the ownership entity will appoint the relevant persons as members of the supervisory board at the general meeting of the company.

¹⁵ Subsection 75 (4) of the State Assets Act.

¹⁶ Subsection 99 (2) of the State Assets Act.

The activities of the ownership entity in the appointment of supervisory board members have been described in detail under clause 8.2 of chapter 8 (“Activities of the ownership entity”).

The management board of the ownership entity will be responsible for the **annual evaluation of the work of the supervisory boards**, submitting the results of the evaluation to the supervisory board of the ownership entity.

Premature removal of members of the supervisory board should also lie within the competence of the management board of the ownership entity, who will be guided by the evaluation performed and will explain the reasons for removal of the supervisory board members to the supervisory board of the ownership entity, where necessary.

10.4. Additional financing of the companies governed

The working group finds that the companies governed should not be financed through increase of share capital in cases where the profit and own funds of the company are sufficient for financing such costs or investments. Thus, the need for an increase in share capital should decrease in periods where the company has paid a substantial amount of dividends. These principles should also be stipulated in the state participation policy which is to be approved by the Government of the Republic.

The implementation of the above principles should reduce the need for conducting annual share capital increase transactions.

As the increase of share capital directly involves the use of state resources, the **Government of the Republic** should have the decision-making competence. In company law, this means that the management board of the ownership entity, who would have the right to decide on the increase of the share capital as the party exercising the shareholder’s right of the company, will have to apply for the previous consent or authorisation of the ownership entity’s shareholder (with the corresponding shareholder’s right exercised by the Government of the Republic or the Minister of Finance under the authorisation of the Government of the Republic).

Another option would be to retain a capital buffer in the course of dividend payment in the ownership entity, which would then be used by the management board of the ownership entity for making smaller-scale investments in the companies governed upon the previous consent of the supervisory board or under the terms and conditions established by the supervisory board.

10.5. Distribution of dividends in the companies governed

Pursuant to the valid State Assets Act, the dividend amount or dividend rate will be established in companies where the state holds the required interest by the Government of the Republic on the proposal of the Minister of Finance. The governor of the participation must thus abide by this decision during the voting at the general meeting.

The proposal with regard to the above amount or rate will be submitted by the governor of the participation to the Minister of Finance together with the report on the governance of participations¹⁷.

In the opinion of the working group, the State Assets Act and the practice of implementation of the State Assets Act does not abide by the principles of the Commercial Code with regard to the allocation of profit and establishment of the amount of dividends. The State Assets Act seems to allow the state as a shareholder to independently decide on the payment of and the amount of the dividends. Pursuant to the Commercial Code, the profit allocation proposal (including the proposal regarding the amount of dividends to be paid to the shareholders) must be made by the management board of the company, subject to any changes by the supervisory board¹⁸. We can even claim that, pursuant to the Commercial Code, the shareholder has the right to choose whether to approve or reject the profit allocation proposal made by the management bodies. Nonetheless, the Commercial Code does not stipulate the shareholder's right to independently submit a proposal for allocation of profit.

If the shareholder was to be able to independently establish the dividend amount, it would be virtually impossible for the supervisory board and the management board to plan the activities of the company (including investments, long-term commitments). By making such a decision, the shareholder would, in essence, assume the responsibility for the company's activities (in extreme cases, this will include bankruptcy).

At the same time, it is quite obvious that the state expects to reap optimal and stable benefits, which are expected to grow in time. Similarly, the state needs to plan its budgetary expenses.

Rather than via the annual establishment of dividends by the Government of the Republic, the above objectives should be achieved, in the opinion of the working group, via the establishment of a general and long-term dividend policy by each company. Dividend policy stipulates the principles for the establishment of the annual dividend amount, and serves as the basis for the planning of the companies' activities by the management bodies of companies, including long-term investments.

Considering the above, it would be reasonable, in the opinion of the working group, to establish the decision-making competences for dividend payment in the companies governed as follows:

- (a) The **Government of the Republic** will specify the state's general expectations with regard to dividend payment and dividend policy in the state participation policy;
- (b) On the basis of the above general policy, the **ownership entity** will define the specific shareholder's expectations of the dividend policy of each company

¹⁷ Section 77 of the State Assets Act.

¹⁸ Subsection 332 (2) and subsection 333 (2) of the Commercial Code.

governed;

- (c) The **supervisory board of each company governed** will approve the dividend policy of the particular company, by considering the expectations defined by the ownership entity;
- (d) The **management board of each company governed** will base the profit allocation proposal on the dividend policy established by the supervisory board; in the review of the proposal, the supervisory board of the company will analyse, among other things, the compliance of the proposal with the established dividend policy;
- (e) The **management board of the ownership entity** as the party exercising the shareholder's rights of the company governed will decide on the approval of the profit allocation proposal made by the management board and supervisory board of the company;
- (f) The **ownership entity** will divide the dividends to the state as a shareholder in accordance with the dividend policy established by the supervisory board of the ownership entity.

The profit forecast prepared by the management bodies of companies will still be used as basis for state budget planning, but the established dividend policy will be taken into account, as well.

10.6. Establishment of new companies; acquisition and transfer of participations

The initiative for the establishment of new companies with state participation or acquisition of participations in such companies is, as a rule, provided by the ministry governing the area. In the opinion of the working group, the decision-making competences in the establishment of new companies or acquisition of participations could be the following:

- (a) **The competent ministry in the area** submits a proposal to the Government of the Republic for establishment of or acquisition of a participation in a company, explaining the need for the establishment or acquisition on the basis of the participation policy established by the Government of the Republic.
- (b) The **Government of the Republic** grants the management board of the ownership entity the authorisation/consent for the establishment of a company with state participation or acquisition of a participation in a company, specifying the reason for state participation¹⁹ in the authorisation/consent; in these issues, the Government of the Republic will exercise the rights of the governor of the participation/shareholder of the ownership entity instead of the Ministry of

¹⁹ Subsections 76 (1) and (2) of the State Assets Act.

Finance²⁰.

- (c) The **management board of the ownership entity** will establish the company or acquire the participation on the basis of the consent of the Government of the Republic.

Any transfer of a state participation should be initiated, above all, on the basis of the analysis of the corporate portfolio conducted by the ownership entity (see clause 8.6 for details). In the opinion of the working group, the corresponding decision-making competences and processes could be the following:

- (a) The **management board of the ownership entity** will submit its opinion on the feasibility and objectives of state participation in companies on an annual basis, making a proposal to the state for transfer of unnecessary participations, or dissolution or merger of the company, where necessary. The corresponding opinion and proposals will be prepared as **a part of or annex to the consolidated report on governance of participations**, and submitted to the supervisory board of the ownership entity for approval.
- (b) The **supervisory board of the ownership entity** will review the opinion submitted by the management board, approve it, and submit it for final approval to the Government of the Republic via the Ministry of Finance.
- (c) The **Government of the Republic** will approve the consolidated report together with its annexes, and decide, on the basis of the proposals made therein, on the dissolution or merger of the company, or transfer of the participation in cases stipulated in the State Assets Act²¹.

10.7. Reporting

Under the Commercial Code, the ownership entity is obliged to prepare an annual report for each financial year. In the opinion of the working group, it would be reasonable to combine the **reports on the governance of participations (consolidated reports)** prepared under subsection 98 (2) and section 99 of the State Assets Act with the preparation of the annual report, considering that the management report, which forms a part of the annual report of the ownership entity, should extensively cover the substance of the reports to be prepared under the State Assets Act (with regard to companies governed by the ownership entity).

²⁰ If the Government of the Republic has essentially decided on the establishment of a company or acquisition of a participation, any additional decisions by the Ministry of Finance in this matter would be unreasonable. It would thus be feasible to establish a special provision in the State Assets Act, stipulating that, in this particular matter, the Government of the Republic will exercise the rights of the shareholder of the ownership entity instead of the Ministry of Finance. Since this is a strategic matter for the state, grant of decision-making competence to the supervisory board of the ownership entity would not be justified.

²¹ Subsection 75 (3) and subsections 37 (3) and (4) of the State Assets Act.

Competences in the preparation of the above reports should, in general, be governed by the provisions of the Commercial Code:

- (a) The **management board of the ownership entity** will prepare the annual report and the accompanying consolidated report on the governance of state participations;
- (b) The **supervisory board of the ownership entity** will review the reports and prepare its own written report, specifying whether the supervisory board approves the report prepared by the management board and explaining how the board has organised and managed the work of the ownership entity.
- (c) The **Government of the Republic** (or the Ministry of Finance under the authorisation of the Government of the Republic) will approve the above reports, exercising the shareholder's rights.

As regards companies which mainly pursue public objectives and whose shares will be governed by the ministries, the ownership entity will summarise the information based on the data received from the ministries.

ANNEX 1: PRINCIPLES FOR STATE PARTICIPATION IN COMPANIES (DRAFT)

Principles for state participation in companies

Draft

TABLE OF CONTENTS

1. INTRODUCTION	63
2. GENERAL PRINCIPLES FOR STATE PARTICIPATION	65
3. THE STATE'S ROLE AS A SHAREHOLDER IN THE MANAGEMENT OF COMPANIES	6770
4. SPECIFICATION OF THE FINANCIAL OBJECTIVES OF COMPANIES	70
5. SUPERVISORY BOARD	72
6. DIVIDEND POLICY.....	74
7. SUPERVISION AND REPORTING.....	75

1. INTRODUCTION

The OECD recommendations for management of companies with state participation emphasise that the state needs to act as an informed and active shareholder, establishing a clear and sustainable participation policy with the aim of ensuring transparent, responsible, professional and efficient management of companies with state participation. The participation policy must define the general objectives for state participation in companies, the state's role in the management of the corresponding companies and the implementation of the participation policy.

In Estonia, participation policy is partly reflected in the State Assets Act, which stipulates the rules of procedure for governance of state assets, including state participation as a shareholder in public limited companies and private limited companies.

Pursuant to the State Assets Act, in line with the OECD recommendations, the Republic of Estonia participates in the management of companies, above all, **via exercising the shareholder's rights**, and does not intervene in the management of companies on any other level, thus respecting the independence of supervisory boards and granting the supervisory boards and management boards full autonomy in daily business activities pursued for the achievement of the goals established.

Thus, the **governor of the state participation**, who holds the shareholder's rights and obligations provided by law, thus plays a key role in the management of a company. The governor of the state participation is the **ministry** or profit-making state agency designated by the Government of the Republic or, in case of a minority holding, by the Ministry of Finance.

At the same time, the provisions of the State Assets Act are quite general and fail to provide the management boards and supervisory boards of companies with state participation, their staff members and cooperation partners, other state agencies and the general public with an adequate overview of how the governor of the participation can implement the state participation policy in various specific issues.

With the aim of ensuring consistency, predictability and transparency of the behaviour of the state as a shareholder, the working group set up with the Ministry of Economic Affairs and Communications has specifically defined the general principles which the state as a governor of participation should be guided by.

The document first presents the general principles of participation in companies with state participation, applicable to all companies where the state has a majority holding. Thereafter, a detailed description of the following is provided: (a) the role of the state as a shareholder in the management of companies; (b) general financial objectives of companies; (c) the state's expectations of the management of companies; (d) the state's expectations of the dividend policy of companies; (e) principles of supervision and reporting.

These principles will be applied in all companies where the state has a majority holding. In companies where the state holds a precluding interest, the governor of the participation will try to implement these principles by consulting and cooperating with other shareholders.

2. GENERAL PRINCIPLES FOR STATE PARTICIPATION

- (a) **A company with state participation must serve as a role model for all Estonian companies, with regard to good management practice, social responsibility and high business culture.**
- (b) **The management of a company with state participation must be transparent. The decisions made by the governor of the participation, including the decisions regarding appointment of members of the supervisory board, must be justified and documented.**
- (c) **The principle, according to which the remuneration of a supervisory board member must be comparable with the remuneration of supervisory board members of other companies in the same sector, must be applied in remunerating supervisory board members of companies with state participation²².**
- (d) **A company with state participation must pursue profitable, sustainable and efficient economic activities, ensuring optimal and stable owner's income for the state.**
- (e) **A company with state participation must be able to develop and sustain growth in order to create and enhance value for the shareholders.**
- (f) **The capital structure of a company must comply with the objective of state participation and the financial position of the company.**
- (g) **The governor of the participation must establish the specific objectives (expectations) with regard to each company governed, broken down by (a) strategic objectives and (b) financial objectives.**
- (h) **A company with state participation must attain the strategic and financial objectives established by the governor of the participation in accordance with the valid legal acts and other regulations.**
- (i) **The supervisory board of a company with state participation will establish the activity objectives of the company, considering the strategic and financial objectives established by the governor of the participation, as well as the principles and expectations specified in this document.**
- (j) **Long-term decisions with a significant economic impact must be passed by consensus in the supervisory boards of companies with state participation.**
- (k) **All shareholders of a company with state participation must be treated equally in equal circumstances.**

²² Amendment of the State Assets Act may prove necessary for the implementation of this principle.

- (l) To ensure equal treatment on markets where private-sector companies are able to compete with companies with state participation, the state as a governor of the participation will not, in the long-perspective, deem it feasible to participate in companies that only seek a profit and pursue no public objectives. Participations in such companies must be disposed at the right time and in the suitable circumstances.**

3. THE STATE'S ROLE AS A SHAREHOLDER IN THE MANAGEMENT OF COMPANIES

The management bodies of a company are the **general shareholder's meeting**²³, the **supervisory board** and the **management board**. The **general shareholder's meeting** is the highest management body, competent to pass the most important of decisions (e.g. amendment of the articles of association; increase or decrease of share capital; approval of the annual report and profit allocation; merger, division and dissolution of companies). The general shareholder's meeting appoints and removes members of the supervisory board. The **supervisory board** is responsible, above all, for (long-term) planning of the activities of and general organisation of the management of a company, including conduct of supervision over the activities of the management board, as well as grant of approval to the management board for conduct of transactions beyond the scope of everyday economic activities. The supervisory board appoints and removes members of the management board. Management board is a management body which organises the everyday activities of the company and represents the company.

The state will participate in the management of companies, above all, by exercising the shareholder's rights and performing the following functions:

3.1. Specification of the reason for state participation

The governor of the participation will specify, for each company governed, the reason for the state's participation in the given company on the basis of the objectives stipulated in subsection 10 (1) of the State Assets Act – above all, for seeking a profit or pursuing a public objective.

The purpose of seeking a profit applies, above all, to companies that have been traditionally held by the state – in areas where there is sufficient market regulation and supervision and effective competition but where, from the perspective of optimising costs, it may be useful to maintain the participation with the aim of earning dividend income or waiting for the right time to maximise the sales price of the participation. The state's strategic interest in maintaining the participation may also be considered a public objective. This objective concerns, above all, companies who render public services or fulfil other tasks which should not reasonably be performed via a state agency or a public procurement, or cases where the product or service is of strategic interest for the state and is required for the general functioning of the economy of the state, but where the private sector is unwilling to provide the service or product, at least not in the adequate volume, due to low cost-efficiency.

In defining the purpose of the participation, we must keep in mind that, due to the nature of any business, seeking a profit cannot be left out of the equation, albeit this may not be the primary purpose. Thus, if the primary purpose of governance of a participation is the

²³ In private limited companies, shareholders or the shareholders' meeting serve as the management body. This document focuses on public limited companies, considering that a majority of companies with state participation have been established in the form of a public limited company.

performance of a public function stipulated in legal acts, statutes or contracts under public law, seeking a reasonable profit from the sale of goods or provision of services must be considered one of the objectives (subsection 10 (2) of the State Assets Act).

The objective of state participation in a company must thus be defined upon the establishment of a company with state participation or acquisition of a participation in a company (subsection 76 (2) of the State Assets Act).

3.2. Specification of strategic objectives

The governor of the participation is obliged to specify the strategic objectives of the company in accordance with national development plans and other documents, and check and evaluate their achievement (section 9 of the State Assets Act).

The governor of the participation shall establish in writing the strategic objectives of the companies governed, and submit these to the general meetings of the companies for approval. At least once a year, the governor of the participation will review the established objectives, introducing specifications, additions or amendments thereof, as required (in case of changes in objectives, market situation, etc.). The updated objectives will be submitted to the general meetings for approval.

The supervisory boards and management boards of companies will be responsible for attaining the strategic objectives approved by the general meetings of companies. The supervisory board has the task of balancing different objectives and protecting the interests of all shareholders in a harmonious manner and in the long-term perspective.

3.3. Evaluation of the feasibility of the retaining or disposal of the state participation

The governor of the participation has the task of evaluating the purpose and feasibility of the governance of participations, and make proposals for transfer of participations that are not needed by the state (subsection 8 (3) of the State Assets Act). Thus, further to the state's purpose of participation in a particular company, the governor of the participation will formulate a justified position with regard to the feasibility of the retaining or transfer of the state's participation, and submit the position to the Ministry of Finance in the report on the governance of participations (subsection 98 (2) of the State Assets Act).

3.4. Selection of supervisory board members

As a rule, the governor of the participation selects a half of the supervisory board members who can be selected by the state. A half of the remaining supervisory board members are selected by the Minister of Finance (see chapter 5 for details).

3.5. Decision-making competence of the shareholder and voting at the general meeting

In addition to the issues that lie within the competence of a shareholder under the Commercial Code, the State Assets Act stipulates certain issues where the decision-making competence with regard to companies where the state has a majority holding lies with the shareholders²⁴.

In addition, the State Assets Act obliges the governor of the participation to ensure the implementation of certain special requirements stipulated in the State Assets Act in the companies governed by the state; via the exercising of the shareholder's rights (above all, by introducing the corresponding provisions in the articles of association)²⁵.

The governor of the participation needs the corresponding authorisation of the **Government of the Republic** for deciding or voting on certain issues that lie within the competence of shareholders: (a) merger, division, transformation, dissolution of a company (except for merger with a company incorporated in the same consolidation group); (b) increase or decrease of the share capital of a company, issue of convertible bonds; (c) acquisition of new shares or capital through the increase of capital, waiver from the pre-emptive right of subscription or acquisition or use of the pre-emptive right in a smaller volume than actually possible; (d) amendment of the articles of association, if this involves a change in the rights related to the participation; (e) entry into, amendment or termination of a contract between the shareholders; and (f) establishment of a company with state participation, or acquisition of a stake thereof²⁶.

²⁴ These issues include (a) acquisition and transfer, by a company and its subsidiary, of a significant stake in another company, (b) establishment of the management and reporting principles for subsidiaries of companies, (c) defining the decisions for which the parent of a subsidiary needs the consent of a general meeting or the supervisory board, (d) establishment of rules of procedure for the supervisory board, and (e) establishment of the procedure for donations and sponsorship as a part of the articles of association.

²⁵ These requirements include the requirements established for members of the supervisory board and management board (subsections 80 (2), (4) and (5) of the State Assets Act), the state's rights with regard to selection of supervisory board members (clauses 81 (1) 3) and 4) of the State Assets Act), remuneration of the supervisory board members (section 85 of the State Assets Act), remuneration of the management board members (section 86 of the State Assets Act), performance of the internal control, internal audit, special audit (section 87 of the State Assets Act), issues related to the competence, number of members and rules of procedure of the supervisory board, minutes of meetings and availability of the minutes (clauses 88 (1) 1)-3) and 7)-9) of the State Assets Act), obligation to adhere to good management practice (clause 88 (1) 10) of the State Assets Act), procedure for donations and sponsorship (clause 88 (1) 11) of the State Assets Act).

²⁶ This requirement will apply, if the state has at least a precluding interest in the company or a holding with a nominal value of at least 1.000,000 euros.

4. SPECIFICATION OF THE FINANCIAL OBJECTIVES OF COMPANIES

Companies, in which the state has at least the required interest, have four major financial objectives: **profitability, sustainability, efficiency** and **generation of owner's income**.

Profitability

As a shareholder, the state expects all companies with state participation operating on the free market to be profitable and able to cover at least the capital expenditure.

Sustainability

As a shareholder, the state expects all companies with state participation to carry out their economic activities with lower-than-average risks and conservative capital structure. Companies must ensure sustainability of their operations through constant innovation and development, as well as the required investments. Any investments must be covered from the cash flows generated from the core activities of the company. As a rule, the state makes no equity investments in companies. The planned investments must be carefully analysed, with the risks identified and quantified.

The capital structure of companies must comply with the objective of state participation and the financial position of the company.

Efficiency

As a shareholder, the state expects all companies with state participation to carry out their economic activities efficiently and in a resource-friendly manner. Companies must define the efficiency objectives appropriate for their field of activity, and strive towards gradual improvement on these objectives.

Owner's income

As a shareholder, the state expects all companies with state participation (mainly pursuing business objectives) operating on the free market to generate stable owner's income (i.e. dividends), which is expected to grow in time. All companies must define their dividend policy and submit it to the general meeting for information purposes.

Qualitative and quantitative indicators will be established for companies who do not operate on the free market or rely on state subsidies in accordance with the public objectives established by the governor of the participation.

In addition to the above, the governor of the participation will present its own expectations with regard to specific financial objectives (return on equity, optimum capital structure), whereas considering that tariff and price coordination requirements have been established by law for companies operating in certain areas.

The management board of a company will consider the above expectations in the establishment of the company's financial objectives, and submit these for approval to the supervisory board. The supervisory board of a company will submit the approved financial objectives to the general meeting for information purposes.

5. SUPERVISORY BOARD

In the appointment of supervisory board members, the governor of the participation must adhere to the requirements stipulated in the State Assets Act for the candidates of supervisory board members, including the requirement regarding the supervisory board member's knowledge and experience necessary for the performance of the tasks, whereas considering the field of activity and financial area of the company. Emphasis must also be laid on the requirement which prohibits any person, who has significant business interests with regard to the company (among other things, a significant holding in the company or service as a member of the management board of a company who is a key seller/buyer of goods to from the company or provider/contractor of services to/from the company) to serve as a supervisory board member²⁷.

The process of appointment of supervisory board members should be carried out as follows (with the process also stipulated in legal acts, where required):

- (a) the chairman of the supervisory board of the company or the governor of the participation identifies the need for a new member of the supervisory board;
- (b) the governor of the participation in cooperation with the chairman of the supervisory board of the company specifies the criteria for the new member of the supervisory board;
- (c) a notice of the job vacancy is published;
- (d) the governor of the participation starts preparing a list of potential candidates in accordance with the established criteria;
- (e) the governor of the participation together with the chairman of the supervisory board of the ownership entity prepares a shortlist of candidates (2-3 candidates);
- (f) the governor of the participation ascertains the terms and conditions of the job and of the candidate's acceptance of the job offer;
- (g) the governor of the participation submits the candidates chosen to the decision-maker for approval;
- (h) the decision-maker (the party exercising the shareholder's rights) appoints a new member of the supervisory board;
- (i) the governor of the participation publicly comments on the decision, the criteria underlying the decision, and expectations of the member of the supervisory board.

In the appointment of a supervisory board member (or in making the corresponding proposal), the governor of the participation must attach to the decision or proposal a

²⁷ Specific requirements for supervisory board member candidates are stipulated in section 80 of the State Assets Act, and requirements for the data to be submitted in section 83 of the State Assets Act.

written notice concerning the supervisory board member elected or proposed, explaining the suitability of the candidate, defining the skills and knowledge required for participation in the work of the supervisory board, and specifying the expectations and objectives of the particular supervisory board member in his/her participation in the management of the company.

Once a year, the governor of the participation will conduct an evaluation of the work of the supervisory boards and supervisory board members of companies, analysing the competence of the supervisory board members and the know-how and experience required for participation in the work of the supervisory board, by considering, among other things, the objectives established for the activities of the company. Self-assessment of the supervisory board members, combined with the corresponding input from the relevant third parties, will be used for the purpose. The results of the evaluation will be prepared in writing and will serve as the basis for the establishment of the supervisory board and introduction of changes in the staff of supervisory boards of companies with state participation. The results of the evaluation of supervisory board members will not be made public.

6. DIVIDEND POLICY

As a shareholder, the state expects to generate stable owner's income (which is expected to grow in time) from companies operating on the free market. Companies, in which the state has at least the required interest, will define their own dividend policy: Competence over the defining and approval of the dividend policy should lie with the supervisory board of the company. The companies will also prepare short-term (1 year) and long-term (4 years) dividend forecasts. The supervisory board of a company will submit the approved dividend policy to the general meeting for information purposes.

The following principles will be applied in the establishment of the dividend amount:

- (a) The establishment of dividends must comply with the dividend policy.
- (b) The dividend amount will be established on the basis of the dividend payment capacity, i.e. by considering the cash flow forecast, the need for investment, as well as the current capital structure (debt-to-equity) and liquidity.
- (c) The dividend amount will be established by considering the retained earnings of the company.
- (d) The dividend amount will be established based on the "superdividend test" method applied by Statistics Estonia – only the dividends which do not exceed the operating profit for the previous year, as adjusted with the profit from disposals of assets, will be recognised as state budgetary revenue.
- (e) Owner's income (dividends) will not be paid by companies with state participation, which are subsidised from the state budget and/or whose services are bought by the state.
- (f) Companies in which the state holds at least the required interest, will be governed by the principle according to which a company **will not increase its share capital and pay dividends in the same fiscal period.**

7. SUPERVISION AND REPORTING

7.1. Supervision over the achievement of the objectives

The governor of the participation will check and give an assessment of the achievement of the objectives established for the company at the annual general meeting. Once a year, the governor of the participation will give an assessment of the work of the supervisory board members in light of the company's results and expectations of the particular supervisory board members.

For the conduct of owner supervision, quarterly meetings will be held between the governor of the participation and the company, giving an overview of the progress made, challenges faced, as well as the main risks and opportunities. The task of the company is to assess whether there is any deviation from the path pursued, and the potential impact of such deviations.

7.2. Reporting

To allow the state as a shareholder to assess and inspect the activities of companies and achievement of the established objectives, the State Assets Act has established the following requirements:

- (a) Among other things, a supervisory board member appointed on the state's proposal must inform the governor of the participation or the Minister of Finance, respectively, of the company's intention to conduct transactions which fall beyond the scope of everyday economic activities or which are of significance to and may incur consequences for the company, as well as the activities as a supervisory board member in general (subsection 84 (1) of the State Assets Act);
- (b) Supervisory board members appointed by the state must submit to the governor of the participation and the Minister of Finance the materials, decisions and minutes of the meetings of the supervisory board (subsections 84 (2) and (3) of the State Assets Act);
- (c) Companies must submit annual reports and the supervisory board management reports (subsection 98 (1) of the State Assets Act);
- (d) The State Assets Act stipulates the requirements for the internal control and internal audit of companies (section 87 of the State Assets Act).

In addition to the reporting procedure stipulated in the State Assets Act, the governor of the participation has the following expectations of the reporting:

- (a) The supervisory board of the company will submit to the governor of the participation its opinion on the feasibility and objectives of state participation in a

particular company on an annual basis (by June 1 at the latest), making a proposal to the state for transfer of a participation, or dissolution or merger of the company, where necessary.

- (b) The governor of the participation will define the general reason for the state's participation (i.e. seeking a profit or pursuing a public objective)²⁸, as well as the shareholder's specific expectations, including the company's strategic objectives, positions with regard to disposal of the state's participation, dissolution or merger of the company in accordance with the objectives of participation in companies²⁹. The opinion and proposals will be prepared by the entity coordinating the governance of the state participation as a consolidated report on the governance of participations, and approved by the Government of the Republic on an annual basis in the "Consolidated report on state-owned companies, foundations and non-profit associations".
- (c) Once a year, at the annual general meeting, the governor of the participation will give an assessment (in writing) of the achievement of the company's objectives and the work of the supervisory board members, considering the company's results and expectations of the particular supervisory board members.

7.3. National coordination of the participation policy

Every year, the Government of the Republic will approve the consolidated report prepared by the governor(s) of participations on the governance of state participations in the "Consolidated report of state-owned companies, foundations and non-profit associations"³⁰. The consolidated report will describe the general rationale behind the state's participation in the companies, the shareholder's specific expectations, positions with regard to disposal of the state participation, dissolution or merger of the company in accordance with the objectives of participation in state companies.

²⁸ Subsections 10 (1), (2) and (6) of the State Assets Act.

²⁹ Subsections 98 (2) and (5) and subsection 99 (2) of the State Assets Act.

³⁰ Subsection 99 (3) of the State Assets Act.

ANNEX 2: SHAREHOLDER'S EXPECTATIONS OF EESTI ENERGIA AS (DRAFT)

Introduction

This document contains the main expectations of the state as a sole shareholder of Eesti Energia AS (hereinafter **Eesti Energia**) with regard to the activities of Eesti Energia.

The Republic of Estonia establishes three key objectives for the companies held by the state:

- (a) to pursue profitable, sustainable and efficient economic activities, ensuring optimal and stable owner's income for the state;
- (b) to attain the strategic and financial objectives established by the state in accordance with the valid legal acts and other regulations;
- (c) to serve as a role model for all Estonian companies, with regard to good management practice, social responsibility and high business culture.

The supervisory boards and management boards of companies will be responsible for attaining the strategic objectives established by the state. The supervisory board has the task of balancing different objectives and protecting the interests of all shareholders in a harmonious manner and in the long-term perspective.

In addition to seeking a profit, the Republic of Estonia holds a stake in Eesti Energia for the following reasons:

- (a) As the largest power producer in Estonia and as the owner of the largest power grid, Eesti Energia plays a key role in ensuring supply reliability;
- (b) The activities of Eesti Energia create value to oil shale as the state's strategic resource.

The state will review and, if necessary, update the shareholder's expectations set forth in this document on an annual basis.

Strategic goals

The local energy economy, energy and fuel production from the resources available in Estonia, is one of the foundations of the Estonian economy. Historically, the energy-dependence of Estonia on other countries has been low, and Estonia is interested in maintaining energy-independence from other countries.

The strategic objective of Eesti Energia is to become a significant market player on the regional electricity market. In recent years, the company's power production portfolio

has allowed to maintain an annual power production capacity of 10 TWh. The shareholder expects the power production capacity not to drop below this level. In the next ten years, Eesti Energia must have the power production and energy trading capacity required for covering peak consumption in Estonia.

As a shareholder, the state expects the company to develop a competitive and versatile power production portfolio which would allow to successfully operate as a power producer and seller on the domestic and foreign markets. The shareholder expects carbon emissions to drop to the level of 0.4 t / MWh by 2030, in accordance with the economic feasibility. The company needs to develop the capacity for exploiting biomass and combustible residue in existing oil-shale-based power plants.

Eesti Energia incorporates significant competence and know-how in the field of energy. The state expects Eesti Energia to continue to develop the energy know-how and contribute to the education of the next generation of Estonian energy specialists by annually making investments in research and development and education in the field of energy.

Over the last decade, a bulk of the activities of Eesti Energia has revolved around creating the highest possible value for oil shale as a resource through shale oil production. As a shareholder, the state expects Eesti Energia to continue the development of shale oil production within the framework of its financial capacity and by keeping in mind that the risk profile and nature of the shale oil production business differs from those of the electricity and heat markets.

Shale oil production must thus be independently measurable within the Eesti Energia group, and, should the need arise, independently financed.

The grid business of Eesti Energia must be governed by the national development plan "Estonia 2030+", in which the Estonian settlement system is expected to move towards network urbanism. Consequently, a regional distinction must be made in the level of supply reliability in accordance with Estonia's competitive ability, balancing the publicly acceptable power failure damage with the grid service price. In urban areas, the objective is to achieve the supply reliability characteristic to cities.

Financial objectives

Profitability

As a shareholder, the state expects all companies with state participation operating on the free market to be profitable. The cost of equity (the expected return on equity) will be determined by the Ministry of Finance in its annual "Consolidated report of state-owned companies, foundations and non-profit associations". The minimum cost of equity expected of Eesti Energia in 2013 is 8.37%.

Conservatism

As a shareholder, the state expects all companies with state participation to carry out their economic activities with lower-than-average risks and conservative capital structure.

Companies must ensure sustainability of their operations through constant innovation and development, as well as the required investments. The investments must be covered from the cash flows generated from the main activities of the company. As a rule, the state makes no equity investments in companies.

The planned investments must be carefully analysed, with the risks identified and quantified. The minimum proportion of equity in total assets will be determined by the Ministry of Finance. The minimum ratio of equity to total assets must be 50%. Eesti Energia's net debt to EBITDA ratio must remain below 3 at any given moment in time.

Efficiency

As a shareholder, the state expects all companies with state participation to carry out their economic activities efficiently and in a resource-friendly manner. Companies must ensure a proportionally quicker increase in revenue than in expenses in the medium perspective. Companies must define the efficiency objectives appropriate for their field of activity, and strive towards gradual improvement on these objectives.

Owner's income

As a shareholder, the state expects all companies with state participation operating on the free market to generate stable owner's income (i.e. dividends), which is expected to grow in time. All companies must define their owner's income policy and submit it to the general meeting for information purposes. Eesti Energia is expected to pay gross dividends in the amount of two-thirds of the net profit.