Sri Lanka's Approach to State Owned Enterprises Reform

Speech Delivered by Mr. K M Mahinda Siriwardana, Secretary to the Treasury and Ministry of Finance, Economic Stabilisation and National Policies at the Serendipity Knowledge Programme on "State-Owned Enterprises (SOE) Reform: Challenges and Opportunities for Sri Lanka", organised by Asian Development Bank (ADB) and held on 05.09.2023 in Colombo, Sri Lanka.

1. Background

The State Owned Enterprises (SOE) sector is being discussed at a time where Sri Lanka is experiencing its worst economic crisis in the post-independence history, which led to serious and far reaching social, and political ramifications. The government has responded the crisis by taking a series of measures to stabilise the economy and gradually bring back economic growth in a much more sustainable manner going forward, while implementing long-delayed structural reforms. Having surpassed an extremely challenging period of turbulence in 2022, the Sri Lankan economy is gradually showing signs of stability on many economic fronts, supported by these reform measures, with initial indications of moving out of recession towards recovery and eventually growth. However, there is no room for complacency and no margin for error to deviate from the envisaged reform path by reverting to unsustainable policies and practices of the past. Given the nascent recovery and prevailing vulnerabilities, it is emphasized that the consequences of such a shift would be devastating.

As in many developing and emerging market countries, Sri Lanka's SOEs have contributed to the government's fiscal and national debt crisis, which led to call for SOE reform and debt restructuring. Hence, tackling the increased vulnerabilities and low efficiency of SOEs is crucial to Sri Lanka's transitioning toward a more sustainable growth path.

SOEs in Sri Lanka have had a mixed record in their contribution to the Sri Lankan economy from the time of their establishment for various reasons. Whilst some sectors such as state owned banks make an important contribution to financial inclusion, several SOEs in sectors such as energy and transport have faced persistent losses with significant adverse fiscal implications. The presence of SOEs in Sri Lanka is very significant and encompasses a broad range of economic sectors, supply of key utilities, and employment of a large number of individuals. SOEs are vulnerable to mismanagement and corruption as well because of potential conflicts between the ownership and policy-making functions of the government, and undue political influence on their policies, appointments, and business practices. It is also observed that their internal control, monitoring and governance frameworks are inadequate to deal with these problems. As indicated in the

"National Transformation Road Map" presented in June 2023, "…*Many of these enterprises have garnered monopolistic positions in the market, hindering private investment. Price fixing, inefficient management, and poor entrepreneurship have weakened public finances, turning these institutions into national burdens that are dependent on the taxpayer"...* Therefore, the success or failure of SOEs has a significant impact on the economy as a whole.

Hitherto loss making SOEs such as Ceylon Petroleum Corporation (CPC), Ceylon Electricity Board (CEB), and Sri Lankan Airlines (SLA) create significant fiscal issues since their losses need to be addressed through Treasury transfers using taxpayer funds or public debt. Loss making SOEs also create vulnerabilities in the banking system since the accumulated debt is often funded by state banks. There are also cross liabilities between SOEs, such as large liabilities incurred by SLA and CEB to the CPC, creating a complex interaction between balance sheets of SOEs, the state banks, and the government. All of these challenges require comprehensive reforms which have been delayed for a prolonged period and have resulted in significant macroeconomic vulnerabilities. As indicated in the Interim Budget Speech in 2022, "*These difficult but necessary measures pertaining to SOEs will no doubt be challenging to address, but failing to do so would create catastrophic risks, particularly for financial sector stability, and will entail even higher taxation burdens on the public in the future*". The reforms in the SOEs is an essential component in the ongoing reforms in the government revenue and expenditure fronts to ensure fiscal discipline, and address critical fiscal and debt sustainability issues.

In designing a reform agenda for SOEs, successful case studies from our neighbouring economies and rest of the world would be of vital importance. Globally, countries have increasingly moved away from a state-led enterprise development strategies to ones which encourage the private sector to engage in businesses with governments providing business-friendly policy and regulatory frameworks without compromising the long-term interests of the public. In consideration of these domestic and global trends and developments, the government has commenced focusing on the following key reform areas on SOEs in recent times.

2. Key Reform 1: Cost-reflective Pricing

The adverse impacts on the economy due to loss making SOEs reached a crescendo in 2022. Energy sector SOEs, Ceylon Petroleum Corporation (CPC) and Ceylon Electricity Board (CEB), experienced the largest impacts due to prolonged periods of product mis-pricing, and weak financial management. As the currency depreciated from around Rs. 200/USD to Rs. 365/USD while global energy prices skyrocketed, the costs of fuel imports increased significantly driving up costs for both entities. However, retail prices for fuel or electricity were not priced in a fully cost reflective manner.

The first key reform for the major loss making SOEs was the introduction of cost reflective retail pricing of fuel and electricity. Electricity prices were increased in a cost reflective manner only in August 2022 and February 2023 for the first time since 2013. Petroleum products were priced in a cost reflective manner since May 2022. Due to the delayed implementation of cost-reflective pricing, both CEB (Rs. 262 bn) and CPC (Rs. 615 bn) ran up large losses in 2022. The Treasury had to step in with increased fund transfers to both institutions to support these losses, which is unsustainable.

While the introduction of cost-reflective pricing is critical for a net energy importing country like Sri Lanka, it does create challenges for consumers, particularly the poor and vulnerable. The government will use direct cash transfers to provide relief to those objectively identified as poor and vulnerable, instead of under-pricing utilities such as fuel and electricity as a tool to provide welfare. This approach would also aid in preventing inefficient energy use by more affluent consumers.

3. Key Reform 2: <u>Balance Sheet Restructuring</u>

Cost reflective pricing alone was not sufficient to fully address the losses of these entities. CPC for instance had large volumes of foreign currency denominated debt on its balance sheet even though its revenue is almost entirely in Rupees. This mismatch leads to large losses arising whenever the currency depreciates. In order to address this, the government took on to its balance sheet, the foreign currency denominated loans guaranteed by the sovereign on the balance sheet of CPC and most of the same of CEB. This was a part of a larger exercise of restructuring balance sheets of fiscally significant SOEs – CPC, CEB, Sri Lankan Airlines, and the Road Development Authority (RDA). During this process, the government also addressed several cross liabilities among SOEs. For instance, due to delays in settlement of fuel supplies, both the CEB and Sri Lankan Airlines have run up large liabilities with CPC, which in turn have been funded by state banks at high cost. The Cabinet of Ministers approved a strategy to unwind these cross liabilities which will be executed in the near term. Following this overall balance sheet restructuring exercise, the financial positions of all of these major SOEs will be significantly cleaned up, reducing the risks emanating to the fiscal sector and to the banking sector. However, a long-term solution that would present any future build-up of similar balance sheet mismatches would be essential.

4. Key Reform 3: <u>Introduction of Competition in Key Sectors</u>

As the financial position of CEB and CPC stabilises, the next requirement is to drive productivity and competitiveness in these entities by introducing greater competition. Measures have already been taken to introduce competition to the downstream petroleum retail market. The first new player, Sinopec, commenced commercial operations last week. Once there is greater competition in the market, it will force CPC to streamline its operations, reduce cost structures, and drive efficiency in order to remain a relevant player in the petroleum retail space. The outcome would be better pricing and services for consumers. Globally, petroleum retail space is a competitive business with multiple players, with governments taking a backstage.

At the same time, the government also has initiated measures to unbundle operations at the CEB where the ADB is also playing an important role. This will lead to greater operational and financial independence of electricity generation and distribution activities, enabling competition within the entity. Improved transparency through Bulk Supply Transaction Accounts (BSTA) will allow for greater price discovery and overall better outcomes for consumers as a whole. As another example, the automation of obsolete practices such as manual reading of meters would benefit consumers through more predictable and timely readings, while improving productivity of the workforce.

5. Key Reform 4: <u>Divestment of Non-strategic Assets</u>

Through SOEs, the government is engaged in commercial activity in a number of spheres. Other than in certain activities such as natural monopolies, sectors with material security or strategic implications, there is limited justification for state engagement in commercial activity. This becomes all the more applicable in situations where fiscal constraints are very significant. In countries like India, even in sectors with strategic implications, including airlines and ports, successful divestments have been observed, with positive fiscal implications.

As said before, the role of the government is primarily in ensuring a stable macroeconomic environment, rule of law, and regulatory framework in which commercial enterprise can take place in an efficient and equitable manner. Towards this end, the government has commenced the process of gradually divesting state-owned assets in commercial activities which do not fit the above criteria. In some cases, this includes entities that are not necessarily loss making. In the context of the announcement of the debt standstill on 12 April 2022, which was the only available option at that time to prevent a hard default and subsequent far worst outcome than the country is experiencing now, and extreme fiscal constraints, the government needs to raise resources to settle its liabilities and if such divestments are to foreign entities, the proceeds can help restore the country's depleted foreign reserves, while largely reducing the future fiscal burden and improving the overall efficiency of the economy. The divestment is also expected to result in increased productivity, efficiency, and greater economic activity through increased investment.

The approval of the Cabinet of Ministers has already been received for divestment of several entities and transaction advisors have been appointed to support these transactions in a professional manner. It will be ensured that such divestments occur following appropriate due diligence and transparent processes. The government has established a State-Owned Enterprise Restructuring Unit at the General Treasury to help with the SOE restructuring process.

6. Key Reform 5: <u>Governance and Legislation</u>

To reduce the risk of recurrence of financial vulnerabilities in SOEs, it becomes crucial to address deeper governance issues in these entities. Most importantly, this applies to the appointments of Board members and senior management, regular publishing of audited financial statements, strict discipline over procurement and capital spending, among others. Whilst the government has already taken measures to bring into practice some of these governance requirements in SOEs, legislation will be drafted to provide a legal framework for this. The proposed State Owned Enterprises legislation and the Public Financial Management Act will together provide an overarching legal framework for the governance of SOEs, going forward.

The government is also in the process of establishing a Holding Company that will eventually take ownership of government owned corporate assets. This will enable professional management of such assets and ensure corporate governance standards are upheld. The Holding Company will be government owned and will be accountable to the Ministry of Finance.

7. Concluding Remarks

The SOE restructuring programme is a crucial element of the overall economic reform effort. Given the extremely challenging fiscal conditions, the government has no space to provide transfers to fund SOE losses any longer, whereas ideally, the government should receive more tax revenues or dividends from such enterprises in the hands of more efficient management. Therefore, a business as usual approach is no longer tenable. Many ADB studies have indeed discussed in-detail the overall efficiency gains experienced by

South East Asian, East Asian, and increasingly South Asian economies through prudent approaches to SOE reforms and creating a conducive environment for private sector activity.

In Sri Lanka, the SOE reform measures already put in place and those in the pipeline will help minimise SOE losses while providing efficient services to the public, going forward. The transformation of existing SOEs from 'fiscal burdens' to 'value creators,' through such reforms, is vital for them to emerge as facilitators of Sri Lanka's progress onto a high growth trajectory, rather than serve as stumbling blocks. Hence, it is essential that there is no rollback of these reforms in the future, as the general public and the work force have been, and could be, easily deceived by short term, selfish and falsified, so-called gains that could be gained by reversing progressive reforms. The proposed legislative measures will help lock in some of these reforms – however it is essential that there is greater public understanding of the need for such reforms and why any reversal of the same would be detrimental to the public interest in the long term, either directly or indirectly.
