Speech made by Mr. K. M. Mahinda Siriwardana, Secretary to the Treasury, and Ministry of Finance, Economic Stabilisation and National Policies at the Seminar on "*Enhancing Efficiency of State-Owned Enterprises*", organised by the National Issues Committee of the Organisation of Professional Associations of Sri Lanka (OPA) on 31st January 2024

1. The Case for Reform

State Owned Enterprises (SOEs) have played a significant role in the Sri Lankan economy throughout our post-independence history. From the perspective of the Treasury, the most visible impact of SOEs is the loss or profit made by these SOEs. However, the impact of SOEs on the economy extends beyond that – they utilise scarce resources of the economy, specifically land, labour, and capital. Optimal economic management requires such scarce resources to be utilised in the most productive manner that maximises the overall social return from those resources.

SOEs employ around two hundred and twelve thousand individuals – that is around 18% of the total employed by the government – and is indicative of the significant usage of labour resources by state enterprises. In some cases, the use of scarce labour resources in state enterprises is socially optimal, however in many cases labour would be more productively employed in sectors such as competitive private sector exporters.

SOEs exist as a result of capital investments by the government – that is capital investments on behalf of the tax payers of the country. It is very clear that tax payer funds are limited and have several competing demands, such as expenditure on social services such as healthcare and education. Therefore, it is necessary to consider the opportunity cost of the deployment of such capital for the maintenance of SOEs. For instance, is it socially optimal for the government to retain its investment in a hotel, or to divest that investment, and use the proceeds for upgrading the public education sector?

This question applies to both profit making and loss making entities. Even a profit making entity is not an optimal investment of tax payer funds, if the return on investment is lower than the government's borrowing cost. If we go back to the previous example, if a particular hotel is profitable, but the return on investment is for example 5%, whereas the government's borrowing cost is 13%, it makes financial sense to divest ownership of the hotel. The proceeds can be used to invest in public education instead of raising funds at 13% to fulfil the same objective, thereby creating a net saving of 8% for the tax payer. In some situations, there are legitimate strategic considerations for government ownership of SOEs that may trump financial considerations. However, in Sri Lanka, there are many non-strategic state enterprises where state ownership should be critically evaluated on financial terms.

SOEs also dominate certain industries. In financial services for instance, state banks control over 40% of the assets of the total banking sector. In certain sectors, such as the energy sector, the state has almost monopoly control. Such situations can be sub-optimal for society since in the absence of effective regulation, monopolies tend to limit productivity gains and consumer welfare due to lack of competition. Therefore, ensuring competition where feasible, even whilst maintaining state ownership, typically results in positive outcomes for society.

Over the years, SOEs have had positive impacts, such as financial inclusion through the vast and often non-commercial network of the state banks. At the same time, SOEs have also had negative impacts, such as the large losses incurred by entities, including CEB, CPC and Sri Lankan Airlines. The objective of the ongoing reforms and restructuring of state owned enterprises is to eliminate or at least minimise the losses and inefficiencies of SOEs, whilst preserving the positive socio-economic impact of SOEs, with a view to optimising returns to society and reduce fiscal risks.

2. Financial Reforms

2.1 Cost Reflective Pricing

The top priority for the Treasury in terms of SOE reforms was to stem the losses of the fiscally significant SOEs. The bulk of SOE losses arise out of the energy sector (CPC, CEB) and the transport sector (Sri Lankan Airlines). In 2022, the collective loss of the 52 large SOEs was Rs. 745 billion. Losses in the energy sector amounted to Rs. 877 billion and the aviation sector had a loss of Rs. 66 billion.

Whilst the loss in 2022 was exceptionally high, losses in these sectors have been a persistent feature. In the energy sector (and in some other utilities such as water), losses have primarily resulted out of pricing products or services below market cost. Successive governments have maintained a policy of keeping fuel and electricity prices stable in spite of fluctuations of costs. The resulting losses have not always been financed by the government, and instead have been financed by the two state banks.

Over the years, these losses accumulated leading to the debt held by the state banks rising continuously. By 2022, CPC debt alone exceeded Rs. 1 trillion. This resulted in deterioration of the quality of the balance sheets of state banks. There were also cross-liabilities between these entities, with CEB unable to settle bills to CPC due to the lack of cost reflective electricity tariffs. As a result, both CEB and Sri Lankan Airlines built up large debts which were parked on the CPC balance sheet. In the case of CPC, their liabilities were denominated in US dollars whereas their revenue is predominantly in Sri Lankan rupees, creating a major forex mismatch leading to large losses. This indicates the circular nature of SOE debt and the deep inter-connections between SOE debt, state banks, and government finances.

The state banks were able to sustain the CPC/CEB loans as long as they were able to match these with foreign counter-party funds. However, as the economic crisis took hold in 2022 and funding flows dried up, the state banks were no longer in a position to support the cash flows of these entities. At the same time, the government was running double digit budget deficits and in the absence of foreign financing and phasing out of monetary financing, there was no space in the government cash-flow to support these losses either.

In this context, cost reflective pricing became inevitable since there was no way to continue to supply electricity and fuel at a loss. It was unfortunate that prices had not been gradually adjusted over the years, as a result of which there was a large adjustment requirement at a time when the population was under significant economic stress. Electricity prices had to be increased in August 2022 by 75% and a further 66% in February 2023 since this was the first adjustment to electricity prices since 2014. Similarly, petrol and diesel prices were also increased to reflect actual costs after a prolonged period of under-pricing.

In the past, successive governments have mixed up policy objectives by trying to achieve welfare objectives through price controls of essential goods and services, such as fuel and electricity to shield the poor from price fluctuations. However, Sri Lanka's recent experience shows how such policies end up being unsustainable. In the new policy framework, the government intends to achieve its welfare objectives through targeted direct cash transfers to poor and vulnerable communities, which can cushion the impact of price shocks.

This enables essential goods and services, such as electricity and fuel, to be sustainably priced at cost-reflective levels, thereby ensuring the financial stability of the enterprise (CPC/CEB) whilst avoiding added stress on the banking system and the fiscal position of the country. In the past, under-pricing of fuel and electricity also contributed to balance of payments issues and currency volatility as the low prices create incentives for over-consumption of Sri Lanka's largest import which is fuel.

2.2 Balance Sheet Restructuring

In order to reduce the risk of losses re-emerging in the future, it became necessary to restructure the balance sheets of the key SOEs. Accordingly, the cross liabilities between the CPC, CEB, and Sri Lankan Airlines were resolved by setting off debts between the entities and the government (as the common shareholder) in December 2023. Some of the foreign currency denominated debt on the balance sheets of CPC and CEB was taken on to the government balance sheet and subject to restructuring along with the overall debt restructuring process. Recent profits made by the CPC and CEB have also been used to set off some legacy debt.

Subsequent to the balance sheet restructuring, the health of the balance sheets of the CPC and CEB have improved significantly. CEB now has a strong positive net asset value position and CPC's negative net asset position has been reversed. Sri Lankan Airlines still faces a deep negative equity position (Rs. 495 billion), however the government is in the process of securing a strategic investor for the airline to address the weakness in the balance sheet. In parallel, measures are being taken to restructure the residual debt of the airline in order to ease some of the cash flow pressures faced by the company.

Following the implementation of cost-reflective pricing and balance sheet restructuring of key entities, the performance of CPC, CEB, and Sri Lankan Airlines has turned around. CPC and CEB both returned to profitability in 2023. Going forward, CPC will continue with formula based cost reflective monthly adjustments in pricing, which will eventually be adjusted on a daily basis, further smoothening price adjustments. CEB will implement quarterly cost-reflective tariff adjustments on a forward looking basis. Sri Lankan Airlines returned a profit before tax of Rs. 80 billion in the first eight months of 2023.

3. Institutional Reforms

Numerous institutional reforms are also being implemented in key SOEs. In the petroleum sector, the government is in the process of introducing further competition in the downstream retail sector. In addition to Indian Oil Company and Sinopec, RM Parks (Shell) is also expected to commence retail operations in the near term. This will ensure that consumers have choice and monopoly behaviour doesn't set in. Competition drives efficiency, which in turn will translate into consumer benefits through lower prices.

The legislation to enable the restructuring and unbundling of the CEB is in advanced stages. The reform is expected to create operational and financial independence of the three segments of the CEB – generation, transmission and distribution. The present structure of all three segments operating under a single entity has resulted in a lack of transparency and opaque management practices which can hide potential efficiency gains. By unbundling the entity, there will be greater visibility over financial and operational practices, which is expected to yield improvements in governance and pricing. Furthermore, the Bulk Supply Transaction Account (BSTA) system is now operational. This provides real-time data on costs and usage, which enables early identification of potential losses or profits. The BSTA will provide a more timely and accurate basis for tariff adjustments.

Another key reform is the proposed establishment of a holding company structure which will have ownership of SOEs. The holding company itself will be owned by and accountable to the government but will have professional management that will provide oversight on governance, key personnel appointments, and financials. The objective is to gradually shift SOEs from line ministries to the holding company, thereby enabling professional management of these entities.

The government is also in the process of divesting a number of SOEs. In sectors such as telecommunications, insurance, private healthcare, the government's role is in regulation and oversight. A stringent, transparent process of RFPs and selection is ongoing in this regard. As mentioned previously, even if some of these entities are profitable, there is a case for divestment given the opportunity cost of scarce capital being tied up in non-strategic assets at a time when public debt is unsustainable.

4. Governance and legislation

Many of the reforms outlined thus far are intrinsically linked to improvements in governance. The unbundling of the CEB for instance creates greater operational and financial transparency, and reduces risk of selective energy dispatch to favour preferred generation entities that may not be the least cost option. SOEs have been identified as being at risk to corruption vulnerabilities in the independent Governance Diagnostic Report (GDR) published last year. This is particularly in areas relating to appointment and accountability of key personnel, procurement practices, internal controls and financial transparency.

The Holding Company structure is expected to build in numerous corporate governance measures comparable to listed private companies. There will be a strict basis for appointment and accountability of directors and key management personnel, with fit and proper guidelines implemented. There will be even more stringent measures applied in systemically sensitive sectors such as the state owned banks. Amendments to the Banking Act, which will be implemented shortly, builds in far stricter rules for appointment to boards, risk management practices, and internal controls.

Most importantly, the above reforms will be codified in legislation. Three crucial laws are in advanced stages of drafting – the Public Financial Management Bill, the State Owned Enterprises Reform Bill, and the Public Private Partnerships Bill. These pieces of legislation collectively address critical governance related disciplines, including on procurement, appointment of key personnel, internal controls, and financial transparency.

5. Concluding remarks

State Owned Enterprises have had important implications for the deep economic crisis the country has faced. This is due to the fiscal losses associated with key SOEs, large accumulated debt and weak balance sheets that have added to public debt, and the implications for the stability of the state owned banks.

The reforms outlined today go a long way towards addressing the structural weaknesses in SOEs that contributed to the crisis. The results thus far have been positive. In the first

8 months of 2022, the 52 largest SOEs recorded a collective loss of Rs. 748 billion. In the corresponding period of 2023, this was turned into a profit of Rs. 311 billion. This shows that the reforms being implemented are working.

The institutional reforms and legislation being put in place is expected to consolidate these reforms and ensure continuity. However, legislation alone is not sufficient to drive meaningful and sustainable change. It is essential that all stakeholders including civil society, the private sector, academia, and the media, understand and support these reforms and hold the government and legislature to account to ensure improvements and continuity of the reform process such that we avoid the repeat of another crisis.

Thank you!