

Kyrgyz Republic: Integrated State-Owned Enterprises Framework Assessment (iSOEF)

Report Presentation: Main Observations and Recommendations

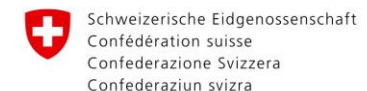
Natalie Manuilova, Senior Financial Management Specialist, World Bank
Cigdem Aslan, Lead Debt Specialist, World Bank
Bekten Doolotov, Energy Consultant, World Bank
Irina Goncharova, Senior Procurement Specialist, World Bank

10 February 2022



Kyrgyz Audit and Reporting Enhancement Project

KAREP is funded by:



Swiss Confederation

Federal Department of Economic Affairs,
Education and Research EAER
State Secretariat for Economic Affairs SECO

Main Sections of the iSOEF Assessment



- » SOE landscape, role and economic importance
- » Fiscal costs and fiscal risks stemming from SOEs
- » Forecast of the long-term fiscal impact of energy sector SOEs
- » SOE legal framework in the Kyrgyz Republic
- » SOE ownership and oversight functions
- » SOE performance monitoring
- » Corporate governance, role of boards of directors, executive management at SOEs
- » Financial reporting, transparency and disclosure
- » Public procurement and SOEs
- » Reform options



*Based on 2018 data, updated where available before finalization in 2020

Report is available here: <https://openknowledge.worldbank.org/handle/10986/35581>



Integrated State-Owned Enterprises Framework Assessment (iSOEF):

SOE Landscape, Role and Economic Importance

SOE Landscape, Role and Economic Importance



- SOEs are of systemic importance in the energy, mining, transport and banking sectors of the economy.
- SOEs are recipients of significant budget transfers in the form of explicit and hidden subsidies.
- SOEs provide taxes and dividends to the budget.
- Increasing concern of the Government in SOEs efficiency and profitability.
- Main source of fiscal risks for the Government is the energy sector:
 - Energy sector was the only sector among state-owned enterprises that ended 2018 with a loss
 - Energy SOEs are not able to cover production costs due to low energy tariffs
 - Debt accumulated by 2 SOEs (generation OJSC Electric Stations and transmission NEGK OJSC) is equal to 17% of GDP (2020 data)
 - Energy sector is the main source of quasi-fiscal operations/activities

SOE Landscape, Role and Economic Importance



- Number of SOEs is still significant. In 2018, there were 23 joint-stock companies and 104 state-owned enterprises (non-joint-stock legal entities) in the Kyrgyz Republic.
- Largest SOEs operate in strategic sectors: energy, mining, transportation, banking.
- SOEs play an important role in the Kyrgyz economy. In 2018, they generated a turnover equal to 22.6% of GDP. Total assets reached 45%, and liabilities - 29.2% of GDP.
- According to SOE reports, in 2018 their total profit amounted to 2 billion Soms.*

All SOEs	Million Soms	Percentage share of GDP
Assets	250 452	45,0%
Liabilities	162 586	29,2%
Gross revenue	125 836	22,6%
Net profit	2 072	0,4%

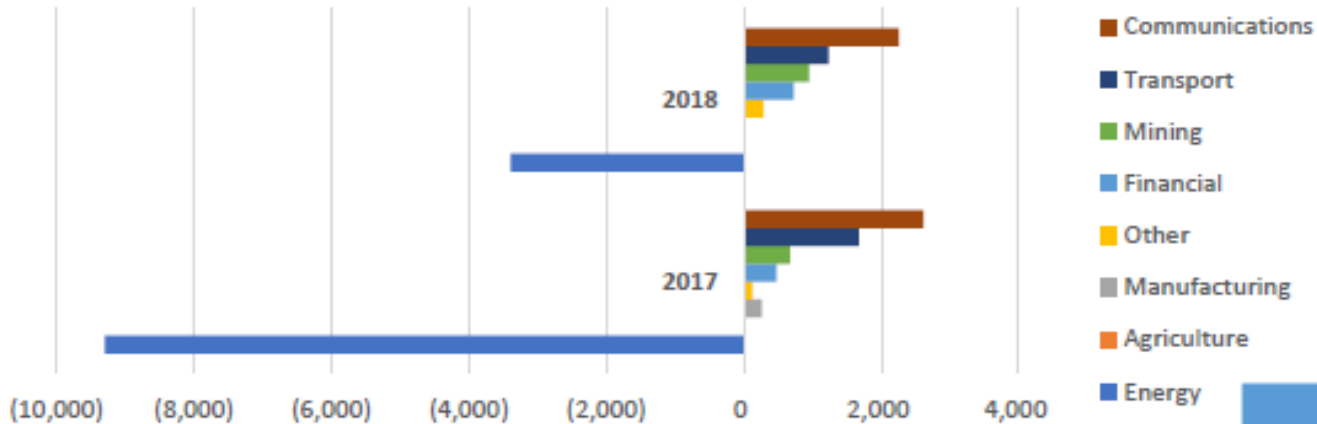
- The energy sector is the only sector that operated at a loss pre-COVID. According to energy SOE 2018 reports, their total loss amounted to KGS 3.4 billion.

* SOE profits are overstated due to explicit and hidden budget subsidies that SOEs receive

SOE Landscape, Role and Economic Importance



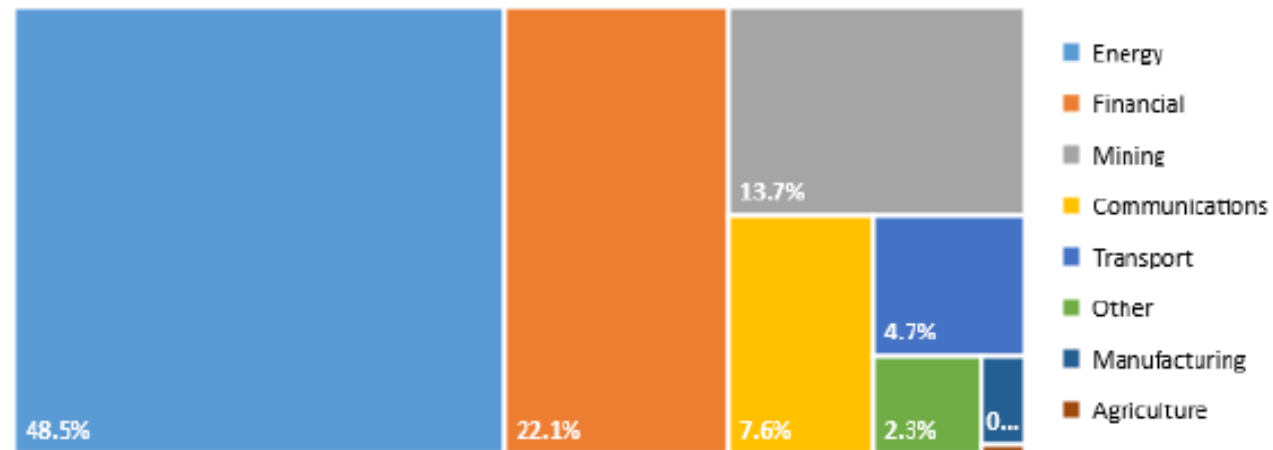
Profitability by sectors, in million Soms



Source: SPMF, energy companies' individual financial statements, World Bank staff analysis.

* SOE profits are overstated due to explicit and hidden budget subsidies that SOEs receive

Distribution of SOEs Assets by Sector, %



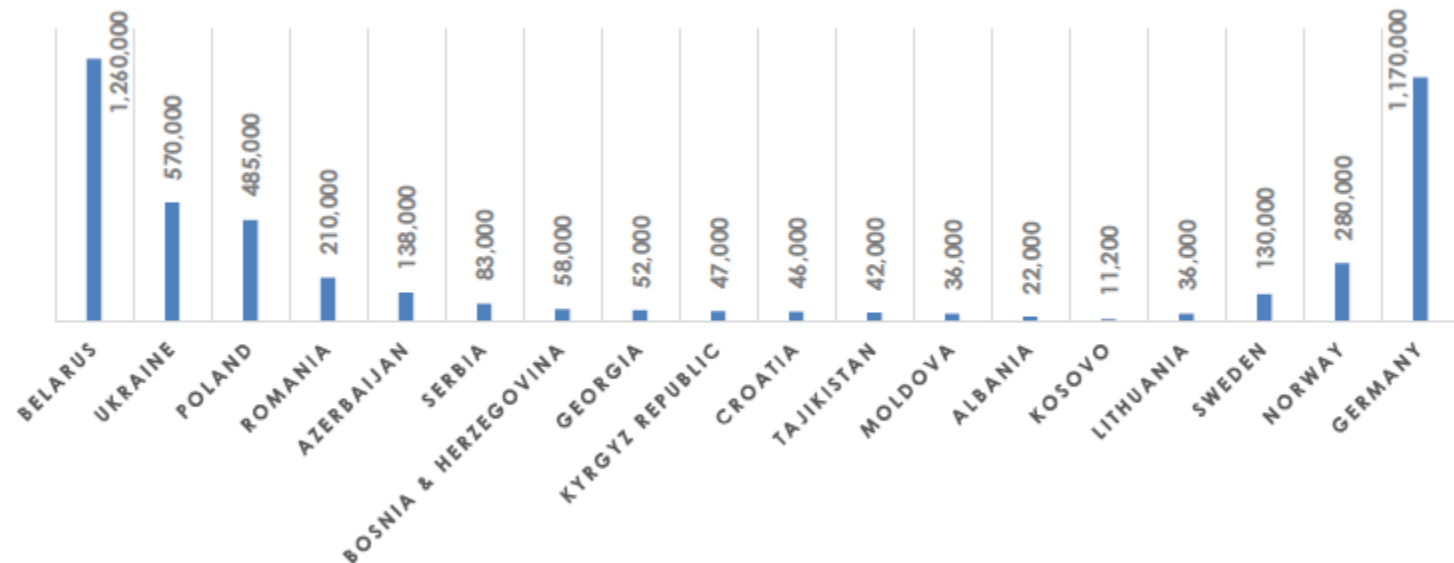
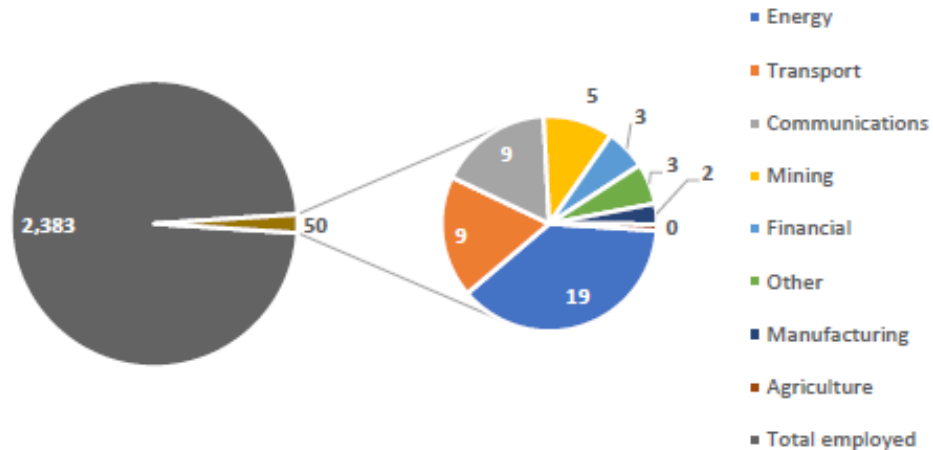
Source: State Property Management Fund, energy companies' individual financial statements, World Bank staff analysis

SOE Landscape, Role and Economic Importance



Share of SOE Employment is modest at 2% of the working age population confirming a clear growth of the private sector in the country =>

- Total number of people working in all legal forms of Kyrgyz SOEs is only ~50,000 people
- Largest share is with energy sector SOEs ~19,000 employees
- Followed by transport and communications at ~9,000 employees each



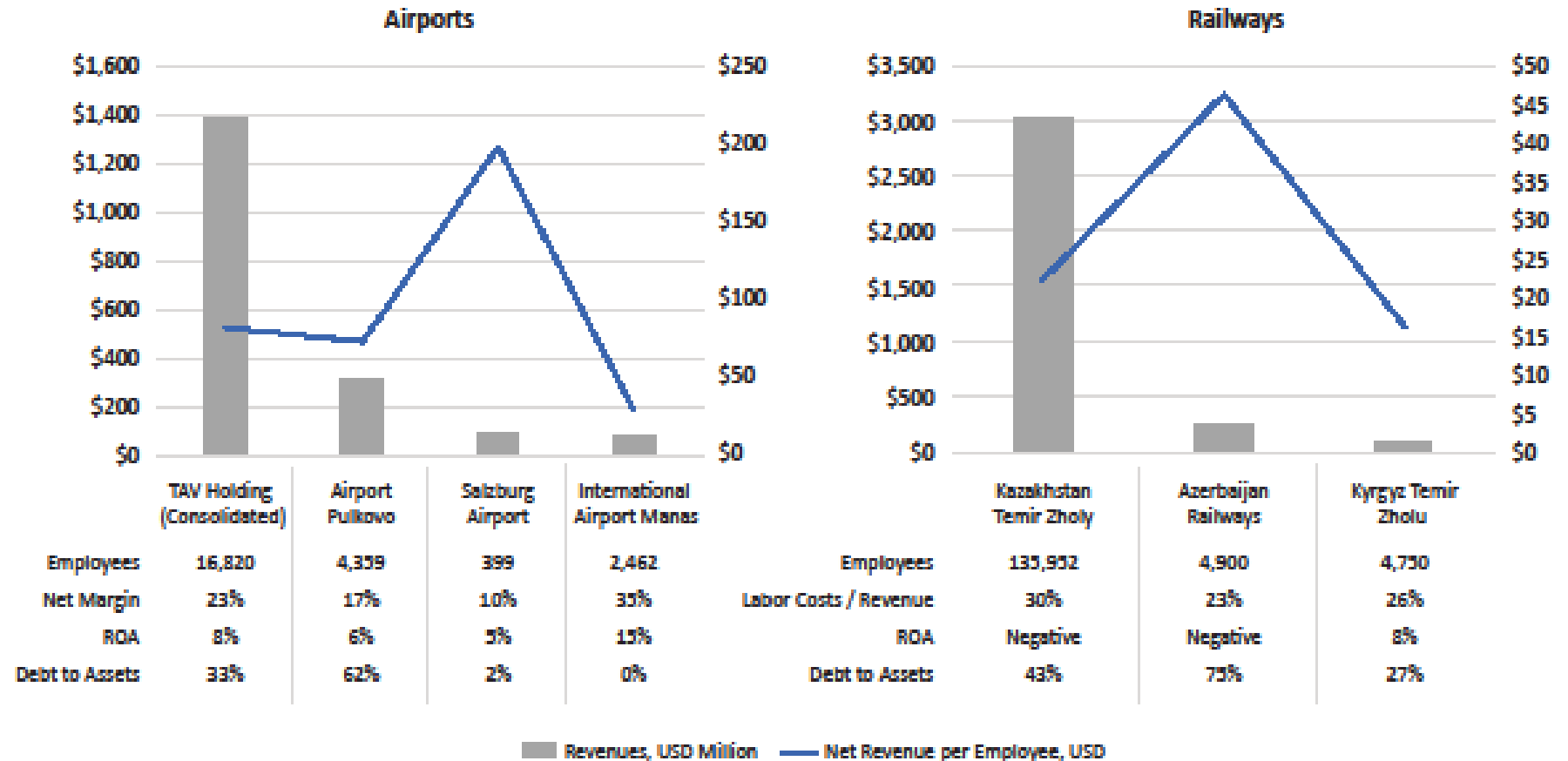
Source: State Property Management Fund, Statistics Committee, World Bank staff analysis

SOE Landscape, Role and Economic Importance



- Kyrgyz transport SOEs operated at a profit (pre-COVID) but failed to invest into the necessary infrastructure
- Comparative SOEs from other countries show lower returns but invest heavily and produce higher revenue per employee than their Kyrgyz peers
- Leverage ratios are low, suggesting that Kyrgyz SOEs may borrow for necessary infrastructure modernization but abstain from doing so

Benchmarking Selected Performance Indicators for Kyrgyz Transport SOEs

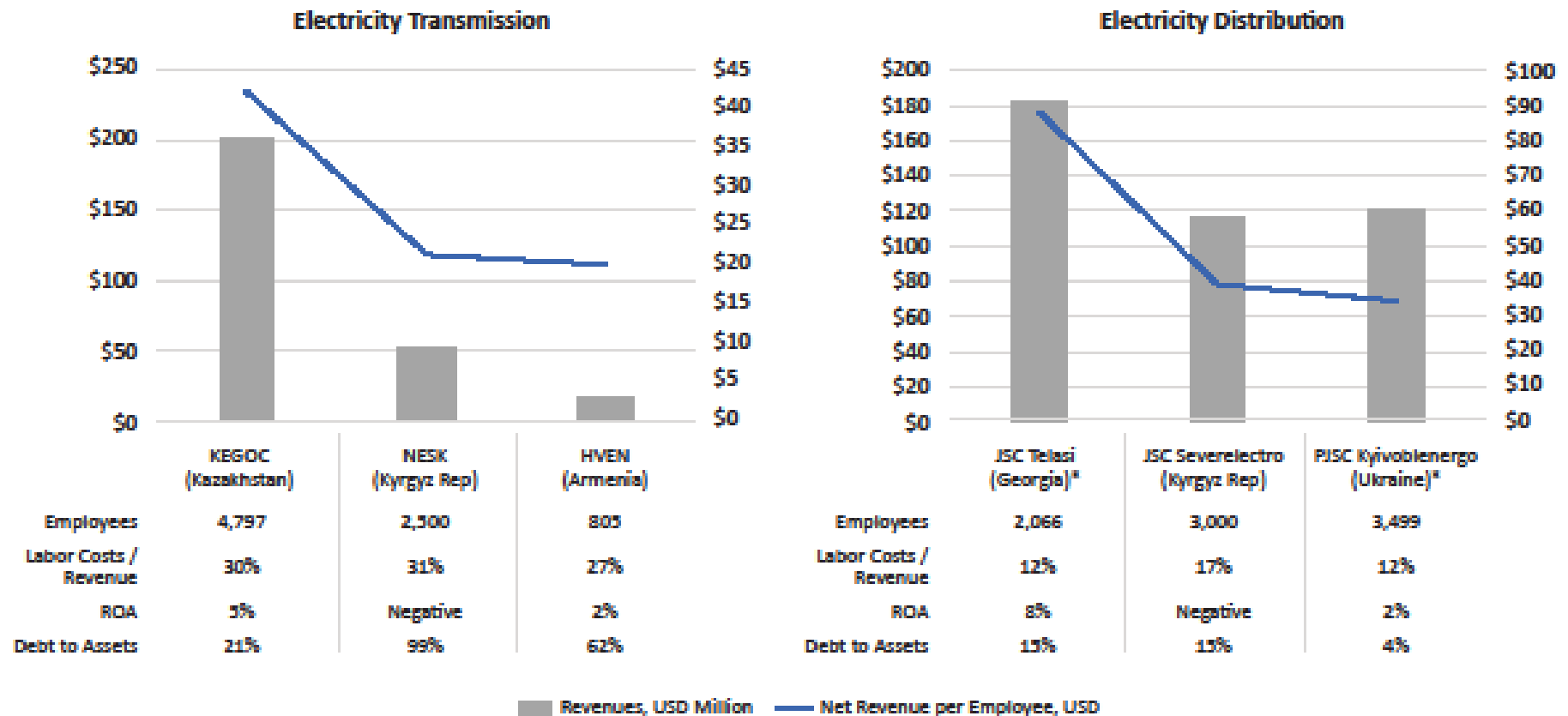


SOE Landscape, Role and Economic Importance



- Kyrgyz energy sector SOEs companies are overleveraged and undercapitalized
- Regulated tariffs constrain revenue growth and negatively impact cash flows and profitability
- Low or negative equity positions and high external debts combined with insufficient operational cash flows
- Measures required to ensure financial sustainability – i.e. by increasing capitalization of this strategic sector, debt-to-equity swaps

Benchmarking Selected Performance Indicators for Kyrgyz Energy SOEs





Integrated State-Owned Enterprises Framework Assessment (iSOEF):

SOE Fiscal Costs and Fiscal Risks

SOE Fiscal Costs and Fiscal Risks

Poor performance of SOEs pose a significant risk to public finances and can affect the financial position of the government:

Less than projected income

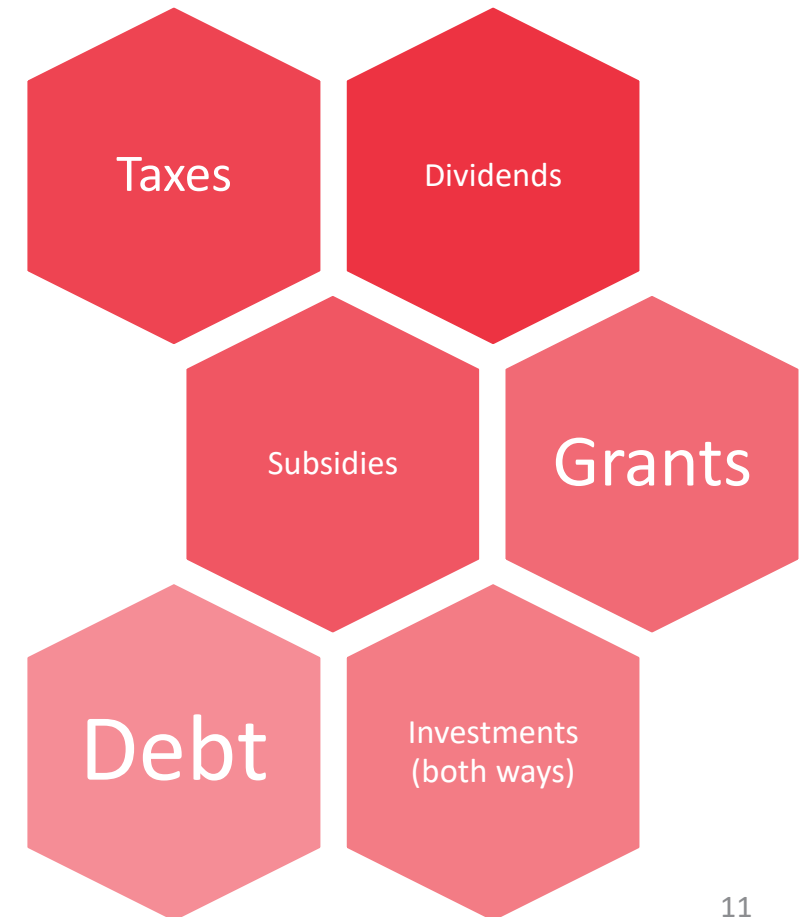
- ✓ SOEs are typically major taxpayers
- ✓ Dividend income for the budget

More than planned or unexpected budget expenditures

- ✓ Subsidies | grants from the budget
- ✓ Large issuers of debt, beneficiaries of on-lending, guarantees
- ✓ “Hidden” expenditures such as quasi-fiscal activities

Impact on growth

- ✓ SOEs investments in public infrastructure
- ✓ Investments attracted by SOEs from 3rd parties



Kyrgyz Republic: SOEs Impact on State Budget



- Contribution of SOEs to the state budget is quite small and amounts to approx. 1% of GDP, it is formed by taxes and dividends, in 2018 this sum amounted to **5.3 billion Soms**
- In 2018, direct budget subsidies granted to non-financial and financial SOEs from both the Republican and local budgets reached **4.5 billion Soms - most of which channeled to energy SOEs**, including SE Kyrgyzteploenergo (residential heating)
- Net contribution of SOEs into the budget can be significantly higher if operational indicators of SOEs are improved and risks are properly managed (i.e., currency risk, repayment risk)
- Government is increasingly concerned about SOEs efficiency and management

REVENUES	Dividends		Taxes*	TOTAL
	Sectors	SOE JSCs	SEs	SE JSCs
Mining	314	3	737	1,054
industrial production	27	-	50	77
Energy and Energy construction	9	-	162	171
Transport	645	285	455	1,385
Information and communication	383	3	1,292	1,678
Finance	389	N/A	403	792
Other	2	148	19	169
Total	1,769	439	3,118	5,326

Source: SPMF, Statistical Committee

* Income Tax data for JSC, SE's tax payment data could not be obtained

SUBSIDIES	Republican budget	Local budget*	State budget
Non-financial SOEs	1,299.8**	2 336,0	3 635,8
Financial SOEs	885,1	26,7	911,8
Total	2 185,9	2 362,7	4 548,6

Kyrgyz Republic: SOEs Impact on State Budget



- Protracted low efficiency may lead to an increase in debt and a deterioration in the value of the state's share in SOEs as a result of accumulated losses.*
 - ! Electric Stations completed 2018 with an equity of 0.7 billion Soms compared to the initial share capital of 4.4 billion Soms.
 - ! NESK, National Transmission Company reported negative capital in the amount of (0.1) billion Soms against a share capital of 1.6 billion Soms, further eroding to KGS (7.9) billion Soms in 2020.
- Quasi-fiscal operations carried out by SOEs and not compensated from the budget may be the main factor that negatively affects their financial performance, especially in regulated industries, i.e. energy sector.

* Materializing in 2020-2021 as accelerated by COVID-19 related pressures

Contingent liabilities from SOEs



- Contingent liabilities are divided into two categories: (i) explicit; and (ii) implicit.
- Guarantees to SOEs (loan, PPPs) and lawsuits against the government as the owner of SOEs are the two most common types of explicit contingent liabilities.
- Liabilities of SOEs (e.g., non-guaranteed debt, fiscal commitments) constitute implicit contingent liabilities. These are based on public expectations that the government will bail out an SOE under financial difficulty with additional capital or debt so that it continues to operate.
 - ✓ In Kyrgyz Republic, the Budget Code prohibits the Government from giving guarantees to repay debt to state enterprises. But SOEs (in particular in the energy sector) benefit significantly from budget lending and on-lending.
 - ✓ The extent of potential financial risks from legal disputes cannot be estimated due to inaccessibility of data. Data represents trade secrets.
 - ✓ In Kyrgyz Republic, the Government also has secondary legal responsibility for the obligations of state enterprises (unitary/ ГП) under operational management.

Kyrgyz Republic: Fiscal risks from SOEs



- **The inability of SOEs in the energy sector to pay interest and principal debt poses a serious financial risk to the Government of Kyrgyzstan.**
- NESK and Electric Stations are the two main beneficiaries of budget lending – in 2020, they held US\$1.3 billion in debt, or 95% of all SOEs loans, which amounted to 17% of GDP, and is quite high by international standards.
- Their current debt levels are volatile. The average liabilities of emerging economies in Europe range from 0.1 to 7.3% of GDP.
- The risk is compounded by the fact that the Government is the main creditor of non-financial SOEs (sub-loans of IFIs and bilateral funds).

Sector	Outstanding debt, million Soms (2018)
Energy	103 826.5
Finance	5 292.9
Transport and Communicaiton	728.6
Industrial production	189.2
Mining	12.5
Agriculture	94.2
TOTAL	110 143.9



Kyrgyz Republic: Fiscal risks from SOEs

In accordance with international sound practice, a country's budget documentation should include information on all major fiscal risks.

- 👍 Starting 2017, the Ministry of Finance includes a section on Budgetary Risks in the explanatory note to the budget.
- 👍 The guidelines for compiling information for the fiscal risk report adopted by the Ministry of Finance of the Kyrgyzstan include the identification of fiscal risks, description of the types of fiscal risks and contain formats for their disclosure.

Possible Recommendations:

- ↙ Increase focus on largest and most likely sources of fiscal risks - starting with energy sector SOEs
- ↙ Improve coordination in reporting: e.g., Energy Holding and its subsidiary companies to submit their financial statements directly to the MoF for regular monitoring of their financial performance, risks
- ↙ Preparation and analysis of financial statements of state enterprises (non corporatized/ ГП) for the purpose of analyzing fiscal risks by the MoF
- ↙ Fiscal risks associated with SOEs to be disclosed in the budget documentation and provided to the Jogorku Kenesh (Parliament)



Integrated State-Owned Enterprises Framework Assessment (iSOEF):

Energy Sector SOEs and Long-Term Forecasts

Energy Sector SOEs and Long-Term Forecasts



- ❑ Energy sector organized under the JSC National Energy Holding Company
- ❑ 10 subsidiaries spanning generation, transmission, distribution and heating
- ❑ Largest borrowers in the country, low capitalization, high leverage
- ❑ Energy SOEs financial stance aggravated by losses from delivering services at below-cost
- ❑ Energy SOEs public service obligations (delivered at below-cost) are only partially subsidized —implicitly and explicitly— by the state budget
- ❑ Energy sector ownership and policy making functions are concentrated with the Ministry of Energy (from 2021) – out of line with good practices

Energy Sector SOEs and Long-Term Forecasts



- Kyrgyz energy sector SOEs are overleveraged and undercapitalized, tariffs constraining revenue growth and negatively impacting cash flows and profitability
- Long term forecast estimated financial resources energy sector SOEs would require from the budget to maintain delivery of their services over the next 10 years (to 2030)
 - 1) **No reform scenario**: average net budgetary requirements of 4.1% of GDP would push the central government's average fiscal deficit above 5.5% of GDP, and raise public and publicly guaranteed debt to 77% of GDP, which is not fiscally sustainable
 - 2) **Tariff reform scenario**: tariff increases would improve the financial condition of the energy sector as compared to the no-reform baseline scenario (3.7% of GDP vs. 4.1% of GDP), but it will not significantly reduce the net budgetary requirements. Tariff increase is an important pre-requisite to achieving cost-recovery of the energy sector
 - 3) **On-budget compensation of PSOs**: Government to compensate SOEs from the budget for the costs that they incur in implementing public policy objectives, such as providing energy to targeted groups of consumers at prices below the cost of service.

Energy Sector SOEs and Long-Term Forecasts



- 4) **Converting Debt to Equity scenario**: Energy sector SOEs' financial position would improve upon even partial conversion of their debt into equity, reducing debt pressure and making the first step in attracting private capital. This would increase capitalization and reduce debt service payments, strengthening SOEs' financial viability. Net impact of this scenario on the budget would be zero.
- 5) **Attracting private investment**: attracting the private sector would enable the Government to decrease its direct contribution to capital costs for a project like Kambarata 1 HPP and decrease the net budgetary requirements of energy sector SOEs by an average of 2.2% of GDP. If combined with tariff reform – to 1.5% of GDP.

Key factors which can determine the degree of private sector interest/ involvement in the energy sector is the tariff policy and financial viability of SOEs/ Investments



Energy Sector SOEs: Ownership and Financial Transparency

- From March 2021, the NEHC is subordinated to the Ministry of Energy now combining sector policy and ownership function over energy sector SOEs – out of line with good practices
- NEHC (Holding Co level) corporate governance practices need to be significantly improved starting with the NEHC Holding Level Board of Directors
- NEHC has not yet established a system for consolidation of its subsidiaries' financial statements
- NEHC financial accounting, reporting and disclosure of full set of IFRS financial statements can be significantly strengthened
- Omission of NEHC from the financial oversight by MoF or FUGI severely limits financial and fiscal risks monitoring by the Government and undermines coordination in monitoring and evaluating the performance of SOE sector as a whole
- In the energy sector, the unified financial Key Performance Indicators (KPIs) need to be significantly improved and consistently enforced



Energy Sector SOEs. Ownership and Financial Transparency

Possible Recommendations:

- ∇ Systematize energy sector SOEs' relationship with the budget —to properly calculate and compensate them for their quasi-fiscal activities— and alleviate their debt burden.
- ∇ Consider implementing comprehensive tariff reform to improve SOEs cost-recovery and reduce the quasi-fiscal deficit generated by the energy sector. All necessary considerations for a proper social safety net for the poor must be ensured.
- ∇ Financial condition of the largest energy SOEs requires urgent improvements and significant capital injections, including through private sector-based solutions.
- ∇ Consider attracting private capital to energy sector enabled via stronger capital position of SOEs (capitalization, debt to equity swap), improved corporate governance and financial performance.
- ∇ Strengthen energy SOE transparency by reinforcing current reporting and disclosure requirements as to their full IFRS-based financial statements.



Integrated State-Owned Enterprises Framework Assessment (iSOEF):

Corporate Governance and Accountability Mechanisms



Importance and Challenges of SOE Reforms

Questions to Ask and Responses to Formulate in Implementing SOE Reforms:

- Which goals does the Government set for the state ownership and reforms?
- How these goals can be calibrated to increase SOEs contribution to the economy and public value for money?
- What are the necessary measures to reform SOEs and how they will be implemented?
- Is the Government ready for difficult decisions?

SOE legislative framework in the Kyrgyz Republic



- Important governance reforms have been partially implemented:
 - ✓ Number of SOE reduced over the past decades ~100 entities remain
 - ✓ Many enterprises were corporatized (JSCs)
 - ✓ Corporate Governance Code is available for voluntary application
 - ✓ Boards of Directors (JSCs) established
 - ✓ Requirements for financial reporting for JSCs with a state share were set
 - ✓ SOEs reporting requirements were strengthened
- No coherent policy on state ownership
- Fragmented legal framework on SOE ownership, supervision and management
- Low level of implementation of reforms and legislation in practice

SOE legislative framework in the Kyrgyz Republic



» Certain successes within the legislative framework:

- The Concept of Reforming the State Property Management System (2015)
- Civil Code
- Law on Joint Stock Companies
- Law on Accounting (2020 update)
- Law on Auditing (2021 update)
- Corporate Governance Code (voluntary application)
- Resolution of the Government No. 666 on KPIs
- Resolution of the Government No. 468 on streamlining the activities of the SE (ГП)

The main difficulties are in consistent application of legal requirements in practice

SOE legislative framework in the Kyrgyz Republic

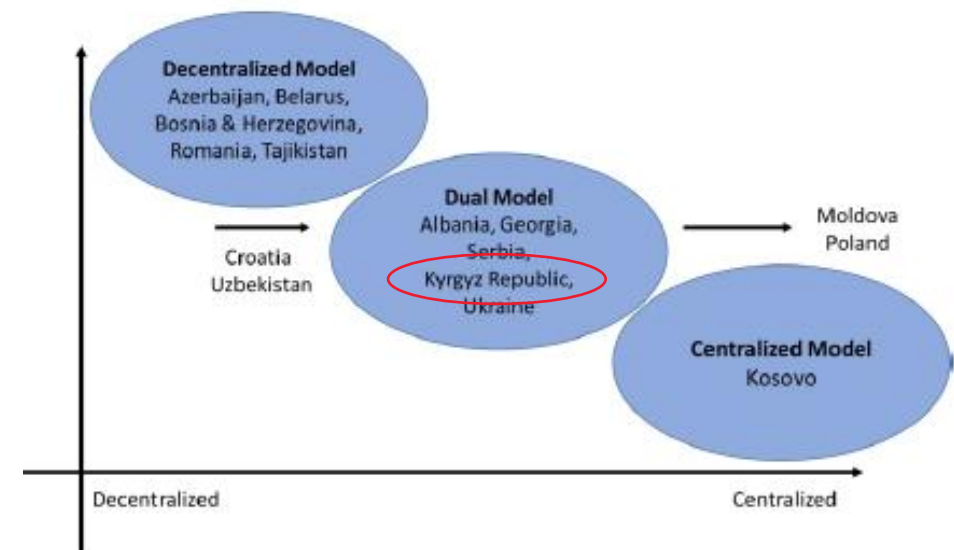
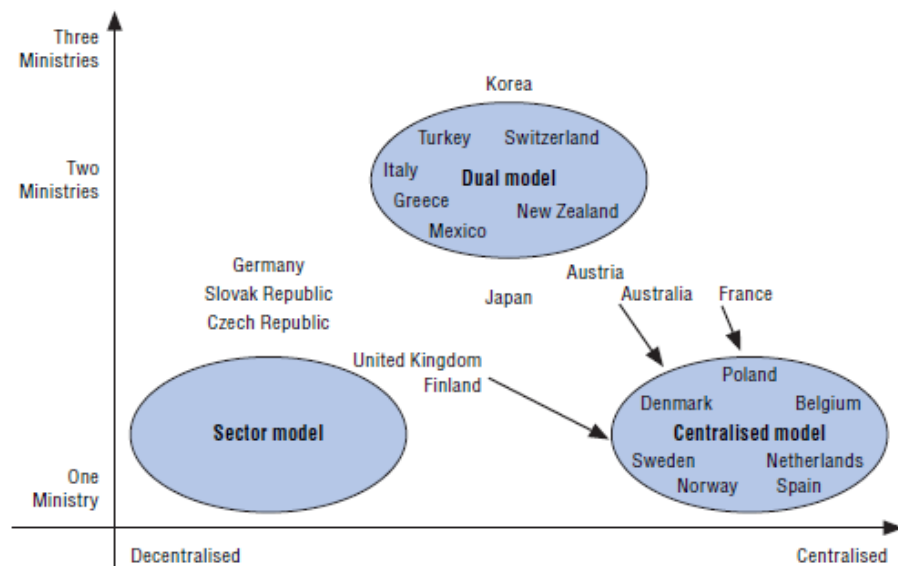


Possible recommendations:

- ❑ Develop a unified SOE ownership policy: define strategic sectors, enterprises, social mandate
- ❑ Analyze SOE portfolio to trim down keeping only strategic SOEs (per SOE ownership policy)
- ❑ Corporatize strategically important and largest SEs by converting them into JSC – Railways?
- ❑ Mandate application of the corporate governance code for SOEs and largest SEs
- ❑ Bring corporate governance and financial reporting requirements for SOEs/ SEs to the same requirements with private sector companies

SOE ownership function in the Kyrgyz Republic

- ❑ FUGI and Energy Holding shared SOE ownership functions over entire SOE portfolio (until 2021) – principally in line with good practices – **Dual Ownership Model**
- ❑ Capacity and enforcement lag behind although most regulatory pieces are in place
- ❑ Large number of SOEs due to lack of strategic vision, state ownership policy





Ownership Models Evolution

Why do many countries move towards a more centralized model?

- » Clear division of responsibilities: shareholder, supervision, regulation, formulation of industry policies, management.
- » Centralization of ownership functions for more consistent oversight.
- » Centralization of experts and specialized teams.
- » Quality and transparency of financial information and performance indicators.
- » Management of aggregate financial and fiscal risks.



Ownership function in the Kyrgyz Republic

Possible recommendations:

- ❑ Maintain and strengthen the dual/ more centralized model of SOE ownership and oversight function (FUGI, Energy Holding and MOF for certain functions)
- ❑ Strengthening oversight mechanisms for operational activities, performance evaluation, and the introduction of incentives and penalties for management
- ❑ Address capacity via further training and skills development for the relevant ownership bodies (FUGI, MOEC, MOF, Energy Holding) and SOEs too
- ❑ Enhance SOE boards' professionalism and independence (selection, training, on-boarding, compensation at market levels)

SOE corporate governance: main functions of the State as the owner

- Use of voting rights
- Nomination of members of the Board of Directors
- Establishment of objectives of state enterprises and their monitoring
- Establishment of a reporting system for state enterprises
- Development of disclosure guidelines
- Communication with external auditors
- Establishment of compensation for members of the Board of Directors

SOE corporate governance, role of Boards of Directors

- » Corporate Governance Code available for voluntary application for SOEs (JSC)
- » SOEs do not apply corporate governance standards => insufficient accountability, weak oversight mechanisms
- » Principles of corporate governance are introduced by law => practical application lags behind
- » The concept of independent directors was introduced (1/3)
- » SOE Boards do not deal with strategic areas, there are no special committees
- » Absence of incentive mechanisms and penalties for SOE management
- » Lack of qualified personnel and a high need for strengthening skills



SOE corporate governance, role of Boards of Directors

Possible recommendations:

- Mandate corporate governance code for SOE (JSC) application
- Legislatively empower SOE Boards of Directors - paying attention to strategic areas
- Establish key Board committees: audit, remuneration and risk (where applicable)
- Legislate and empower SOE Boards of Directors to apply incentives and penalties mechanisms for SOEs management
- Increase (gradually) professionals and industry experts in SOE Boards, reducing the number of public officials/ political appointees
- Implement training programs and advanced training of candidates and existing Board members
- Create pool of candidates for the positions of SOE board members



SOE financial reporting and transparency

- ✔ IFRS and IFRS for SMEs adopted as single reporting standards in the Kyrgyz Republic
- ✔ Requirements for publishing reports on the websites of state enterprises (JSC) – not enforced
- ✔ KPI system developed
- ✔ Requirements for the mandatory audit for SOEs (JSC)

- ✘ Lack of link between enterprise strategy and performance indicators
- ✘ No connection between enterprise performance and remuneration for managers
- ✘ Lack or absence of Board-level audit committees => lack of monitoring of financial statements, internal control and risk management
- ✘ Limited use and practical application of IFRS
- ✘ No requirements for mandatory audit of reporting for un-incorporated state-owned enterprises (SEs)
- ✘ Not enough public information on the finances, management and performance of SOEs - at entity and aggregated level



SOE financial reporting and transparency



SOE financial reporting and transparency

Possible recommendations:

- Enforce compliance and quality of SOE financial reporting and compliance with IFRS / IFRS for SMEs
- Introduce mandatory reporting requirements by state enterprises (SE/ ΓΠ)
- Enforce and track the actual publication of SOE/ SE financial reports on their websites
- Introduce audit requirements for SEs (non-corporatized SE/ ΓΠ)
- Strengthen and systematize financial analysis of audited statements of SOEs/ Ses, monitoring their KPI compliance (SPMF, Energy Holding, MoF)
- Establish Board-level audit committees at SEs (non-corporatized)
- Develop and initiate publication of an aggregated report for all state enterprises (JSC and SEs)
- Develop at the legislative level a transparent incentive system for SOEs management, linking it with SOEs' effectiveness, achieving KPIs and a system of possible sanctions (dismissal, reappointment)
- Improve capacity and qualification of financial analysts in IFRS - employees of FUGI, MoF





Integrated State-Owned Enterprises Framework Assessment (iSOEF):

Public Procurement and SOEs

Public procurement and SOEs



- ✔ State-owned enterprises are subject to the provisions of the Law on State Procurement, the electronic portal (50 +% of capital / share)
- ✔ Flexible legislation takea into account the requirements for individual TORs and specifications
- ✔ Good practice in applying uniform rules of public procurement to state-owned enterprises (JSCs and SOEs!) => Saving, transparency, minimizing corruption

Possible Recommendations:

- » Preserve and develop the procurement of state-owned enterprises under the Law on Public Procurement based on the electronic portal



Integrated State-Owned Enterprises Framework Assessment (iSOEF):

Attracting Private Sector

Private sector mobilization



- » Attracting private capital can help solve the problem of updating state infrastructure - PPPs, private investments, concessions
- » Private investors are interested in projects with a clear decision-making structure - the Ministry of Finance, the Ministry of Economy, the State Property Management Fund... Management functions are currently fragmented
- » Private investors look at projects with a clear and transparent corporate and financial management system.
- » Private investors look at projects with a clear and transparent procurement system
- » Several potential sectors for working with private investors - transport, water supply, irrigation, roads, tourism

Private sector mobilization



Possible Recommendations:

- » Develop a strategy for working with private investors (Ministry of Economy, FUGI)
- » Prioritize selection of projects – high priority to the Government and attractive for investors
- » Strengthen corporate governance practices - legally and in practice
- » Provide detailed and timely reporting by SOEs - audited and published
- » Enforce SOEs' compliance with KPIs, monitor their activities
- » Build up work with private investors - conferences, consultations, investor days
 - » **Formulate political and technical consensus at the central Government level on attracting private capital and high level investors' support**

Closing Remarks



Experience of other countries proves that sound institutional framework and good corporate governance system have several advantages for all companies, private and public:

- ✦ better access to external financing
- ✦ investment growth and lower cost of capital
- ✦ higher growth
- ✦ higher companies' rating
- ✦ creation of jobs
- ✦ improved operational performance, increased management efficiency
- ✦ reduced risk of corporate crises and scandals
- ✦ poverty and inequality reduction

Taken together, these advantages can increase the efficiency of state-owned enterprises and the economy as a whole, make transactions between companies more competitive and transparent; lead to a more efficient allocation of resources; reduce the budget burden and fiscal risk of state-owned enterprises; lead to increased public and private investment in strategic sectors and promote competitiveness and economic growth.



Thank you!