The Future Of State Owned Enterprises In Pakistan

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At Independence, Pakistan inherited 12 SOEs. This number rose by a bit in the 1950s and 1960s as some development authorities and corporations (e.g., PIDC and WAPDA) were established. Then an explosion in numbers took place in the 1970s with the nationalization of large scale industries, banks, insurance companies, and educational institutions. A process of reversal eventually began in the 1990s. Between 1991 and 2015 as many as 172 privatization transactions were completed. The process then slowed, leaving the government with 212 SOEs at present. These are divided as follows: 85 are commercial SOEs while another 83 are subsidiaries attached to one or another SOE; 44 are non-commercial entities (such as trusts, foundations, regulatory bodies, universities, research and training institutions, promotional and advocacy bodies and welfare funds).

In recent years a SOE Triage exercise was conducted for commercial SOEs (consolidated with subsidiaries). Such SOEs make up 98% of the government's assets and account for almost 100% of losses. This exercise has helped clarify the many sources of risk exposure for the government through a computation of such items as recurring subsidies (explicit and implicit), concessions, unfunded liabilities, tax and tariff exemptions, guarantees, bank borrowings, pension liabilities, and foreign loans. It has also provided rationales for various actions proposed for the remaining commercial SOEs, such as retention, restructuring, privatization, leasing out, divesture of shares, liquidation and winding up. This diversity of choices goes beyond the usual binary "privatize" or "keep in government ownership" and allows for more nuanced and non-ideological approaches. This article provides a summary of the main findings of the SOE Triage exercise.

Selected Highlights

Sectoral distribution: The 85 commercial SOEs operate mainly in sever sectors: Power; Oil and Gas; Infrastructure Transport and Communication; Manufacturing, Mining and Engineering; Finance; Industrial Estate Development and Management; and Wholesale, Retail and Marketing (see Chart I).

Profit and Loss Performance: Over the past six years, one-third of the commercial SOEs have experienced losses intermittently. As many as 51 of these made profits in FY 19 amounting to Rs 336 billion but this was outstripped by the 33 loss making entities. The top ten loss-making SOEs contribute around 90% to the total. The set includes NHA, Pakistan Railways, PIA, Pakistan Steel, five power sector DISCOs and ZTBL (see

Chart II). The top ten profit-making SOEs include six in the Oil and Gas sector, three in Power, and the National Bank of Pakistan (see Chart III), together generating net profits of Rs 294 billion.

Mixed purpose entities: The NHA has been excluded from the triage examination since it undertakes many commercially unviable projects for social and political/security reasons. One fourth of the NHA network is located in, or is under construction in, Baluchistan. This locational consideration makes it difficult for the NHA to service its loans from its own revenues originating from lightly travelled and unprofitable routes. Other regulatory bodies (such as PTA and PEMRA) have also been excluded because of the mixed commercial and non-commercial nature of their activities. PTA does contribute to nontax revenues of the budget. We follow the same logic with the State Bank of Pakistan which is the highest contributor to nontax revenues but has never been included among SOEs.

Assets and Revenues: The overall revenues of the SOEs in FY19 was Rs. 4 trillion (see Chart IV) while the book value of their assets was around Rs. 21 trillion. Excluding financial institutions, the assets of non-financial companies were Rs. 16 trillion. (see Chart V). Power sector companies had assets of Rs 7.8 trillion, Infrastructure Rs 5.3 trillion and Oil and Gas Rs 2.6 trillion. The revenues that year were roughly 10% of nominal GDP. Additionally, SOEs provided employment to more than 450,000 people which constitutes around 0.8% of the total workforce. Despite their important role in providing essential public goods and services, the financial performance of several SOEs has remained unsatisfactory. In FY 19, the commercial SOEs collectively recorded net losses of Rs. 143 billion (see Chart VI) which was significantly lower than net losses (Rs. 287 billion) incurred by the SOEs in FY 18. This improvement was driven by policies to encourage growth in local up-stream oil and gas markets translating and some operational improvements in the power sector.

Government support: Explicit GOP support during FY 19 amounted to Rs. 1 trillion, including guarantees, foreign and domestic loans, equity investment and subsidies. The dividends received were merely Rs. 60 billion on an asset base of Rs 16 trillion. The difference between the demand put forth by the Ministry of Energy for subsidies and the actual amount allocated usually passes through into circular debt as unfunded subsidies, including payments not made by the provincial governments to DISCOs. Budgetary grants to Railways and other enterprises are in addition to this amount of Rs. 1 trillion shown in the SOE Annual Report.

Performance by sector: Aggregate net losses (net profits minus net losses) show an interesting sectoral pattern. Oil and Gas companies show net profits of Rs. 242 billion while Infrastructure companies (PIA, Railways, NHA, Post Office etc.) show net losses of Rs. 267 billion and Power companies of Rs 117 billion. The other five sectors do not matter much to the overall numbers.

Overall trend: Financial performance of SOEs has declined since FY14 when an overall net profit of Rs. 204 billion was recorded. This fell to Rs. 61 billion in FY15 and then to a net loss in FY16. Since FY16 SOEs have consistently incurred significant losses.

Triage Principles

Whether an economic activity should be undertaken by the government itself hinges on (a) whether it falls within the public policy framework of the government and (b) whether it can be adequately performed by the private sector. These aspects are elaborated below.

Relevance to public policy framework: The public policy framework (PPF) refers to the overall development priorities of the Government. These priorities are reflected in various documents including Principles of Policy (Clause 3 of the Constitution of Islamic Republic of Pakistan) and sectoral polices relating to agriculture, industry trade and so on. To assess the applicability of PPF the

triage exercise considered whether enterprises were connected to any of the following core functions:

(i) Ensuring national food security.

(ii) Developing and managing large scale infrastructure.

(iii) National defense and security related entities.

(iv) Entities established through Government to Government or inter-governmental arrangements.

(v) Entities supplying goods and services of national economic interest.

Market failure: A second question relates to whether the proposed activity can be adequately performed by the private sector. Accordingly, each SOE was evaluated in terms of its operations, functions and market structure. The following aspects were considered:

(a) Is the SOE a natural monopoly? If yes, is there an appropriate regulatory framework present to ensure socially optimal and cost-effective service delivery in case the function is performed by the private sector?

(b) Is the SOE performing a function that has significant positive externalities and is therefore less profitable for the private sector to perform?

(c) Is there an alternate delivery mechanism available to achieve the objectives? In order to further support our analysis regarding the categorization of SOEs, the recent financial performance of SOEs was taken into account to divide them into financially viable and/or financially stressed entities. The brief explanation of financial viability analysis is given below:

Financial viability: This refers to an organization's ability to generate sufficient revenues to meet operating costs, debt commitments and where applicable, to invest for growth while maintaining desirable service levels. The financial viability test was based on the following:

(a) Negative Shareholders' Equity: Any entity which has negative equity for the last three years is deemed financially stressed because its balance sheet is not bankable and therefore it is dependent on government's support to obtain finances from the commercial banks under GoP guarantee or direct support from the budget.

(b) Continuous losses: Any entity having losses during the last three years is also categorized as financially stressed because the losses result into dependence on GoP support or lead to gradual erosion of equity.

(c) Return on Assets (ROA): One of the key measures to assess financial viability of a company is its Return on Equity (ROE). However, if shareholder's equity is negative, a more appropriate measure is ROA which tells how well the management is utilizing the company's assets to generate earnings. ROA is calculated by dividing net profit by total assets. As per industry standards, SOEs that do not have an ROA of 5% or above for the last three consecutive years are considered financially stressed.

Triage Results

The above principles were applied to each of the selected commercial SOEs to achieve a sorting into two broad categories:

(a) to be retained under state ownership and

(b) to be privatized or liquidated.

SOEs to be Retained in the Public Sector

This category includes those performing core functions and that fall within the scope of the PPF. These SOEs are further sub-divided into two parts according to their financial performance.

(i) Those which are profitable and financially viable: 25 SOEs were profitable in FY 2018-19. Using a more stringent criterion to evaluate their financial viability four SOEs are categorized as financially viable, namely GHPL, Pak-Arab Refinery Company, Pak-Kuwait Investment Company and Pakistan Revenue Automation Ltd. Another 19 entities have been consistently profitmaking during the last three years - however, their ROAs have been lower than the threshold required. Another two SOEs - CPPA and Pak-Iran Investment Company – have positive equity and were profitable in FY 2017 and FY2019. Although these SOEs are financially self-sustaining their financial performance needs

improvement through institutional reforms, such as governance improvement through Ownership and Management Policy, to be enacted via an SOE bill. Apart from sector specific reforms that will be undertaken, a well-structured and institutionalized mechanism of performance monitoring and reporting shall be put in place with the objective of bringing financial outcomes to the required threshold.

(ii) Retain but restructure and reform. Fourteen SOEs will be retained under government ownership but require immediate reforms and restructuring for improved financial performance. Among them are Pakistan Railways and Pakistan International Airlines with a collective loss of Rs. 88 billion in FY 19.

Pakistan Railways (PR) is currently implementing a comprehensive restructuring plan to enhance operational and financial efficiency to curtail losses and improve service delivery. The plan envisages formation of an infrastructure company under the Government management, a Freight company to be operated by private sector to expand freight operations and generate additional revenue, and a passenger train company also under private sector. The office of GM/CEO of Pakistan Railways would be strengthened and the existing workforce rationalized to ensure work efficiency among its employees. Steps have to be taken by addressing the core issue of pension liability that equals the amount of losses incurred.

Pakistan Railways improved its performance by curtailing its losses during FY 2018-19. However, Covid-19 Pandemic has negatively affected its operations since March 2020.

Pakistan International Airlines has initiated a reform process by route rationalization and bringing efficiency in human resource management. The Restructuring plan recommends the split of PIA in tow companies –a holding company that assumes the liabilities and assets and a new company that starts with a fresh balance sheet, one half of the current work force, route rationalization, outsourcing of non-core functions and induction of new aircraft.

SOEs to be Privatized or Liquidated

This category includes SOEs not performing core public policy functions and therefore slated for privatization or liquidation. They are grouped into the following four sub-categories.

(i) **Already in privatization process:** There are 10 SOEs which are on an active privatization list and are at various stages of the privatization process. Pakistan Steel Mills is an important entity on the active list and is at an advanced stage of the privatization process. SME bank is another loss making SOE which is on active privatization list. In addition to these, partial divestment of shares of OGDCL and PPL through capital market is also underway.

(ii) **To be put in next round of privatization:** 24 SOEs are identified for the next batch of privatization, 12 of which were loss making in FY 19 with a combined loss of Rs. 156 billion. Among the loss making SOEs proposed for privatization are 8 DISCOs (HESCO, IESCO, PESCO, SEPCO, MEPCO, LESCO, FESCO and QESCO), 1 GENCO (Jamshoro Power Company) along with Pakistan Textile City Ltd., State Engineering Corporation and Telephone Industries of Pakistan.

Potential privatization or liquidation candidates: Ten SOEs have been identified as potential privatization or liquidation candidates and consultations with line ministries had been initiated. Six entities were loss making with a combined loss of Rs. 38.5 billion mainly emanating from ZTBL (Rs. 18 billion), SSGC (Rs. 14.8 billion) and USC (Rs. 5 billion). Industrial Development Bank of Pakistan is already under the process of liquidation.

Summary

To sum up, 25 out of the total 84 SOEs (excluding NHA from the list) would be retained under state ownership as they are performing public policy functions or for market failure or externalities considerations. They also meet the criteria of financial viability. Another 14 would be retained but they have to go through major restructuring; this set includes PIA and Pakistan Railways. The restructuring plans of both these entities have already been approved by the Cabinet. In all, thirty-nine out of eighty-four SOEs would be retained under state ownership.

The remaining forty-four are would be privatized. Ten are already in process, including Pakistan Steel Mills. Twenty-four are poised for the next batch of privatization, including twelve with cumulative losses of Rs 156 billion (originating mainly from the five DISCOs). Another ten are potential candidates for privatization or liquidation of which six are currently making losses of Rs 38 billion.

The proposed Pakistan Steel Mills transaction is innovative. The assets including land would be held by a holding company owned by the GOP which would enter into a long term lease agreement through an open transparent process in which the winner of the bid would commit investment to raise the capacity from one million tons to three million tons. In case of DISCOs, the infrastructure, land and assets would remain with the Government but the day to day management and operations would be contracted out to the private sector based on key performance indicators. Therefore, the popular fear that the family silver is being sold to the cronies would be allayed through this innovative model of privatization. The resistance therefore ought to be minimal.

One message from the above analysis is that actions relating to the power sector SOEs would make a substantial difference to the economy. The Government should take immediate steps here since these companies are putting stress on public finances, adding to the circular debt, making downstream industries uncompetitive, leading to load shedding and imposing a burden on households.

CHART - I

Commercial SOEs Sectoral Classification

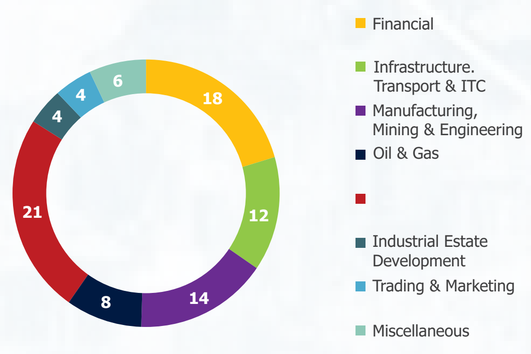
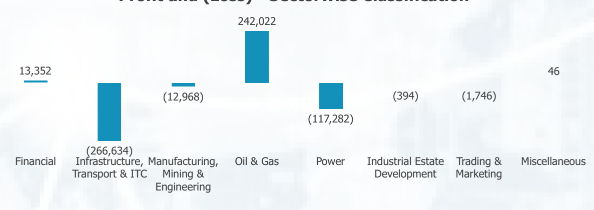


CHART - II

Profit and (Loss) - Sectorwise Classification



Top Ten Profit Making Companies (Rs. Million)

	FY2019		FY2018	
1	OGDCL	118,386	OGDCL	78,737
2	PPL	59,459	PPL	45,826
3	GHPL	34,179	GHPL	28,069
4	NPPMCL	18,993	NBP	20,016
5	NBP	16,647	PARCO	18,517
6	PARCO	12,335	PSO	15,462
7	NTDC	11,236	NTDC	14,736
8	PSO	10,587	SNGPL	11,121
9	SNGPL	7,076	PQA	6,779
10	GEPCO	6,496	NPPMCL	3,283

CHART - III

Top Ten Loss Making Companies (Rs. Million)

	FY2019		FY2018	
1	NHA	(173,792)	NHA	(140,748)
2	PIAC	(56,121)	PIAC	(66,827)
3	QESCO	(36,832)	LESCO	(56,635)
4	LESCO	(31,621)	PESCO	(44,521)
5	PESCO	(29,263)	FESCO	(39,771)
6	MEPCO	(22,782)	Pakistan Railways	(36,622)
7	ZTBL	(18,153)	MEPCO	(33,825)
8	PSM	(16,550)	IESCO	(27,337)
9	SEPCO	(10,956)	QESCO	(24,255)
10	Pakistan Post Office	(9,135)	HESCO	(21,701)

CHART - IV

Revenue - Sectorwise Classification

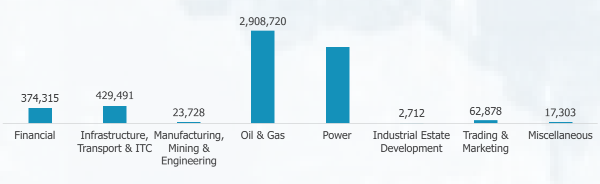
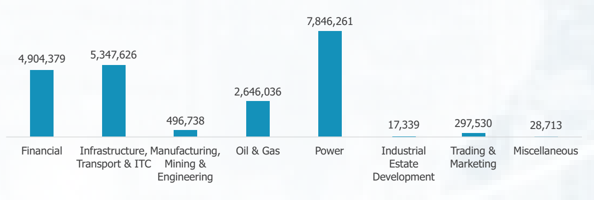


CHART - V

Total Assets - Sectorwise Classification



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