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In recent years, corporate governance has been one of the most discussed issues among authorities, politicians, business people, scholars and commentators. Although this attention is particularly due to well-publicized governance failures and subsequent regulatory changes, this topic is an area of longstanding interest. OECD (2004) defined it as a set of relationships between a company and its stakeholders. Corporate governance provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.

In public utilities corporate governance assumes a much more complex and relevant role than in other companies: market regulation, public-private ownership, political connections and multiple agency relationships may change the company’s objectives and relationships, arising critical and interesting questions.

This issue of the Network Industries Quarterly will look at different aspects of corporate governance of public utilities. De Masi and Paci analyze the role of independent directors, focusing on corporate governance codes and independent directors’ influences over corporate objectives. Menozzi and Vannoni discuss the issue of politically connected directors, their role and their value for firms dominated by state shareholders. Smith, Thompson and Wright instead, debate the role of the governance mechanism ‘Say on Pay’, comparing UK utilities and non-financial companies. Cambini, Gugler and Rondi examine the dividend policy of EU telecommunications and electricity industries, showing differences between the sectors. Miriello and Castelnuovo study the mergers and acquisitions (M&A) activities in energy networks, looking at the effects of different owners on investment propensity.

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Board composition in the public utilities: A focus on independent directors

Sara De Masi* Andrea Paci **

The efficient internal management control mechanisms are the center of the corporate governance debate. One of these mechanisms, emphasized by many authorities and corporate governance codes, is the increasing number of independent directors in the boardroom. This article discusses the role of independent directors in the public utilities, offering new approaches for the debate over a more efficient internal management control mechanism.

Introduction

Recent corporate scandals and the financial crisis have focused an increasing attention on the board of directors and its composition. Directors play a significant role for the success or the failure of any company, taking part in the strategy formulation and in the monitoring of managers’ behaviors (Tricker, 2012). Corporate governance codes, introduced in most European countries in the last few years, have developed a set of corporate governance guidelines aiming to have a more efficient board of directors, avoid opportunistic managerial behaviors, protect shareholders’ interests and pursue corporate transparency. Among these guidelines, an increasing attention has been given to the independent directors. Independent directors are board members without affiliations with the company (i.e. not current employees, without business or relatives relationships with the company). Due to their ‘independence’ from the company and the management, they are believed to be willing to stand up to the managers and protect shareholders’ interests (Duchin et al, 2010). Specifically, by using their experience to understand how decisions would affect firm performance, they may have an important role in advising managers towards decisions that are the most appropriate for the success of the firm.

The common assumption about independent directors is that a high number of independent directors in the boardroom positively influences firm performance. However, in the academic literature their empirical effect remains a ‘puzzle’ (Rosenstein and Wyatt, 1990; Yermack, 1996; Bhagat and Black 1999; Kumar and Sivaramakrishnan, 2008).

Although most of these studies focus on different industries, the role of independent directors is more relevant and more critical in the public utilities than in other companies. In this article we discuss the role of independent directors on corporate boards, focusing on public utilities. We challenge the conventional wisdom regarding their influence on firm performance and we suggest other corporate issues on which independent directors may have a stronger effect.

The debate over the independent directors

There is a long tradition of considering the independent directors within the debate on corporate governance. This discussion has paralleled the introduction of new rules and corporate governance guidelines regarding the increase in the number of independent directors on corporate boards 1. Most of the European countries have enacted Corporate Governance Codes with similar requirements, clarifying the convenience of a higher representation of independent directors in the boards. For instance, in Spain, the corporate governance code argues «the number of independent directors should not fall below one third of the total members […] The primordial mission of independent directors is to ensure that the interests of the floating capital are heard in the board of directors» (1998, p.13). According to the Italian corporate governance code, «the number of independent directors should be adequate in relation to the total number of non-executive directors […] and in the FTSE companies, independent directors have to account at least for one third of the total members in the board» (2011, p. 16). The code specified that independent directors have to verify that potential conflicts of interests between the interests of the company and those of controlling shareholders and between the interests of the company and those of managers are assessed with adequate independence of judgment2.

This convergence toward an increase in the number of independent directors has been reached by most European countries in the last few years. This pattern reflects the

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1 For instance, the Sarbanes-Oxley Act (SOX) (2002) changed corporate governance rules of the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASDAQ), requiring majority of independent directors on the boards (Sharma, 2011).

2 Also Corporate codes in UK (1992, 2003) and France (1999, 2003) recommended a higher number of independent directors on corporate boards.

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* This article was adapted from "Independent directors: Are they really effective or just a myth?" presented at the Conference on Corporate Governance in Network Industries, October 30-31, 2013 in Vienna, Austria.
common view that independent directors are better able to contribute to positive firm results. On the one hand, corporate governance codes specified clearly the opportunity to have independent directors in the board, on the other hand academic research has questioned the tasks the independent directors are supposed to carry out.

In the literature there are different approaches to the role of independent directors.

According to the agency theory (Fama, 1980), shareholders and managers have diverging interests. Specifically, shareholders ask managers to work in their best interests—that is, to maximize their wealth. However, managers may take decisions based on self-interest rather than firm performance maximization. In this context, independent directors can be used as tools to monitor managers and reduce agency costs. Independent directors behave as supervisors who serve shareholders’ interests by restraining management from pursuing their own interests.

According to the stewardship theory, instead, managers and employers are not motivated by individual goals, but they behave as stewards whose interests are aligned with the interests of the organization (Donaldson and Davis, 1997). Stewardship theory suggests that the main role of the board of directors is to advice and support the management rather than to discipline and monitor. Hence, independent directors give added value in a supportive role, providing industry-specific expertise or acting as advocates for corporate performance and financial viability.

Resource dependency theory provides a third approach. According to it, the board of directors is a primary linkage mechanism to connect a firm with external resources (Pfeffer and Salancik, 1978). A popular and well-connected person (such as an independent director) in the corporate board provides confirmation to the rest of the world of the good standing of the organization.

Hence, theoretically, independent directors may serve a crucial role within the company and their influences may be multiple. The most discussed influence of independent directors is their effect on firm performance. Specifically, independent directors may direct managers’ decisions at the maximization of firm performance, positively influencing firm performance. Even though in theory this positive effect is widely accepted, empirically it is notoriously difficult to find reliable evidence (Duchin, 2010). Some of the existing literature finds no relationship (Hermalin and Weisbach, 1991; Bhagat and Black, 1999), others find a positive relationship (Cotter, Shivdasani, and Zenner, 1997; Borokhovich, Partino, and Trapani, 1996) and still others find a negative relationship (Yermack, 1996; Agrawal and Knoeber, 2001; Rosenstein and Wyatt, 1997).

This lack of clear results can been explained with a theoretical argument rather than empirical methods employed in the estimations of data. In theory, independent directors are particularly effective as monitors and custodians of stakeholders’ interests. Using their experience they may be more effective in building external relations, facilitating access to financial resources (Mizruchi & Stearns, 1988), increasing innovation (Haunschild & Beckman, 1998) and contributing to the strategy formulation (Hillman and Dalziel, 2003). Moreover, as monitor of corporate decisions, independent directors may be particularly effective in improving the quality and level of corporate information, increasing the disclosure of information and reducing the asymmetry of information (Linck et al. 2008). This influence gives the stakeholders the opportunity to better understand the firm performance and directors’ professional background and experiences.

Independent directors may be more relevant in the context of public utilities. In the next section, we discuss their importance in the public utilities.

Independent directors in the public utilities

There are three features that make the public utilities an interesting context to study the influences of independent directors. The first feature is the nature of the business activities. Public utilities offer services of general interest. Specifically, they cover a broad range of different types of activities (such as energy, waste, water, postal services, transport, and telecommunications), which are based on a set of common elements (i.e. general accessibility, standard quality of the service, consumer protection). According to the definition given by the European Commission (Green Paper, 2003), these services are fundamental for citizens’ life and their role is essential for increasing the quality of life and for overcoming social exclusion and isolation (pp. 3). These services are also ‘universal’, meaning that they are made available, at an affordable price, to all consumers and users throughout the territory of Europe, independently of geographical location. According to this definition, public utilities companies have to offer «efficient and non-discriminatory services» which should be affordable and available to everyone. Nevertheless, public utilities are business organizations and some of them are listed companies. As any listed company, they have to achieve good firm performance and a rewarding return to their shareholders. This feature raises a first issue about public utilities: the conflict of corporate goals, which is making profit

versus the universality of the service.

The second interesting feature is the public-private ownership. Traditionally, a number of services of general interest have been provided by state-owned companies. Nowadays, public authorities increasingly entrust the provision of such services to public or private companies or to public-private partnerships and limit themselves to monitoring, and, where necessary, regulating. The result is that within the same company private and public shareholders may coexist. This heterogeneity of owners lead to the second issue of public utility: the diversity of interests and the possible conflict of interests within the boardroom.

The public-private ownership creates a multiple agency relationship, which is the third feature of public utilities. As in any company with a separation between ownership and control, also in the public utilities the agency relationship between managers and shareholders may be an issue. However, beside this, the private-public ownership of these companies raises a second agency cost: the conflict of interests within shareholders (i.e. State versus private shareholder). Owners diverge in their preferences for risk and returns, in their private costs of monitoring and in their strategic motivations for investing in a company. The interests of State and local government may be different from the interests of private investors. Moreover, a third agency cost exists: because of the nature of the activities of the public utilities, citizens are the primary stakeholders for these organizations. According to this view, citizens may be seen as principals, whereas local or central governments are the agents who should act as the representatives of citizens' interest. However, local or central governments may be motivated by self-interest, such as the interests of political parties, the control of some industries, the reduction of unemployment level, the development of a specific geographical area, etc, rather than citizens' interests (Calabrò et al. 2013).

In this context independent directors may be particularly effective to address all these issues. Specifically, independent directors may be the effective custodians of stakeholders’ interests: monitoring managers and directors, they may suggest CEO and managers to take decisions aimed at satisfying stakeholders’ interests. They may be particularly effective in reducing the conflict of interests and the conflict of goals, behaving as custodians of the governance process and as long-term, consensus-based decision makers (Higgs, 2003).

Independent directors and firm performance

In this section, we show the path both of the number of independent directors and of the firm performance in the corporate boards of 43 listed energy utilities in Europe in the years 2002-2009. These years are particularly inter-

We look at European countries subject to the European Commission’ guidelines regarding public utility services (Green Paper, 2003). Specifically, we focus on the largest European economies by GDP. They are France, the United Kingdom, Italy and Spain.

We followed the common practice of dividing directors into executive directors (current officers in the company), outside directors (not current employees but likely to have business relationships with the company, such as investment bankers and lawyers; officers in the recent past; or relatives of employees), and independent directors (outside directors without such affiliations). The board composition (i.e. number of executive, non-executive and independent directors) has been taken as reported in the corporate governance reports. There are some possibilities that some directors, who are classified as independent, are not truly independent. For example, some nominally independent directors may be employed by a foundation that receives financial support from the company, or some directors may have personal relationships with the CEO that affect their independence. Unfortunately, the data needed to capture these relationships are not available. We assume that such assessment has been done by the board of directors.

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<th>Variable</th>
<th>Obs</th>
<th>Mean</th>
<th>Min</th>
<th>Max</th>
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<tbody>
<tr>
<td>Board size</td>
<td>271</td>
<td>10.68</td>
<td>3</td>
<td>23</td>
</tr>
<tr>
<td>Number of independent directors</td>
<td>250</td>
<td>5.30</td>
<td>0</td>
<td>16</td>
</tr>
<tr>
<td>Number of executive directors</td>
<td>255</td>
<td>2.28</td>
<td>0</td>
<td>9</td>
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<table>
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<tr>
<th>Values in Percentage</th>
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<tbody>
<tr>
<td>Independent directors scaled by board size</td>
<td>250</td>
<td>49%</td>
<td>0%</td>
<td>89%</td>
</tr>
<tr>
<td>Executive directors scaled by board size</td>
<td>255</td>
<td>25%</td>
<td>0%</td>
<td>100%</td>
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</table>

Table 1 – Board composition (Full sample)

4 The starting year (2002) is due to the availability of corporate governance data and the firms’ attitude to disclose information about their board composition.
5 We exclude Germany. The reason is that German corporate governance model is profoundly different from the other companies in our dataset. Specifically, German companies have two separate governing bodies that operate independently: the supervisory board and the management board (so called “two-tier system”). The management board conducts the day-to-day management of the company, while the supervisory board has the monitoring function. In the management boards every members are executive directors. Without heterogeneity in the board composition, we cannot test the effect of independent directors. Hence, we exclude Germany and other companies adopting the two-tier system.
We use two measures for firm performance: EBIT (accounting-based measure) and Market Value of Equity (market-based measure).

In Europe, on average, board size of energy utilities is 10, with a minimum of 3 and a maximum of 23. The average percentage of independent directors in the boardroom is 49% and the highest percentage of independent directors on corporate board is 89%, whereas on average, the percentage of executive directors is 25%.

Figure 1 reports the ratio between the average number of independent directors and the average board size among the countries (2002-2006). Italy shows the highest value. This means that in Italy the average percentage of independent directors in the board is 60%, 45% in the UK, 44% in Spain and 36% in France. Interestingly, Figure 2 reports the path of ratio of the average number of independent directors over the average board size from 2002 to 2009. The European countries in the dataset exhibit a similar path. This empirical evidence shows the convergence, among European countries, towards a higher number of independent directors in the boardroom. Specifically, in these years, European corporate boards have followed the corporate governance guidelines that suggested an increase in the number of independent directors.

In Figure 3, we report, country by country, the path of the average percentage of independent directors in the boardroom and the path of two measures of firm performance: Ebit and market value of equity. The average percentage of independent directors and the firm performance do not exhibit a similar path. It seems that there is no direct correlation between the increase in the percentage of independent directors and the change in Ebit and market value of equity over the years 2002-2009.

Conclusions
Corporate governance—and, in particular, board composition—has been a topic of much attention lately.
One of the corporate governance mechanisms that has been widely discussed is the role of independent directors. Specifically, independent directors may be particularly effective in monitoring managers, advising CEO and managers to take decisions aimed at satisfying stakeholders’ interests. They appear to be the best custodians of stakeholders’ interests, ensuring the achievement of good firm performance. It is not surprising that in recent years most European countries have introduced corporate governance codes providing guidelines to improve firm results.

The role of independent directors has an additional significance in the public utilities: the general and universal service, the maximization of shareholders’ wealth and the conflicts of interests make the independent directors to be perfectly eligible as a good corporate governance mechanism.

This paper underlines the debate over the independent directors in the corporate governance codes and their role in the context of public utilities. Although most scholars and corporate guidelines emphasize their influence on corporate results, their efficacy may be measured on other corporate issues. Specifically, independent directors may be particularly helpful in managing two other important tasks within the boardroom. First, since independent directors make decisions based on information they receive, they may influence the level and the details of reported information. They may require a higher level of corporate transparency, increasing the accountability towards a wide range of stakeholders, such as shareholders, employees, customers and the society. Second, acting as a node among networks, they may build external relations, increase innovation and facilitate access to financial resources.

More research is needed to explore these avenues and to evaluate how independent directors may affect other corporate variables. Further qualitative studies can determine the effectiveness of independent directors looking at their competences and experiences, their personal networks and their reputation.

References
Political connections in boards of directors

Anna Menozzi*, Davide Vannoni**

Politically connected directors dominate board of directors of state-owned enterprises as the public owner’s representatives. Their political influence affects board organization and performance. We propose a framework to analyze the topic with reference to firms in network industries, which are still dominated by state shareholders.

Introduction

Despite the extensive privatization process that took place over the last two decades, state ownership remains a significant form of ownership especially in middle and lower income countries. State-owned enterprises (SOEs) remain the predominant form of ownership in many network industries such as telecommunications, rail transport, airlines, electricity, gas and water supply, broadcasting, in banking and insurance. In many countries the State still controls the majority of the capital and in others it keeps golden shares. Globally, in 2006, SOEs accounted for 20% of investment and 5% of employment (World Bank, 2006). OECD (2014) confirms that the numbers had not significantly changed from 2006 to 2013 for OECD countries as a whole.

In SOEs, state ownership and government control present inherent governance challenges that might contribute to poor performance. SOEs face the same core problem of separation of ownership and control as privately held firms, the owners in this case being the citizens. Unlike a widely held corporation in the private sector, a SOE generally cannot have its board changed via a takeover and most of them cannot go bankrupt. The absence of potential takeovers and proxy contests reduces the incentives for board members and managers to maximize the company’s value and the lack of bankruptcy can lessen the pressure to contain costs. In addition, although SOEs have a very diffused ownership structure, they are generally overseen by a higher body or a combination of government entities (Ministries, Municipalities, the Parliament). These various authorities could pursue different and potentially conflicting goals thus increasing the level of complexity in the SOEs’ management. Actually, SOEs’ overall results have been disappointing over the world. SOEs have tended to create patronage and reward their supporters. In the process, state firms have diverted resources from both the private sector and other state priorities. OECD (2014) admits that «Even though regulatory barriers to product market competition have been lifted to a substantial extent since the mid-1990s, room for further reform remains. The policy domains with largest scope for improvement both in OECD and non-OECD countries include public ownership and the governance of state-owned enterprises, as well as regulatory barriers to entry in network industries and professional services».

Board of directors in SOEs: role and value of politically connected directors

In the analysis of the corporate governance challenges of state-owned (or state-controlled) enterprises, some important questions concern the role of board of directors. The World Bank (2006), in reference to emerging economies, says that «the boards of state-owned enterprises should have the necessary authority, competencies and objectivity to carry out their function of strategic guidance and monitoring of management», thus recognizing to board composition a role. When defining board composition in state-owned enterprises, the categories into which directors are classified by the prominent literature on the private firms’ governance (insiders vs. outsiders and independent vs. not independent directors) are conveniently integrated by the ‘politically connected directors’ class. In SOEs, indeed, the presence of politicians on the board is guaranteed by those firms’ public (direct and indirect) control.

A large literature on privatization neglects any social welfare goal to bureaucrats in control of state firms (Shapiro and Willig, 1990; Shleifer and Vishny, 1994). In this literature, bureaucrats are moved by political interests. At best, they only have an indirect concern about profits and have goals that are very different from the social interest, so that they can force the firms they control toward harmful objectives.

As warned by OECD (2006), «a major challenge is to

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find a balance between the state’s responsibility for actively exercising its ownership functions, such as the nomination and election of the board, while at the same time refraining from imposing undue political interference in the management of the company» (p. 3). OECD (2006) adds: «In order to minimize possible conflict of interest, the ownership entity should avoid electing an excessive number of board members from the state administration. This is particularly relevant for partly owned SOEs and for SOEs in competitive industries» (p. 25).

In corporations providing a public service and where the sensitivity to social or economic developments is necessary, such as utilities and manufacturing firms with high environmental impact, some (outside) directors could be considered as ‘politically useful’ (Faccio, 2006). Recent contributions (Fan et al., 2007, among others) find that political connection at top levels harms newly privatized firms’ performance. Menozzi et al. (2012) find that board size and the presence of politically connected directors have an inflationary effect on the level of employment of Italian public utilities during the period 1994-2004 and that the overall board size and the number and proportion of politicians have a negative effect on the accounting performance. Apparently, when privatization does not remove politicians from boards of directors, these directors can seriously undermine the goals of privatization. These results support the interventions introduced by the Italian legislator in recent years. The Italian law decree no. 95/2012 (the so-called spending review) and the law decree no. 39/2013 imposed a limit to the total number of directors sitting on the board of public utilities and in general, of firms fully owned by local municipalities (directors must be three to five, depending on the firm size). Two (or three, in boards with five components) directors must be chosen among the local municipality’s employees but they cannot cover the position of President or CEO. The declared purpose was to avoid that executive positions in those sectors were covered by politicians.

Carretta et al. (2012) disentangle the effect of tout court politically connected boards from that of politically connected executive directors within Italian cooperative banks: they find that banks with politically connected boards have a significantly higher overhead costs (relative to total assets) and higher net interest revenues than non-connected banks if the bank also has, at least, a politician in an influential position. On the contrary, Infante and Piazza (2010) find that Italian firms, politically connected at a local level, benefit from lower interest rates and that this effect is stronger when politically connected firms borrow from banks with politicians in their boards.

Sometimes, politically connected directors are explicitly recognized as ‘useful’ in virtue of their political status that gives them a comparative advantage in the struggle for a board seat even in absence of a remarkable curriculum or a significant experience in the sector. For example, politicians might help the firm in achieving a higher economic result by predicting the government’s actions or, in a straight line, when the firm’s revenues depend on the political process, like in the case of contracts with public institutions. In 2009, the United Kingdom’s Financial Services Authority (FSA) approved the appointment of Mr Paul Flowers as a non-executive directors of the Co-op Bank and his promotion to chairman a year later despite his lack of experience in the banking sector, believing that his experience as a local Labour politician and his close relationship with the Co-op movement could help bring order to the bank’s board. The FSA ordered the mutual to offset Mr Flowers’s lack of banking knowledge by appointing two deputy chairmen who had greater expertise. Nevertheless, the Co-op Bank’s 1.5bn pounds capital hole in 2013 revealed the shortfall in governance and the Co-op’s new chief executive, Euan Sutherland, arranged the appointment of a new bank chief executive and chairman.

Cronyism in the appointment of state-owned enterprises’ directors is an actual and widespread fear. On June 28, 2012, the Thailand’s newspaper The Nation wrote: «Several state enterprises, including Thai Airways International […] are inviting candidates for the position of chief executive officer. […] But they aren’t going to get any professionally qualified managers to apply». The reasons were found in the CEO appointment process, supposedly subject to a «heavy political manipulation» that would produce «only mediocre leaders at best and political cronies or lackeys at worst». CEO of state enterprises are chosen by board of directors that are, in turn, «usually picked by Cabinet members whose only yardsticks are whether the directors can serve the politicians’ interests or not». In Britain, at the end of 2013, despite a succession of controversies in the previous years, a series of people with link to senior politicians received honours in the 2014 Honours list, which rewards services to public life, thus sparking accusations of cronymism in the system. At the beginning of July 2014, the Irish Cabinet was put under fire for three former Labour councillors being appointed to cover state board positions under the Department of Transport, Tourism and Sport.

The ability to attract, motivate and retain suitable candidate to the firm’s top positions crucially depends on the remuneration offered. European SOEs, and in particular public utilities, interested by the liberalization movement
of the ’90s, have gone through a corporatization process that has transformed them into limited companies in with both private and public entities could invest. As a consequence, both private citizens and public servants could sit on the board of directors as shareholders representative. To that respect, in order to attract well-qualified and experienced executives and board members, rewards should reasonably be included in the compensation schemes. However, for reasons of fairness and in order to avoid public controversy over unequal and excessive pay in the public sector, there are serious concerns about the extensive use of incentive remuneration schemes for companies owned by central or local government.

In fact, the empirical evidence confirms this intuition: Barontini and Bozzi (2011) find that between 1995 and 2002, board members of Italian listed state-owned companies received a significantly lower compensation than directors of family or widely held firms; Feng et al. (2007) show that in regulated US REITs, the regulator tries to influence the CEOs’ and directors’ pay in order to avoid excessive payouts that would challenge the prevailing public sentiment; Joskow et al. (1996) find that, for a sample of 87 US state-regulated private utilities observed during 1978–1990, CEOs of regulated firms earn less than their counterparts in unregulated firms and that their compensation scheme is less tied to firm profitability; Menozzi et al. (2014) find that the proportion of politicians sitting in the board negatively influences the level of per capita compensation in Italian local public utilities between 1994 and 2004. Also, boards are better remunerated in big firms and in the energy sector with respect to the water sector, and no relationship is found between firm performance and board per capita compensation.

In Italy, the appointment and financial treatment of directors and executives of non-listed firms directly or indirectly controlled by the Ministry of Economy and Finance are regulated by a recently updated set of norms. In a note from June 24th, 2013, the Italian Ministry of Economy and Finance stressed its intention to guarantee the «maximum transparency and quality in the corporate charges’ appointment process, with a special attention to the integrity and level of professionalism of board directors», to achieve with the adoption of «specific procedures aimed at pursuing the public interest and assuring a correct resource management and the safeguard of the public ownership’s image». The Ministry of Economy and Finance’s decree 166/2013 has imposed a cap to the yearly compensation received by executive directors sitting on the board of firms it directly or indirectly controls, effective April 1st, 2014. The norm comes as an integration and completion of previous interventions that, starting from the Italian budgetary law 296/2006, were intended to rationalize the governance of public firms by reducing, at the same time, the public expenditure.

**Conclusions**

It is common wisdom that SOEs are affected by the presence of multiple and potentially conflicting objectives. In SOEs, board directors are called to pursue a social mission and are subject to social control. If politically connected, they might go after goals other than profit maximization, like increasing the level of employment at a local level or offering low prices to consumers. These practices have commonly been used in many network industries, such as local public utilities, so that clear and good corporate governance practices are strongly required. Reforms have been introduced in order to improve the performance of SOEs but their effects could be neutralized by the activity of self-interested CEOs and by the presence of weak board of directors.

**References:**

Dividend Policy in Network Industries

Carlo Cambini*, Klaus Gugler**, Laura Rondi***

Dividend policy is one of the key measures in corporate finance for all corporations and across all industries. Usually corporations retain a portion of their earnings and pay the residual as a dividend to stockholders. However, how companies set their dividend payments can vary significantly and is often viewed as a puzzle. A firm’s decision about dividends is often mixed with other financing and investment decisions. Some firms pay low dividends because management is optimistic about the firm’s future and wishes to retain earnings for expansion. In this case the dividend policy is a by-product of the firm’s capital budgeting decision. Other firms finance their capital expenditures largely by borrowing. This strategy releases cash for dividends. In this case the firm’s dividend is a by-product of the capital structure policy.

Since Miller and Modigliani (1961) established the irrelevance of dividends in perfect capital markets, several theories have appeared in the literature to justify the payment of dividends and variations in dividend payout policy by focusing on market imperfections. In brief, these studies made a case for the payment of dividends by concentrating mainly on financial and economic considerations such as tax clienteles, transaction costs of external financing, the signaling role of dividends and the role of dividends in reducing agency problems.

Dividend policy plays a crucial role also in network industries and is highly valued by investors in the capital markets. The reason is simple. A recent report by J.P. Morgan (2011) shows that telecom and electric utilities have been the highest-paying industries in the U.S. in the last few years. Dividend payout, i.e. the ratio between dividends and net income, reached 118% for telecoms and 56% in utilities, while dividend yield, i.e. annual dividends per share divided by the share price, is 5.3% for the telecom industry and 4.5% for the other utilities, which are the highest values among all sectors. As described in Bremberger, Cambini, Gugler and Rondi (2013), utilities are even more generous in Europe: as of December 2013, the “STOXX Europe Select Dividend 30 Stocks” included 12 telecom companies and utilities, among which were 7 energy (non-oil) companies. While the average payout ratio for the 30-stock group was 110%, the average for utilities and telecoms was 198% and, for the energy firms, it reached a peak of 317%. Finally, turning to dividend yield, Thomson Reuters Datastream reported that «the MSCI pan-European utilities index - which compares the size of the most recent payout with the share price - has risen to 6.8%, the highest of any sector and nearly twice the market averages» (September, 25th, 2013).

Interestingly, in the empirical literature on dividend policy, utilities and infrastructure companies are often set apart from the analysis, and the reason usually given is that they are subject to market regulation and, for this reason, somewhat different from other industrial companies as regulation in many respects limits managerial discretion as far as investment and financing decisions is concerned.

With this paper we throw some light on the dividend policy of such companies, presenting descriptive evidence, as well as some insights about its determinants, for telecom and electric companies in the European Union, where more than twenty-five years of reforms in the public utility sector have changed many features of their operating environment. In doing so, we will also pay attention to two dimensions that were deeply affected by the above reforms, namely firm ownership and regulatory mechanisms, and check whether dividend policy differs accordingly.

The EU telecom case

The telecom industry is the sector where liberalization is most advanced in the EU. Regulation of the retail sector disappeared around mid-2000s, but is still pervasive in the wholesale or access segment of the industry, particularly in the definition of the different access prices to existing infrastructures. Just to provide an overview of the
change in the regulatory environment of telecom companies, we show the evolution of the country-level OECD Index of Product Market Regulation, for the five largest EU countries, France, Germany, Italy, Spain and UK, over the period 1990-2009 (Fig. 1). This index captures several aspects of liberalization reforms, such as the presence of entry barriers, the vertical structure of the market, the market share of the dominant player(s) and the presence of the state as a shareholder. Since high values of the index are associated with low degrees of market competition and liberalization, the figure suggests that the five largest incumbent telecom operators faced, especially from the end of the 1990s, a steady and progressive deregulation of their domestic markets. The decreasing intensity of market regulation in the telecommunications sector is usually associated with a ‘lighter’ approach of regulatory intervention as well as with the privatization of many of the former public telecom operators (PTOs), which was meant to encourage competition and to favor the entrance of new players.

As market reforms were implemented and the telecom market expanded, the former incumbents also revised their strategies. In Figure 2, we report the evolution of total revenues of the five largest operators, and we notice that from the end of the 1990s, when ‘deregulation’ was already well advanced in all five countries, these companies started growing at a faster pace, partly due to foreign acquisitions and partly because of the fast growing mobile telephony sector.

We notice the rise of Spanish operator Telefónica which, thanks to the expansion in South America, United Kingdom and Germany amongst others, is now one of the European leaders together with France Telecom and Deutsche Telekom. The Italian operator, Telecom Italia, following Telefónica’s example, acquired telecom companies in South America and Eastern Europe, but in the mid-2000s had to scale back its operations due to the increasing financial pressure caused by debt overhang. Likewise, British Telecom paid the consequences of its choice not to focus on mobile telephony and to concentrate its activity only on its domestic market, and witnessed declining revenues in recent years.

Meanwhile, what about shareholders? How did they fare in terms of received dividends while their companies underwent privatization, de-regulation and multinational expansion? In the following, we present some evidence based on a dataset we constructed for publicly listed telecom companies between 1990 and 2009 based on Datastream and Worldscope databases. Notwithstanding the presence of market regulation in the telecoms, dividend policy in the industry has received considerable interest from both shareholders and financial investors.

Figure 3 provides a visual representation of the total dividend distributed by the star performers in the European telecommunication market. Since these firms differ in terms of size and profitability, the figure plots the cumulative dividends paid out over the twenty-year period against the cumulative net income generated in the same period, with the bubble size representing the average total assets.

Interestingly, the biggest dividends payers in the industry are also the incumbent players of the most populated European countries: Spain, Germany, France, United Kingdom and Italy. Most likely, this result is due to the fact that they were operating for a long period without facing substantial competition from newly entered or anyway weak alternative operators. In spite of the similar competitive conditions, however, we notice that the decision about
how much dividends to pay can vary a lot across firms. For example, Deutsche Telekom and Cable & Wireless paid to shareholders almost the same amount of dividends as, respectively, Telefónica España and Vodafone, though the latter have generated much higher profits than their peers in the same period.

Finally, in Figure 4, we look at dividend policy more closely, by scaling total annual dividends with total assets. This allows us to provide some indications about the stability of dividend policies, since one of the most delicate and costly decisions is to change (increase or decrease) the dividend payout. As shown by Lintner (1956) in a seminal paper, managers are very concerned with the stability of dividends and prefer to ‘smooth’ their distribution over time to avoid abrupt changes that may raise shareholder concerns.

Figure 4 shows that telecom (former) incumbent operators behave very much in line with Lintner’s expectations, substantially maintaining stable dividend payments (represented by the Dividend Paid/Total Assets Ratio) over time, except for BT Group which adopted, before the dot.com bubble in 2000, a more generous but unsustainable earnings’ distribution. The BT peak in the dividend-asset bubble in 2000, a more generous but unsustainable time, except for BT Group which adopted, before the dot.com bubble in 2000, a more generous but unsustainable earnings’ distribution. The BT peak in the dividend-asset ratio in 1998 was due to the break-up of the proposed BT/MCI merger and the payment of a £2.2 billion special dividend. Following the literature that associates different dividend policies to firm ownership (Gugler, 2003, Michaely and Roberts, 2012), we try to discern a pattern within telecom companies. Interestingly, however, the stability over time of dividend policies does not appear to be much influenced by the type of ownership: France Telecom and Deutsche Telekom, which are still majority-owned by the state, do not show a substantially different path from Telefónica de España, Telecom Italia and BT, which are privately controlled. For example, Telecom Italia, which was privatized in 1997, does not seem to have changed its policy in those years, if anything the change occurred in 2004, when the company had already been under private control for some years. Our evidence so far does not suggest a difference in dividend policy across privately and state controlled firms, while it confirms that telecom firms, similarly to many industrial corporations, favor stability when it comes to payout dividends.

The EU electricity case

For the case of EU electricity companies we mainly rely on a recent research by Bremberger, Cambini, Gugler and Rondi (2013), which studies the impact of different regulatory regimes and state ownership on dividend policy for a large panel of 106 European publicly traded electric utilities from 1986 to 2010 operating in 14 EU countries. Compared to the telecom sector, the reforming and liberalization process is less advanced and more heterogeneous across countries. For example, while the generation and retailing of electricity have been fully liberalized in most European countries, the transmission and distribution segments are still subject to market regulation, with national regulatory authorities (NRAs) implementing different regulatory schemes. The difference in regulatory regimes allows us to analyze an additional dimension of dividend policy.

The alternative contractual regimes that regulate electric and, in general, network utilities all over the world range from low-powered incentives/cost-based mechanisms – such as rate of return regulation – to incentive regulatory schemes – such as revenue or price cap or benchmarking. The most common cost-based regulatory instrument is the rate of return mechanism, whereby regulators fix the rate of return the utility can earn on its assets. With this form of contract, regulators set the price the utility can charge in order to cover all main operating costs and to allow it to earn a specified rate of return. The regulated price can then be adjusted upward (downward) if the firm makes a lower (higher) rate of return. Evidently, such a pricing scheme, by guarantying the firm’s financial integrity, does

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1 In June 1994, BT and MCI Communications Corporation, the second largest carrier of long distance telecommunications services in the US, launched Concert Communications Services, a $1 billion joint venture company. On 3 November 1996, BT and MCI announced they had entered into a merger agreement to create a global telecommunications company called Concert plc, to be incorporated in the UK. As part of the alliance BT acquired a 20 per cent holding in MCI. Nevertheless, following US carrier WorldCom’s rival bid for MCI on 3 October 1997, BT ultimately decided in November, to sell its stake in MCI to WorldCom for $7 billion. The deal with WorldCom resulted in a profit of more than $2 billion on BT’s original investment in MCI, with an additional $465 million severance fee for the break-up of the proposed merger.

2 Included countries: Austria, Belgium, Czech Republic, Denmark, Finland, Italy, Luxembourg, Norway, Poland, Portugal, Spain, Sweden, Switzerland, UK.
not encourage efficiency-seeking managerial practices, but, more interestingly for us, it reduces earnings volatility. Differently from standard cost-based mechanisms, the purpose of incentive regulation is to encourage efficiency gains and reduce managerial slack. By pursuing cost savings, managers can generate higher profits and thus benefit shareholders. Periodically, incentive schemes are revised by national regulators in order to preclude regulated firms from earning supernormal profits: managers can obtain high profits only if they keep pursuing further cost savings and succeed in meeting the incentive/constraint set by the regulators (the ‘caps’). Therefore, if on the one hand incentive regulation leaves excess profits to the regulated operator, on the other hand, it also shifts the risk of demand or cost fluctuations entirely onto the firm, thereby increasing the variability of its earnings.

In Bremberger, Cambini, Gugler and Rondi (2013), we derive testable hypotheses on dividend policy based on the different pattern and stability of cash flows. Because under cost-based regulation the regulated price moves with ex post costs, firms typically have more stable cash flows while in contrast, under incentive regulation profits depend more closely on the firm’s ability to achieve efficiency gains hence firms will have more volatile cash flows and profits. Accordingly, we predict the electric firms under cost-based regulation will ‘smooth’ their dividend payout more than electric firms under incentive regulation.

A preliminary inspection of the dividend to total assets ratio of the publicly traded electric operators in our database provides interesting evidence in line with the above prediction, as reported in Figure 5.

![Figure 5: Dividend Paid/Total Assets ratio of in 106 EU electric operators by regulatory regimes](image)

This figure not only shows that firms under incentive regulation pay out a significantly larger share of dividends as a percentage of Total Assets, but also suggests that firms under cost-based regulation smooth their payout much more than incentive regulated firms. In this paper, a thorough econometric analysis using dynamic panel estimation methods which account for the potential endogeneity of the choice of regulatory as well as of ownership regimes, confirms the above speculations. The main findings indicate that incentive-regulated firms smooth their dividends less than cost-based regulated firms and also that they report higher target payout ratios. This evidence implies that incentive regulation leads dividend policy to be more responsive to earnings variability and more consistent with efficiency-enhancing pressures.

Similarly to telecom operators in the previous section, we also examine the impact of firm ownership. In the electricity sector, most transmission and distribution operators are not only subject to regulation, but also partly owned by the state. We argue that the reluctance of the national governments to release control and ownership of energy incumbents is in part related to the reluctance to give up the large dividends that accrue to the state as the main shareholder. Especially when the budget constraint tightens, as in recent years in all Western economies, the ‘energy dividend’ may become a safe and steady source of financing. After controlling for firm ownership, our results show that lower smoothing is due to privately-controlled traded companies while target payout is higher within state-controlled firms, regardless of the regulatory regime. In contrast, state-controlled firms (i.e. electric utilities that are still partially state owned) continue to smooth their dividends and to pay larger dividends, despite moving from cost-based to incentive regulation. Our claim is that obtaining excessive and stable dividends is a more hidden way to enforce political preferences than direct taxation.

To conclude, the above analysis provides new evidence on the dividend policy of regulated network industries, specifically in the telecommunications and electricity industries, and suggests that differences across sectors may emerge due to different regulatory schemes or ownership patterns. The descriptive evidence on the telecommunication industry suggests not only that telecom incumbent companies distribute large amounts of financial resources to shareholders, but also that their dividend strategy presents a highly stable profile over time. On the other hand, dividend distribution does not seem to be too much influenced by the state vs. private ownership status of the companies. The evidence appears more compelling and informative for regulated EU electric companies, where a more thorough econometric analysis has been conducted, highlighting the dividend policy differences associated...
with regulatory and ownership regimes. This suggests that further studies are needed to better understand the dividend policy of telecom operators.

References:
"Say on pay" before and after the crisis: UK utility companies?

Ian Gregory Smith*, Steve Thompson** and Peter Wright***

Introduction

The extensive academic literature on the growth of executive compensation has tended to polarize around one of two positions: the rents capture view and the optimal contracting approach. These analyses lead to very different positions on the value of a "say on pay" policy:

The rents capture position, most strongly articulated by Bebchuk and Fried (2003, 2004), holds that CEOs can subvert the compensation-setting process through their 'capture' of the remuneration committee. In consequence, the secular rise in CEO rewards is treated as a reflection of a flawed governance process. On this view the introduction of direct democracy in the form of a stockholder vote should help to rectify problems caused by the timidity of the board. In the Bebchuk-Fried formulation, executive pay is only constrained by the 'outrage' of stockholders and media. It follows that allowing an easy expression of this sentiment should limit excessive rewards; by witholding assent to egregious proposals and/or by constraining these proposals in anticipation of the vote.

By contrast, the optimal contracting view suggests that CEO compensation is determined by the operation of the market for managerial talent. The prevalence of external hires – at least in countries such as the US and UK – is taken as an indication that this market is relatively frictionless. Hence any secular growth in executive rewards is suggestive of a long-term supply shortfall, perhaps in managers with general – i.e. non-firm-specific - human capital [Murphy and Zabojnik (2004)]. A recent, more sophisticated, variant of the argument by Gabaix and Landier (2008) models the executive labour market as a process of matching talent to productive opportunity, proxied by firm size. Their model gives rise to the prediction that among firms in the upper tail of the size distribution, rewards will track average firm value. This hypothesis appears reasonably well supported – see Gabaix, Landier and Sawagnat (2014) - either side of the financial crisis¹.

The optimal contracting view sees “say on pay” as at best meddlesome and at worst disruptive. Requiring the shareholders' retrospective endorsement of any pay offer introduces uncertainty into the executive appointment process. If this causes executives to see a risk premium – which Peters and Wagner (2012), for example, find has been a consequence of the rising probability of executive dismissal – the impact on compensation levels could even be perverse.

Public limited companies and utility companies in particular provide an interesting setting to examine these ideas. Utility companies operate in markets where competitive forces are naturally imperfect and where the potential for rent extraction is higher. In this respect, utility companies in the UK have a checkered history, notorious for three-fold CEO salary increases within two years after privatisation in 1990 (Wolfram 1998). They are also companies which are popular holds for pension funds and the population at large. Consequently utility companies attract their fair share of media attention around the AGM date, an important constraining mechanism in the Bebchuk-Fried thesis. Indeed, Joskow et al (1996) produce evidence that political sensitivity can constrain CEO pay among utilities with a strong consumer involvement. The following article summarises our research into “say on pay” with a particular emphasis on utility companies.

UK Background and Sample

The UK became the first country to adopt "say on pay" in 2003 and hence it provides a good test for the effectiveness of the policy. Before 2003 a minority of British companies had held shareholder votes, but on a voluntary basis. Since 2003 boards of quoted companies have been required to put a resolution to accept the report of the

¹ The Gabaix-Landier model does permit some rent seeking; although the authors decline to speculate the on extent of this.

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company’s remuneration committee to a vote of shareholders at that firm’s AGM. Until now the vote has had advisory status only; although the Combined Code on corporate governance has required that management who go against a pay resolution explain their decision to the company’s stockholders.

Early evaluations of the policy—Conyon and Sadler (2010), Ferri and Maber (2013) – reported that despite high levels of shareholder participation, no more than one or two pay resolutions per year were rejected and the annual average vote against the board rarely exceeded six%. However, the financial crisis of 2008, with its attendant stock market fall and subsequent squeeze on real incomes was widely believed to have altered shareholder and – perhaps as importantly – media sentiments. By 2011 both the popular and financial press were claiming a “shareholders’ spring” reaction to executive rewards packages deemed to be excessive.

Our dataset comprises all non-financial companies that figured in the FT350 in any year between 31st December 1998 and 31st March 2012. Voting and executive characteristics data were supplied by Manifest Information Services Ltd and financial data were derived from Thomson Datastream. A total of 4090 pay resolutions were analysed, of which 116 were at utility companies.

Shareholder Dissent
Our raw data confirm that shareholder voting has overwhelmingly supported the status quo. Very few report resolutions (22 of 4090) are rejected and most secure very large majorities (more than half receive 95% approval). There has been some reduction in ‘yes’ voting since 2008, but this has merely brought dissent back to the level experienced immediately after the start of “say on pay”. Moreover this result is not obviously a product of shareholder apathy; ‘voter’ turnout has climbed to over 70%, a level comparable to that of national elections.

Our data allow us to examine how CEO pay, company performance and corporate governance characteristics can influence the level of dissent on “say on pay” resolutions. In recognition of the high average degree of support for the board, we define dissent as both votes cast against the remuneration resolution and abstentions. We find that across the period as a whole – and having controlled for company performance and corporate governance factors – there is a negative correlation between dissent and CEO pay. Its magnitude is small however, equivalent to a 0.2% increase in dissent for a 10% increase in compensation: a result which suggests CEOs could extract much larger rewards still before they risk the remuneration resolution being overturned. Interestingly, we find no evidence of any structural break in the dissent-reward relationship in 2008 or 2009: shareholders do not appear more anxious about pay since the crisis. Similarly, we find no significant effect played by the proportions of insider and non-executive directors. There is, however, some evidence that voting reflects shareholder returns, with the better rewarded shareholders more likely to endorse the pay proposal.

Ceteris paribus, utility companies receive approximately 3 percentage points less dissent on the remuneration proposal than other UK plcs. In the sample period, shareholders of utility companies experienced the highest rates of return against all other sectors. While overall dissent levels are lower, the sensitivity of dissent to performance is higher for utility companies (0.38 as oppose to 0.2 for all sectors). Therefore, this relatively satisfied shareholder base does not appear to be more apathetic towards CEO pay (albeit average turnout is lower).

We also examine the influences of the above factors across quintiles of dissent. We find both the pay (positive) and shareholder return (negative) effects strengthen notably across the higher quintiles of dissent. This suggests that the very relaxed shareholder attitude to pay, implied by the coefficients at the mean, may substantially underestimate hostility at higher quintiles.

Does Dissent moderate Compensation?
Finally, we explore the impact of last year’s dissent on this year’s suggested CEO rewards. We find, as expected, that lagged dissent does have a moderating effect across the sample as a whole, but again its overall magnitude is small. However, we find strong evidence that the effect is not uniform over the sample. Fitting a spline function suggests that levels of past dissent up to 10% had no moderating effect on current rewards and perhaps even encouraged higher pay. By contrast, lagged dissent above 10% exercised a clear restraining effect. This increased across the remuneration quantiles. That is, remuneration committees representing the more highly rewarded CEOs were quite sensitive to dissent, provided it had reached above a critical threshold of about 10%.
With utility companies, the 10% dissent threshold is also necessary for the moderating role of “say on pay”. However, affect is present at each quantile in the pay distribution. For utility companies, “say on pay” would appear to be relatively potent, even at the lower end of the pay distribution.

Table 2: Moderating impact of dissent on pay

<table>
<thead>
<tr>
<th></th>
<th>Pay quantiles</th>
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<tbody>
<tr>
<td></td>
<td>Mean</td>
<td>Q10</td>
<td>Q90</td>
</tr>
<tr>
<td>Dissent(t-1) &lt;10%</td>
<td>3.559***</td>
<td>2.288***</td>
<td>5.600***</td>
</tr>
<tr>
<td>Dissent(t-1) &gt;10%</td>
<td>-0.434**</td>
<td>-0.104</td>
<td>-0.615***</td>
</tr>
<tr>
<td>Utility companies</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dissent(t-1) &lt;10%</td>
<td>5.734***</td>
<td>7.266***</td>
<td>4.291***</td>
</tr>
<tr>
<td>Dissent(t-1) &gt;10%</td>
<td>-1.771**</td>
<td>-3.117***</td>
<td>-1.559***</td>
</tr>
</tbody>
</table>

The figures in the table represent the predicted percentage change in CEO pay arising from a 1 percentage point increase in lagged dissent, above and below the 10% threshold respectively. For example, a 10% increase in dissent above the 10% threshold at the 90th percentile of pay is predicted to moderate pay in the subsequent year by 6.15% in all sectors, 15.59% amongst utility companies. The stars represent statistical significance at conventional levels (** p < 0.01, *** p < 0.05).

We could find no evidence of structural breaks in the pay-lagged dissent relation. Taken together with the absence of breaks in the dissent-compensation relationship, this suggests the anecdotal evidence for a ‘shareholder spring’ revolt in the aftermath of the crisis is no more than anecdotal.

Conclusion: Has the Policy Worked?

“Say on pay” does appear to have moderated CEO compensation awards, but the overall effect appears quite small. Indeed the effect only appears at levels of dissent which are historically high and is then substantial only across the higher pay quintiles. Since our study covers all the larger UK firms – firms where the growth in compensation has been most pronounced – it does suggest a limited role for “say on pay”.

However, the picture is more optimistic when focusing on utility companies. Here, dissent is lower, more sensitive to high pay and the moderating effect of dissent on subsequent pay settlements is greater and present in both the higher and lower pay quintiles. It would appear the ability of shareholders to moderate executive compensation is greater in these relatively high profile companies. This is consistent with the ‘outrage’ narrative in the Bebchuk-Fried model.

What caveats should we add to our findings? First, the study covers a period when the pay resolution was non-binding and the institutional shareholders were largely unconstrained in their behaviour. Recent amendments to UK company law (Statutory Instrument 2013) make the voting outcome mandatory upon boards and the Financial Reporting Council [FRC (2010a, b)] requirement for greater involvement by institutions on executive pay determination may well affect future pay proposals. Second, voting brings greater public scrutiny to executive compensation arrangements, which quite possibly constrains egregious behaviour in ways we are unable to observe here. Finally, there is some evidence that executive turnover increases after displays of serious shareholder dissent. This possibility, which awaits empirical confirmation, would suggest a further mechanism by which voting might constrain excessive rewards.

Further details, including tables of descriptive statistics and regression results, on the extent to which CEO pay and shareholder dissent are related can be found in Gregory-Smith et al (2014).

References
What future for European energy networks?

Matteo di Castelnuovo and Caterina Miriello*

European energy networks are experiencing a wave of changes of ownership. Does this fact have a consequence from a regulatory point of view?

Background

Since 2009 there has been a considerable increase in the number of acquisitions of European energy network companies. Such acquisitions have been carried out not only by energy companies and traditional stakeholders of the energy sectors, but also by investors coming from the financial world, such as pension funds and sovereign wealth funds. These changes in networks’ ownership are occurring almost everywhere in Europe and involve both power and gas infrastructures, located onshore or offshore, at transmission or distribution level.

From a policy perspective, one of the most important events that gave rise to such an extensive change has been the unbundling requirement by the European Commission included in the “Third Energy Package” (Regulation EC No. 714/2009), that intended to separate generation from transmission in order to foster competition and to avoid market foreclosure within the European energy market.

From a regulatory perspective, a change in ownership of an essential facility raises several concerns. First, it is relevant who can buy or is interested in buying the networks because it is likely that different types of owners will have different objectives. A network company may decide to buy another network firm in order to expand its core business or to have access to strategic infrastructure, while a financial company, e.g. a pension fund, will probably invest in a regulated asset in order to benefit from the safe, long-term returns guaranteed. Particularly when large infrastructural investments are required, who are the owners of an essential facilities and to which investment incentives they will respond appear to be relevant issues. In the eye of increasing market integration within the EU, the problem seems particularly urgent in the case of inter-connections; as noted by Guthrie (2006) the welfare cost of delaying investment in essential infrastructures might be very high.

A second issue related to the first is that network companies and financial (also called institutional) investors have different degrees of information asymmetry and agency problems, and hence different investment behaviours.

A third issue, associated to unbundling, is how to tackle the unavoidable increase in transaction costs that will arise due to the presence of a plurality of owners and how to coordinate such different owners. There exists a well-established literature on the benefits of vertical integration viewed as a tool to reduce transaction costs and improve coordination, and showing that vertical separation increases the need for coordination and the transaction costs. Empirical evidences so far indicate that there exist inherent trade-offs between static and dynamic efficiency and between vertical synergies and competition benefits.

In short, the effects of ownership unbundling on competition and investment might be less straightforward than expected. To begin with, there is no conclusive evidence of a positive effect on consumer prices (Fiorio and Florio, 2009 and Florio, 2007). Similarly, the effect of unbundling on investment is not yet empirically cleared. Gugler et al. (2013) analyse a cross-country panel on the effect of ownership unbundling of the transmission grid on investments (16 EU countries, period 1998-2008) and find that ownership unbundling significantly reduces aggregate investment in the electricity industry. Having to face a multifaceted ownership, with investors mainly interested in the returns, may exacerbate these effects, forcing regulatory bodies to offer higher returns to guarantee investments in the network. We built a unique dataset that monitors the most important M&A activities targeting energy networks throughout the European Union, in order to draw some useful conclusions on the drivers for investment according to the nature of the owner.

M&A activities in energy networks

Ownership unbundling provides a unique context for
isolating the importance of ownership type to investment efficiency, similarly but not equivalently to what happened with privatisation. As with privatisation, in fact, the ownership structure undergoes dramatic changes, and as such constitutes the ideal environment to assess how different types of owners affect firm investment and efficiency. The notable difference with privatisation is that with unbundling the change in ownership may not necessarily entail a transfer from public to private ownership, but rather a transfer across different sectors. Also, should investment occur, agency and informational problems may arise, as a consequence of the hidden information about the true cost of capital across different owners. Revenues for network companies derive from tariffs, tariffs are typically set to remunerate WACC, WACC in turn depends on the cost of capital, which differs across firms.

As remarked earlier, it is sensible to assume that different owners will have different objectives from the investment and will respond to different incentives. In this section we present a brief overview of the most common types of buyers of target companies within the deals that have occurred in the deals we have collected.

Network companies. Also called strategic buyers, their principal objective in acquiring other network companies is typically to expand their core business or to acquire strategic assets. In our dataset it often happens that the State is the ultimate owner of these firms. Network companies are able to create additional value by exploiting synergies and are available to develop also ancillary services. As an example, in 2011 Fluxys, the Belgian gas transmission system operator (TSO), bought ENI's stakes in the TENP (Germany) and Transgas (Switzerland) gas pipelines for a purchase price of approximately € 860 million. Not all network companies have the same objectives in acquiring networks. For example, it is a very recent news the agreement between the Italian Cassa Depositi e Prestiti Reti and State Grid Corporation of China (Sgcc), the biggest electricity worldwide: SGCC is going to acquire a 35% stake in Cdp Reti for 2 billion Euros via its subsidiary State Grid International Development Limited (SGID), a network company, entering de facto in the board of both gas and electricity national transmission operators.

Financial investors. The category is exceedingly vast and comprises venture capitalists (or Private Equity), sovereign funds and pension funds. The largest institutional investors, in terms of capital collected, are undoubtedly pension funds. Monks and Minow (2011) define pension funds “the biggest pool of money in the world”. They typically have a lower cost of capital, because of the large liquidity available and of the low premium they typically pay to their clients), and tend to stay persistently in their investment.

Sovereign funds (SWF) are also very conservative in the investments, but they have a less clear strategy for exit, and may be moved by strategic considerations. Bortolotti et al. (2010) examine whether SWFs impact value as investors in listed companies. They find that while SWF investment announcements yield small but significantly positive stock returns, target firms experience much larger, significantly negative abnormal returns over the three years after investment. Frequently, the different types of financial investors create consortiums to invest in the energy asset. For example, in 2012 a consortium of financial institutions (Macquarie, British Columbia Investment, Abu Dhabi Investment and MEAG Munich) bought Open Grid Europe, a German gas transport network owned by E.ON for € 3.2 billion.

Energy companies. Energy companies in our sample are producers of power or gas. As such their ownership is typically related to monopolists that still retain ownership, or to companies that invest in specific assets in order to create a chain to sell their product. A typical example of the latter is the stake held by Sonatrach in the pipeline Medgaz, that transports the gas produced by the Algerian company to Spain.

Which M&A deals?

We collected data about around 60 ownership changes in European energy network companies from the financial and economic press, and double-checked on Thomson Reuters and Zaphyre (Bureau Van Dijk) databases.

Most of the M&A activities tracked happened in the years 2010-2013 and affected both distribution and transmission; however, due to the local characterization of distribution deals, our coverage is more thorough for transmission deals. For this reason, we detected a significantly higher share of gas deals, as Table 1 shows, since these often involve transmission lines. Tables 3-4 summarize the main findings of the descriptive analyses conducted on such deals.

Interestingly, although the number of deals is equally shared among network companies, financial companies and energy companies, the value of takeovers carried out by financial firms tends to be constantly higher than the value of takeovers conducted by the other types of company (tables 3 and 4). This may be due to two complementary effects. The first explanation is given by the different (better) investment opportunity that financial firms have. The second one is that the network company only represents a safe asset to invest in for the financial company, hence it is willing to offer a higher price to outbid all other
offers. However, if this is the case, concern may arise on the future management of the asset, should further investments be required in the network.

The anecdotal evidences provided above are explained in the light of the following research hypotheses:

• Hypothesis 1: different owners of energy network companies have heterogeneous propensities to invest.
• Hypothesis 2: financial firms, owning stakes of network companies for the purpose of investing in an asset with safe returns, may have a lower propensity to invest.

Drivers for investment

In order to test the hypotheses, we conduct an econometric estimation of the investment rate of a panel of 29 network companies covering 26 European countries over the period 2004-2012, in order to measure their propensity to invest, following the model by Fazzari et al. (1988), already applied to energy utilities by Cambini and Rondi (2011). We are able to distinguish different types of actors owning the firms’ capital (network companies, pension funds, SWFs or other financial actors), however our explanatory variable is the share of capital owned by three different firms’ type: energy companies, network companies and financial companies, because our sample is not wide enough to account for differences within a broader category. The ownership variables of network companies and financial companies are both negative and significant (with respect to the energy companies ownership category). The negative sign of the financial companies ownership variable confirms our hypothesis 2 that financial owners may be less willing to invest with respect to the other types. An alternative explanation of this result is that financial firms tend to invest in assets that are more developed and require less investment interventions. Interestingly, there is a positive and significant effect of the M&A activity with firms’ propensity to invest, i.e. firms that have a history of engaging in M&A activities have a higher investment propensity.

Conclusions

Energy networks are being targeted for acquisition activities by a number of actors, broadly categorized as energy companies, network companies and financial companies. Preliminary analyses have shown that the value of takeovers carried out by financial firms tends to be constantly higher than the value of takeovers conducted by the other companies. However, concerns may arise that financial firms may not be willing to invest in networks once they have acquired the target company, since their objective is mainly to invest in assets yielding safe returns. Therefore we tested two hypotheses: the first one, that such different owners have different investment propensities; the second one, that among these owners, financial firms are the one less prone to invest in spite of their (allegedly) better investment opportunity.

Our results confirm these hypotheses, showing that the three types of owner have heterogeneous investment propensities. Energy companies are the most willing to invest: this may be explained in part with the fact that in some countries of our sample energy networks are still owned by a vertically integrated incumbent, in part observing that energy companies need a well-developed network to sell their products. This finding could have profound policy
implications, since in principle energy companies should not be allowed to own networks. As a matter of fact they still can exert control over networks, if they choose softer degrees of unbundling (e.g. the ISO option). Network companies owning other network companies show less straightforward results: they have less propensity to invest with respect to energy company, but their propensity to invest is positive if they have engaged in M&A activities in the past. Results for financial companies ownership confirm our hypothesis that financial owners are less willing to invest with respect to the other types, or that they tend to buy assets that are very well developed.

Although our analysis has several limitations, our findings suggest that the nature of the owner of strategic and essential assets as energy networks does indeed matter, and policymakers should pay particular attention to ownership implications.

References

Call for papers

**Competition and Regulation in Network Industries**

7th annual conference of the multidisciplinary journal *Competition and Regulation in Network Industries*

7 November 2014
Brussels, Belgium

Residence Palace, Rue de la Loi 155

**Network industries** are caught between competition and regulation. To perform adequately, vital infrastructures (such as energy, water, telecom, post, railways, aviation, and transport) need to carefully balance private interests and public values, economic efficiency considerations with social service obligations, and pressures for further liberalization with the need to regulate monopolistic networks. At the same time significant innovations - notably in the field of ICT - are taking place that offer new opportunities and impediments for infrastructure operations and governance. Exploring this balance between competition and regulation in network industries provides a fascinating field of research that challenges politics and business alike.

The conference takes a multi-disciplinary approach and explores the legal, economic, institutional and public policy aspects of network industries. It aims to highlight dominant current trends and issues affecting network industries through parallel sessions, including but not restricted to:

- Challenges in Network Industry Regulation
- Liberalization Models in Network Industries
- Measuring Network Performance
- Inter supra-nationalization of Infrastructures
- Investments and Innovation in Network Industries
- Sector-specific issues (Electricity, Gas, Railways, Telecom, Post, Water, Aviation, Transport, Internet, ...)

**Keynotes**

In addition to the parallel sessions, the conference will feature two keynote speeches by leading academics and/or practitioners in the fields of competition, regulation, and network industries.

With this call for papers the CRNI invites you to contribute to the conference through papers and panel suggestions.

**Guidelines**

Please send a 600 to 1000 word proposal in a word document by 2 June 2014 to a.g.cruzvelis@tudelft.nl. The proposals will be refereed by the editorial board of the CRNI. The proposal should include:

- Title of the paper and a few keywords
- Name and full address of the (corresponding) author(s)
- The aim and methodology of the study
- Results obtained or expected

**Important dates**

Deadline for panel submission: 16 May 2014
Deadline for paper proposals: 2 June 2014
Notification of acceptance: 4 July 2014
Final paper submission: 15 October 2014

**Fees**

Members of academic / non-profit institutions: 200 Euro
Members of business community: 300 Euro
PhD students: fee waivers are available upon request

**Further details**

For further information about the conference, registration, submission, and program, please visit: www.crninet.com.

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Infrastructure Conference 2014

**Topic:** Mobility Pricing

**Date:** Friday, October 24

**Time:** 09:00 - 14:00

**Location:** University of St. Gall

**Participants:** open to the public

**Fee:** free entry

**Registration:** mir.epfl.ch
The Transport Area of the Florence School of Regulation

The Florence School of Regulation (FSR) has been created in 2004 as a partnership between the European University Institute (EUI) and the Council of the European Energy Regulators (CEER). Since then, the Florence School of Regulation has expanded from Energy regulation to Telecommunications and Media (2009), Transport (2010) and Water (2014).

The Transport Area of the Florence School of Regulation (FSR Transport) is concerned with the regulation of all the transport modes and transport markets (including the relationship among them). It currently focuses on regulation and regulatory policies in railways, air transport, urban public transport, intermodal transport, as well as postal and delivery services.

The aim of FSR Transport is:

• to freely discuss topics of concern to regulated firms, regulators and the European Commission by way of stakeholder workshops;
• to involve all the relevant stakeholders in such discussions; and
• to actively contribute to the evolution of European regulatory policy by way of research.

The core activity of FSR Transport is the organization of policy events, where representatives of the European Commission, regulatory authorities, operators, other stakeholders, as well as academics in the field meet to shape regulatory policy in matters of European transport.

The results of FSR Transport’s activities are disseminated by way of policy briefs, working papers and academic publications. All FSR Transport materials are open source and available on the FSR Transport webpage, as they aim to involve professors, young academics and practitioners to become part of a unique open platform for applied research.

To learn more visit our website: www.florence-school.eu or contact us at FSR.Transport@eui.eu.

FSR-Transport: Events 2014

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<td>3 October 2014</td>
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For more information about our activities please contact: FSR.Transport@eui.eu.