



Latvia: State Ownership Policy Review [Part II]



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Glossary

Term	Definition
Akciju sabiedrība, AS	Joint stock company
Cabinet of Ministers	Cabinet of Ministers of Republic of Latvia
CAGR	Compound annual growth rate
CapEx	Capital expenditures
Capital company of a public person	A capital company, in which all capital shares or voting stocks belong to one public person
Commercial law	The Commercial Law of Republic of Latvia. Latvijas Vēstnesis, 158/160, 04.05.2000. https://likumi.lv/ta/id/5490
Company	State-owned enterprise
Competition Council	The Competition Council of Republic of Latvia
COSO	The Committee of Sponsoring Organizations of the Treadway Commission, which is a joint initiative of the five private sector organizations and is dedicated to providing thought leadership through the development of frameworks and guidance on enterprise risk management, internal control and fraud deterrence
CSDD	VAS Ceļu satiksmes drošības direkcija
CP	Commercial paper
CSB	Central Statistical Bureau of Latvia
CSCC	Cross-Sectoral Coordination Centre Republic of Latvia
EBITDA	Earnings before interest depreciation and amortization
EBRD	European Bank for Reconstruction and Development
EC	European Commission
Enterprise Risk Management	The culture, capabilities, and practices, integrated with strategy setting and its performance, that organizations rely on to manage risk in creating, preserving, and realizing value.
EU	European Union
FCMC	Financial and capital markets commission
General strategic objectives	Objectives of the company specified by the highest decision-making body of the public person, which the public person wants to achieve through participation in the company and which arise from legal acts and policy planning documents
GDP	Gross domestic product
IFRS	International financial reporting standards
Internal Controls	A process, effected by an entity's Supervisory board, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objective relating to operations, reporting, and compliance (<i>Source: COSO</i>) The policies, processes, tasks, behaviours and other aspects of an organisation that taken together: <ul style="list-style-type: none"> Facilitate effective operation by enabling it to respond in an appropriate manner to significant business, operational, financial, compliance and other risks to achieve its

	<p>objectives. This includes safeguarding of assets and ensuring that liabilities are identified and managed.</p> <ul style="list-style-type: none"> • Ensure the quality of internal and external reporting, which in turn requires the maintenance of proper records and processes that generate a flow of timely, relevant and reliable information from both internal and external sources. • Ensure compliance with applicable laws and regulations and also with internal policies. (Source: ACCA) <p>Policies, procedures, practices and organizational structures designed to provide reasonable assurance that business objectives will be achieved, and undesired events will be prevented or detected and corrected.</p> <p>In that context, internal controls are structures, tools, processes or mechanisms that help ensure an outcome. (Source: ISACA)</p>
IPO	Initial public offering
ISACA	Previously known as the Information Systems Audit and Control Association®, ISACA now goes only by its acronym to reflect the broad range of IT governance professionals it serves
KPI	Key performance indicator
LSE	London Stock Exchange
Medium-term operational strategy	Medium-term strategy
Ministry of Agriculture	Ministry of Agriculture of Republic of Latvia
Ministry of Culture	Ministry of Culture of Republic of Latvia
Ministry of Economics	Ministry of Economics of Republic of Latvia
MoF, Ministry of Finance	Ministry of Finance of Republic of Latvia
Ministry of Health	Ministry of Health of Republic of Latvia
Ministry of Transportation	Ministry of Transport of Republic of Latvia
OECD	Organisation of Economic Co-operation and Development
OLE	Owner's letter of expectations
OTC	Over the counter
Public policy objective	Specific performance requirements and activities imposed on SOEs other than the maximisation of profits and shareholder value. More broadly defined public policy objectives include not only non-financial objectives, but also "expectations" communicated to SOEs, for example related to corporate social responsibility, sustainability, etc.
PPP	Public private partnership
PwC	PricewaterhouseCoopers SIA, Registration Number: 40003142793, Address: Krišjāņa Valdemāra iela 21 - 21, Rīga, LV-1010, Latvia
Regulation no 20	Cabinet of Ministers Regulation No 20 "Nomination procedure of the Executive management and Supervisory board members in the capital companies, in which shares are owned by the State or by a public body" (07.01.2020.)
Regulation no 63	Cabinet of Ministers Regulation No 63 "Regulations on the Number of Members of the Executive management and Supervisory board of Public Limited Companies and Public Private Companies and the Maximum Monthly Remuneration of Members of the Executive management and Supervisory board" (04.04.2020.)
RAKUS	SIA Rīgas Austrumu klīniskā universitātes slimnīca
ROA	Return on assets



ROE	Return on equity
Sabiedrība ar ierobežotu atbildību, SIA	Limited liability company
SASL	The State Administration Structure Law. Latvijas Vēstnesis, 94, 21.06.2002. https://likumi.lv/ta/id/63545
SOE	State Owned Enterprise
SOEL	Law “On Governance of Capital Shares of a Public Person and Capital Companies”. Latvijas Vēstnesis, 216, 31.10.2014. Available at: https://likumi.lv/ta/id/269907
State	Republic of Latvia
Subsidies, state budget funding	Funding that SOEs receive from the state budget directly or indirectly, e.g., through subsidies, appropriations, public service contracts, compensations for performing certain services, or through guaranteed income (e.g., customers are legally required to purchase services from the company or company’s revenue is generated mainly from providing services to public sector clients)
Supervisory board	Non-executive board
VAS	Valsts Akciju Sabiedrība. State owned joint stock company
VSIA	Valsts Sabiedrība ar ierobežotu atbildību. State owned limited liability company

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Synthesis of the Assignment

The State-owned enterprises (SOEs) are the backbone of many economies around the world accounting for 20% of investment, and up to 40% of domestic output. According to the International Monetary Fund (IMF), SOEs' assets are worth 45 trillion US dollars, equivalent to half of global gross domestic product (GDP). In Latvia, the SOEs play a critical role as well. Over 170 SOEs (from which 70 group SOEs in which the State has a decisive control) influence the economy of Latvia and people's lives by providing goods and services ranging from sports infrastructure and culture to electricity and transportation.

The outbreak of COVID-19 has magnified the importance of well-organized and financially sound SOEs. The pandemic has left a profound negative impact on the global economy – including the Latvian economy. The fiscal deficits have widened, unemployment level has risen, and many businesses have either permanently closed or face impaired future prospects amid unexpected indebtedness and withdrawn investment projects. These unprecedented consequences call for exceptional and bold measures. This is a critical moment for the policy makers governing the SOEs to revamp and promote more resilient, profitable and sustainable SOEs for the long-term benefit of the society.

The macroeconomic dynamics mentioned above in conjunction with the “room for improvement” circumstances across the Latvian SOE landscape related to undiversified funding / financing sources and in many cases conservative financial target setting make the objective of this Assignment timely and critically important: **an assessment and gap analysis of the current capital structures and corporate governance standards of SOEs as means to draft a methodology towards forming optimal capital structures and related roadmap to implement it.**

The **key takeaways** from the conducted assessment indicate the following:

- SOE ownership and **corporate governance practices are not harmonized** increasing the risk of ambiguous expectations, inactive ownership, and heterogeneous corporate governance.
- The SOEs' financial positions exhibit signs of too high indebtedness relative to the peers as well as poor profitability that in combination may lead to **potential debt overhang¹ issues**.
- The financial instruments used by the SOEs are mostly **bound to traditional types of financing** such as subsidies, European Union (EU) funding, and commercial bank loans despite the available spectrum of alternative instruments providing many benefits that the former tools cannot.
- Public capital markets and especially **initial public offerings (IPOs) could resolve some of the inherent corporate governance challenges and accommodate sustainable risk taking** by financing new expansion projects without assuming excessive financial risk.
- The feedback from pan-Baltic institutional investors, recent examples of other Baltic SOEs, and the preliminary assessment of IPO readiness among selected sample of SOEs display that **certain larger, more commercially oriented SOEs are viable candidates for tapping public capital markets**.

¹ Debt burden so large that an entity cannot take on additional debt to finance future projects. The burden is so large that all earnings pay off existing debt rather than fund new investment projects, making the potential for defaulting higher.



In addressing the challenges identified and to meet the objective of the Assignment, a holistic approach for developing the necessary methodology was used. Namely, the proposed changes include two separate yet interlinked processes (all of which are supported with the necessary changes in the legislation):

Active ownership principles – developed with an aim of creating efficient, transparent and simple process for active ownership. It is a fundamental building block for making sure that the proposed SOE financing methodology becomes successfully implemented in practice.

SOE financing methodology – designed specifically to stimulate efficient allocation of capital and to solve subpar financial performance by introducing a determination of objective and market based financial targets, diversified set of financing instruments, and a more active use of public capital markets as a source of capital attraction and reason for corporate governance improvement.

State ownership policy document (active ownership principles)

To bring greater clarity and consistency to ownership issues, a State ownership policy document should be developed serving as a tool for communicating expectations and good practices to shareholders, boards and executive management team. A State ownership policy document would unify the State's longer-term vision on the overall SOE governance that would ultimately allow the stakeholders to comprehend the structural direction in which the State sees its enterprises heading. This would also inform the public of the key principles guiding the State's assets and its ownership policy towards them.

Owner's letter of expectation (active ownership principles)

An OLE is a vital and necessary tool to induce an active ownership by the State and in the same time foster a more efficient and transparent communication of the relevant expectations for the SOEs. The OLE provides a framework under which the State has the option to voice its expectations for an SOE for a 5-year period.

SOE financial target setting methodology (SOE financing methodology)

A more granular methodology is needed to translate the high-level expectations set by the State (via State ownership policy document and OLE) into measurable and objective targets. Therefore, there should be a defined perimeter of objective and balanced financial target setting (neither too aggressive nor too conservative), especially, against the backdrop of undiversified funding / financing sources and the overarching notion of maximizing shareholder's returns in a sustainable manner.

The SOE financial target setting methodology takes into account three key aspects that should be quantified based on corresponding guidelines and benchmarks: **balance sheet metric (optimal capital structure), rate of return target and dividend policy**. The proposed SOE financial target setting methodology, linked with OLE period, offers guidelines for the SOEs to define objective financial targets that stem from comparable benchmarks, sectors / industries, and companies – i.e. *market based benchmarking*.

Preferred financing instruments (SOE financing methodology)

A list of financing instruments tailored specifically for each SOE segment by taking into account the current gaps in financing (possible and recommended use of financing instruments vs actual use) serves the purpose for making the overall use of financing instruments more diversified. This is necessary to reduce



concentration risks observed among SOEs by relying predominately on traditional forms of financing that in many cases do not offer the same benefits as alternative sources of financing. In addition, a more diverse set of actively used financing instruments should warrant more flexible balance sheets and provide a boost for corporate governance processes.

IPO readiness assessment (SOE financing methodology)

Finally, given the identified signs of high indebtedness and dismal profitability levels among the SOEs, IPOs should be increasingly considered as a possible option in attracting fresh capital to cover future investment plans, make capital structures optimal, and improve overall governance practices. Similarly, some data points indicated overcapitalized balance sheets that hints for conservative business activities and inefficient use of capital. The preparation for an IPO encompasses building attractive equity story considering optimal use of capital structure, ambitious growth targets and enticing dividend yields – all of which resolves the issue of overcapitalization.

For this to happen, it is recommended to introduce an IPO readiness assessment that would allow the State to determine the level of maturity or readiness for making a successful debut on stock exchange. Exchanging ownership rights for private capital must be done correctly and with a high confidence of favourable acceptance by the FMPs. In this regard, an IPO readiness assessment is based on a market-based criteria (quantitative and qualitative) that have to be assessed and fulfilled in order to warrant a successful IPO.



Executive summary

Corporate governance review

1. The sheer number of SOEs and the limited institutional capacity by SOE governance institutions (i.e. line ministries, shareholders and Coordination Institution) hinder harmonized corporate governance practices.

In order to ensure similar governance of SOE performance, the Latvian SOE ownership model has been restructured, moving from a decentralized model to a decentralized with a coordinating institution. The ownership and governance structure of Latvian SOEs is set up according to a hybrid model – SOE operational and strategic governance is implemented through the Coordination Institution, shareholder and line ministries.

To safeguard the separation of the State's ownership functions and other State functions, the existing governance framework establishes clear separation of the roles and tasks for all involved governmental bodies in the SOE governance. Therefore, each of the SOE governance institutions should exercise its governance rights with high degree of professionalism and effectiveness and have the capacity and competences to effectively carry out its duties. In practice, the ownership holdings are largely in line with the sectoral breakdown of responsibilities among the line ministries.

However, considering the significant number of the SOEs in Latvia and limited capacity of shareholders and Coordination Institution, the overall SOE corporate governance practices exhibit a relatively high degree of unevenness. Within the scope of the Assignment a heterogeneous corporate governance has been observed in the following areas - assessments for State's participation in SOEs, monitoring of SOE performance, disclosure and transparency as well as internal controls.

2. The Coordination Institution in its current advisory role lacks tools to enforce harmonized SOE governance practices.

The Coordination Institution has been established with the aim to oversee and harmonize SOE corporate governance practices. The Coordination Institution attempts to maximise the performance, and economic and social contributions of SOEs. The duties of Coordination Institution have been entrusted to CSCC. The CSCC, in broad terms, is the only public institution that supervises and offers guidance to SOEs; therefore, it is one of the institutions that must be informed about the SOE dividend pay-outs, medium term strategy and annual reviews. However, as Coordination Institution is neither a shareholder or a Supervisory board member of the SOEs, stakeholders perceive its policies as recommendations rather than mandatory norms that need to be followed.

Although the Coordination Institution was established to unify corporate governance practices, it was provided only an advisory role in the SOE corporate governance and has not been provided with tools to enforce the implementation of corporate governance practices. The recent changes



of the Law on Governance of Capital Shares of a Public Person and Capital Companies (SOEL)² increases Coordination Institution's role in the control of good governance practices by imposing a duty to monitor SOE compliance with disclosure of information; yet again with no tools for the Coordination Institution to enforce the compliance. Even though the disclosure and transparency practices by shareholders and SOEs still vary, significant changes in the SOE and ministry practices have been observed leading to more transparent disclosure.

3. The existing SOE target setting and monitoring practices revolve around a yearly assessment of financial targets that have been set at the inception of medium-term strategy and after a period of time might not always correspond to SOEs development due to being overly operational, thus discouraging the Executive management to push for bold long-term targets.

The current corporate governance framework requires that SOEs undergo a yearly performance review. The evaluation of SOE performance regarding the fulfilment of the company's financial and non-financial objectives is carried out in accordance with the practices set in the CSCC Guidelines³ and corresponding Rulings of the Cabinet of Ministries⁴. The medium-term strategies are created as a base planning document via the cooperation of all SOE's ownership levels – representative of shareholder, Supervisory board or shareholder meeting, and the Executive management. The aim of a medium-term strategy is to determine SOE strategic objectives, and business development plans forecasting SOE potential development scenarios.

However, in practice, SOE financial operating reports are compared with the planned financial results in the medium-term strategies. Hence, the existing SOE performance evaluation process does not lead to an effective assessment of SOE operations due to a mismatch of underlying economic conditions in the time when the goals are established, and the time when they are reviewed. In other words, it is an undue exercise to define operational financial metrics (that correspond to achieving long-term goals) as tools of SOE performance review in a so far future as theoretically 7 years. State Ownership Policy Review [Part I] has recommended SOE target setting model providing that SOEs should limit a number of financial and non-financial targets that should be reported to shareholders. State Ownership Policy Review [Part I] suggests that a set of 6-8 financial and non-financial are optimal to ensure a focused approach in the SOE governance. Hence, according to best practice, the number of targets should not be excessive reminiscing operational rather than long-term plans, and the targets themselves should generally be based on overall convergence and performance that are similar to closest peers rather than overly detailed projections (e.g., gross-margin in certain segment, specific renovation project etc.).

Best practice tells that the existing operations and developments within the companies should be considered and evaluated both on an operational level and in long-term perspective. Furthermore,

² Law "On Governance of Capital Shares of a Public Person and Capital Companies". Latvijas Vēstnesis, 216, 31.10.2014.

³ Cross-Sectoral Coordination Centre Republic of Latvia. Guidelines for Performance Evaluation in SOEs In Which State Exercises Decisive Influence.

⁴ Cabinet of Ministers Regulation No 95 "Rules on the Performance Evaluation in SOEs in Which State Exercises Decisive Influence", 09.02.2016.

the focus should be directed towards identifying the strengths and weaknesses of SOEs' management.

The existing target setting process discourages SOEs from setting ambitious goals in their medium-term strategies as the failure to achieve the set goals could possibly result in negative SOE's performance review. Additionally, the current SOE evaluation process leads to an unintentional lack of interest to set ambitious goals as the Executive management remuneration in terms of the yearly bonus is dependent on the evaluation of the SOEs operational performance and fulfilment of yearly financial and non-financial target set in medium-term strategy. Although, it is necessary to indicate that the international best practices support Executive management's variable remunerations, i.e., bonus dependency on the achievement of the long-term strategic objectives.

4. The legislative framework provides detailed procedure for appointment of the Supervisory board and Executive management, while the revocation of the Supervisory board and Executive management lacks a clear procedure, thus increasing the chances of political influence on the SOE Supervisory board and Executive management.

Existing legal framework regarding the Supervisory board and Executive management in SOEs follows the same commercial corporate practices as those of private market participants. In addition to the general corporate practices, the SOEL and CSCC guidelines provide policies and procedures regarding the composition of the SOE Supervisory board and Executive management members and nomination of Supervisory board and Executive management members, following OECD guidelines with the aim to allow SOE Supervisory boards to make objective, experienced and independent judgements.

For a Supervisory board to effectively operate in an independent manner, the SOEL dictates that at least half of the members of the Supervisory board members must be independent. The SOEL provides clear criteria based on which the Supervisory board member is considered independent.

While most of the Supervisory and Executive management's tasks are described in SOEL or Commercial law, the existing regulations regarding the Supervisory board's and Executive management's liabilities (both Supervisory board and Executive management) are vague and thus open to wide interpretation by the shareholder. There have been some cases in which the manner of the changes in the Supervisory board composition (i.e. sudden revocations and short-term tenures) clearly indicated that the decisions were made based on other factors than economic considerations from the line ministries. While there should not be any changes in the existing regulations, in order to safeguard the independent judgment and encourage focused and ambitious SOE development, SOE Supervisory board and Executive management members should continue to follow the private market practices and revocation of Supervisory board or Executive board members should be publicly communicated clearly indicating the reasoning for the revocation thus limiting any potential influence on the SOE Supervisory board and Executive management.

5. The internal control and risk management system of SOEs is designed to fit into the context of public sector control measures and maintain the integrity of the company, rather than focusing on business objectives and promoting its growth.

External legal requirements, for example, the law On Prevention of Squandering of the Financial Resources and Property of a Public Person, Law on Annual Financial Statements and Consolidated Financial Statements, Law on Accountancy and the Commercial Law, and control mechanisms define basis of internal controls and establish compliance framework for SOEs in Latvia.⁵ The framework distinguishes different compliance levels for companies receiving State funding. The regulatory framework for SOEs receiving State funding is as stringent as for public administration institutions. Its priority is to ensure compliance of operations with the outside regulatory framework. Meanwhile, SOEs operating without State funding can operate with relatively broad discretion, allowing to link risk management with strategy and improvement of business performance, and therefore can be more commercially oriented. Despite of the attempts to improve SOEs' transparency by requiring these to report on the operating principles of the risks management policy, most of the SOEs deviate from the legal framework and do not publicly disclose the operating principles of their risk management policy. Consequently, public cannot have an assurance if the internal control procedures are adequately implemented in SOEs.

The proposed SOE segmentation



The proposed segmentation for SOEs in the context of new methodology

The importance of having a segmentation in place for the planned methodology is explained by the sheer number of Latvian SOEs, and the aspects of “one size does not fit all”. As of the Assignment date, there are over 70 majority-owned SOEs with heterogeneous business profiles, different sizes and State dependency, etc. Therefore, it is important to introduce a specific form of an SOE segmentation that would render the methodology applicable for all SOEs addressing various aspects of different financial characteristics.

The proposed segmentation approach is based on a SOE categorization that is subject to the main source of generated income. As a result, there are two broad categories of SOEs – **State dependent SOEs**, and **commercial SOEs**. The notion of using source of income as the key differentiator for the SOEs segmentation is attributable to the key objectives of the Assignment, namely, to propose a methodology, which would address the formation of optimal capital structures, and the choice of relevant financing instruments given unbiased and well-formed financial targets. As these objectives entail a high degree of financial focus, the corresponding metrics used for segmenting the SOEs should also take into account financial aspects. The source of income differentiator has the following advantages: (1) Easy to gather and interpret when making the actual segmentation; (2) Reflects well the dependency on State's support and the level of commercial activities; (3) The source of income plays also an important part in several financing instruments and broad financial targets. The segmentation also is made on a **consolidated basis**, meaning that all subsidiaries should be classified in the same segment as the holding (concern) company. The rationale for this lies in the fact that in the process of capital allocation, attraction of larger financing and investors, a company is usually analysed in conjunction with the subsidiaries. This approach also coincides with IFRS reporting, and dividend

⁵ For specific regulations of SOE internal control systems and SOE conformity with them please see Annex 9.

expectations from an SOE. Lastly, it mitigates the risk of moving capital among the group’s companies to influence the direction of results for a particular subsidiary or mother company.

Financial review

1. The SOEs have delivered a subpar growth over the period 2015-2019.

The sales compound annual growth rate (CAGR) of 70 SOEs – all that are majority-owned by the State and include subsidiaries – has significantly lagged behind the EU average and to a lesser degree other European SOEs (selected sample size of 90 SOEs, see **Annex 1**) during the period 2015-2019. There is a notable divergence between commercial SOEs (i.e. SOEs that are not included in the State budget, and receive less than 10% of the 3-year average sales as State support) and State dependent SOEs (i.e. SOEs that are included in the State budget and/or receive more than 10% of their 3-year average sales as State support). The commercial SOEs have grown their sales at a faster pace, namely, delivering a sales CAGR of 6.7% compared to 5.1% generated by the State dependent SOEs. Compared to an average Latvian company, the Latvian SOEs have achieved a similar performance with commercial SOEs slightly outperforming and State dependent SOEs falling short by 0.8%. Baltic publicly traded SOEs have clearly lagged behind the other comparable, yet, the conclusions should be viewed with caution since the sample size represent only a handful of companies most of which are in mature and regulated industries.

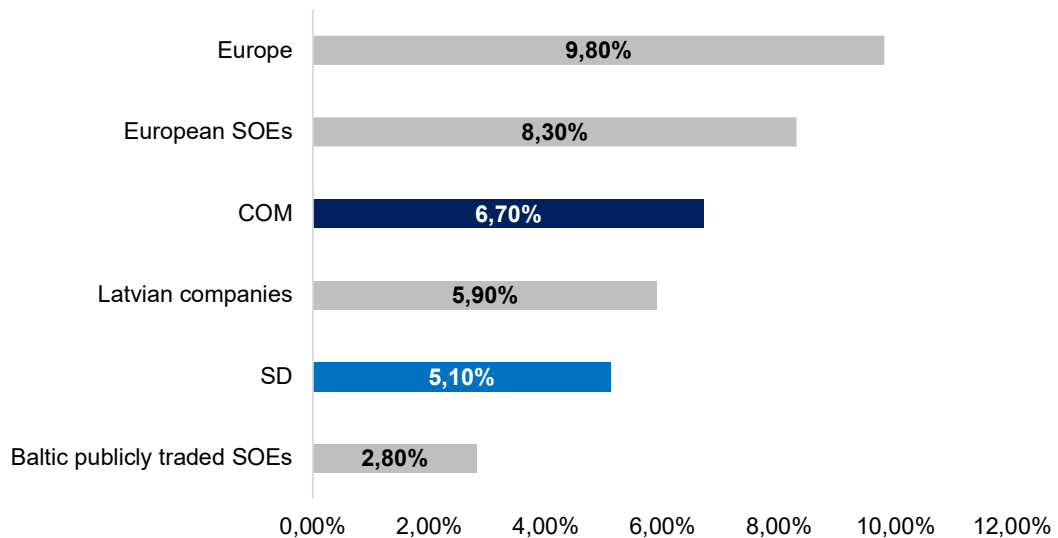


Figure 1. Sales CAGR, 2015-2019, [COM= Commercial SOEs; SD = State dependent SOEs]

The reason for the subpar performance of SOEs, and, in particular, of the State dependent SOEs is twofold:

On one hand, the level of State financing received for delivering goods and services with the objective to fill the market gap or fulfil the State’s objectives is oftentimes (during the SOE interviews) cited to be insufficient. The consequences of an insufficient State financing for its mandated objectives can lead to depressed profitability, inefficient cross subsidisation, and,

ultimately, render an SOE incapable to compete with private competitors. In some cases, SOEs cross subsidise the non-commercial goals (i.e. fulfilment of State objectives) with the monies generated by the commercial activities. This, in turn, implies a certain degree of opportunity cost within the commercial segment.

On the other hand, the commercial activities could be driven inefficiently, thus disabling the SOEs from delivering similar growth as private peers. During the SOE interviews, this was not explicitly mentioned as a key reason behind the aforementioned underperformance. In addition, certain SOEs (mostly commercial SOEs) are exposed to a country-specific regulatory environment, which sets a pricing cap as to how far the sales can be increased, making the benchmarking process subjective. However, according to the conducted analysis, commercial SOEs have fallen short the EU average benchmark values, and given the fact of the limited scope of non-commercial goals that such SOEs embody, the commercial activities remain as an obvious area of concern.

2. The SOEs have become more indebted over the period 2015-2019, exceeding the average level of indebtedness among EU companies and other EU SOEs.

The SOE indebtedness as measured by debt-to-equity ratio has spiked higher during 2015-2019. The increase of debt levels has happened for both commercial and State dependent SOEs. Comparing the median debt-to-equity ratio in 2019 to that of 2015, an uptick of 61% and 3% can be observed for commercial and State dependent SOEs, respectively. While the indebtedness levels of State dependent SOEs have remained flat over the period 2015-2019, the debt-to-equity ratio of 1.21 as of 2019 is more than threefold higher (in absolute terms) than that of the EU average. Conversely, commercial SOEs have experienced a higher uptick in the debt-to-equity ratio during 2015-2019, i.e. an increase of 61%. Yet, in absolute terms, the debt-to-equity of 0.58 recorded in 2019 can be broadly considered a relatively sound level – also falling in the mid-range of other Baltic publicly traded SOEs.

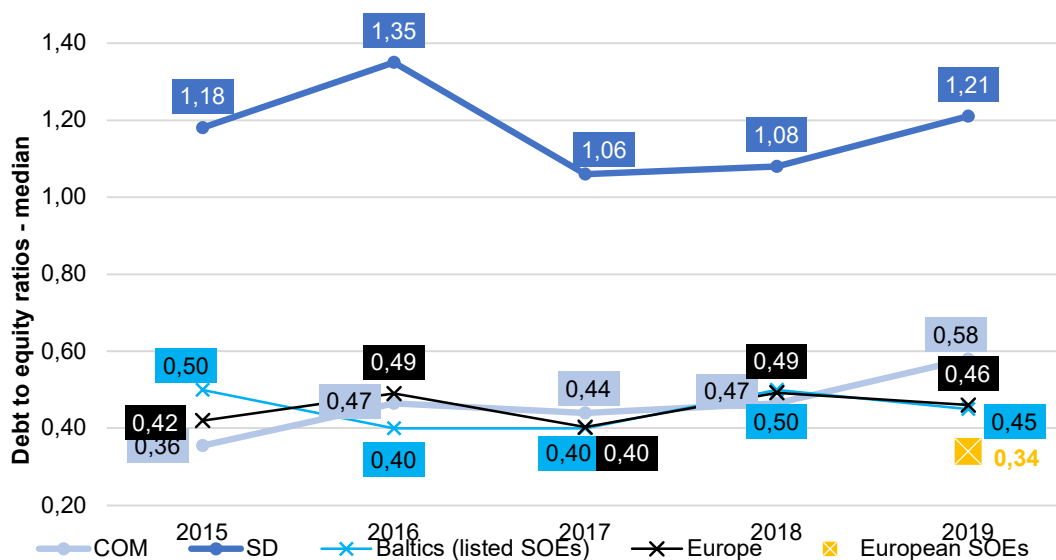


Figure 2. Historical development of SOE debt to equity ratios (2015-2019), [COM= Commercial SOEs; SD = State dependent SOEs]

The sectoral breakdown of Latvian SOE debt to equity comparison to that of the selected sample size of 90 European SOEs strengthens the overall argument of Latvian SOEs carrying excessive amount of debt on their balance sheets. The analysis in **Figure 3** reveals that Latvian SOEs are too indebted across major sectors relative to a yardstick derived from European peers.

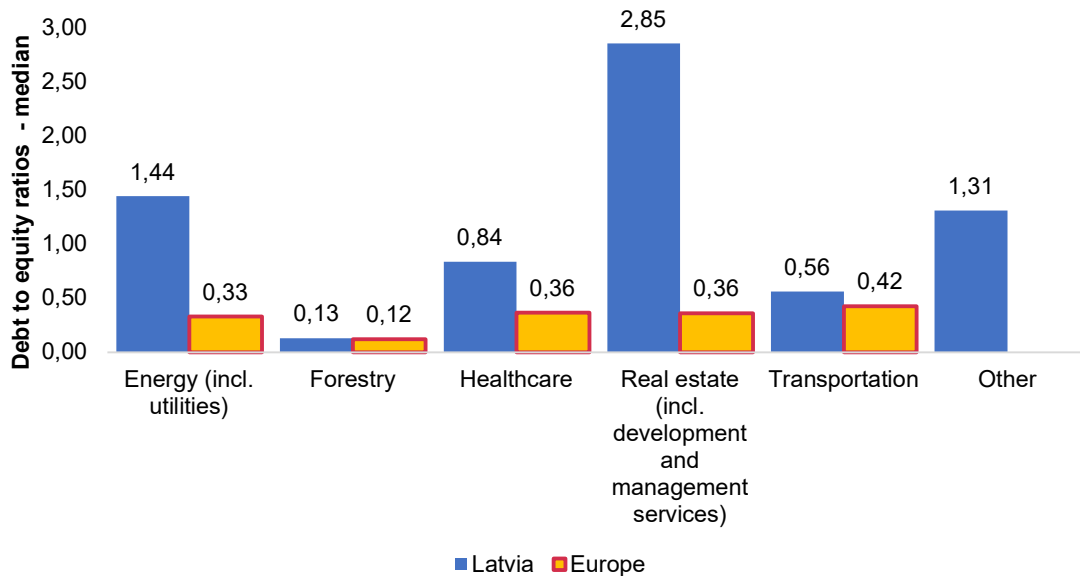


Figure 3. Debt to equity of Latvian SOEs vs European SOEs⁶, 2019

Overall, it can be concluded that an average Latvian SOE has become more leveraged in the recent past, and for the State dependent SOEs, the debt carried on balance sheets can at some point imply an elevated risk of requiring the State to contribute with direct equity injections. The combination of poor growth and persistently elevated debt levels send a clear signal that either the undertaken investment programs offer insufficient return prospects (the likely scenario⁷) or that the SOEs have been forced to assume a large portion of debt to fund short-term, operational activities.

The risks associated with overly leveraged SOEs can lead to system-wide negative consequences, especially in the case of unprecedented external shocks. Under conditions of decreased demand (i.e. tightening cash flows), SOEs may have to cut on necessary investment programs, furlough employees and/or request notable equity injections from the State.

3. The sources of financing used by the SOEs are undiversified and concentrated on State subsidies, retained earnings, and loans from commercial banks.

In analysing the financial source (i.e. what and the extent of its use), a selected sample of 14 SOEs was scrutinized. From the 14 SOEs (see **Annex 2**) 8 are commercial and 6 State dependent SOEs (Sadales tīkls and LDz cargo consolidates within the respective mother companies). The analysis revealed six different financing instruments on which the SOEs have relied upon during 2019, including the amortization effects of the present instruments, e.g., commercial bank loans and

⁶ SOEs indicator poll is compiled from the financial data of 90 various European SOEs

⁷ The asset base of the SOEs in which the State has a decisive influence has persistently grown over the 2015 – 2019 period, yet the profitability levels have not picked up with the EU peers (see figure 1.).

bonds. The six financing instruments consisted of the following: subsidies (State financing), retained earnings, EU financing, State Treasury loans, bonds, and commercial bank loans. The bond financing was observed only among three SOEs.

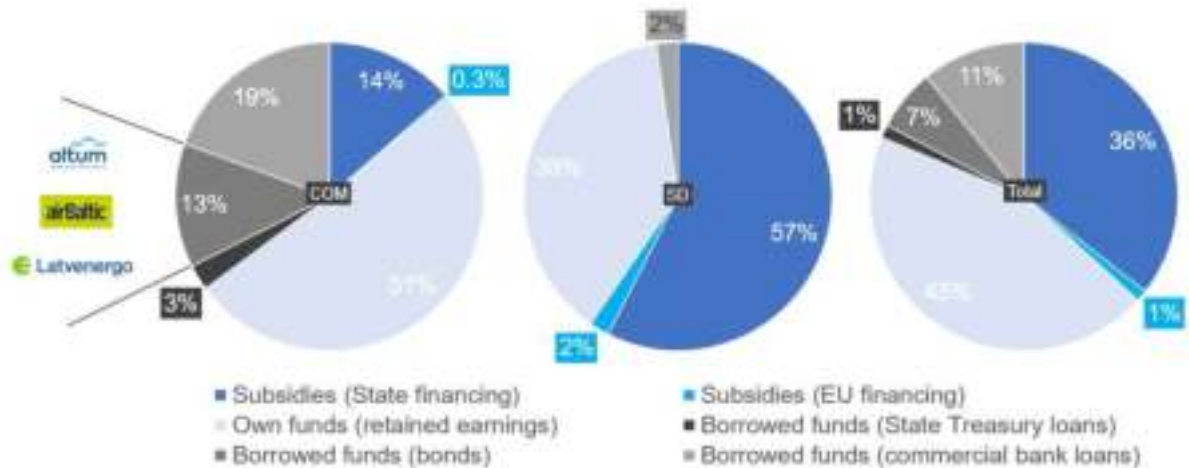


Figure 4. SOE financing sources used in 2019, split between Commercial SOEs (COM) and State dependent SOEs (SD)

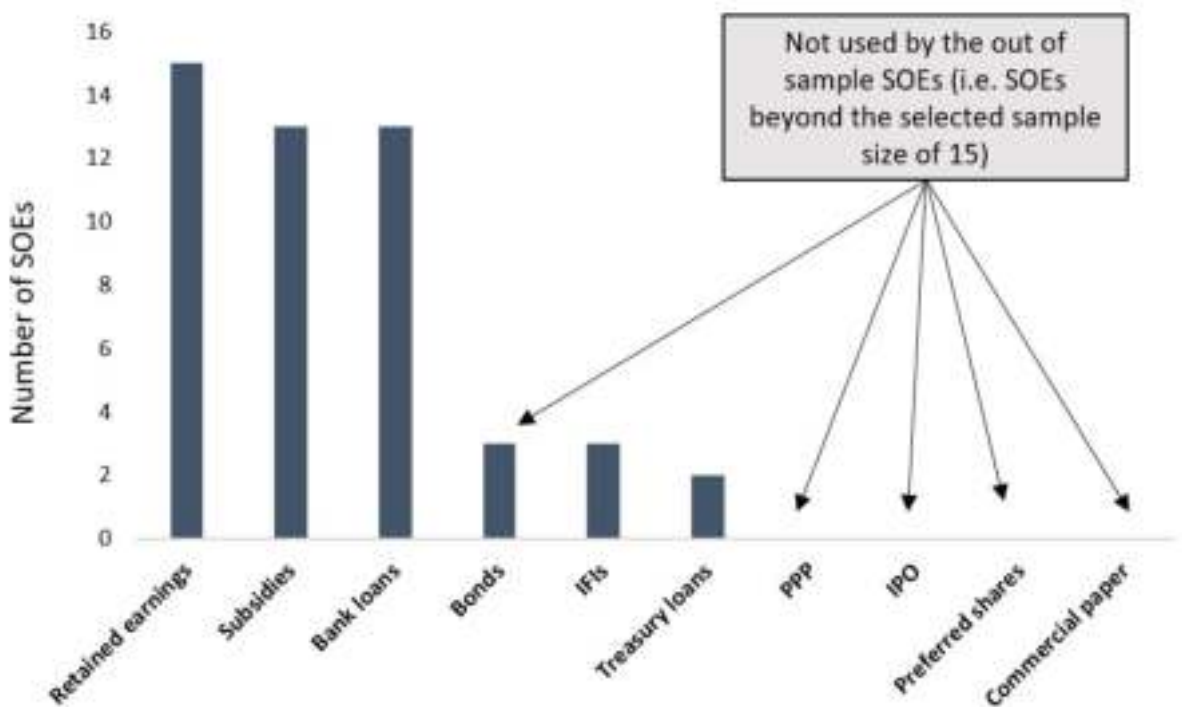


Figure 5. Selected SOEs and their use of financing instruments in 2019

The aforementioned analysis and breakdown of the various financing sources indicates a high degree of homogeneity and concentration in a limited subset of possible alternatives. There is a significant reliance on commercial bank loans (in terms of the possible borrowing instruments)



among both commercial and State dependent SOEs. While this is somewhat offset by the presence of bonds, it has to be noted that the actual picture presents a much lower use of bonds. This is due to the sample size bias, which currently includes all SOEs, which have tapped public fixed income markets, and leaves other SOEs out from which no one has issued bonds.

Finally, the gap analysis on financial instruments reveals that there is a wide range of different alternatives that currently are not put into use by Latvian SOEs. These alternative financing instruments embody attracting financing from both public capital markets and other sources such as public private partnerships (PPP) and commercial paper issues that offer many benefits that traditional forms do not. Hence, a more active use of different financing instruments beyond just traditional alternatives allows one to not only mitigate concentration risks, but also capture various financing instrument specific benefits such as fresh financing without increased leverage profile, more flexible debt maturity profiles as well as lower cost of debt.

4. The domestic public capital markets are well-functioning and able to channel successfully private investment, despite the illiquid patterns of the secondary market, and historic unpopularity among Latvian SOEs and private companies.

Statistically, the domestic (and pan-Baltic) capital markets have been on a structural decline since the great financial crisis. The number of Latvian publicly traded companies has plunged from 35 in 2008, to 21 in 2019. Similarly, the market-cap-to-GDP measure indicates a significant divergence from the world's average. In 2019, the Latvian market-cap-to-GDP ratio stood at 2.7%, while the corresponding average for the world was ca. 90% and for Europe around 70%. The structural decline has led to shallow liquidity in secondary markets and caused a pessimistic perception of the underlying feasibility of domestic public capital markets.

However, the past examples and the recent activity in the primary market have proven that the market is well-functioning, namely, it can successfully channel private investment provided that certain pre-requisites are met. For instance, both of Latvian SOEs (i.e. Latvenergo and Altum) have issued bonds, which have been oversubscribed by the investors, confirming the appetite from institutional investor for transparent and well-structured issues. The presence of strong demand, in turn, allows the SOEs to consider longer maturities, larger issues and/or lower yields. Both SOEs have communicated a willingness to proceed with bond issuances (e.g., refinance the maturing ones) that sends a clear signal of the benefits offered by the public capital markets.

The most recent IPO by Ignitis grupe (Lithuanian SOE) was the largest IPO in the Baltic capital markets' history, where private investment amounted to EUR 450 million. The firm was dual-listed on Nasdaq Vilnius and London Stock Exchange and benefitted from previously tapping the debt capital market via issuing green bonds. This allowed Ignitis grupe to get comfort with the level of disclosures required by the public markets and ensure there is a smooth transition to raising new equity capital via the IPO.

Another relatively recent IPO by Estonian SOE Tallinna Sadam succeeded to attract EUR 147.7 million of private investment, and over 14 thousand retail investors, thereby boosting domestic savings culture. The feedback from the management teams has been unanimously positive citing many benefits offered by the public capital markets – e.g., enhanced corporate governance and well-needed funds for future growth opportunities.



There are also ongoing pan-Baltic efforts to develop short term tradeable instruments such as Commercial Paper (CP). This can be another tool for local SOEs to tap the money or debt capital markets. CP's development is backed by the memorandum of understanding signed by all Baltic Central Banks together with EBRD and Nordic Investment Bank with the aim to promote and develop a regional CP market – which will contribute to diversifying sources of short term finance for local firms and improving the regional debt capital market while mobilising funds from institutional investors.

5. Institutional investors expect from SOEs (in the case of SOE IPOs, bond or CP placements) stability, transparency, visibility on the future growth path and the dividend policy, as well as a seasoned management team with a focus on active value creation.

After the discussions with pan-Baltic institutional investors, and the conducted analysis on all of the SOEs that have used capital markets to fund growth, several important elements crystalized. These elements represent the common expectations from the private investors' side when it comes to capital allocation decisions.

For the two recent (Tallinna Sadam and Ignitis grupe) SOE IPOs, the following pre-requisites for a successful IPO were held in common:

- Sufficient level of free-float – offering ca. 33% to private investors;
- Resilient cash flows with a momentum of growth and a visibility on the future development;
- Seasoned management team, and corporate governance practice up to the par;
- Macroeconomic tailwinds supporting the future development;
- Transparent and predictable dividend policy;
- Obtained credit rating from a reliable agency.

Similarly, the following pre-requisites were held in common for the two recent SOE bond issuances (Latvenergo and Altum):

- Transparency and visibility on how the company envisions putting the capital at work;
- Sufficient issue size for private investors to cover the administrative costs;
- Long enough maturity profile creating a higher term premium;
- Obtained credit rating from a reliable agency.

6. SOEs should be forerunners in joining stock exchange, which is supported by pan-Baltic FMPs and deemed necessary by many policy makers.

Many policy makers are increasingly appreciating the benefits of a robust capital market and are viewing it as a mechanism in order to facilitate growth, strengthen corporate governance practice and provide knock-on benefits for a wider society.

Initiatives such as EU capital markets union (CMU) aiming to create a single capital market in the whole territory of EU, Financial and Capital Market Commission (FCMC) developing a 10-step program to enliven domestic capital market, and Finance Latvia Association citing the importance of well-functioning capital markets. Additionally, many of the analysed countries have formed dedicated policies and made notable steps towards improving active ownership by opening the



SOEs for non-State capital via public capital markets. For example, Norway has developed a new policy aiming to gradually reduce ownership in more commercially oriented SOEs, Sweden has purposely divested many SOEs to improve corporate governance and attract financing for growth, and other Baltic countries have been active in this field as well (as described above).

Just as important, pan-Baltic institutional investors have indicated their willingness to participate by subscribing to SOE share and bond issuances.

Finally, an IPO readiness assessment was developed during the Assignment in order to determine commercial SOE readiness to successfully enter stock exchange. The assessment covers many criteria, the fulfilment of which is deemed vital by FMPs to increase the likelihood of a successful debut.

From the five analysed commercial SOEs, it can be concluded that Latvenergo and Latvijas valsts meži are ready candidates for a strong and favourable IPO process. Among the many fulfilled criteria, both companies have robust financials, operate in stable and growing industries and are well-governed (especially, Latvenergo considering the transparency stemming from active bond issuances that to a large extent would provide a major tailwind for Latvenergo in structuring the IPO).

Recommendations

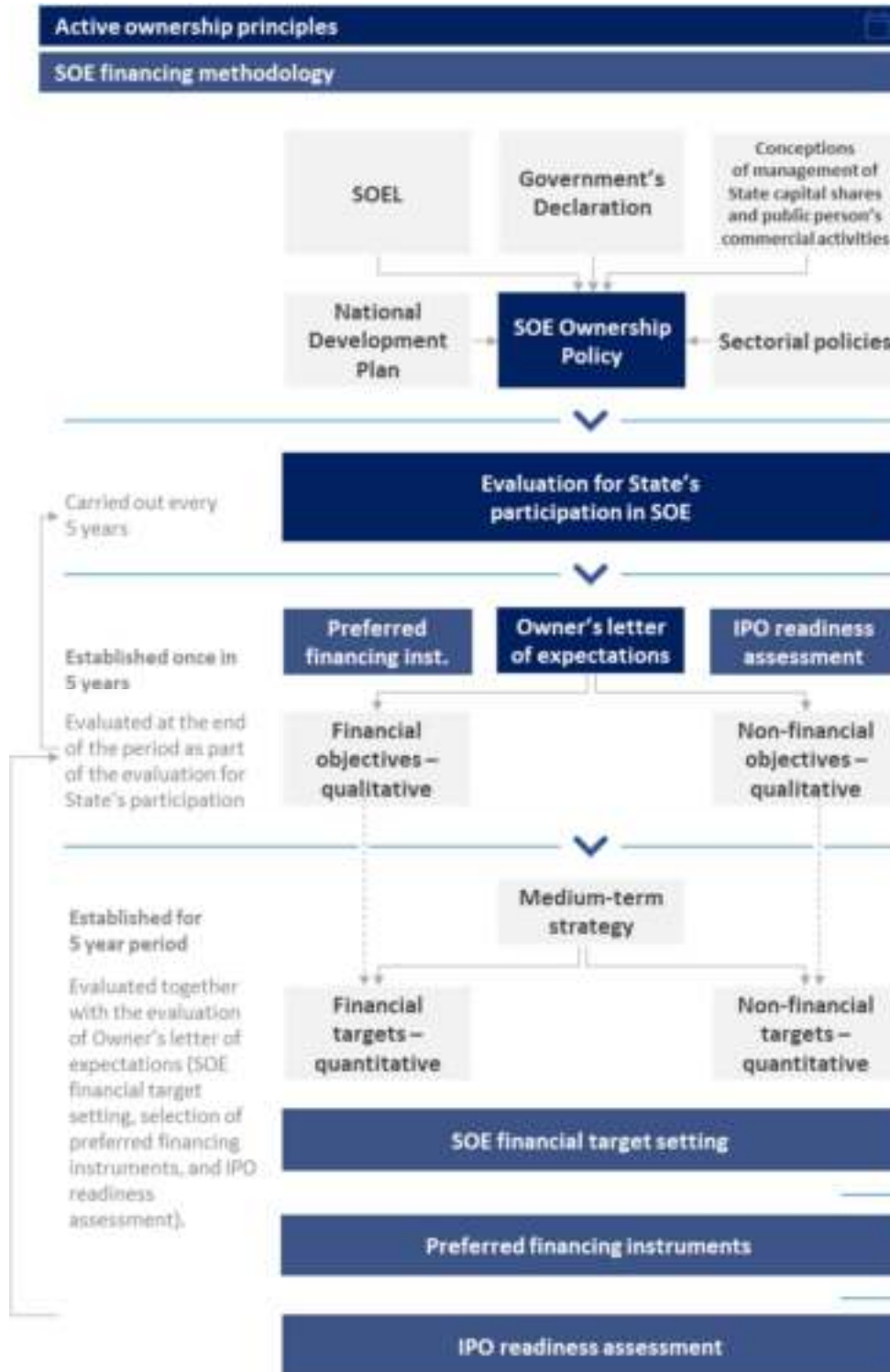


Figure 6. Overview of proposed active ownership principles and SOE financing methodology



Induce active ownership principles by ratifying a comprehensive SOE State Ownership policy document, creating owner's letter of expectations and adjusting the existing medium-term strategy guidelines.

Context

- Latvian SOE ownership model has been strengthened by creating a Coordination Institution with an aim to harmonize SOE corporate governance. However, the existing corporate governance practices show that despite the attempts to unify shareholder and SOE practices, significant discrepancies remain. This is mostly attributable to the sheer number of SOEs and lack of a comprehensively established single State ownership policy document.
- During the interviews with pan-Baltic institutional investors, SOEs and other financial market participants (FMPs) active ownership was cited as the most vital issue to be solved. Several examples were brought up illustrating the detrimental consequences of shareholder's inactivity – e.g., foregone investment opportunities that would have resulted in favourable returns, structurally lagging financial results relative to the closest peers, lower flexibility and predictability due to unexpected dividend extractions etc. The most imminent homework for solving the perceived inactivity, according to the feedback from the market, includes a mechanism that transparently outlines the long-term expectations by the State, clear-cut methodology how to measure and set specific targets, and a more active dialogue involving shareholders, SOEs, line ministries as well as key FMPs.

The State ownership policy on the SOE governance has to take **a long-term approach allowing SOEs to become efficient**, profitable and given an opportunity to develop. Considering the Latvian SOE ownership model, it is crucial to have clearly defined SOE objectives, target setting and monitoring procedures all of which ensure harmonized and efficient SOE governance. For the State to allow SOEs full operation autonomy in achieving their defined general strategic objectives, it is necessary to first establish concrete expectations regarding the SOE performance evaluation as well as determine clear SOE performance monitoring procedures.

State ownership policy document

The SOE ownership policy in Latvia is expressed in several policy documents such as Latvia's sustainable development strategy, Latvia's National Development Plan and the Government's Declaration of the intended activities of the Cabinet of Ministers, SOEL and Conception of management of State capital shares, Conception of public person's commercial activities and the subsequent sectoral policies. Based on the SOE ownership model the ownership policy is implemented by 11 ministries and the National Electronic Mass Media Council and Public Asset Manager "Possessor" having various understandings and interpretations on the SOE ownership policy and its objectives.

To harmonize SOE corporate governance practices the State should develop unified SOE ownership policy document complying and clearly defining State's overall SOE ownership policy strategy and objectives towards SOEs. The SOE ownership policy should be developed as medium-term policy planning document **aligned with the political cycle and government's period of operations and aimed at achieving**

specific objectives of national importance and covering a wide range of issues. The SOE Ownership Policy and State's objectives toward SOE should be subject to public disclosure.

Firstly, the SOE ownership policy **should determine specific criteria and strategic rationale for State's participation in SOEs.** The policy should encourage establishing or maintaining a participation in an SOE only if the strategic objective for establishing or maintaining participation in SOE cannot be achieved by exercising its public power directly through the State administration or by encouraging private market participants to ensure delivery of the necessary goods or services. It would decrease the number of SOEs in Latvia, and simultaneously increase the institutional SOE governance capacity allowing the State to act as an informed and active owner. The SOE ownership policy should serve as a foundation to review State's ownership objectives and legal framework establishing SOE corporate governance.

Many OECD countries have opted to limit their SOE portfolio to companies delivering strategically important goods or services (e.g., mining, energy, transport sectors) or having a commercial purpose. To fulfil non-commercial public policy objectives, governments have established public administrations or non-profit foundations. For example, the relatively small amount of the SOEs in Estonia and Lithuania - 29 and 51, respectively - allows governments to more actively engage in SOE governance and to monitor their performance on a more granular basis. In Lithuania and Estonia entities providing healthcare or culture services (i.e. State-dependent non-commercial SOEs) have been established as either public administrations or foundations.

Based on the State's rationale towards participation in an SOE, the SOE ownership policy should establish **SOE segmentation process.** The segmentation should constitute from the same principles and implementation as outlined in the proposed segmentation approach. The segmentation should inform State's strategy towards commercial and State-dependent SOE development by determining the level of State's participation in SOE, financial targets and financing instruments. The SOE Ownership policy should establish State's objectives towards each of the segments, for example, asserting that commercial SOEs should work in the similar market conditions as private market participants, including but not limited to increasing their profitability and ensuring effective State capital management. To render a coherent segmentation process, where the SOEs could be assessed by applying one common language understood by a broad base of FMPs, it is recommended to adopt International Financial Reporting Standards (IFRS) for primarily commercial SOEs and more mature State dependent commercial SOEs. Additionally, based on the State's objectives towards each of the segments, State should require commercial SOEs to have an IPO readiness assessment, evaluating SOE potential to join the capital market. Depending on the readiness assessment's results, State should re-evaluate it's the level of participation in SOE.

Secondly, the SOE ownership policy should include the **State's objectives on a sectoral level** in order to provide a clear guidance for the SOEs. This is vital to allow both the overall SOE management and general public to grasp the potential impact to SOEs of the envisaged sectorial changes. Furthermore, the disclosures per each sector in which the SOEs operate would facilitate higher visibility on the future investments and allow to make necessary adjustments in the overall capital allocation tactics. Lastly, the SOEs are often perceived as flagship organizations that are expected to pave the way for other organizations in absorbing the imminent structural changes. To do so, defined sectorial objectives in the SOE Ownership Policy document would allow the SOEs themselves to prepare and take bold steps that are necessary to achieve the envisaged sectorial plans.



Thirdly, SOE Ownership Policy should establish overall SOE broader public policy objectives, for example, implementation of **ESG standards**. As an owner, the State should have high ambitions for sustainable business that would follow **objectives set in global Sustainable Development Goals (SDG)**. SOEs have to act in an exemplary way, which includes working strategically and transparently with a focus on cooperation to promote sustainable business practices. Other examples include a stipulated policy for gender balance in SOEs' management, capped compensations difference from the top decile and the bottom decile, carbon neutral investment projects, etc.

Fourthly, to clearly establish State's ownership objectives on the individual SOE level, the SOE ownership policy should clearly establish the requirement for shareholder to create an **owner's letter of expectation that encompasses and aligns SOE ownership policy objectives and SOE development ambitions**.

Lastly, to strengthen SOE corporate governance practices State should **enhance Coordination Institution's role in the SOE governance**. The Coordination Institution should act as an advisory institution for SOE Supervisory boards and shareholders respecting their autonomy and giving the necessary guidance. However, to harmonize corporate governance the Coordination Institution should have an authority to monitor shareholder practices towards implementation of SOE Ownership Policy. The State ownership policy should provide an opportunity for the Coordination Institution to act as a temporary Supervisory member for a period up to one year, if (1) the SOE's Supervisory board has been established for its first term or there are significant changes in the SOE Supervisory board, i.e., at least half of Supervisory board members have changed or (2) shareholder has requested a Coordination Institution's assistance in SOE governance. To allow Coordination Institution to ensure necessary guidance, Coordination Institution would need to strengthen their institutional capacity by attracting more professionals involved in the SOE governance.

Evaluation of State's participation in SOE

Having a significant SOE pool and various reasons for State's participation in the company, it is necessary to **harmonize procedures associated with the State's participation in an SOE**. The existing framework creates an obligation for State to carry out a competitive neutrality and economic assessment to either establish or maintain its participation in SOEs. To strengthen corporate governance practices related to shareholders' rationale for State's participation in SOE it is necessary to define a **precise scope and criteria for the evaluation of the State's participation in an SOE**. The assessments should be subjected to an independent and binding review by the responsible authorities, such as, Competition Council and CSCC.

The process of evaluation of the State's participation needs to (1) follow the State's objectives towards participation in SOE set in SOE Ownership policy and (2) focus on the scrutinization of the State's participation in a capital company and active evaluation of alternative solutions how to ensure the necessary goods or services. The process of evaluations or re-evaluation of State participation in SOEs should be strengthened by:

- stipulating that a public person has a duty every 5 years to re-evaluate its participation in all SOEs without an exception;
- providing precise criteria that must be included in the competitive neutrality and economic assessment. The assessments should be subject to independent binding evaluation by the competent authorities;

- the economic assessment and competitive neutrality assessment should be subject to public disclosure. To protect the commercial secret of the capital company, assessment on continuing participation in the company shall be made public by obscuring information containing commercial secrets.

As a result of the evaluation for State's participation in SOE the State should determine its interest for participation in the SOE and the general strategic objectives of the SOE. The State's interest for further participation in SOE should be defined in owner's letter of expectations.

Owner's letter of expectations

Given the State's diverse interests in participation in SOEs, size and variety of SOE portfolio in Latvia, the "one size fits all" solution for the SOE objective setting does not lead to an effective SOE governance. To clearly establish State's ownership objectives on the SOE level the shareholder should create an **owner's letter of expectation that encompasses and aligns SOE ownership policy objectives and SOE development ambitions.**

The owner's letter of expectations would strengthen SOE corporate governance practices by **encouraging State to take more active participation in the SOE governance and would help track the fulfilment of the SOE ownership policy objectives.** The aim of owner's letter of expectations is to communicate State's expectations towards further development of SOEs.

For example, if the owner has decided to reduce the level of its participation in the SOE, the owner's letter of expectations would serve as a transparent and accountable tool for outlining such path with the corresponding high-level steps that the shareholder would expect from SOE to achieve or consider as to deliver on the newly defined objective (i.e. opening of capital structure via IPO or increase firm-wide transparency by tapping the bond market). Similarly, the shareholder might perceive the environmental targets of paramount importance, and thus draft such targets in owner's letter of expectation by assigning a high level of priority for the objective to be achieved.

The owner's letter of expectation should be a natural result of the evaluation for State's participation in SOE and thus **should be tailored to each specific SOE** considering the SOE ownership policy objectives, sectoral objectives, specific objectives and potential developments of SOE.

The owner's letter of expectations should outline the general strategic objective and high-level long-term financial and non-financial objectives that the SOE should strive to achieve over the owner's letter of expectation's term. It would be at the shareholder's and Supervisory board's discretion to set additional commercial objectives for the SOEs. The owner's letter of expectation should include at least:

- The **reasoning for States participation** in the SOE;
- **Non-financial objectives** - strategic SOE ownership and sectorial policy objectives that the State as an owner expects from the SOE,
- **Financial objectives** regarding rate of return, dividend policy and capital structure based on the proposed SOE financial target setting (see in the following sections).

The owner's letter of expectation should be renewed during the re-evaluation of State's participation in SOE or adjusted in cases when there are structural changes in the market or company's commercial and non-commercial activities.

Strengthen and diversify SOE financial standings by implementing a SOE financing methodology.

Context

- Latvian SOEs have been delivering subpar performance relative to comparable private businesses – both similar SOE and EU. In the same time, the SOEs carry higher debt burden, mainly due to low-yielding CapEx, than what is on average observed for the publicly traded Baltic SOEs and an average EU private business. The combination of mediocre returns and high indebtedness implies a significant risk for sustainable growth prospects, in the worst case, leading to debt overhang issues (inability to borrow even when the new borrowing is actually a good investment that would more than pay for itself).
- The financing sources used by the SOEs are undiversified and split predominately among three sources: bank loans, state financing (incl. grants) and retained earnings. The concentrated portfolio of financing sources has direct negative implication on the companies' potential to withstand economic shocks in a way that protects shareholder's capital. It also implies lower flexibility and forgone advantages associate with other more innovative financing sources as well as leaves implications on an adequate profitability.
- According to the OECD guidelines and best practice, the key building block of SOE governance is to warrant a level playing field and to facilitate a competitive neutrality. To achieve these elements, the following must be accounted for in a well-defined SOE financing methodology: transparency and disclosure around cost allocation, transparent and adequate compensation for non-financial objectives, and methods in place to calculate a market-consistent rate of return on business activity.

SOE financial target setting

	Commercial SOEs	State dependent SOEs	
		Commercial	Non-commercial
Optimal capital structure	<ul style="list-style-type: none"> Based on leverage and coverage factors stemming from relevant investment grade credit rating (methodology) defined by one of the top-tier credit rating agencies. 	<ul style="list-style-type: none"> Debt-to-equity (or any other sector specific metric) based on sector or close peer benchmarking. 	<ul style="list-style-type: none"> Return and capital structure expectations set as to fulfill non-commercial goals in an efficient and sustainable manner, not making losses.
Rate of return	<ul style="list-style-type: none"> Return on equity (or any other sector specific metric) based on sector or close peer benchmarking. Regulated business segment should be subject to benchmarking based on the maximum allowed level of return by the relevant legislation (e.g., nominal WACC). State subsidised business segment should be subject to sector or close peer benchmarking. 		<ul style="list-style-type: none"> The focus should be given to efficient and sustainable fulfilment of non-financial goals adhering to best corporate governance practice. The formulation of non-financial goals should follow the recommendations outlined in the SOE ownership policy review [Part 1].
Dividend policy	<ul style="list-style-type: none"> Dividend pay-out ratio (or any other sector specific metric) based on sector or close peer benchmarking. Dividend pay-out ratio should consider the leverage and coverage factor levels / ranges necessary to achieve or maintain an investment grade credit rating. 	<ul style="list-style-type: none"> Dividend pay-out ratio (or any other sector specific metric) based on sector or close peer benchmarking. 	<ul style="list-style-type: none"> Dividends should be determined for each company separately, allowing to make no dividends. Financial targets should be discretionary and determined on a company-by-company basis.

Figure 7. An overview of SOE financial target setting methodology

The aim of medium-term strategy is to clearly cascade the objectives set in the owner’s letter of expectations by establishing more concrete steps of action to deliver on the set expectations. The medium-term strategy is structured on a similar basis as the OLE covering both operational financial and non-financial targets. In the process of defining and quantifying the communicated targets by the shareholder, the SOEs should take into account two aspects: **(1) achieving similar performance to that of comparable businesses in commercial lines of business and (2) fulfilling the non-commercial goals outlined in the OLE with high-quality and cost efficiency.** Namely, the more concrete targets set in the medium-term strategy should unambiguously reflect the planned trajectory of defined targets moving into a direction of successful fulfilment of OLE expectations.

5 years for owners letter of expectation and medium-term strategy

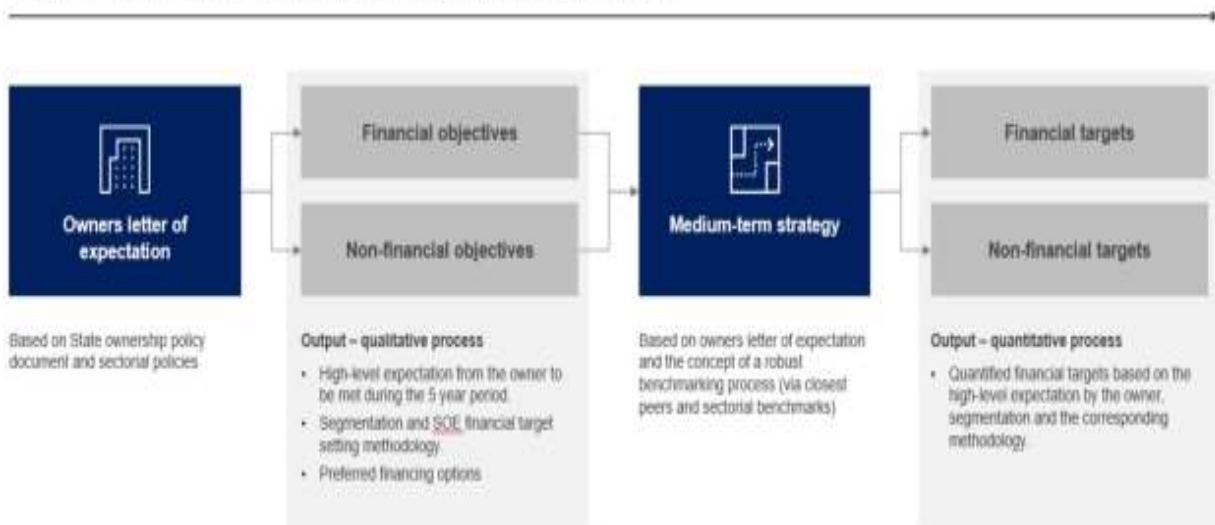


Figure 8. OLE’s interplay with medium-term strategy

When the OLE expectations are received and the appropriate segment is assigned, it is the responsibility of Supervisory board to initiate a process of quantified target setting based on the proposed SOE financial target. As depicted in the **Figure 8** above, the SOE financial target setting, which facilitates the mechanism of setting objective and comparable targets, should be implemented jointly with other OLE expectations.

The SOE financial target setting offers the following:

- A **unified guide** that helps Supervisory boards and Executive management teams setting 5-year financial targets that are similar to those of comparable businesses. This is driven by applying credit rating methodology, industry/sector averages and a targeted sample size of comparable peers;
- A set of critical **financial aspects that have to be factored in to converge to comparable businesses and deliver sufficient returns without excessive risk taking.** These financial aspects tackle company’s balance sheet (optimal capital structure), income statement (rate of return targets), and shareholder’s compensation level (dividedness). This set of financial aspects tackles the most common financial targets set for SOEs as well as assesses a company from a similar perspective as OECD in defining well-defined optimal capital structures.
- A **guide on concrete financial metrics** to be used for defining appropriate target values for each of the previously mentioned financial aspect.

The SOE financial target setting methodology does not address the following:

- The necessary projections and year-by-year values to achieve the 5-year financial targets. The decisions and tactical capital allocation processes related to how the 5-year financial targets should be better achieved are left at the discretion of Supervisory board and Executive management team.
- The process and structure around budgets.
- The fulfilment of other goals and expectations laid out in the OLE except for the financial targets.

Preferred financing instruments

Given the highly homogenous portfolio of financing instruments used by the SOEs, the State should **encourage a more active use and exploration of alternative solutions** to reduce the negative consequences of limited and concentrated financing sources. It is recommended that the State communicates a list of preferred financing instruments on a segment basis taking into account the existing gaps of financing instruments and the viability aspects. Namely, the list should be tailored for each SOE segment separately focusing on the viable and highly advantageous financing instruments that in present are rarely used (or even not at all).

The underlying premise of outlining a preferred list of financing instruments for each SOE segment is to evoke an active and high-level dialogue between the owner and the management with the intent to **facilitate assessment of other financing instruments in the context of larger investment projects, re-financing activities or other capital allocation decisions**. The financing instruments included in the preferred list should not be obligatory per se, however, the management should devote a reasonable effort to justify the selection of a specific financing instrument and provide a clear argumentation for why the preferred financing instruments were or were not selected.

	Commercial SOEs		State dependent SOEs																			
	Equity	Debt	Commercial		Non-commercial																	
Preferred financing instruments	<ul style="list-style-type: none"> • IPO and secondary offerings • Preferred shares 	<ul style="list-style-type: none"> • Bonds (including green bonds) • Commercial paper • Borrowings from IFIs 	<ul style="list-style-type: none"> • State subsidies and grants • Retained earnings 	<ul style="list-style-type: none"> • Bonds (including green bonds) • PPP • Borrowings from IFIs 	<ul style="list-style-type: none"> • State subsidies and grants • Retained earnings 	<ul style="list-style-type: none"> • PPP • Borrowings from IFIs 																
Aspects to consider when deciding which financing instrument to choose	<table border="1"> <tr> <td>Financial parameters →</td> <td> Maturity</td> <td> Financial capacity</td> <td> Administrative costs</td> <td> Cost of capital</td> <td> Bureaucracy</td> <td> Info disclosures</td> </tr> <tr> <td>Specific parameters →</td> <td> Innovation</td> <td> Flexibility</td> <td> Knowledge</td> <td> Ticket size</td> <td> Marketing / brand</td> <td> Reduction of financial risk</td> <td> Control effects</td> <td> Improved corporate govern.</td> </tr> </table>						Financial parameters →	Maturity	Financial capacity	Administrative costs	Cost of capital	Bureaucracy	Info disclosures	Specific parameters →	Innovation	Flexibility	Knowledge	Ticket size	Marketing / brand	Reduction of financial risk	Control effects	Improved corporate govern.
Financial parameters →	Maturity	Financial capacity	Administrative costs	Cost of capital	Bureaucracy	Info disclosures																
Specific parameters →	Innovation	Flexibility	Knowledge	Ticket size	Marketing / brand	Reduction of financial risk	Control effects	Improved corporate govern.														

Figure 9. The list of preferred financing instruments

The list of preferred financing instruments is developed **based on the prevailing gaps in the overall SOE portfolio** of most often-used financing instruments, as well as on the notion of how viable each instrument is for a specific SOE segment. For example, the bond financing is rarely used among the commercial and State-dependent commercial SOEs despite the fact of potentially tighter yields (especially, in the case of green bonds) relative to what the traditional banking could offer, more flexible maturity and repayment profile, improved corporate governance elements, and strong overall demand from the institutional investors.

IPO readiness assessment

An IPO readiness assessment in relation to how viable an SOE is for an IPO is crucial before deciding to explicitly require a particular SOE to tap the capital market and issue new shares. This step will help **scope the potential IPO candidates, highlight the currently lacking areas that have to be improved, and initiate a fact-based discussion around the IPO**. Therefore, it is recommended that the vision on gradual reduction of ownership in commercial SOEs is outlined in the State ownership policy document in conjunction with the obligation to perform an IPO readiness assessment.

	Quantitative measures	Qualitative measures
Higher priority	<ul style="list-style-type: none"> Positive historical and future cash flows sufficient to cover the expenses and generate positive returns. Stable, predictable and high yielding dividend policy. Company's indicative valuation over EUR 100 million. 	<ul style="list-style-type: none"> Good corporate governance standards implemented across the entire organization – in compliance with OECD and best practices. ESG considerations present in the company's current as well as future operations. Clear reasoning behind IPO ("investment driven" or "ownership driven"). Seasoned executive board team and highly experienced and independent supervisory board with no scandals or controversies in the past.
Lower priority	<ul style="list-style-type: none"> Positive growth prospects for the company and industry / sector in which it operates. The market provides healthy valuation levels across the board, and is not in the bear market territory. Meaningful sales exposure in foreign markets. Minimal level of free float at 25% (yet depending on size – the larger the company, the lower the free float could be and vice-versa). 	<ul style="list-style-type: none"> Financial risk is properly managed and not elevated in relation to the peers or sector / industry benchmarks. Credit rating from top-tier agency on an issuer level. Transparent public reporting with additional (albeit not mandatory) levers of reporting.

Figure 10. Criteria for IPO readiness assessment

IPO readiness assessment includes both quantitative and qualitative measures, and each of the two groups include two tiers of criteria, namely, higher priority and lower priority criteria, that need to be evaluated to determine whether a company is viable for potential IPO. These criteria stem from the interviews with institutional investors, the analysis of all of the Baltic SOE IPOs and bond issuances as well as capital market expert opinions on the potential Latvian SOE IPOs. The direct benefits of the IPO readiness assessment are the following:

- Formal criteria that **allow decision makers to judge how close an SOE is to making a debut in stock exchange**.
- Criteria that **help identify gaps and set additional targets** to improve financial and corporate governance profile.
- Increased odds of a **more successful and better priced IPO**.



Most of the proposed approaches how to tackle and assess each criteria exhibit a degree of subjectivity and can differ from case to case (especially, for quantitative measures). Therefore, it is also recommended to approach the criteria by giving them an appropriate context (industry, company, shareholder). For instance, for the “meaningful sales exposure in foreign markets” it is recommended to have at least 10% of sales outside domestic market to fully meet the criterion. However, for a certain industry or company such level could be structurally impossible to reach for clear reasons that are also understood by the market, and thus the approach in fulfilling the criterion should be relaxed.

Consider periodically bringing larger and more mature SOEs to public capital markets. To do so, stipulate capital market policy – including both debt and equity – in a State ownership policy document, impose it through owner’s letter of expectation, and amend the existent IPO-restrictive law(s).

Context

- Several largest and commercially oriented SOEs have cited the current legislation (that prohibits several SOEs from diluting the ownership base) as a factor for why an IPO - opening of capital structure for attracting new equity funds - is not assessed as a potential financing source. In addition, a lack of more tangible vision from the shareholder’s side in terms of recommended financing sources for covering future investments was brought up as a potential impediment in increasing the diversity of financing sources.
- In the recent past, both of neighboring Baltic countries have carried out large and successful SOE IPOs by attracting ca. EUR 140 (Tallinna Sadam) and EUR 450 million (Ignitis grupe) of capital, while keeping majority ownership at the hands of government. The key stakeholders (e.g., management and shareholders) have clearly communicated the notable benefits the IPOs have brought for the SOEs and the general public.
- Institutional investors have expressed readiness to invest in Latvian SOEs as long as the whole IPO or bond placement process is transparent, well structured, and the pricing is in line with the consensus estimates.

An IPO has to stem from an active ownership and has to be appropriately justified by providing the rationale why it is necessary, what benefits it will bring and what risks it could introduce. To facilitate new and successful SOE IPOs (also relevant for bond issues) that would set a benchmark for the subsequent issues, we recommend taking the following actions:

Provide a precise vision on the State’s ownership for a certain group of SOEs in which a gradual reduction of ownership is expected; and incorporate it in the newly established State ownership policy document.

To stimulate active ownership and establish transparent expectations for the SOEs, it is recommended to include a clear vision about the aims of State’s ownership in State ownership policy document. It should include guidance that **commercial SOEs are subject to a potential IPO process by which the State’s ownership level is expected to decrease allowing the exchange between the capital and shares to take**



place. Such vision should be backed with reasons describing what benefits it will add: e.g., to fund future growth opportunities, bring contributions to State budget, improve corporate governance and / or stimulate domestic savings culture and development of domestic capital markets.

For that to happen, the State **should adopt the proposed SOE segmentation**, which separates commercial SOEs that exhibit a high degree of discretion on influencing the trajectory of long-term growth and returns from the State dependent SOEs that are focused more on efficient and sustainable fulfilment of non-financial objectives. Private investors seek long-term capital appreciation that commercial SOEs are able to deliver without being overly constrained by the fulfilment of non-financial objectives.

Use Owner’s letter of expectations as a tool to communicate decisions surrounding IPO

The mechanics of **OLE provide a solid ground for laying out shareholder’s expectations associated with an IPO.** It can serve the purpose for communicating that an SOE should prepare for IPO by working on lagging aspects identified in the IPO readiness assessment phase. Similarly, it can also be used to express a requirement to conduct an IPO under the actual OLE period.

In the scenario in which the shareholder wishes to realize an IPO under the actual OLE period since the IPO readiness criteria are met sufficiently, the following criteria should be disclosed:

- The motivation behind the IPO why it is chosen (preferably, with the disclosure of either being driven by ownership/corporate governance and/or investment needs).
- The range of ownership percentage that should be provided to the private investors.
- The date or timeframe in which the IPO should be concluded.

It also should be noted that the range of ownership percentage and, especially, the timeframe **should be viewed from the lens of prevailing market conditions** in order to minimize the risk of forcing an IPO when the offered valuation levels are depressed.

Amend “The Law on the Privatization of State and Local Government Property and the Use of Privatization Certificates” and relevant sectorial laws

The Law on the Privatization of State and Local Government Property and the Use of Privatization Certificates and certain sectorial laws, for example, Energy law, Law on Forests, exempt several largest SOEs from considering tapping equity markets. This, in turn, **limits the available instruments of financing to fund growth, and disables SOEs from achieving an optimal capital structure** (either excessively leveraged or overcapitalized balance sheets), if an additional amount of equity would be deemed to maximize shareholder’s value.

The policy makers should amend the Privatization of State and Local Government Property and the Use of Privatization Certificates and subsequent sectorial laws lifting prohibition to expropriate SOE shares and allowing all SOEs going public. The best practice does not discourage SOEs from certain financing instruments, but, instead, provides a full spectrum of financing instruments, which can be applied for according to the SOEs’ prevailing needs. The two most recent IPOs by Baltic SOEs (i.e., Ignitis grupe and Tallinna Sadam) revealed a pattern how the State can remain as a majority holder, and still structure IPOs in a manner that is attractive for the markets, resulting in healthy demand levels. Hence, if the key policy makers circumspect the notion of potentially allowing private participation in some of the largest SOEs, the laws should be amended by determining that the State should hold a majority in the SOEs. The Law

on Governance of Capital Shares of a Public Person and Capital Companies could be amended by drawing a borderline as to how far the voting rights could be diluted in case of private participation in the SOE. For State to hold a majority, ca. 33% of the total shares (one third of ownership rights) would be the limit for private participations (also the case in Lithuania and Estonia).

Additional recommendation for a successful IPO

The very first SOE IPO will play a key role in the attempts to enliven the domestic capital markets. It will set the tone for the future IPOs, which will help improve SOE financing diversity and domestic savings culture. In Latvia, there have not been any IPOs by SOEs since 1999. The reasons lie in high levels of scepticism among policy makers and general public that stem mostly from ill-fated privatization cases in nineties. Given the backdrop of bad experience and stagnating Latvian capital market, it is of utmost importance to execute perfectly the forthcoming SOE IPO.

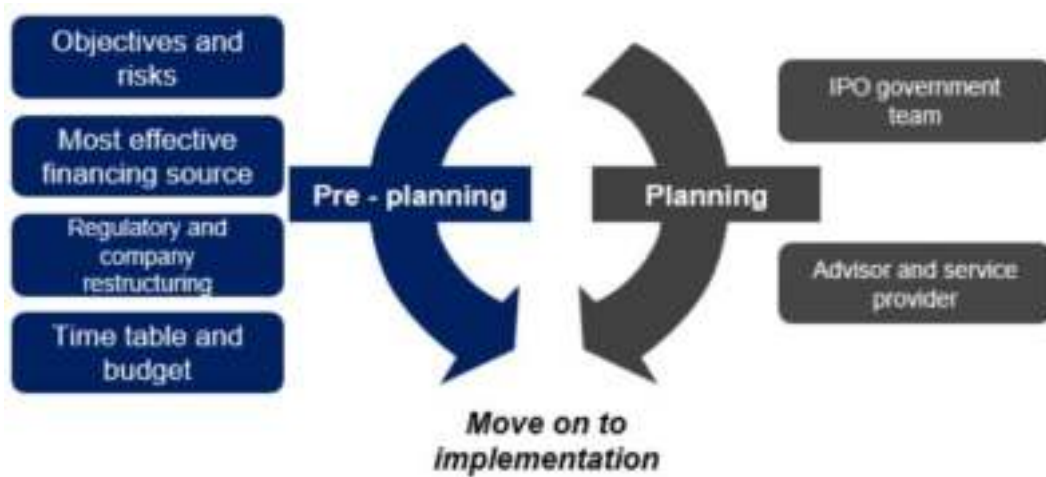


Figure 11. Pre-planning & planning phase for a successful IPO

Pre-planning

- Shareholder and MoF should cooperate closely to define objectives and risks associated with the potential IPO. The most common objectives by conducting SOE IPOs are ownership diversification, introduction of new competition, raising revenue prospects, performance efficiency improvements, capital market development and changing market conditions/no longer market failure. The risks are mostly linked to the IPO processes itself, where a mismanaged process could lead to an unfavourable sale of State ownership rights (e.g., timing of IPO, selection of advisors and stock exchange, unclear or inefficient use of proceeds etc.).
- Decision on the most effective capital raising alternative should be made taking into account the planned objectives and identified risks. Most governments and SOEs choose IPO as a tool for raising capital through the use of ownership rights. However, the government should evaluate and determine which alternative is the most efficient from the available scope of financing alternatives – e.g., private sale, trade sale auction, IPO, etc.
- Regulatory, industry and/or company restructuring should take place before the IPO implementation process begins. The degree of restructuring is shaped by factors such as the planned method of sale; the structure of the market in which it operates, government objectives



with respect to the envisaged market structure post-IPO and environmental aspects. It is advised to assess the potential need for restructuring in the following areas:

- Strategic restructuring focusing on the corporate performance and business strategy with the aim of maximizing sustainable and long-term returns;
 - Operational restructuring pertaining to management and employment (e.g., pension liabilities, remuneration policies);
 - Financial restructuring (introducing dividend policy, re-evaluating rate of return targets imposed by the State, “cleaning up” the balance sheet);
 - Legal and regulatory (also changes in applicable laws, if needed) restructuring to adapt to the regulatory requirements in the marketplace. For example, the separation of monopoly activities might be necessary for SOEs operating in public utilities sector. Similarly, certain subsidiaries might be needed to divest or separate from the IPO entity. This could relate to subsidiaries that are incongruent with the presented corporate strategy, held jointly with other owners other than IPO entity or when the combined market share of the subsidiaries and the potential buyers could introduce antitrust issues.
- The government should agree on a timetable and budget, and the range of share issues in a quantitative and clear-cut manner so that the parties responsible for IPO planning and implementation would have a sound framework to apply in the following steps.

Planning

- IPO government team consisting of steering committee and project team (e.g., shareholders, line ministries, Supervisory board, Executive management, and potentially representatives of sell-side firm). The IPO government team should be made of high-level representatives from shareholder, regulatory party, and independent experts that would form a body responsible for ensuring the integrity of transaction. Its role is to ensure that the Government benefits from best approach of opening the capital structure of the SOE. The skill set and experience embedded in the IPO government team should cover economic, financial and legal skills.
- Appoint advisor and service provider through a competitive process. The selection of advisor should be based on a competitive process involving not only domestic, but also foreign experts. The advisor selection process should also be based on the planned size of IPO and stock exchange platform. In case the size of IPO and stock exchange are relatively small, and the new shares are planned to be issued on NasdaqBaltic, respectively, the regional pan-Baltic advisors could bring more value for money.



Further reinforce the principle of market consistency among the SOEs.

Context

- The feedback from SOEs indicate that in some instances in which the State provides a periodic financing for the fulfilment of non-financial objectives, the underlying compensation levels are inadequate. The provided financing by the State has been observed to be too low in order for the SOEs, especially State-dependent commercial and non-commercial, to deliver similar returns to the comparable private sector peers.
- Even more so, several SOEs have mentioned the need and reliance on cross-subsidies (i.e., directing funds generated by the commercial activities towards the fulfilment of non-commercial goals). The lack of adequate level of State financing is limited to situations in which the State finances periodic or recurring delivery of non-commercial goods or services. Direct equity injections and debt financing from the State Treasury have not been cited as issue in terms of market consistent financing that can be explained by the rigorous private sector benchmarking procedures (i.e., involvement of EC) that are attached to the respective financing assessment and approval processes.

The conditions of under-financed SOEs hinders achieving competitive neutrality or “level playing field” between SOEs and privately owned businesses, which is of utmost importance to enable competition to work properly. All companies should compete on the merits and should not receive an undue advantage due to the underlying ownership structure. The “level playing field” maintains economy efficient and allows an efficient capital allocation to take place.

This problem has to be addressed from two sides since the root cause of underperformance can be attributable to either insufficient State financing or inefficient business operations by the SOEs.

1. Separation of accounts is the key building block for transparency and disclosure around cost allocation. The OECD has outlined that identifying the costs of any given function of commercial government activity and separating such costs from non-commercial activity is essential if competitive neutrality is to be credibly enforced. The current framework stipulates that SOEs should provide separation of accounts disclosures, however, in practice, most SOEs do not follow the requirements, and almost none of them provides this information to the broader public. The State should find effective means (e.g., sanction mechanisms) to facilitate transparency and disclosure regarding the separation of accounts for all SOEs. Otherwise, without such a disclosure in place, it is unfeasible to conduct a thorough review of the adequacy of State financing and/or the effectiveness of SOE business operations.

2. A robust process for determining adequate levels of State financing should be assigned for each round of State financing directed towards SOEs for the fulfilment of non-commercial goals. The State in conjunction with Supervisory board (or Executive management’s team if the Supervisory board is non-existent) should closely cooperate to determine adequate levels of State financing. The process should be driven by otherwise private business equivalent benchmarks so that the SOE does not become over-financed or under-financed relative to an average private business operating in the same industry with similar risk exposures.

Introduction

Objectives and outputs

The CSCC has requested the EBRD to provide technical assistance in developing the methodology to identify the optimal capital and governance structures for Latvian SOEs.

The key motivation behind this Assignment and the CSCC's request lies in the subpar conditions associated with how the various financing sources are used among the SOEs. The "room for improvement" conditions are effectively a by-product of the lack of clarity on SOEs' commercial and strategic objectives coupled with the absence of objective, market based financial targets. Moreover, during several discussions among investors and policy makers it has emerged that key SOE stakeholders were not fully aware of the merits of active ownership and diversifying the financing tools by, for instance, tapping the debt or equity capital markets, thus confirming the relevancy of the Assignment.

To deliver on the set objectives, the involved stakeholders have recognized the importance of a robust corporate governance structure that could impose a strong oversight mechanism to achieve the corporate targets, ensure adequate internal controls and fair treatment of potential new shareholders.

Lastly, the key stakeholders of the Assignment have also acknowledged the issues within the local capital markets (e.g., illiquidity, low turnover, limited availability of tradeable securities), and appreciated the potential benefits of turning this from a problem to a solution. Hence, during the Assignment there will be assigned a special focus on the development of the local capital markets, mostly in relation to the interplay of SOE long-term objectives and the local capital markets as a tool for a successful fulfilment.

Outputs of the Assignment

The following outputs are deemed necessary to reach the goals of the Assignment:

1. An assessment and gap analysis of the current capital structures and corporate governance standards of SOEs;
2. Drafting the methodology for achieving optimal capital structures and related roadmap to implement it;
3. Several workshops for testing the methodology on the selected SOEs, including a final workshop to present the action plan to a wider audience.

All these actions shall be complemented by a study visit to one OECD relevant country to exchange best practices.

Approach

The Consultant (i.e. PwC) has closely liaised with the CSCC, key capital market participants and representatives of shareholders, EC and EBRD in carrying out the defined outputs.

The underlying approach in executing the defined outputs is driven by the stipulated terms of reference of the Assignment, and can be broken down into four main areas:

1. **Corporate governance review** – a review of SOEs’ governance framework and practices, and a comparative analysis of peer OECD member states in terms of the available governance structures.
2. **Financial review** – a review of existing capital structures and general financial position. Assembling a comprehensive picture of types of capital structures available in peer OECD member states. An identification of missing funding instruments and if the existing ones are being applied with sufficient level of comprehension. A formation of criteria, which should form a basis for deciding among the instruments.
3. **Active ownership methodology** – a proposal of new methodology with the intent to induce active ownership for the SOEs by providing a high-level framework in which the State’s expectations would be laid out in a transparent and accountable manner.
4. **The SOE financing methodology** – a proposal of new methodology, which shall be enforceable under applicable Latvian legislation while considering the available debt and equity capital market tools. If necessary, proposing high-level legislative changes to facilitate successful implementation of the envisaged methodology (also applicable for active ownership methodology). Enhancing the methodology with a market sounding of institutional investors, and potential risks of the methodology to be implemented. Testing the merits of the methodology for the selected sample of SOEs.

The implementation of the methodology is also supported with a roadmap defining actions, timeline, and clear responsibilities per stakeholder. Lastly, the methodology is tested on several SOEs during the Assignment, and the list of SOEs can be found in **Annex 2**.

Methodology for the Assignment

The chosen methodology in conducting the Assignment is aligned with both CSCC and EBRD and is structured in a manner to address the key areas reflected in the chapter above.

Corporate governance review

The methodology for the corporate governance review is based on a comparative analysis of the international best practices and existing corporate governance practices in Latvia. The national and EU legal framework, guidelines and policy papers by different national and international organisations, standards and good practice recommendations were examined to analyse the corporate governance framework for SOEs in Latvia. To review the SOE corporate governance practices in Latvia, 14 SOEs and one derived public person were selected. The full list of selected companies is reflected in **Annex 2**. The SOEs were selected in cooperation with CSCC based on their classification made in the report “State ownership policy review in Latvia Part 1”, size and industry representation. One derived public person was selected with the aim to assess the company’s corporate governance in respect to the governance framework due to the State’s plans to change the legal status of this company. Detail information about each of the companies in **Annex 3**.

Financial review

The methodology revolving around the financial review is parsed across the whole Assignment (i.e. the main body) by being introduced before certain sections to provide a more detailed context. However, the

key tasks linked to the financial review are in most cases self-explanatory and do not require a pre-defined methodological approach to arrive at the necessary conclusions. The majority of the tasks have been limited to comparing the prevailing conditions to the stipulated law, best practice or general guidelines, as well as reflecting the “status quo” situation of certain areas (e.g., the existing capital structures, financial ratios etc.).

The financial review is based on finding relevant comparisons, and benchmarking to them various financial metrics of Latvian SOEs. The financial benchmarks have been taken from widely used and reliable sources, mostly within the EU, and peer countries. Yet, assessing the use, and the pros and cons of financing instruments, a more tailored methodology was established. The key financing instruments are characterized and grouped into four separate categories: equity financing & private markets, borrowings & private markets, equity financing & public markets, and borrowings & public markets.

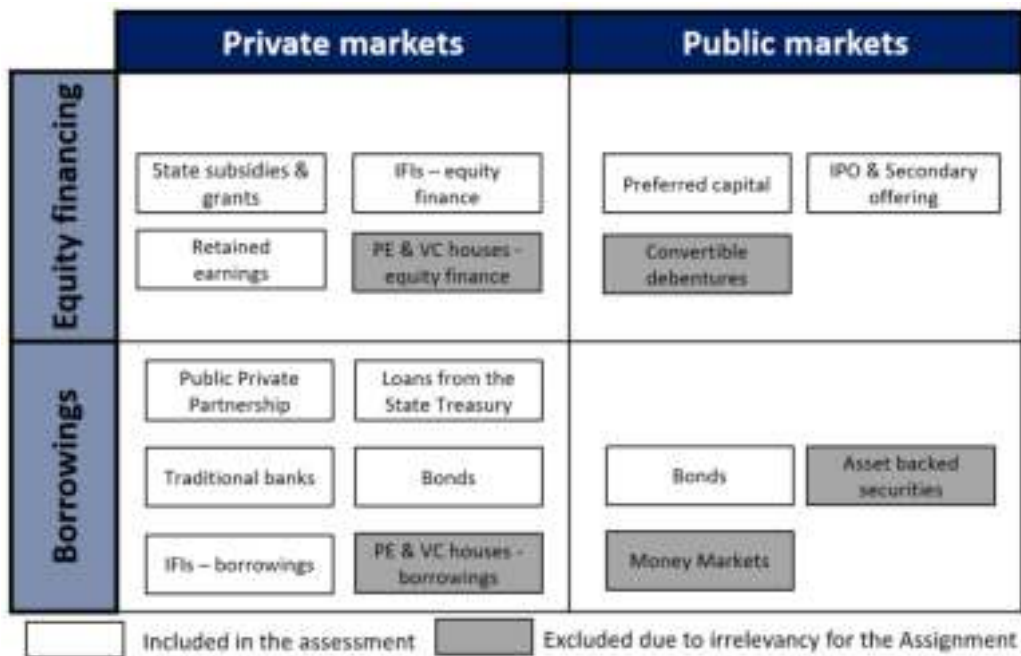


Figure 12. Overview of various financing instruments

The financing instruments listed in **Figure 12** exhaust most of the universe of the fundamental financing instruments that a regular corporate company can theoretically access. It has to be noted that there exist countless variations for most of the financing instruments listed above (e.g., for bonds – callable, puttable, mortgage backed, extendable, convertible, inversely floated etc.). However, these more “exotic” types of financing instruments as well as the greyed-out instruments are excluded⁸ from a thorough analysis because of:

- In the context of Latvian corporate finance landscape, such instruments are too complex and would require a deep case-by-case analysis limiting the process of developing a system-wide framework.

⁸ The set of financing instruments is not constant and remains subject to additions/subtractions during the market sounding activities further in the Assignment.

- Given the current state of Latvian SOE financing, introducing such instruments would be premature (due to insufficient experience in more common types of financing such as IPO and bond issues) and evoke an elevated resistance from the key stakeholders.

All of the defined financing instruments are assessed through the lens of seven different aspects, see **Figure 13** below:



Figure 13. Seven aspects assessed for each financing instrument

The analysis of financing instruments presumes that all of them are equally viable and are scrutinized from the perspective of a corporate company. The advantages and disadvantages of each financing instrument are determined based on a relative comparison, where the characteristics of each individual financing instruments are contrasted against the basket (i.e. perceived average characteristic) of all instruments.

Later, when all of the identified characteristics are consolidated into a one single comparison table, a relative comparison is continued on a basis of a specific instrument providing favourable, average or unfavourable conditions for the company⁹. The more specific set of advantages and disadvantages that each financing option provides is outlined in **Annex 4** and **Figure 28**.

Active ownership methodology

An actively owned SOE's strategy and desired outcomes should be connected to the vision and strategy of the government at the relevant level (national, regional or local). This should in turn provide a clear purpose and mission for the SOE.

⁹ For example, "favourable" maturity for the IPO & Secondary offering option means that the company will benefit on this aspect because there is no payback of the received capital required. Conversely, the maturity aspect for loans from banks option is deemed as "unfavourable" due to relatively tight financing duration schedules imposed by the lenders.



To develop a framework of transparent, clear and accountable means of active ownership tools, the following steps were taken:

- Review of best practices in Norway, Finland, Sweden and other Baltic countries.
- Review of current tools available in Latvia that facilitate active ownership.
- A tailor-made approach consolidating the two aforementioned points in order to accommodate active ownership and the likelihood of diversifying financing instruments and achieving optimal capital structures.

SOE financing methodology

Developing a methodology (also called SOE financing methodology) is a more complex exercise involving more reliance on a quantitative analysis and the feedback from the key stakeholders. The following are the key constituents of the SOE financing methodology:

The SOE **segmentation** provides means to facilitate SOE formation into different categories to, ultimately, warrant a more tailored SOE financing methodology when, for example, imposing optimal capital structures and dividend policies. In the context of this Assignment, the SOE segmentation is critical to avoid unsystematic approach and to develop a sound framework for both policy makers and SOEs to follow.

To support a reasonable and practical SOE segmentation in the Assignment, the following steps are taken:

- Assessment of how the SOEs are segmented in other countries with the focus on neighbouring and EU nations.
- Assessment of the current SOE segmentation form used in Latvia and evaluation of the underlying efficacy of that.
- Consolidation of opinions from key experts and stakeholders in order to accommodate tailored and appropriate constituents of the chosen SOE segmentation form.

SOE financial target setting encompasses capital structures and return targets steps, both tightly linked in terms of the approaches, address the prevailing financial situation among the SOEs, and identify areas of improvement. The capital structures step focuses on the balance sheet metrics of SOEs (e.g., debt to equity), while the return targets step is directed towards an assessment of income statement metrics (e.g., return targets and dividends).

This assessment mostly relies on an evaluation of medium-term strategies and looking how the elements relevant for the capital structures and return targets are filled in the practice. SOE financing guidelines developed by OECD, and the best practice from peer countries are contextualized with the medium-term strategies.

IPO readiness assessment provides a list of criteria against which the SOEs for which an IPO is deemed necessary should measure the company specific quantitative and qualitative factors, thereby determining the level of readiness to attract private equity investors via stock exchange. To develop such criteria, a series of interviews with institutional investors were conducted, all of which was supported with a case study analysis of Baltic SOEs tapping public capital markets.



A list of **preferred financing instruments** recommends the SOEs (based on segmentation) the most viable and beneficial financing instruments to use, and that are currently neglected as concluded from the financial review analysis.

Takeaways from SOEs step encompasses two rounds of interviews with the selected 15 SOEs (three second round interviews did not take place due a limited availability of the relevant representatives). Five interviews with pan-Baltic institutional investors were held as a part of the **market sounding** step. The purpose of the interviews was to get a direct feedback on the areas of improvement on the overall SOE corporate governance and financing practice, and to test various merits (segmentation, financial target setting benchmarks, and public capital markets potential) of the SOE financing methodology.

Limitations

The outbreak of COVID-19 caused several impediments for having a smooth and efficient communication flow with several stakeholders and parties, whose knowledge and experience could benefit the Assignment. Most notably, study visits to an OECD country to exchange best practices did not happen on site, and instead were organized online. To offset the potential drawbacks from having a face-to-face conversation with the parties from an OECD country, the number of workshops with OECD countries was increased. Nevertheless, the consequences of COVID-19 had affected the availability of the key stakeholders of certain envisioned countries (i.e. Lithuania and Finland), and, as a result, the best practice was shared in writing.

A sample of selected 15 SOEs was provided by the CSCC for the purpose of a more in-depth methodology testing and a more practical illustration on how the Latvian SOEs rank against several financial and good corporate governance benchmarks. While the sample includes a diverse set of SOEs representing various caveats and different extents of a dependency on the State, making inferences on the entire population would be suboptimal. A sample size of 15 SOEs against the backdrop of over 170 operating SOEs (including 70 majority owned SOEs) is relatively small and could misrepresent the underlying situation. In several cases for which the data availability is favourable, the sample size of the analysed SOEs was increased substantially (e.g., historical performance and capital structures).

The availability of data was, in many cases, insufficient to execute the envisioned tasks properly. The most challenging area was the transparency and the quality of data related to the financial information associated with the SOE medium-term strategy documents. A reasonable number of SOE annual reports do not comply with International Financial Reporting Standards, rendering the benchmarking process difficult. Several workarounds were introduced to address the areas for which there were lack of data. For example, the amount of loans used in a particular year was implied via either the linear amortization of the total loans outstanding or by taking the short-term loans as a proxy.

Interviews with institutional investors were conducted with the FMPs that operate predominately in domestic market and/or on a pan-Baltic level. This can potentially lead to biased opinions from parties with already pre-existing agendas, for instance, financial interest to motivate SOEs going public. To mitigate such risk, the SOE financing methodology as well as the opinions around the domestic capital markets were tested with two institutional investors outside Baltics.

1. Corporate governance review

The corporate governance of SOEs in Latvia has been defined as an aggregate of measures for achieving the operational objectives, control, and governance of the capital company.¹⁰ The corporate governance of the companies encompasses elements of the outside regulatory framework and voluntary business practices. The objective and aim of corporate governance are to facilitate effective, entrepreneurial and prudent management that can deliver the long-term success of the company. Good corporate governance helps companies build trust with investors and the community. As a result, corporate governance helps to promote financial viability by creating a long-term investment opportunity for market participants.

Good governance of SOEs has an essential role in the country's economic growth in both developed and developing countries as often SOEs are the main providers of key public services. However, often compared to the private sector companies SOEs can have financial and service delivery performance challenges due to the lack of competition, multiple competing objectives and soft budget constraints. The underperformance of SOEs can impede competitiveness and growth and translate into a fiscal burden and a source of fiscal risk for the State. Therefore, improving SOE performance remains an important challenge for State as a shareholder. Lately efforts to strengthen corporate governance have been gaining international momentum to improve the performance of SOEs.

The purpose of the SOE corporate governance review is to assess the existing regulatory framework and analyse SOE and shareholder corporate governance practices with an aim to observe inadequacies in the existing practices and **determine necessary improvements in SOE corporate governance framework in developing the SOE active ownership principles and financing methodology.**

The SOE corporate governance review has been performed by analysing publicly available information and conducting interviews with the sample of selected 15 SOEs and their shareholders.

Box 1.1. - The constituents of SOE corporate governance review

Information

The following information has been used for conducting the SOE corporate governance review:

- OECD¹¹ and World bank¹³ guidelines for SOE corporate governance;
- SOE regulatory framework in Latvia and the corresponding laws¹⁴ and Cabinet of Ministers regulations¹⁵
- CSCC guidelines¹⁶
- information provided directly by CSCC, SOEs and shareholders;
- SOEs annual reports;

¹⁰ Article 1, Law "On Governance of Capital Shares of a Public Person and Capital Companies". Latvijas Vēstnesis, 216, 31.10.2014.

¹¹ OECD. OECD Guidelines on Corporate Governance of State-Owned Enterprises, 2015 Edition, 19.11.2015

¹² OECD. Ownership and Governance of State-Owned Enterprises. A Compendium of National Practices. 2015.

¹³ World Bank Group. Corporate Governance of State-Owned Enterprises a Toolkit 2014.

¹⁴ CSCC. Laws regulating SOEs governance.

¹⁵ CSCC. Cabinet of Ministers regulations regulating SOEs governance.

¹⁶ CSCC. Guidelines regulation SOE governance.

- information available on the websites of individual SOEs and shareholders.

Selected sample

The analysis is based on the review of the sample of selected 15 SOEs and their corresponding shareholder corporate governance practices.

Time period

The corporate governance analysis has been performed in time period from 01.10.2019. to 21.05.2020. and do not include any observations or changes that might have occurred after the set date.

1.1. SOE ownership and supervision

Key takeaways

- When establishing and re-evaluating participation in SOEs, State is required to carry-out competitive neutrality and economic assessment. The legal framework does not determine detailed procedure and content of the assessment.
- The existing corporate governance framework attempts provide clear separation of the State's SOE ownership functions and State's policy making and market regulation functions. In practice the division of roles is not clearly identifiable as line ministries have role of a shareholder and a policy maker.
- To ensure efficient SOE governance ownership entities should have a capacity and competencies to effectively carry out their duties. Considering the significant amount of the SOEs in Latvia shareholders and Coordination Institution have a limited capacity to ensure the best corporate governance practices in SOE ownership.
- The medium-term strategy has been established as a main strategic planning document for the SOEs and is created by the cooperation of all SOE management levels. In practice, the medium-term strategy is used as a control mechanism rather than a strategic tool for SOE management.
- While the corporate governance framework has been strengthened by trying to assimilate the same level of transparency and disclosure for SOEs, the existing disclosure and transparency practices by SOEs and ministries are adjusting to the new requirements and are becoming more harmonized. Since the Coordination Institution has been required to monitor SOE and shareholder practices, it is believed that the corporate governance practices will become even more unified.

The review of the corporate governance framework of the SOEs in Latvia provides a general overview of the existing corporate governance framework, in particular, analysing State's practices regarding ownership and supervision of the selected SOEs.

The ownership and supervision structure of Latvian SOEs is set up according to a hybrid model – SOE operational and strategic governance is implemented through a Coordinating Institution and shareholders (most often line ministries). **As the current legislative framework does not provide centralized ownership for the SOEs, it is particularly important to ensure similar governance practices and separations of State's function in the SOE governance.** It is especially relevant for SOE's that operate in



economically or otherwise important sectors, for example, such as electricity and gas, telecoms, transportation, or finance.

To ensure similar governance including monitoring of SOE performance, the Latvian SOE ownership model has been restructured, moving from a decentralized model to a decentralized with a Coordinating Institution. In order to ensure the separation of the State's functions and other State functions **the existing governance framework establishes clear separation of the roles and tasks for all involved governmental bodies in the SOE governance.**

The aim of the State ownership practice review is to provide an analysis on the existing legal framework and the current State ownership practices. The State ownership practices in the selected SOEs are scrutinized by examining the process of State obtaining participation in a SOE. The State's rationale for participation are analysed by assessing the State's disclosed reason for participation. The exercise of the State's ownership rights is analysed by the examination of State practices as a shareholder. The State's role as a shareholder are determined by analysing the tasks and responsibilities of the shareholder and assessing the State's current practices regarding the separation of its functions.

The analysis of supervision of the selected SOEs examines the existing corporate governance framework regarding the supervision of the SOE performance and the role of the Coordination institution. The evaluation of the SOE performance is assessed by scrutinizing the process of the SOE evaluation and the aim of the SOE medium-term strategy. The transparency of the SOE governance is evaluated by examining the disclosure of information by shareholders and the SOEs.

1.1.1. SOE ownership practices

Justification for State's participation in an SOE

The Latvian corporate governance framework establishes that State must only participate in SOE in order to maximise value for the society through an efficient allocation of resources, if one of the following conditions is met – market failure, management of production of strategic goods or services and management of strategic properties. The State's reasoning and strategic aim for participation in an SOE should be publicly available and disclosed on a shareholder's webpage. The evaluation on the State's practices for the participation in SOEs has been based on the assessment of shareholder practice's towards disclosing justification for participation in the selected sample SOEs.

Figure 14 indicates the State's disclosed justification¹⁷ for participation in SOEs have been in accordance with the objectives set in Article 88¹⁸ of SASL for only 7 out of 15 selected SOEs:

¹⁷ Disclosure of the justification for State's participation in the SOE by 21.05.2020.

¹⁸ Article 88(2). The State Administration Structure Law. Latvijas Vēstnesis, 94, 21.06.2002.

Objective for participation	SOE
Prevention of market failure	Latvijas Koncerti, CSDD, Latvijas Pasts
Management of strategically important goods or services	Latvijas Gaisa Satiksme, Pasažieru vilciens
Management of strategically important properties	Latvijas valsts meži, Valsts nekustamie īpašumi

Figure 14. Disclosed justification for participation in selected sample SOEs

While the Ministry of Economics and Ministry of Finance do not provide justification for the participation in the SOEs in accordance with objective set in SASL, the participation in SOEs is justified by referencing industry specific laws - the Energy Law for Latvenergo and the Development Finance Institution law for Altum. Detailed analysis for the disclosure of information regarding State's participation in SOEs can be seen in **Annex 5**.

In practice, **starting from March 2020 the shareholder practices and interpretation for the disclosure of the State's reasoning strategic aim for the participation in the company has become more transparent and harmonized**. Thus, providing public with clearer understanding of the State's objectives towards participation in particular SOEs.

Practices on economic and competitive neutrality assessments for the participation in SOEs

In addition to the determination of an objective for participation in SOEs, the **State must evaluate and provide justification for the need, risks and benefits for the establishment of the SOE taking interests of public as a priority**. Such evaluation has to be carried out before the establishment of the SOE in order to limit the use of public resources and protect fair competition in the market.

The assessment of State's participation must include an economic assessment that substantiates the effective achievement of establishing SOE or participation in an existing enterprise¹⁹, meaning that one of the three conditions set out in Article 88 of SASL is met and cannot be achieved by other means. Additionally, State must re-evaluate its participation in SOEs every 5 years, except for those SOEs which cannot be expropriated.²⁰

Neither the SOEL, nor SASL clearly indicate SOEs which cannot be expropriated. The prohibition to expropriate certain SOEs is set in the Law on the Privatization of State and Local Government Property and the Use of Privatization Certificates²¹ and each industry's specific law, for example, Latvenergo – Energy law, Latvijas valsts meži – Law on Forest etc. From the 15 selected SOEs eight companies cannot be expropriated – Latvenergo and Sadales tīkls, Latvijas valsts meži, Latvijas Pasts, Latvijas Dzelzceļš and LDz Cargo, Latvijas Gaisa Satiksme and Altum.

By indicating that the State does not need to carry out the evaluation for certain companies, the law implicitly allows the State not to carry out the re-evaluation. **Thus, the State does not have an obligation**

¹⁹ Article 88(2). The State Administration Structure Law. Latvijas Vēstnesis, 94, 21.06.2002.

²⁰ Article 7. The Law on Governance of Capital Shares of a Public Person and Capital Companies, 18.06.2015.

²¹ Article 17(1). Law on the Privatization of State and Local Government Property and the Use of Privatization Certificates.

to re-evaluate its impact on the particular industry and assess whether the market is capable of functioning without State participation, or if the production of strategic goods or services, or management of strategic properties and critical infrastructure can be achieved by means other than State participation in the market.

Additionally, as the legislative framework does not clearly provide a unified process or rules for the economic assessment, the content of the assessment is an interpretation of each shareholder. **Evaluating available economic assessments, clear deviations can be observed, starting from the overlooked aspects and continuing to the depth of the analysis.** Rules of procedure of the Cabinet of Ministers stipulate public involvement by publishing draft and final evaluations of State participation in an SOE. In practice, **draft evaluations are not published or are published in a manner that is not easily accessible for public and requires specific knowledge to know where to look for.** Thus, even though the legislative framework sets good governance practice, the existing practices do not meet the objective of the legislation.

In most SOEs, the assessment of State participation was carried out in 2015. Therefore, the re-evaluation of the State’s participation had to be carried out in 2020.

Separation of the State’s ownership and other State’s functions

To ensure similar SOE governance, the Latvian SOE ownership model has been restructured, moving from a decentralized model to a decentralized with a coordinating institution. In order to ensure the separation of the State’s ownership functions and other State functions the existing governance framework establishes clear separation of the roles and tasks for all involved governmental bodies in the SOE governance – shareholder, line ministry and Coordination Institution.

In practice the ownership holdings are largely in line with the sectoral breakdown of responsibilities among the ministries leading to the situations when the responsible ministry has to carry out the tasks and obligations of a shareholder and line ministry, i.e., policy maker. There are, however, some exceptions (Elektroniskie Sakari (held by Ministry of Environmental Protection and Regional Development) and Augstsprieguma tīkls (held by Ministry of Finance)), where the line ministry is not the shareholder. The division of roles for the selected SOE shareholders and line ministries is listed in **Figure 15**.

State-owned enterprise	Shareholder, %	Line ministry
Latvijas Koncerti	Ministry of Culture, 100%	Ministry of Culture
Latvijas valsts meži	Ministry of Agriculture, 100%	Ministry of Agriculture
Valsts nekustamie īpašumi	Ministry of Finance, 100%	Ministry of Finance
Altum	Ministry of Finance 40% Ministry of Economics 30% Ministry of Agriculture 30%	Ministry of Finance Ministry of Economics Ministry of Agriculture
Latvenergo	Ministry of Economics, 100%	Ministry of Economics
Latvijas Pasts	Ministry of Transportation, 100%	Ministry of Transportation

Latvijas Dzelzceļš	Ministry of Transportation, 100%	Ministry of Transportation
Air Baltic	Ministry of Transportation, 100%	Ministry of Transportation
CSDD	Ministry of Transportation, 100%	Ministry of Transportation
Latvijas Gaisa Satiksme	Ministry of Transportation, 100%	Ministry of Transportation
Pasažieru vilciens	Ministry of Transportation, 100%	Ministry of Transportation
RAKUS	Ministry of Health, 100%	Ministry of Health
LDZ Cargo	Latvijas Dzelzceļš, 100%	Ministry of Transportation
Sadales tīkls	Latvenergo, 100%	Ministry of Economics
Rīgas Brīvostas pārvalde ²²	n/a	n/a

Figure 15. List of selected sample SOE shareholders and line ministries

The SOE governance framework does not imply any differences in the ownership of the SOEs based on strategic objective or purpose of fulfilling States functions. **The legislative framework tries to separate State ownership function from State market regulation function, by providing that the shareholder does not actively engage in the management of the SOEs. However, in individual cases the separation of functions is not always clear and may influence the market conditions not only for SOEs, but also for private companies.**

For example, the Ministry of Economics has to balance the market regulation functions by setting tariffs for energy distribution and its ownership interests by increasing SOE profits. Similarly, potential conflict of interests and conflict of separation of powers can arise if ministry is a both a shareholder for an infrastructure manager and primary user of the said infrastructure. For example, Ministry of Economics is a shareholder of Latvenergo - user of infrastructure (producer of energy) – and indirectly shareholder of a Sadales tīkls - infrastructure manager (distributor of energy). Ministry of Transportation is put in a similar situation being a shareholder of various SOEs managing and operating the same infrastructure - Latvijas Dzelzceļš (infrastructure manager), its subsidiary LDZ Cargo (user of infrastructure), and SOE Pasažieru vilciens (user of infrastructure). At the same time, it is necessary to indicate that to ensure fair market competition and clear separation of State functions both industries – energy and railway – have market regulators that do not have any institutional relation or dependency from the ministries.

The deviations from clear separation of function can also generate a positive influence on the SOEs and the market. The stakeholders indicate that connection to the policy makers, i.e., line ministries, significantly eases the decision-making process and allows SOEs to more efficiently carry-out their State delegated functions. For example, the close cooperation with the shareholders and line ministry allows Altum to proactively respond to the market situation and thus efficiently provide necessary financing

²² Rīgas Brīvostas pārvalde is a derived public person under the supervision of the Cabinet of Ministers. The Executive board, having similar duties as a Supervisory boards in SOEs, has representatives nominated by the Ministry of Economics, Ministry of Finance, Ministry of Transportation and Ministry of Environmental Protection and Regional Development.

tools. Notwithstanding the positive aspects of the close connectivity to the shareholder, the State should enhance the separation of State’s functions by establishing independent Supervisory boards.

Exercise of the State ownership rights

The State, i.e., shareholder exercises its rights and obligations as an owner through a representative. The representative of shareholder is either the head of the ministry or the head of an institution and is the key State officials setting up and monitoring SOE performance.

Ministries have various approaches in the division of the responsibilities of being representative of shareholder. While the general approach is to divide the role of shareholder’s representative between several ministry officials, there are ministries which prefer to appoint the same ministry official as shareholder for all its SOEs. Most of the selected SOE representatives of shareholders are State Secretary or Deputy State Secretary. However, for none of them the role of being shareholder’s representative in SOE is the official’s main responsibility and is performed along with other duties. The question of the representative’s ability to fully execute their ownership rights arises in situations when one official is appointed as representative of shareholder for a significant number of SOEs. **Figure 16** encompasses distribution of the role of the shareholder’s representative among ministry officials represents the distribution the duties of shareholder among ministry officials. Therefore, **for harmonized SOE governance it is crucial for the ministry officials to have a unified interpretation of the existing corporate governance principles.**



Figure 16. Distribution of the role of the shareholder’s representative among ministry officials in selected sample SOEs²³

The distribution of the shareholder’s representative role among ministry officials has been only analysed for the selected sample SOEs and does not include any observations for other shareholder practices.

The current legislative framework and Coordination Institution have created guidelines providing a reliable framework for setting up and monitoring the SOE financial and non-financial objectives. However, **due to the suggestive nature of the guidelines, the interpretation of the preferred SOE performance and target ambition is left to the shareholder.** While all interviewed shareholders require quarter, mid-year and annual reports from the SOEs in accordance with the medium-term strategy evaluation process to monitor their performance, the required level of detail and justification varies from ministry to ministry.

²³ Distribution of the role of the shareholder’s representative among ministry officials by 21.05.2020. The report does not include any observations or changes that might have had happened after the set date.



This leads to an incoherent state approach for SOE governance, allowing ministries to execute different SOE ownership objectives rather than unified SOE governance.

The recent changes of the SOEL provide that the Coordination Institution must monitor SOE compliance with disclosure of information. However, it does not provide any tools to enforce compliance.

1.1.2. SOE supervision practices

Development of medium-term strategies

The medium-term strategy is a base planning document for planning SOE development activities, dividend pay-out level and related financial targets. The SOEL regulates an obligation for the SOEs to prepare a medium-term strategy for a three to seven-year period.

The medium-term strategy is a planning document created by the cooperation of all SOE's ownership levels – representative of shareholder, Supervisory board, and the Executive management. However, in order for the medium-term strategy to be approved by the Supervisory board, it must be submitted to the Coordinating Institution and line ministry for the assessment.²⁴

The Coordination Institution gives an opinion or assessment of the financial objectives and financial performance (profit, dividend pay-out, return on capital, etc.) of the SOEs medium-term strategy and its consistency with the non-financial objectives of the SOE's medium-term strategy.²⁵ **Under the existing legal framework companies are not required to implement the assessment or opinion of the Coordination Institution within their medium-term strategies. Therefore, the procedure currently has a superficial nature** as companies have the final decision over implementation of the assessment of the Coordination Institution.

As the legal framework does not impose the obligation to review the medium-term strategy annually it is at the SOEs discretion to assess changes in their financial goals after two to three years since the development of the medium-term strategy.

SOEL and CSCC guidelines do not require SOEs to disclose their medium-term strategies; therefore, SOEs disclose information about medium-term strategies in a limited form. As medium-term strategies are provided by a limited number of SOEs and the rest of SOEs have chosen to provide the disclosable information within their annual reports, analysis of medium-term strategies cannot be carried out due to considerations of the quality of analysis.

All selected sample SOEs have confirmed that the medium-term strategies are created according to CSCC Guidelines. The reasoning for the SOEs' decisions not to publish them fully or not publish them at all, might be explained by the fact that the medium-term strategies include information that the company considers a commercial secret.

²⁴ Article 26. The Law on Governance of Capital Shares of a Public Person and Capital Companies. Latvijas Vēstnesis, 216, 31.10.2014.

²⁵ Article 26 (4). The Law on Governance of Capital Shares of a Public Person and Capital Companies. Latvijas Vēstnesis, 216, 31.10.2014.

Evaluation of the SOE performance

The SOEL provides that SOE's performance must be evaluated by the shareholder, the line ministry (if separate) and the Coordinating Institution annually, analysing the fulfilment of the financial and non-financial objectives set in the SOE's medium-term strategy. The detailed guidelines on how the SOE's performance should be evaluated is provided in Cabinet of Ministers regulation and CSCC has created Guidelines for Performance Evaluation in SOEs in which State exercises decisive influence.²⁶

In order to evaluate the performance of SOEs, they are required to provide a pre-defined set of financial and non-financial indicators based on which the SOE performance is evaluated. **In practice, SOE financial results are compared with the SOE planned financial targets in the medium-term strategies.**

The current framework in some cases has unintentionally established the practice of dual reporting. The SOEs are required to report to the shareholder based on the ministry practices and financing agreements, as well as report to the Coordination Institution based on the financial targets set in medium-term strategy or other planning document.

Additionally, **the existing evaluation practices discourages SOEs from setting ambitious goals in their medium-term strategies as the failure to achieve these goals would possibly result in low evaluation of the SOE's performance** and in worst case scenario – additional audits by the shareholder. Additionally, there is a limited interest to set ambitious goals as the Executive management's remuneration in terms of the yearly bonus is dependent on the evaluation of the SOEs performance. Although, the international best practices support Executive management's variable remunerations, i.e., bonus dependency on the achievement of the long-term strategic objectives.

During the performance evaluation process the SOE administrative burden often increases as the Coordination Institution requires explanations for both positive and negative deviations from the targets set in the strategy. However, there have been situations when positive deviations from non-financial targets have cause negative financial results.

1.1.3. Disclosure and transparency standards in SOEs

Latvia has made significant steps towards increasing the transparency of its SOE corporate governance. The corporate governance framework has been strengthened by, initially, setting the minimum transparency requirements for the SOEs and shareholders and later increasing transparency and disclosure standards assimilating requirements set to the publicly listed companies. For instance, significant steps are visible in amendments of the SOEL starting from March 2020 indicating Coordination Institution as a responsible institution for providing guidance and monitoring the disclosure of information by SOEs and shareholders.

All assessments regarding disclosure of information were made for the selected sample SOEs and their shareholders. The assessments were carried out by 21.05.2020. and do not include any observations or changes that might have had happened after the set date.

²⁶ Cross-Sectoral Coordination Centre Republic of Latvia. Guidelines for Performance Evaluation in SOEs In Which State Exercises Decisive Influence.



Disclosure of information by ministries as shareholders

The SOEL provides an overview of the necessary level of information that needs to be publicly disclosed by the ministries as shareholders²⁷. The corporate governance practices by shareholders asserts that even though the legal framework precisely sets out the information disclosure requirements, the ministries have varying compliance levels. For the detailed assessment see **Annex 5**.

The Ministry practices regarding disclosure of information varies the most on the accessibility and traceability of the information. Even though only one of the analysed ministries fully complies with the requirements set in the SOEL and the ministries deviate from the requirements set in the legislative framework, most information disclosed by ministries is accessible, comprehensive and provides general understanding on States ownership regarding the respective SOE.

The deviance from the legislative framework can be observed in the shareholder practices to disclose the reasoning for State's participation in the SOEs and their subsidiaries. Most of the information provided by the ministries partially conforms with Article 4 of the SOEL as the information is focused on the strategic goals of the SOEs. Even though the ministries provide information regarding the States participation in the SOEs, often the State participation is justified by specific laws or other legislative acts than requirements set in SOEL and thus SASL.

Additionally, **ministries have diverging approaches regarding the disclosure of SOE financial information.** While SOEL has imposed ministries with the responsibility to disclose financial information of SOEs, the ministries often leave the responsibility of disclosing information of annual reports to the SOEs by indicating a link to the respective SOEs webpage.

As the ministries do not have a unified approach regarding the form of disclosure of information, the practice results in some ministries disclosing all information about their SOEs on their web-page, while others, for example, the Ministry of Transportation, disclose information about the SOEs in a downloadable attachment. Both forms are viable instruments, however it is more difficult to identify whether the information displayed as a downloadable attachment is up to date as ministries indicate various dates for the updates of the file on their webpage.

Consequent and harmonized information disclosure including both financial and non-financial is essential for the government, so that it can act as an effective owner and for the Parliament to evaluate the performance of the State as an owner. **Partially conforming approach to information disclosure of shareholders sets a bad example for their SOEs to fully comply with disclosure and transparency standards** and significantly impacts the society's understanding of the SOE performance. Contemplating SOE potential IPO processes, it is necessary for State to build trust in society and potential minority shareholders by showing transparent and accountable SOE ownership practices and equitable treatment of all stakeholders.

Starting from March 2020 the shareholder practices and interpretation for the disclosure of information became more transparent and harmonized; however, State should take necessary actions to even more

²⁷ Article 29(2) The Law on Governance of Capital Shares of a Public Person and Capital Companies. Latvijas Vēstnesis, 216, 31.10.2014.



unify shareholder practices putting a significant focus on State's practices towards disclosure of financial information.

Disclosure of information by SOEs

The Latvian corporate governance framework supports OECD good governance practices by setting high-level disclosure and transparency standards for the SOEs. The SOE disclosure and transparency standards are set in SOEL²⁸ and are supplemented by CSCC guidelines.

SOEs, similar, to the ministries, have different approaches to the disclosure of information. It differs from case to case, which partially can be explained by the amendments to the SOEL and the transitional period until March 1, 2020 when the amendments came into force. The amendments expanded on the requirements for the disclosure of information regarding the members of the Executive and Supervisory board by requiring detailed information about the members themselves as well as their duties and obligations. For the detailed SOE assessment see **Annex 6**.

The most common inconsistency in SOE practices is the timeframes within which the results of implementation of financial and non-financial objectives are provided. As the amendments within the SOEL require information to be published within the scope of 5 years it is clear that the law aims to harmonize these timeframes. However, in practice SOEs publish annual reports on various timeframes, starting from two to five years.

Secondly, SOEs provide different amount and depth of information about the payments made in the State budgets. For some the reason is Cabinet of Ministers diverting the finances either to coverage of losses incurred by the SOEs or for future development while for others the payments of social benefits have been displayed within the annual reports. Moreover, this aspect is also visible when assessing the received funding from the State and its distribution by the SOEs. The SOE practices on the disclosure of information do not provide transparency regarding the received State funding and its traceability, and do not follow OECD guidelines on the disclosure of cost and revenue structures for public policy objectives. By analysing the publicly available information, **the account separability of commercial and non-financial objectives was limited to only a handful of SOEs.**

Furthermore, SOEs have provided information about their annual audited reports for the last 5 years; however, inconsistencies lie within the fact that some SOEs provided the information partially by disclosing only the annual audited reports or their summaries. Additionally, majority of the SOEs have not created diversity policies or have only alluded to the necessity to establish them with regard to their management with the exceptions being – AirBaltic and Altum.

All and all, SOEs have varying approaches to information disclosed, which makes it more difficult for the public to get relevant information in an easily accessible and in a manner that allows comparing the information.

Considering that the requirements for disclosure of information are assimilating requirements set to the publicly listed companies, significant actions for increasing SOE transparency for SOEs interested in capital

²⁸ Article 58 The Law on Governance of Capital Shares of a Public Person and Capital Companies. Latvijas Vēstnesis, 216, 31.10.2014.

markets should be made. Almost all SOEs should increase their transparency towards **account separability of commercial and non-financial objectives in terms of received State funding, costs of objectives and their revenue.**

In case of capital attraction in capital market, greater transparency in information disclosure can result in a higher company credit rating as rating agencies evaluate company's transparency practices and quality of the disclosed information.

Even though for some of the SOEs changes in transparency practices would require significant organizational changes and initial costs related to the preparation of required information, the obtained benefits would outlay the SOE challenges. Increased SOE transparency would not only lead to the potential capital attraction in capital markets but would also allow State to ensure better State asset management and increase society's trust.

Analysing SOE information of disclosure practices only two of the selected SOEs that already are using capital market financing meet the disclosure of information requirements set by Financial Instrument Market law for publicly listed companies as AirBaltic bonds are not issued in Latvian capital market and therefore are not subject to Latvian law.

1.2. SOE governance practices

Key takeaways

- The legal framework set outs detailed requirements for the impartiality of the Supervisory boards. While the framework establishes the practice of independent Supervisory board members, it also leaves the possibility to that for less than half of the Supervisory board members to have political interests.
- The regulations regarding the impartiality of the Supervisory boards and nominations of the board members apply only to the new board members allowing to re-appointment the existing board members, without the re-evaluation of their conformity with the requirements. Such practices allow to maintain political or other influence over the SOE management.
- The existing legislative framework provides detailed procedure for appointment of the Supervisory board and Executive management, while the revocation of the Supervisory board and Executive management lacks the procedure thus allowing political influence on the SOE Supervisory board and Executive management.
- Internal control and risk management framework for SOEs in Latvia are designed to fit into the context of public sector control measures and safeguarding public integrity rather than focusing on the business sector goals that could boost business growth
- All reviewed SOEs have some elements concerning Internal Controls in place but systems are not comparable as there is no general benchmarking or minimum requirements.
- Internal control elements are not balanced with materiality and impact of risks, but due to external regulation some areas of risk are disproportionately addressed and especially highlighted.

- There is no full assurance that, in most assessed companies, the full range of Internal Control activities is an integral part of business operations, of daily practice and interlink with execution of business strategy. Mostly it is the task of specially appointed employees in risk management.

The review of the selected SOE governance practices provides a general perspective of the SOE internal governance. The aim of the SOE governance practice review is to provide an analysis on the existing legal framework and the current SOE practices. The SOE governance practices in the selected SOEs are scrutinized by examining the role of the Supervisory and Executive boards in the SOEs and analysing selected SOE the internal control framework.

Moreover, SOE governance analysis is made to conclude the main challenges of the Executive management and determines the necessary improvement areas to strengthen the SOE corporate governance with a particular focus on the introduction of the active ownership principles and SOE financing methodology.

The analysis of the Supervisory and Executive board's roles is scrutinized by examining the selection and nomination of the Executive board members, the tasks and obligations of the management, as well as the liability of the Executive board. The analysis provides a general overview of the main corporate governance challenges faced by the SOEs' Supervisory and Executive boards.

Review of the internal control framework of selected SOEs provides an opinion on the internal control framework in the selected SOEs. The assessment includes an analysis of the existing controls and their integration within the SOE operations.

1.2.1. Roles of the Supervisory and Executive boards

Selection of Supervisory board and Executive management members

The process of nomination and selection of members of the Supervisory board and Executives management is governed by both the SOEL and Regulation of Cabinet of Ministers.²⁹

The selection of Supervisory board members is centralized and in order to select the most suitable candidate for the position. The process begins with the establishment of the nomination committee. The nomination committee is responsible for the selection and evaluation of candidates for the Executive management and Supervisory board members, the selection of candidates, and the recommendation of the candidate to the Supervisory board or shareholder.

The main difference between the selection process of Executive management and Supervisory board members is that the selection process for the members of the Executive management is not centralised and thus the Coordination Institution does not perform the duties of organizing and supervising the selection process. The candidates for membership in the Executive management are selected via a public application procedure for candidates. The nomination committee for Executive management members is

²⁹ The Cabinet of Ministers Regulation No 20 "Nomination procedure of the Executive management and Supervisory board members in the capital companies, in which shares are owned by the state or by a public body", 07.01.2020. <https://likumi.lv/ta/id/312171-valdes-un-padomes-loceklu-nominesanas-kartiba-kapitalsabiedribas-kuras-kapitaladals-pieder-valstij-vai-atvasinatai-publiskai-...>

established by the same similar principles as the for the nomination process of the members of the Supervisory board. The Supervisory board has the right to reject the candidates nominated by the nomination committee but must provide good reasoning. In such cases, the process of selecting the required candidates must be repeated.

Based on the interviews with the stakeholders it has been established that the **since the implementation of the selection and nomination processes of the Supervisory board and Executive management, the shareholders and SOEs are following the set practices.**

For the Supervisory board to effectively operate in an independent manner the SOEL dictates that at least half of the members of the Supervisory board must be independent. The SOEL provides clear criteria based on which the Supervisory board member is considered independent. In order to ensure a professional and impartial work of the Supervisory board, which would promote a long-term growth and efficiency of the SOE's, at least half of the members of the Supervisory board must be independent.

Impartiality from the line ministry is necessary in order to prevent political interests from interfering in the choices of the supervisory board members during decisions and operation of SOE. **Figure 17** includes a list of the selected SOE Supervisory board impartiality. Detailed analysis of the Supervisory boards' and its members impartiality can be examined in the **Annex 7.**

State-owned enterprise	Number of Supervisory board members	Number of independent Supervisory board members	Independent / dependent
Latvenergo	3	0	Dependent
Latvijas valsts meži	5	4	Independent
Sadales tīkls	n/a	n/a	n/a
Latvijas Pasts	3	3	Independent
Latvijas Dzelzceļš	5	3	Independent
LDz Cargo	n/a	n/a	n/a
Air Baltic	4	-	n/a
Altum	3	0	Dependent
CSDD	3	2	Independent
Latvijas Gaisa Satiksme	3	1	Dependent
Pasažieru vilciens	3	3	Independent



Valsts īpašumi	nekustamie	3	1	Dependent
Latvijas Koncerti		n/a	n/a	n/a
RAKUS		3	2	Independent
Rīgas Brīvostas pārvalde ³⁰		4	0	Dependent

Figure 17. Independence of the selected sample SOE Supervisory boards as of 21.05.2020

Most of the analysed SOEs are following good governance practices having independent Supervisory boards and thus ensuring competent and objective strategic guidance and monitoring practices. In case of capital attraction in capital market, independent and competent Supervisory boards play a significant importance and leads to a higher company credit rating.

Liability of the Supervisory board and Executive management members

Maintaining accountability for tasks and obligations of the Supervisory board and Executive management is crucial to achieving successful and efficient governance of the SOE.

The Latvian regulation provides for the aim by assigning liability to the members of the Supervisory board in cases where the legal process of decision making wasn't followed or members failed to act honestly, as an honest and careful owner and in good faith. A member of Executive management may be revoked by shareholder or Supervisory board, if there is an important reason for it. The SOEL defines that as an important reason can be understood a violation of authorisation, non-fulfilment or insufficient fulfilment of obligations, inability to manage the SOE, causing of harm to the interests of the SOE, as well as a decision of the meeting of shareholders or Supervisory board (if such has been established) on loss of trust. **Therefore, the liability of the Supervisory board and Executive management from the perspective of Latvian law is often attributed to the failure to act as would an honest and careful owner and may leave a significant room for interpretation, potential abuse, and political influence of the shareholder.** The norms established in the SOEL have been based on the similar notion of the Commercial law providing the same high-level legislative norm and protection for the Executive management members of the private companies.

Examining the changes in the SOE Supervisory boards and their composition, **sudden revocations and short-term tenures of the Supervisory board members can be observed only in specific cases.** For example, Latvenergo has had one full withdraws of the Supervisory board and one temporary board, leading that there have been change of 10 different Supervisory board members within the timespan of a year.³¹

³⁰ Rīgas Brīvostas pārvalde is a derived public person under the supervision of the Cabinet of Ministers. The Executive board, having similar duties as a Supervisory boards in SOEs, has representatives nominated by the Ministry of Economics, Ministry of Finance, Ministry of Transportation and Ministry of Environmental Protection and Regional Development.

³¹ Within the timespan since the beginning of the State Ownership policy review in Latvia in 2018.

Analysing changes in the SOE Executive managements, most of the SOEs have maintained a consistent composition of the Executive management which proves as an indicator for stable corporate governance of the SOE as strategies can be implemented by the Executive management which have developed them. **However, in order to ensure that Executive management members do not have interest of conflict due to the long continuity of the fulfilment of the duties, for several SOEs the change in Executive management were necessary.**

Recurring changes in the composition of the Executive managements may impact the ability of SOEs to be governed like publicly traded companies, as the changes in the Executive management might indicate the political involvement in the SOEs. Moreover, these factors not only impede the effectiveness of the SOE's ability to carry out their overall strategic goals, but also to remain consistent within their governance practices as they may be impacted by external interests.

1.2.2. Internal control framework

The internal control framework in Latvia does not provide for a nationally regulated legal requirement to ensure comprehensive internal controls in SOEs as such. However, common elements of internal control framework include external compliance to the legal framework quoted in the Law "On Prevention of Squandering of the Financial Resources and Property of a Public Person" (hereinafter - PSFRP) and internal control systems that are utilized by the SOEs within their business operations. **Financial accountability of SOEs creates the duty to apply the PSFRP Law and provides certain requirements and restrictions for SOEs, especially in respect of handling of the assets and financial resources.**

Additionally, the State Audit office performs external audits based on requirements of PSFRP Law, the Procurement Monitoring Bureau performs oversight on implementation of all procurement regulation and the Corruption Prevention and Combating Bureau monitors prevention of conflicts of interest in activities of public officials.

While there are no direct regulatory measures in place governing the question of internal control measures practiced by SOEs, risk management regarding financial risks and legal compliance is top priority which is visible in the following regulatory provisions:

1. Law on Annual Financial Statements and Consolidated Financial Statements General and Law on Accountancy. It defines Principles for Preparation of a Financial Statement (Section 14), need for accounting policy, the management report in certain cases which states objectives and policy of the financial risk management, and approved risk management policy in respect to each type of significant foreseeable future transaction to which risk limitation should be reflected in accounting. Additionally, the SOEL envisages an annual account to be checked by a sworn auditor.
2. Sanctions on management are established by Section 168 of Commercial Law. Members of the Executive management and the Supervisory board, a proctor or a person with a commercial power of attorney shall not be liable in accordance with Paragraph two of this section if they prove that they were acting as honest and careful managers. This norm with a high level of abstraction is one of incentives to establish such kinds of internal controls that protect the board from liability.

Internal controls mainly are focused on compliance, as in certain areas there are some regulations highlighting risk management in place. **SOE's Internal control elements are not balanced with materiality and impact of risks, but due to external regulation some areas of risk are disproportionately addressed and highlighted.** Examples are public procurement, lease of assets, corruption prevention and whistle-



blower protection. Others, mainly related to achieving a strategic objective or the policies, processes, tasks, behaviours and aspects of a company that are taken together to facilitate its effective and efficient operation lag. For specific regulations of SOE internal control systems and SOE conformity with them please see **Annex 8**.

External control system

The internal control of the SOEs under consideration is also influenced by external monitoring. The more scrupulous the external monitoring is, the greater the internal effort required to ensure compliance. Activities of all SOEs could be examined by the State Audit Office, the Procurement Monitoring Bureau and the Corruption Prevention and Combating Bureau. In parallel, several of the SOEs are subject to strict professional supervision.

The State Audit Office is engaged in establishing and reviewing internal control systems and either to the full extent or as far as public resources are managed.³²

The Procurement Monitoring Bureau³³ monitors the conformity of the procurement procedures and examines administrative violation cases in the field of public procurements and public and private partnership and imposes administrative sanctions.

The Corruption Prevention and Combating Bureau monitors prevention of conflicts of interest in activities of public officials of SOEs. Public officials are those who are part of the Executive management and the Supervisory board, as well as members of procurement commissions in case of application of Public Procurement Law (PPL). Therefore, those SOEs that apply PPL experience a higher administrative burden in this process, but the result is more transparent and staff members much more accountable than in case of application of Public Service Providers Procurement Law.

Internal control systems

There is no full assurance that, in most assessed SOEs, the full range of Internal Control activities is an integral part of business operations, of daily practice and interlink with execution of business strategy. Mostly it is the task of specially appointed employees in risk management.

The most advanced are financial controls and area of compliance to external legal regulation. Resistance to negative economic trends or frequent changes, standardization of complex processes, ability to ensure that no employee or group is in a position both to perpetrate and to conceal errors or fraud in the normal course of their duties are the least popular control objectives set by the SOEs.

Review of policies of internal controls in combination with regulatory framework in selected SOEs show substantial differences between organisations that is basically caused by applicable regulation and distinct size, capacity, sources of financing and profile of organisations.

SOEs which are large or middle-sized, have relatively tough external control if public financing is provided. The approach can be compared to public administration institutions, where Internal Control plays a key role in ensuring compliance. The focus of Internal Control is more on compliance of operations or human resource management.

³² Article 2. State Audit Office Law. Latvijas Vēstnesis, 80, 29.05.2002.

³³ Article 66. Public Procurement Law. Latvijas Vēstnesis, 254, 29.12.2016.



However, SOEs which are large companies, with limited external control and no public financing operate with relatively broad discretion, so the main focus of Internal Control systems could be on achieving SOE management goals or attaining the entity's strategy and business objectives. Detailed analysis of the established Internal Control Systems in selected SOEs in **Annex 9**.

Additional observations within the analysis

Most of the SOEs and stakeholders interviewed and surveyed believe that their administrative organization and internal controls are organised properly. At the same time there is either limited public information or no information at all available to establish that assessed companies are in control.

Some SOEs completely ignore public access to information requirements by SOEL. Transparency of policy assures that the company is in control and increases the trust in predictability of its figures. In case of publicly listed companies, greater transparency can result in a higher rating of rating agencies due to their evaluative criteria including the quality of the internal controls. With higher ratings, companies can raise capital and it increases the value of the company. However, if a company does not demonstrate a comprehensive and transparent internal control mechanism, it becomes impossible to eradicate the impression of instability of an SOE in the event of mismanagement.

All companies report that they examine their internal control as part of the financial reporting. Financial control is well established, prompt and proper recording of transactions and events, which is deployed (control activities) through policies and procedures. Focus on proper financial reporting is important but at the same time provides just a fixed picture of a moment, like the annual or semi-annual accounts. Thus, allowing for the possibility of the administrative processes and structural internal control remaining underexamined.

Not all SOEs reported that there is an indication on the efficiency of the internal control in the annual management report.

External compliance is one of the top priorities of the internal control system of SOEs. The SOE practices show that the control environment of the compliance with legal requirements is ensured by management control activities. Both strategy and organizational behaviours and desired culture demonstrates full attention to regulatory compliance.

Controls are designed and in place but are not always adequately documented, the completeness of the records on regular check of the control is not assured. Consequently, some part of internal controls is informal and mostly dependent on people.

No formal training or communication of control activities to all staff is regularly provided by SOEs.

SOEs in line with their size have laid down how the administrative organization and Internal Control must function. **However, there is no full assurance that within the operation processes of most of those companies, the internal control is an integral part of business operations, of daily practice and interlinked with execution of business strategy.**

There is no certainty that the risk monitoring is provided by the individuals carrying out business operations. Instead, Internal Control policy is defined by the top-level management, monitored by the special audit units and does not always correspond to the level of risks involved. **Even if the ownership and accountability within the business cycles is formally assigned to only one individual (e.g., Head of Department), additional responsible people (Risk Champions, Risk Members) should be assigned and**



made accountable for managing and verifying the risks under their supervision. Otherwise, this can lead to gaps in controls and inefficiencies within a process going undetected and unresolved.

Many elements of the control environment are in accordance with the highest international standards, including but not limited to IIA, COSO, ISO 31000, ISO 19600, ISO 37001, and ISO 27001 are in place. Full compliance is neither requested by the State, nor is information of compliance made public.

SOEs admit that their Internal Control processes can be simplified, thus resulting in less complication and burden during monitoring activities especially. Moreover, **this leads to resistance to the introduction of new controls where systems and processes remain complex, disparate and lack alignment, which can result in high system maintenance costs and create challenges for management to access comparable business information across the entities.**

Establishing an Audit Committee is not a frequent practice in the SOEs. It would be recommended to ensure that in all large SOEs that the Audit Committee ensures corrective actions because monitoring the adequacy and effectiveness of risk responses, accuracy, and completeness of reporting, and timely remediation of deficiencies could be achieved just by implementation of all three lines of defence.

Due diligence activities are not structured, and new business partners could be taken on without due diligence, especially in the utility sector of SOEs where procurement procedures are less restrictive.

There is a significant difference between the procedure of prevention of conflicts of interest, declaration of conformity, limitation of spare-time activities, restrictions of competition for public officials and other employees. SOEs should be encouraged to align these requirements and procedures to ensure integrity for all persons employed.

Data or public information of external assessment of Internal Control systems is not provided. Once an internal risk assessment is conducted it is important to confirm the chosen perspective and receive recommendations for how to enhance the efficiency of controls.

2. Financial review

2.1. SOE financing landscape

Key takeaways

- Latvian SOEs make up a significant part of the Latvian economy in terms of assets (31% of GDP) and dividends paid to the State budget (more than 100 million growth over the last 5 years).
- Latvian SOEs face more indebtedness in every sector than European SOEs, with the highest debt to equity ratio hitting 2.85 in Real estate sector (based on the analysis of all 70 SOEs).
- With Latvian commercial SOEs growing faster than the state dependent ones, growth rate altogether falls short of European companies' growth level significantly (based on the analysis of all 70 SOEs).
- The financing sources of SOEs are conservative and undiversified, relying on traditional means of financing – such as commercial bank loans, retained earnings and subsidies, grants (based on the analysis of the selected sample of SOEs).
- Commercial SOEs rely mostly on retained earnings (53% of total), and borrowings (35% of total) to cover investment projects, while State dependent SOEs are more dependent on subsidies (63% of total) and retained earnings (22% of total) (based on the analysis of the selected sample of SOEs).
- In a number of SOE cases analysed, certain financial information (e.g., account separation, loans received, government funding) was not publicly disclosed (based on the analysis of the selected sample of SOEs).

The purpose of the SOE financing landscape analysis is to assess the historical performance of the SOEs, analyse the SOE capital structures, and contrast various financial metrics to the relevant peers. This way an overall financial picture of the SOEs will be attained **that will allow one to make conclusions and determine areas of concern in developing the SOE financing methodology.**

An important part of the assessment process is to gather and scrutinize the publicly available SOE financial information. Already in this step, a series of important takeaways crystalized.

- There tends to be a lag between the stipulated date in which annual reports should be published, from the actual date when certain SOEs make the annual reports available to the public.
- The level of detail of the financial information provided tends to vary widely, and oftentimes does not meet the necessary or recommended standards of transparency. For example, most of the SOEs tend not to disclose full information on loans received.
- In addition, some of the SOEs tend not to disclose full information on government funding, and planned investments.
- In many cases, SOEs have failed to provide the necessary level of account separation for the revenues and costs that are related to a fulfilment of non-financial objectives for which private competition does not exist or is extremely limited.

Box 2.1. - The constituents of SOE financing landscape analysis

Information

The following financial information has been used for conducting the SOE financing landscape analysis:

- the SOEs financial indicators database maintained by CSCC;
- information provided directly by CSCC;
- SOEs annual reports;
- Financial data of European companies compiled by Aswath Damodaran;
- Statistics provided by Central Statistical Bureau of Latvia;
- information available on the websites of individual SOEs;
- data about 90 selected EU SOEs;
- interviews with the selected sample of SOEs.

Subsidiaries

To avoid duplication of data, the ensuing subsections cover SOEs at the group level (excluding subsidiaries). In the subsections of SOEs historical performance and capital structures, the entire portfolio of 70 SOEs (at a group level) has been analysed. The full list of analysed SOEs can be found in **Annex 10**.

Financing sources

In the financing sources subsection, only the selected SOEs on a group level have been analysed. The reason why the total portfolio of SOEs have not been included in the sample lies in the limited availability of data and transparency in terms of the received financing sources.

Segmentation & selected sample

The analysis is based on the SOEs segmentation methodology described in section 3.2.2. Namely, the SOEs are divided into two broad categories – commercial SOEs with state funding less than 10% of the total 3-year historical revenues (the abbreviation for the following graphs – COM), and State dependent SOEs (the abbreviation for the following graphs – SD), which are classified within the State’s budget and receive State funding in amounts of 10% or above from the 3-year historical sales. Although the SOE segmentation outlines an additional divide for the State dependent SOEs (i.e. State dependent commercial and State dependent non-commercial), the ensuing analysis does not follow this split due to limited sample size and lack of data and transparency. The segmentation of all 70 SOEs lead to the result of – 14 commercial SOEs, and 56 State dependent SOEs.

Time period

The analysed 5-year window from 2015 to 2019 is considered appropriate and justified given the fact that 5 years coincide with the optimal period of the medium-term strategy setting, which is between 3 and 7 years.

2.1.1. Benchmarks and sector breakdown

Any chosen benchmark has to be appropriate and include common factors that explain variation in the performance. For SOEs choosing an appropriate benchmark is oftentimes a challenging task considering the specifics of such enterprises that are not necessary characteristic to standard private businesses (e.g., the fulfilment of public policy objectives, impediments for merger and acquisition activities, reduced flexibility to issue shares etc.). Hence, to render a reliable conclusions from the benchmarking process, the following inputs are brought into the analysis:

I. SOE sectorial breakdown split into forestry (and agriculture), real estate, energy, healthcare, transportation and other sectors. The constituents of the sectors are 70 Latvian SOEs in which the State exercise a decisive influence.

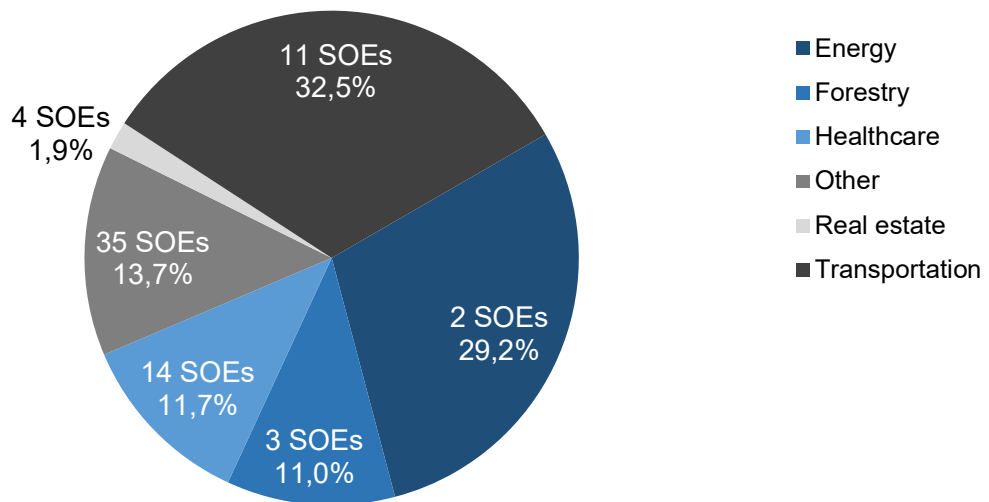


Figure 18. Latvian SOEs sectoral breakdown by sales amount, 2019

ii. Selected sample size of 90 European SOEs, please refer to **Annex 1** for a more detailed breakdown³⁴.

iii. Baltic publicly traded SOEs

- Tallinna Vesi AS – water utility company in Estonia (albeit municipality owned enterprise);
- Ignitis grupe AB – utility and renewable energy company in the Baltic region;
- Litgrid AB – operator of electricity transmission system operating electricity transmissions in Lithuania;
- Amber Grid AB – natural gas transmission system operator in Lithuania;
- Kauno Energija AS – indoor heat and hot water supply systems, repair and maintenance of heat unit equipment, rental services premises.

³⁴ Source: publicly available data on annual reports from local business register, stock exchange and industry summary reports.

iii. Financial data of European companies compiled by Aswath Damodaran – Aswath Damodaran is world renowned and one of most respected corporate finance and valuation expert who has been compiling and analysing corporate financial data for over 20 years.

iv. Central Statistical Bureau of Latvia – used for obtaining general statistics, e.g. gross domestic product.

2.1.2. Capital structures

Asset size is the sum of all balance sheet assets managed by the SOE.

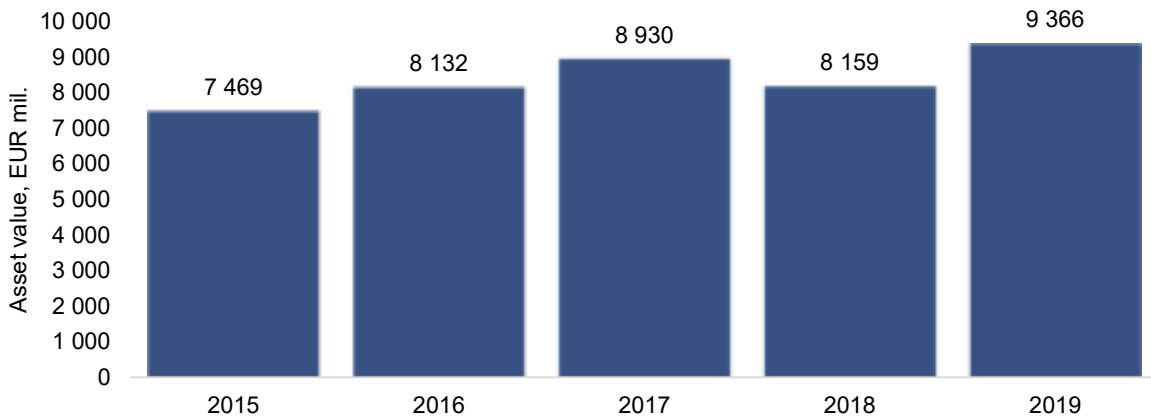


Figure 19. Total asset size of Latvian SOEs, 2015 – 2019

From 2015 to 2019, the asset size of SOEs increased, with the exception of 2018. In 2018, the value of SOEs fell by EUR 8.6%. One of the most significant cause of this drop was the reduction of Latvenergo current assets position by EUR 454 million, due to a fee for the electric capacity installed in the cogeneration power plants TEC-1 and TEC-2. Overall, the value of SOEs' **assets increased by almost EUR 2 billion during the period** under review. Even though more than 73% of the value of all SOEs' assets is formed only by 5 SOEs, general situation pattern indicates regular and purposeful investment flows in order to develop and augment the present asset base.

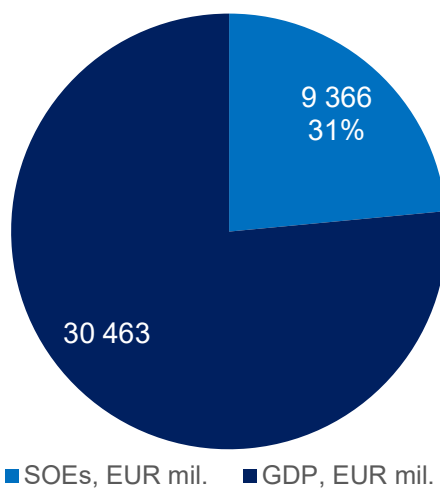


Figure 20. SOE asset size versus GDP, 2019

In terms of asset value, Latvian SOEs **measure at nearly a third of the Latvian GDP in 2019**, confirming the significance and an important role that the Latvian SOEs play in the economy.

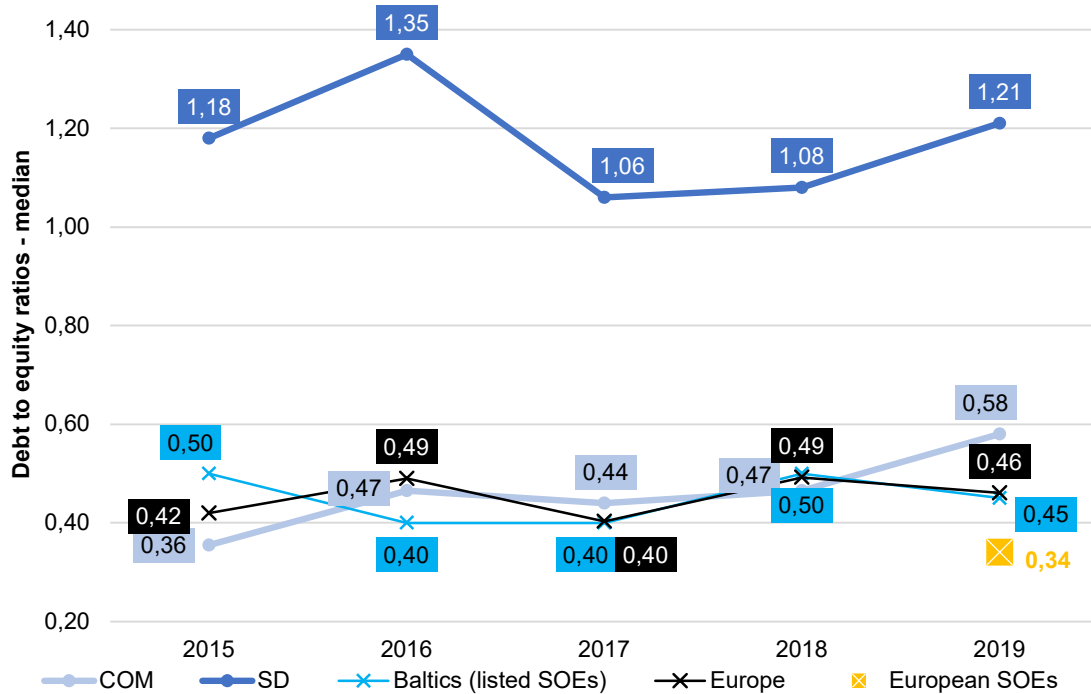


Figure 21. Debt to equity ratios 2015 - 2019

COM has the lowest debt to equity ratio³⁵ of the two SOE groups. The **COM debt to equity ratios has steadily increased over time**, and as of 2019, surpassed that of the European average and many other publicly traded Baltic SOEs. Nearly all of COM SOEs experienced increase in debt to equity ratios from 2018 to 2019. The most impactful SOEs with over 50% increase in debt to equity ratio in 2019 were AirBaltic, Meliorprojekts VSIA and Latvijas Vēstnesis VSIA³⁶. **SD group has the highest debt to equity ratio that exceeds all of the outlined benchmark values.**

An acceptable level of debt to equity is subject to factor exposures and idiosyncratic risks, but the fact that the interest-bearing debt exceeds the equity amount indicates a theoretically unsafe financial position. In fact, as the SOEs become more dependent on state subsidies, the financial risk typically improves due to having more predictable cash flows.

³⁵ The financial position of the SOE groups shows the level of indebtedness through debt to equity ratio. It allows one to achieve a high-level estimate on whether the SOEs possess a meaningful additional borrowing capacity. A safe level of debt (i.e. acceptable / low financial risk) is assumed when the debt to equity ratio of an SOE group or a particular SOE is below that of any of the defined benchmarks. The debt to equity ratios of the SOE groups in **Figure 21** include only the interest-bearing liabilities such as borrowings from credit institutions, bond issuances, and financial leases – both long-term and short-term parts. The equity part of the equation factors every component of the total equity (e.g., common stock, retained earnings).

³⁶ Even though according to the proposed segmentation approach, SOE falls under the Commercial SOE segment, shareholder is suggested to consider changing SOE's segment to State-dependent commercial as most of the SOE's revenues are generated from State fees.

Figure 22 below shows sectoral comparison of Latvian SOEs' debt to equity ratios with debt to equity ratios of European SOEs. European SOEs poll is compiled from the financial data of 90 various European SOEs. In comparison with European SOEs sectorial debt to equity ratios, **Latvian SOEs face higher indebtedness in every sector.**

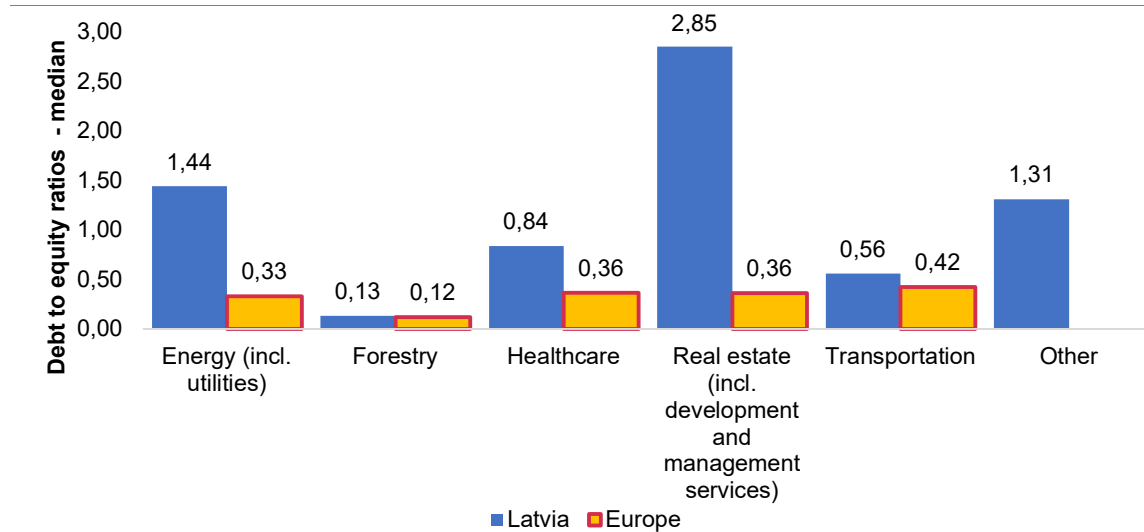


Figure 22. Latvian and European SOEs debt to equity ratios by sector, 2019

2.1.3. Historical performance

Sales CAGR is a growth indicator, which in this case shows the growth rate of SOEs over the last five years. The indicator also indicates the potential to acquire new market shares. As for investors, indicator is very important, given that it shows trends in demand for SOEs products or services.

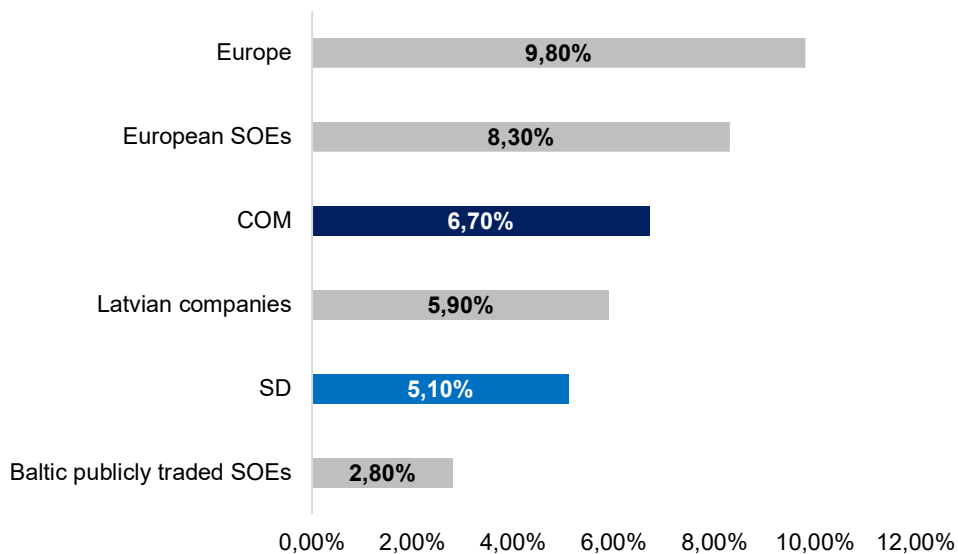


Figure 23. SOE sales CAGR, 2015-2019

Latvian SOEs' growth rate falls behind European companies' growth significantly. Sales of commercial SOEs grew significantly faster than those of the State dependent SOEs. Lastly, the Latvian SOEs have on average outperformed the Baltic SOEs in terms of the generated sales growth from 2015 to 2019 (that can be partially explained by the mature and regulated businesses that the publicly traded Baltic SOE sample includes).

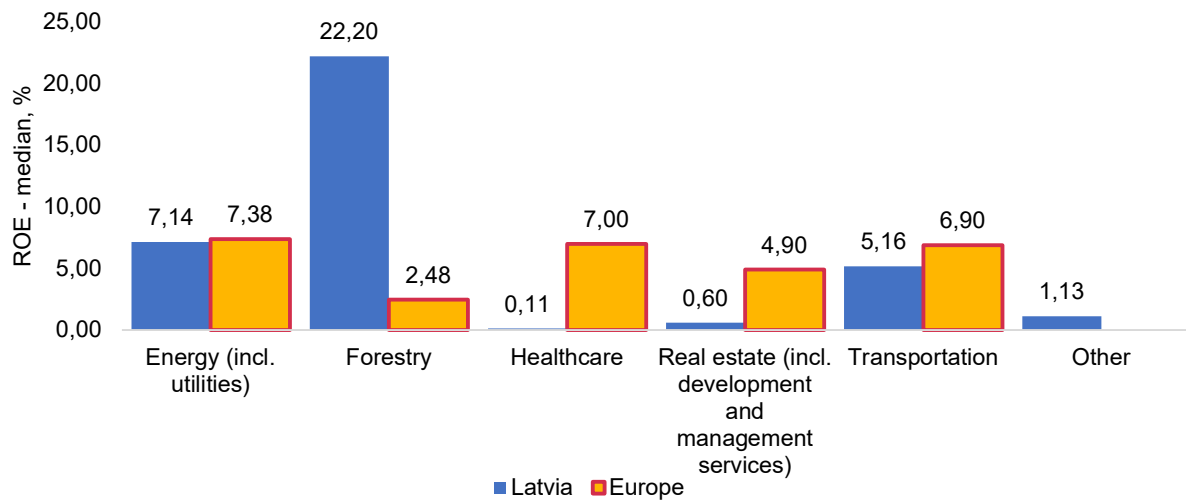


Figure 24. ROE comparison between Latvian and European SOEs, 2019

In comparison with the median ROE generated by European SOEs, **Latvian SOEs fall behind in every sector.** Given the soaring level of subsidies, the healthcare sector shows the lowest ROE among all of the other sectors under review. Moreover, the ROE of the real estate sector is also considered to be on the low side, given the administration of state-owned facilities, which limits the profitability. The highest ROE ratios are evident in the energy and transportation sectors, which are largely made up of commercial SOEs.

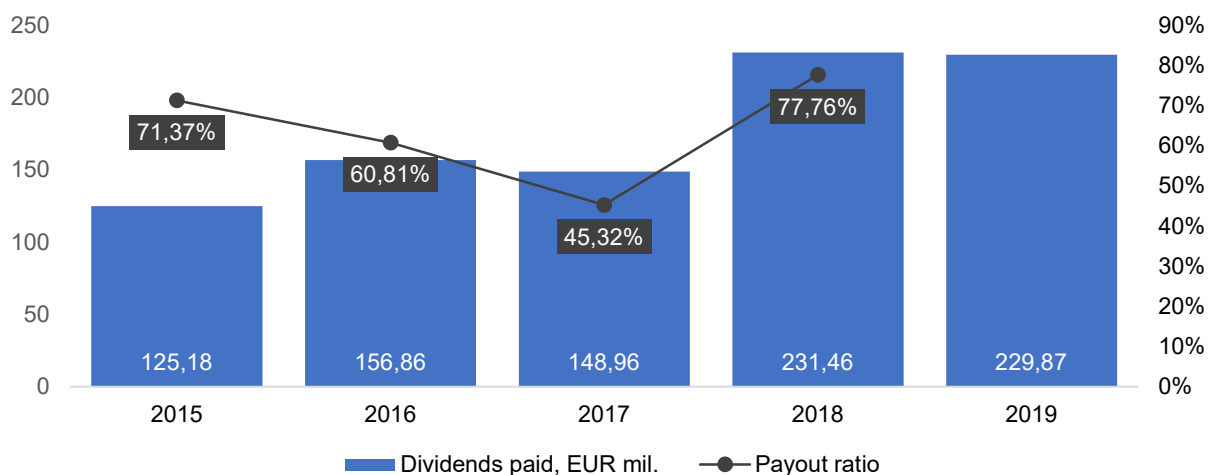


Figure 25. Latvian SOEs dividend pay-out ratios and dividends paid, 2015 – 2019

By comparing 2015 with 2019, **the amount of dividends paid has increased by more than EUR 100 million over 5 years**. A significant decline in the dividend pay-out ratio³⁷ has been evident in 2017, after which the highest total dividend pay-out ratio in the reporting period was immediately reached in 2018.

Figure 26 shows sectoral comparison between Latvian and European dividend pay-out levels.

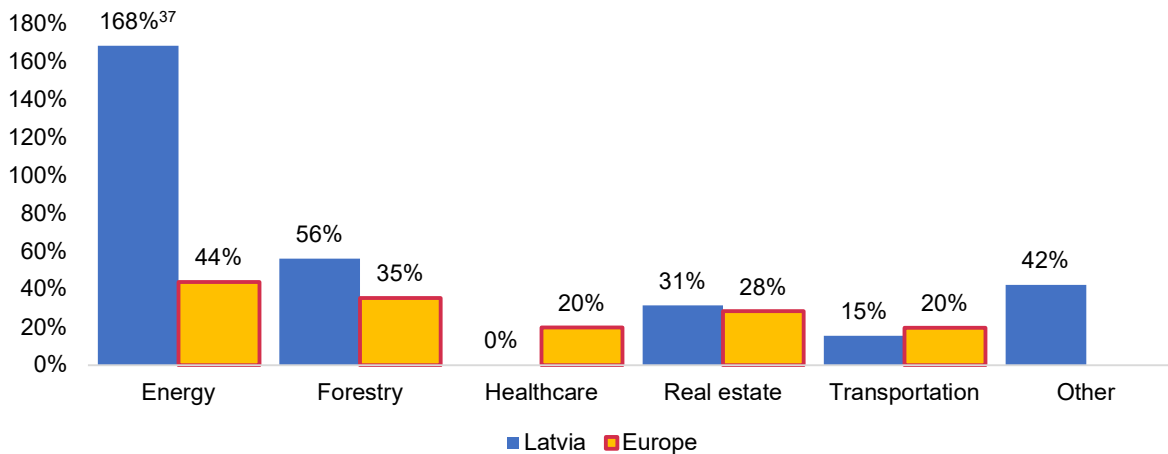


Figure 26. Latvian and European SOEs dividend pay-out ratios by sector, 2018

In 2018, **most of the Latvian SOEs paid out higher portion of their earning as dividends than compared to the European SOEs**. Energy, forestry and real estate exhibit relatively high dividend pay-out ratios (which include corporate income tax) with the energy sector distributing considerably more proceeds than the earnings generated under that year.

2.1.4. Funding and financing sources (based on sample size)

In the context of this assessment, funding is defined as the funds or monies provided by a government sector for a specific investment purpose. Financing is defined as a process of receiving capital for business purposes, and is usually provided from local commercial banks, international financial institutions (IFIs), and primary markets (i.e. bond issuances). The financing part is extended with an element of retained earnings in which an SOE itself covers investments from the accumulated profits. However, in practice retained earnings are sometimes part of funding, because dividends are retained for covering costs or losses of public policy goals.

Box 2.2. – Extrapolating funding and financing sources used by the SOEs in 2019

Subsidies (EU financing) – short-term part of the deferred income attributable to various investment projects as of 31 December 2019. These investment projects stem mainly from EU projects funding.

Subsidies (State financing) - also include a direct State support during 2019 that is disclosed in CSCC database and/or found in annual reports.

³⁷ The dividend payout ratio has been approximated by dividend total dividends paid by total net income generated during the year under consideration (for all SOEs in aggregate).

³⁸ Including the effect of reduction of Latvenergo share capital in 2018

Own funds - approximated by subtracting the declared distributable dividends from previous year profits (2019 for all of the SOEs).

Borrowed funds (commercial bank loans) – each company discloses the relevant information to a varying degree of detail; hence there are multiple approaches for estimating the relevant loan amounts (see footnote³⁹).

Borrowed funds (State Treasury loans) – equivalent approach as for the commercial bank loans.

Borrowed funds (bonds⁴⁰) – as of year-end 2019, the outstanding bond issues’ principal amounts are based on a pro-rata allocation of the corresponding tenures.

Other – funding and financing sources not captured by the aforementioned items (e.g., PPP financing, structured products) are scoped by analysing SOE annual reports and / or publicly circulated information in the media.⁴¹

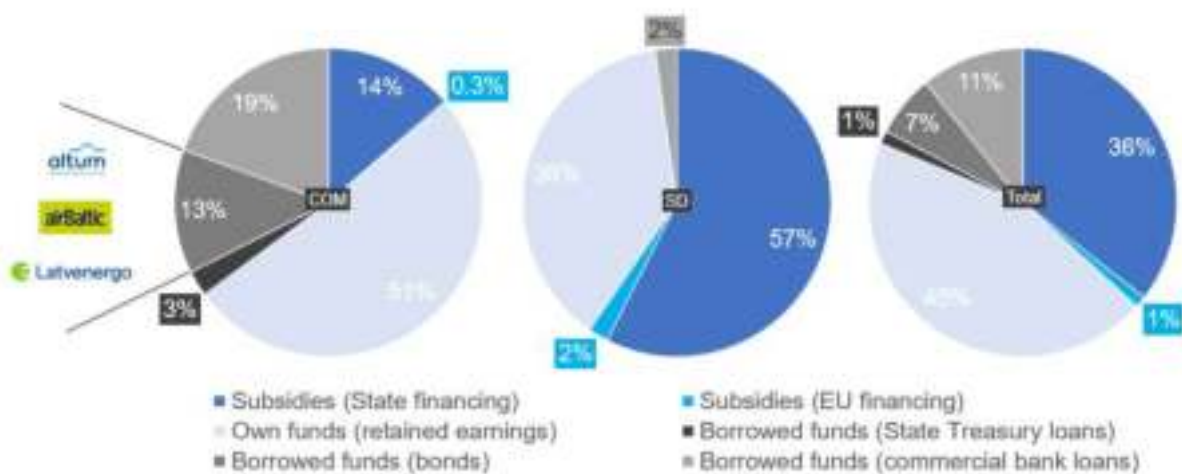


Figure 27. SOE financing instruments used in 2019, selected sample size

In aggregate, the **State subsidies and own funding are the two largest sources** how SOEs choose to sponsor investment projects – each accounting for ca. 37% of the total funding and financing sources in 2019. Conversely, bonds and State treasury are used least often, with the former being prevalent mostly among COM SOEs, and the latter among SD SOEs. Commercial bank loans constitute a notable share of the total SOE funding and financing and are used by almost each of the selected SOE.

Financing from retained earnings is most widely used among the commercial COM SOEs (51% of total), with the borrowed funds being the second largest source of financing. As AirBaltic and Latvijas Pasts operated with accumulated losses in 2019, the borrowed funds from both commercial banks and bond

³⁹ In cases where the date of receiving the loan as well as loan maturity date were explicitly stated per annual accounts of the companies, a proportionate amount of principal was applied to 2019, whereas in the case of no such information, it was assumed that the loan repayment sequence is linear, thus, to 2019 attributable amount corresponds to short-term part of outstanding principal amount.

⁴⁰ Proportionate amount based on bond maturity was applied to 2019.

⁴¹ Within the selected sample size, no other funding and financing sources were discovered.



issue, as well as subsidies consume most of the total funding and financing sources. The subsidies both from the State and EU projects are rarely used and account for relatively tiny share of the total sources of funding and financing. Adjusted for Latvijas Pasts, the part attributable to the subsidies becomes insignificant. Altum, as a financial entity, carries a rather diversified capital structure and exploits various financing sources as a means to fulfil its objectives.

All SD SOEs are largely dependent on the subsidies. In the case of RAKUS, Pasažieru vilciens and Latvijas Koncerti, State financing exceeds 90%. CSDD is the only SD SOE, which mostly relies on retained earnings as a tool to cover investment projects.

Spectrum of SOE financing instruments

The financing sources of SOEs, as illustrated in **Figure 28**, are conservative and undiversified, relying on traditional means of financing – such as commercial bank loans, retained earnings and subsidies, grants. **Such homogeneity naturally leads to sub optimal capital structures or makes the build-up of them more complex and expensive.** In fact, this phenomenon is prevalent for most of the developed world, not only the EU⁴².

⁴² OECD. Ownership and Governance of State-Owned Enterprises: A compendium of National Practices, 2018.

Box 2.3. – Optimal capital structures

Determining whether a company has an optimal capital structure is a complex task, which should encompass company's risks, structure of balance sheet, cash flows etc. There exist several approaches in assessing the state of capital structure (whether optimal or sub optimal); the following are the most popular:

Maximizing company's value – the ultimate goal of this approach is to maximize company's value via minimizing weighted average cost of capital (WACC). Namely, the capital structure that is considered optimal is the one that decreases WACC. The premise is to issue more debt to replace expensive equity. However, *as more debt also increases the WACC via heightened gearing, financial risk, beta equity and WACC – the end calculations in factoring in the corresponding effects render the approach highly subjective, complex and time-consuming.*

Peer leverage – to gauge how risky a company is, many financial market participants (FMPs) look at the debt-to-equity ratio. They also compare the amount of leverage other businesses in the same industry are using—based on the premise that these companies are operating with an optimal capital structure. Hence, if the company has a higher or lower debt debt-to-equity than the defined comparable benchmark, the capital structure can be deemed sub optimal. This approach is widely used due to the ease of applicability and straight-forward approach. [Used in developing the SOE financing methodology in further sections]

Credit rating – capital structure hypothesis – this approach claims that credit ratings are a material consideration in capital structure decisions due to the discrete costs (benefits) associated with different rating levels⁴³. The underlying principle of using credit rating as a yardstick in guiding the formation of optimal capital structures factors in the necessary balance sheet structure necessary for minimizing cost of debt and the associated inputs in determining that (e.g., probability of default, loss given default, spread duration etc.). The company would strive to reach the highest possible credit rating that is feasible considering the country and industry specifics. [Used in developing the SOE financing methodology in further sections]

To accommodate an efficient transformation of the sub optimal capital structures into optimal ones, **it is vital for the policy makers to ensure favourable conditions in which the SOEs can decide and access various financing instruments.** The most conspicuous benefits of such impetus would be the following:

- *Diversified funding / financing* that leads to more robust capital structures with better ability to handle economic shocks.
- *Lower cost of financing* that eases the interest cost burden and thus increases the overall profitability as well as accelerates growth.
- *Frees up equity capital* by decreasing overcapitalization conditions and applying benefits of external financing, ultimately mitigating opportunity cost of the State's equity.

⁴³ Darren J. Kisgen. Credit Ratings and Capital Structure, 2006.

- *Optimal capital structure* that, most importantly, warrants sustainable growth by achieving the highest risk / reward vis-à-vis the underlying capital.

However, there are some countries, which have already recognized the issue and appreciated the potential benefits for the SOEs in exploiting a wider range of financing instruments. For instance, Sweden has been stimulating its SOEs to enter the public markets via initial public offerings (IPO) as to optimize the capital structure and enhance the long-term growth prospects of certain SOEs (e.g., Telia Company and PostNord). Finland has been proactive in terms of reinforcing the SOEs capital structures by listing directly four large-cap SOEs and indirectly 13 smaller size SOEs via Solidium⁴⁴. Similarly, Baltic neighboring countries have also been proactive and considered public capital markets as an alternative means of financing for its SOEs via certain IPOs and bond issuances (see section 2.2.4.).

Figure 28 below consolidates all of the perceived benefits and drawbacks of each financing instrument described in the following chapters, as well as introduces specific considerations for which a notable importance is usually assigned before opting for a specific financing instrument. In addition, the table also reconciles the actual use of each financing instrument per each SOE segment (based on the analysis above), and in the same time illustrates whether the particular financing instrument is viable for SOE segment. This way conclusions on existent gaps are made – **viability versus actual use**.

	Equity financing options					Borrowing options				
	IPO & secondary offering	Preferred capital	State subsidies and grants	IFIs – equity part	Retained earnings	Loans from banks	Loans from Treasury	PPP	IFIs – borrowing part	Bonds
Commercial	Viable	Viable	Viable	Rarely viable	Viable	Viable	Rarely viable	Viable	Viable	Viable
SD commercial	Rarely viable	Rarely viable	Viable	Rarely viable	Viable	Viable	Viable	Viable	Viable	Viable
SD non-commercial	Not viable	Not viable	Viable	Not viable	Viable	Viable	Viable	Rarely viable	Not viable	Not viable
How often it is used among LV SOEs?	Never	Never	Often	Very rarely	Often	Often	Rarely	Never	Rarely	Rarely
Financial capacity	Favourable	Favourable	Favourable	Average	Average	Unfavourable	Average	Favourable	Average	Average
Cost of capital	Unfavourable	Unfavourable	Favourable	Average	Unfavourable	Average	Favourable	Favourable	Average	Average
Maturity	Favourable	Favourable	Favourable	Average	Favourable	Unfavourable	Favourable	Average	Favourable	Average
Administrative costs	Unfavourable	Unfavourable	Favourable	Unfavourable	Favourable	Favourable	Favourable	Unfavourable	Unfavourable	Unfavourable
Disclosure of inf.	Favourable	Unfavourable	Average	Unfavourable	Favourable	Favourable	Average	Unfavourable	Unfavourable	Unfavourable
Bureaucratic level	Unfavourable	Unfavourable	Unfavourable	Unfavourable	Favourable	Average	Average	Unfavourable	Unfavourable	Unfavourable
 Specific considerations obtaining the respective financing 										
Stimulates innovation	x			x				x		
Financial flexibility	x	x					x			x
Received know-how				x				x	x	
Size of financing	x	x		x			x	x	x	x
Enhances "brand"	x	x		x						x
Decreased financial risk	x	x	x	x	x			x		
Dilution of control	x			x				x		
Enhanced corp. gover.	x	x		x				x	x	x

Figure 28. Spectrum of SOE financing instruments

⁴⁴ Solidium is a state-owned limited company with a mission to reinforce and consolidate domestic ownership in companies of national significance and increase the economic value of its assets in the long term.



On the equity financing side, the most conspicuous gaps are observed among commercial SOEs and the IPO and preferred capital financing instruments.

On the borrowing instruments side, the gaps are not as pronounced with an exception of PPP financing instrument, which is considered fully viable for commercial and State dependent commercial SOEs, but in practice never used.

Interestingly, the observed financing instrument gaps all form a common pattern in terms of how they are scored on aspects such as administrative costs, disclosure of information and bureaucratic level (being unfavourable) versus financial capacity and many specific considerations that add more value relative to traditional and currently widely used financing instruments.

This circumstance speaks of structural unwillingness to incur near-term costs and administrative pressure in an exchange to obtain long-term benefits (e.g., enhanced corporate governance, decreased financial risk, innovation) that other non-traditional financing instruments provide.

2.2. Public vs private capital markets for SOE financing

Key takeaways

- The benefits offered by public capital markets stretch beyond just exchanging shares for private capital, and offer such elements as job growth, diversified funding, enhanced corporate governance practice and an overall reduction of systematic risk in the economy.
- On the surface, domestic (or Baltic) public capital markets present room for improvement, where the number of publicly listed companies has been on a structural decline since the global financial crisis, and the market capitalization ratio to the GDP is significantly below the EU and World average.
- However, the recent IPOs (e.g., Ignitis grupe and Tallinna Sadam) and bond issuances (e.g., Latvenergo and Altum) have shown that the primary markets are well-function and able to channel private investment if the provided offer is properly structured.
- For the two recent (and relatively successful) SOE IPOs, the following pre-requisites for a successful IPO were held in common:
 - Sufficient level of free-float – offering 33% to private investors;
 - Resilient cash flows with a momentum of growth and a visibility on the future development;
 - Seasoned management team, and corporate governance practice up to the par;
 - Macroeconomic tailwinds supporting the future development;
 - Well-positioned to promote a long-term green strategy as for instance endorsed by Ignitis Grupe;
 - Transparent and predictable dividend policy.

- Similarly, the following pre-requisites were held in common for the two recent SOE bond issuances:
 - Transparency and visibility on how the company envisions putting the capital at work;
 - Diversifying the investor base and attracting long-term reputable investors;
 - Increasing the international profile of the firm by listing the Eurobonds in international financial centers and pass-porting the trading rights to Nasdaq Baltic;
 - Sufficient issue size for attracting a diverse set of institutional investors allowing them to meet the minimum investment size hurdle;
 - Long enough maturity profile creating a higher term premium, which enhances the offered yield-to-maturity and thus facilitates higher demand by investors.
- Private capital markets complement well some of the features of sourcing capital from public markets – and depending on the ultimate use of proceeds. Yet, in Baltics, the private capital markets are used rarely for financing SOEs, mostly because of a narrower investor base, and the lack of perceived benefits in relation to the public capital markets (e.g., less stimulus on the improvements of corporate governance practice).

A capital market is a market that connects the surplus capital from net savers (e.g., retail and institutional investors) to net spenders such as corporate entities and governments. The difference between public and private capital markets lies in the subsequent tradability of the underlying instrument, and the necessary disclosure of information that is required to access financing.

In the public capital markets, entities issue various financing instruments to the general population, who can then trade the corresponding instrument via secondary markets. The level of information disclosure and the regulatory environment is profound and facilitates accountability of the issuers. Conversely, the financing via private capital markets happens via channels targeting only qualified investors, where there are no coherent pre-requisites for obtaining the expected financing and where the regulatory environment is more relaxed.

The outlined differences between these market forms entail a wide set of specific advantages and disadvantages, which are explained in the following sections below.

2.2.1. Public capital markets

EU is predominately a loan-based economy with a notable bank bias both as both in terms of choice of financing and the means of savings. This circumstance is clearly confirmed with the abnormally high bank assets to GDP ratio⁴⁵, which in EU exceeds more than twofold that of the U.S. and Japan. Similarly, the stock market capitalization levels to GDP in EU are also significantly below the world's average indicating a lower reliance on market-based financing.

⁴⁵ European Central Bank. Bank Bias in Europe: effects on systemic risk and growth.



The dominance of banks is commonly recognized as a problem, which should be resolved in order to harvest many benefits from having integrated and well-functioning public capital markets. The following are considered the key benefits:

- By tapping public capital markets, an entity is able to **reduce liquidity premium**⁴⁶ that is prevalent among non-tradable securities and financing instruments. Privately held businesses and securities are typically illiquid investments with an elevated risk of having difficulties to be subsequently traded. This forces the general public and investors to assign greater risk premium in the form of higher discount rate that ultimately puts a downward pressure on the securities' or companies' valuations.
- Limited funding choices per definition increase exposure to idiosyncratic risks in banking. Namely, in the event of a considerable macroeconomic shock, an economy, which is comprised of companies with constrained access to flexible financing is exposed to larger risks than an economy with a **diversified funding ecosystem**. For instance, when companies' prospects are impaired and there are a series of headwinds impacting the short-term performance of underlying business operations, banks (and especially the weaker ones) tend to tighten their lending policy standards and be unwilling to introduce "covenant-light" loans for companies to bridge temporary cash flow gaps.
- In Europe it is observed that an IPO stimulates a **job growth** on average 6% three years following the IPO date. For instance, because of listings on Nasdaq First North Growth Market between 2006-2012 the number of employees increased by an annual average of 36.5 % following their IPO, compared with 1.5 % for private companies on the Swedish market⁴⁷.

Box 2.4. - The mitigation of systemic risk

The outbreak of COVID-19 has inflicted a considerable damage on the global economy forcing many businesses to revisit their investment plans and to take a number of painful measures to reduce the cash drain.

While there are many caveats behind the aforementioned divergence of economic resistance towards major shocks such as COVID-19, a lack of well-developed capital markets is a critical one. In the case of limited liquidity and an increasing need for capital at the same time, it is vital to have a diversified base of available funding mechanisms. The businesses, which are able to borrow and access equity financing from multiple sources benefit from the increased options (more demand) and thus are able to stay more nimble and choose the most suitable financing alternative. Conversely, if a business is heavily dependent on a single capital provider (e.g., a bank), the company is exposed to more idiosyncratic risks and foregoes the option to decide among potentially more attractive financing alternatives.

⁴⁶ Farlex Financial Dictionary: The rate of return that an investor expects above other rates or return in order to make an illiquid investment. All other things being equal, an investor generally expects a higher return for investing in something that may be difficult to convert to cash. For example, an inactive bond may pay a higher coupon rate than an active bond with a similar credit rating.

⁴⁷ Nasdaq, 'Ett förbättrat börsnoteringsklimat för Sveriges tillväxt – Problemanalys och förslag till åtgärder', 2013

The World Bank in its recent publication⁴⁸ “COVID-19 outbreak: Capital Markets Implications and Responses”, described it this way:

“Countries with high public- and private-debt levels, high foreign-investor participation, as well as less-developed domestic capital markets are most vulnerable. The private sector is highly exposed to the current crisis, especially small- and medium-sized firms, BBB-rated corporates and firms with heavy reliance on foreign exchange debt”.

- Going public or issuing bonds **facilitates good corporate governance principles** among the issuers. Before accessing public capital markets, companies have to comply with numerous rules and regulations to meet the required principles of corporate governance set forth by both the legal national acts and the regulated market organizations or exchanges⁴⁹. Adopting good corporate governance principles bears a positive influence on company performance and, more specifically, improves top-level decision-making processes, introduces a better control environment and reduces company’s cost of capital⁵⁰.
- In the event of no well-functioning public capital markets and a considerable entanglement with the banking industry (i.e. lending), certain types of companies, notably start-ups with limited tangible assets, are especially disadvantaged. Companies in asset heavy industries usually pledge their assets to obtain bank loans. Nevertheless, companies with limited tangible assets such as **start-ups and technology often have no meaningful collateral; so they tend to thrive in well-developed public capital markets**, where they can access a larger investor base (e.g., venture capitals, private equity, and generally more risk-seeking investors). In addition, the IMF staff estimates⁵¹ find that real value-added growth of companies with fewer tangible assets increases with public capital market development.

In the same time, it is also important to appreciate the obstacles faced by the companies when tapping public capital markets. The European IPO Task Force in “European IPO Report 2020”⁵² has outlined the following obstacles that impede European capital markets of becoming more popular as a financing alternative:

- **Cost of going and being public** is considered the key hindrance for companies when contemplating public capital markets. Federation of European Securities Exchanges (FESE) has estimated the costs to be approximately: 10 to 15% of the amount raised from an initial offering of less than EUR 6 million; 6 to 10% from less than EUR 50 million; 5 to 8% from between EUR 50 million and EUR 100 million; 3 to 7,5% from more than EUR 100 million.
- **Adverse regulatory impact disincentivising SMEs from listing.** There have been several regulatory changes since the great financial crisis in 2008 that are favouring larger blue-chip companies rather than providing incentives for SMEs to list. For instance, there has been a shift in the economics of trading larger company shares making the IPO less attractive for SMEs.

⁴⁸ World Bank. COVID-19 Outbreak: Capital Markets Implications and Response.

⁴⁹ Nasdaq OMX Riga. Principles of corporate governance and recommendations on their implementation.

⁵⁰ OECD. The tangible benefits of good governance.

⁵¹ IMF: “A capital Market Union for Europe”, September 2019

⁵² European IPO Report 2020.

Similarly, MiFID I and II, and MAR have also favoured larger blue-chips, and eroded the domestic ecosystem of smaller brokers and analysts covering the SMEs.



Figure 29. “What may cause public equity markets to decline in popularity?”⁵³

The policy makers have taken broad measures, to tackle the issue of relatively shallow public capital market in Europe, acknowledging the importance of robust public capital markets.

The capital markets union (CMU)⁵⁴ is a plan to create a single market for capital with the aim of getting investments and savings following across the EU to benefit consumers, investors and companies irrespective of the location. CMU will tackle a myriad of aspects all of which will help boost the capital markets. These include (but are not limited to) a lower cost of funding for SMEs in particular finance they need, support the economic recovery post-COVID-19 and create jobs, create more inclusive and resilient economy. For the SOEs specifically, this could enhance the prospects of facing favourable demand while taping domestic capital markets, relax the underlying complexity of, for example, going public, and decrease the amount of administrative costs to access public capital markets.

The European Green Deal (EGD)⁵⁵ is a plan to make the EU’s economy sustainable, where there is no net emission of greenhouse gases by 2050, economic growth is decoupled from resource use, and no person and no place is left behind. The EGD provides an action plan to boost the efficient use of resources by moving to a clean, circular economy, and restore biodiversity and cut pollution. A keyway to deliver on these goals entails a notable investing in environmentally friendly technologies. In December 11, 2019, the EGD underlined⁵⁶ the need for long-term signals to direct financial and capital flows to green investments⁵⁷; and that an EU Green Bond Standard (GBS) will be established. The GBS and favourable environment for green bond financing allows SOEs to access the necessary financing for environment friendly projects or assets at relatively lower costs to other orthodox debt financing instruments due to a strong secular demand. Lastly, the secular shifts towards **environment, social and governance (ESG)** investing adds an additional layer of support for companies to face a reasonable level of demand in

⁵³ PwC, 2019, The Economist Intelligence Unit, ‘Capital markets in 2030: The future of equity capital markets’

⁵⁴ European Commission. What is the capital markets union?

⁵⁵ European Commission. A European Green Deal.

⁵⁶ European Commission. EU Green Bond Standard.

⁵⁷ Climatebonds.net: The majority of the *green bonds* issued are *green* “use of proceeds” or asset-linked *bonds*. Proceeds from these *bonds* are earmarked for *green* projects but are backed by the issuer's entire balance sheet.

attracting capital via public markets. For instance, the world’s largest passive index provider Blackrock has communicated sustainability as its new standard for investing⁵⁸ - confirming the thesis of favourable tailwinds within ESG investing and capital sourcing.

2.2.2. Domestic public capital markets

As with all three Baltic public markets, the only asset classes traded on the Nasdaq Baltic exchange are fixed income (i.e. bonds), equities and open-end funds⁵⁹. There have been no exchange-traded derivatives such as option and futures listed on any of the Baltic exchanges.



Figure 30. Structure of Nasdaq Baltic market decomposed by the traded asset classes

The fixed income part of the Nasdaq Baltic exchange consists of government bonds and corporate bonds. The corporate bond category is further distinguished into a First North corporate bond market, which provides more relaxed and flexible criteria for issuing corporate debt (elaborated below).

The equity part of the Nasdaq Baltic exchange can be split into three lists:

1. The Baltic Main list, which includes Baltic companies that meet the following requirements: at least three years of operations, market capitalization⁶⁰ of at least EUR 4 million, stable financial position, IFRS accounting reporting and satisfactory level of free float⁶¹ (at least 25% of companies’ shares).
2. Baltic Secondary list, which includes companies that do not meet the requirements of the main list. There are no specific quantitative admission requirements in relation to market capitalization, free float or IFRS.
3. First North Baltic, which is an alternative market that provides simpler means for companies to list without having to comply with IFRS and other quantitative admission requirements. For example, there is no requirement to prepare listing prospectus as opposed to the Baltic Main list and the Baltic

⁵⁸ BlackRock. Sustainability as Blackrock’s New Standard for Investing.

⁵⁹ Open-end fund (or open-ended fund) is a collective investment scheme that can issue and redeem shares at any time.

⁶⁰ Market capitalization (also known as market value) is the share price times the number of shares outstanding.

⁶¹ Free float, also known as public float, refers to the shares of a company that can be publicly traded and are not restricted (i.e. held by insiders). In other words, the term is used to describe the number of shares that is available to the public for trading in the secondary market.



Secondary list. Company description prepared with a certified adviser is sufficient for new offerings in the First North Baltic market.

In terms of the information reliability and FMP safety, the key differences among the three lists are implicit. The parameters listed above, requirements related to disclosure language, frequency of financial reports, role of certified adviser, and submission of corporate governance reports, are the only list-specific points that directly distinguish the lists. The implicit list-specific distinctions are mainly related to the consequences stemming from the highlighted (i.e. explicit) differences.

An assessment of Baltic capital markets (both equity and bond side) looking specifically of market's structure, size and liquidity, can be found in **Annex 11**.

2.2.3. Cross listing

Cross listing or dual listing is a process in which company's equity shares are listed on one or more foreign stock exchanges, while simultaneously having an active listing in the domestic stock exchange. These equity shares become close to completely fungible with one another, meaning that there are same voting rights assigned to each share and no foreign currency risk.

Oftentimes cross listing is mistakenly used interchangeably with depository receipts, which are issued by third party banks and not the company itself. The depository receipts are a proxy of foreign company's equity shares where the company has an active listing (i.e. issue) on the domestic stock exchange only.

Baltic context

Baltic companies that have active listings in either the domestic equity or fixed income market have, historically, limited their issues only to the domestic capital markets. From all of the 34 companies in the Baltic Main List and 28 companies in the Baltic Secondary list, only two companies⁶² has chosen to cross list its equity shares in foreign market. Similarly, out of five funds listed on the Baltic Fund list, only one⁶³ has sought for potential benefits by cross listing a part of the outstanding equity shares. Nevertheless, the recent IPO by Lithuanian SOE Ignitis grupe and the initial plans of Citadele bank IPO to list in London Stock Exchange (LSE) have confirmed that cross listing is a viable tool to attract foreign demand, especially for larger issues.

In terms of the depository rights derived from the Baltic publicly traded companies, there is also only one such issue trading on the Nasdaq Helsinki stock exchange. Importantly, the underlying of the associated Finish Depository Receipt is the largest and most liquid Baltic equity market's company – Tallink AS.

Another form of foreign capital sourcing is a direct (i.e. primary) listing on the foreign capital markets. For example, in 2019 AirBaltic placed a successful a EUR 200 million bond issue listed on Euronext Dublin stock exchange. This issue became the first airline in Central and Eastern Europe to access the international debt capital markets with a Eurobond offering.

⁶² Silvano Fashion Group by making additional offering in the Warsaw stock exchange in 2007.

⁶³ Baltic Horizon Fund by making additional offering in the Nasdaq Stockholm stock exchange in 2016.



The benefits of cross listing

The most immediate benefit of cross listing is a **larger exposure to the potential investor base, which can lead to better terms, increased valuations or lower cost of financing.**

The cross listing can serve as a solution when the size of the company's planned issue exceeds the capacity of its domestic market. While size is often the most prevalent obstacle for having an additional issue on the domestic capital market, the aversion of domestic institutional investors to invest in certain sectors, maturities or security types can be also an additional barrier.

These benefits come from the shares trading at numerous time zones and exchanges that **provide more ability to raise additional capital and potential increased liquidity** – though this can be less favourable for the domestic capital market as liquidity pools tend to follow the larger well-established financial centers.

There are also other, not directly capital market related, advantages that stimulate long-term shareholder value creations from having part of the outstanding issues listed on foreign capital markets. For instance, the company gains exposure to larger marketability opportunities, becomes more recognized globally, achieved broader shareholder base and well-functioning corporate governance.

The key obstacles in cross listing

Most importantly, maintaining an additional listing comes with the corresponding service costs such as listing fees for the stock exchanges, legal costs and heterogeneous reporting requirements. **Significant costs are usually linked to the necessary administrative burden to comply and oversee the extra process from multiple listings.**

Consequently, for a **company to cross list or initiate new issues in the foreign capital markets, a certain size level has to be met to pass the relevant threshold point where the benefits outweigh the corresponding costs.**

The aforementioned of Baltic company examples unanimously confirm this aspect. For example, the Airbaltic bond issue of EUR 200 million has been one of the largest bond issues in the Baltic history. Similarly, Baltic Horizon Fund, cross listed on Nasdaq Stockholm stock exchange, is the largest publicly traded Baltic real estate company.

2.2.4. SOEs and public capital markets

In Baltics there are currently four SOEs, which have in the recent past relied on the domestic public capital markets for financing investment plans. The table below summarizes each event to gain a better understanding of the underlying rationale behind going public or issuing bonds.

Tallinna Sadam
Equity


In June 2018, Tallinna Sadam realized an IPO, which was oversubscribed by more than threefold and which allowed to access EUR 147.7 million of new funds in exchange for 32.97% shares⁶⁴. The Ministry of Economic Affairs and Communications retained 67.03% of the shares.

The key intentions⁶⁵ behind the IPO were the following:

- increase flexibility, transparency and efficiency of the Company and to establish the Company's market value;
- facilitate the implementation of the Company's strategic objectives;
- provide domestic investment opportunities for Estonian private investors and pension funds;
- and increase liquidity and attractiveness of the Tallinn Stock Exchange by attracting international investors.

The Company used the net proceeds received from the offering to fund part of the declared EUR 105 million extraordinary net dividend to the Government Shareholder together with a corresponding corporate income tax amounting to approximately EUR 26 million. In addition, the Group plans to use part of the proceeds for general corporate purposes, including ongoing investments into the passenger harbours' facilities, and to reduce the Company's leverage.

CEO Valdo Kalm:

"Port of Tallinn's vision is to become the most innovative and modern port in the Baltic Sea Region with an emphasis on digitalization, strong customer base and dedicated employees, with a business model structured around well-balanced core operational areas. Port of Tallinn has a track record of stable financial results and regular dividend distributions. In pursuing a listing on the Tallinn Stock Exchange, we are positioning ourselves as a high-quality dividend asset. Listing the Company on the Tallinn Stock Exchange will add a stamp of quality to our achievements and push us to seek further developments."

Chairman of the Supervisory board, Aare Tark:

"Port of Tallinn has an important role of being a lighthouse in port services in Estonia, as well as operating as a gateway to Europe and beyond for both passengers and cargo. The Company has a professional management team and a great potential for future development."

Minister for Economics and Infrastructure, Kadri Simson:

"The Government's intention to list the shares of Port of Tallinn on Nasdaq Tallinn Stock Exchange primarily provides new investment opportunities in Estonia. This step is hoped to improve liquidity and attractiveness of the local capital market. The planned listing will also increase the efficiency and transparency of the Company even further and will provide an example for possible listings of other Estonian state-owned companies in the future."

⁶⁴ ERR News. €1.70 share price approved in Port of Tallinn IPO.

⁶⁵ Port of Tallinn. Offering, listing and admission to trading.

The Company considered the following key strengths and strategies that should provide competitive advantages and support its operations (and thus warrant attractive demand for the IPO):

- attractive macroeconomic conditions and industry dynamics driving continued regional demand for port infrastructure to service both cargo and passenger flows;
- multimodal marine infrastructure with a strong competitive position supported by Nordic links;
- track record of operational excellence and innovation; Operating as a landlord port with diversified and stable revenue streams;
- substantial cash flow generation;
- broad range of attractive strategic initiatives to maximize existing portfolio value
- and highly experienced management and a supportive governance framework.

Ignitis grupe

Equity



In October 2020, Ignitis grupe successfully dual-listed in London and on Nasdaq Baltic by offering 26.92% of the total shares and raising EUR 450 million of gross proceeds. This was clearly the largest IPO in the Baltic public capital markets, ranking Ignitis as also the largest publicly traded company in Baltics (i.e. over EUR 1.6 billion in market capitalization).

The key intentions⁶⁶ behind the IPO were the following:

- create a sustainable future by continuing to grow renewables;
- ensure resilience and flexibility of the energy system, enable energy transition and evolution and capture growth opportunities;
- deepen and improve the local capital markets.

Darius Maikštėnas, CEO and Chairman of the Executive management:

“Ignitis grupė has experienced real transformation in recent years and we are very proud to have grown to be a leading regional utility player with the majority of power generation coming from renewable sources. The Company benefits from a large, regulated asset base with high levels of visibility over future earnings. Our ambition is to continue on our growth trajectory, and we are targeting an increase in installed green generation capacity to between 1.6 and 1.8 GW by 2023 and 4 GW by 2030. Our clear growth strategy, together with our extensive distribution networks and our increasing range of customer-focused solutions and innovations – from unique remote solar platforms to smart meters and EV charging stations – positions the Group well to meet the region’s growing demand for clean energy.”

Darius Daubaras, Chairman of the Supervisory board:

⁶⁶ Ignitis grupe. Regarding the adopted order of the Ministry of Finance to increase share capital of AB “Ignitis grupė” and apply for listing of financial instruments.



“The Group has achieved a great deal in a relatively short amount of time, and I am proud to see it become Lithuania’s national green energy champion, whilst meeting the highest international standards – from environmental protection to best practices in corporate governance. The Group mirrors the rapid modernisation, development and ambition of Lithuania, which since 2012 has been one of the fastest growing economies in the EU. The Group has a clear growth strategy built around our four business segments, and I am excited about the growth opportunities that lie ahead.”

Vilius Šapoka, Minister of Finance of the Republic of Lithuania:

“This is an exciting chapter in the development of Lithuania’s economy. An IPO of Ignitis grupė would provide the investment needed to ensure both Lithuania’s and the wider Baltic region’s energy security and to help achieve the decarbonisation targets of these countries over the coming decades. Furthermore, it would deepen and improve the liquidity of our capital markets, attracting fresh capital into our dynamic economy.”

The Company considered the following key strengths and strategies that should provide competitive advantages and support its operations (and thus warrant attractive demand for the IPO):

- one of the largest utilities and renewable energy groups in Lithuania and the Baltic region with a critical role for the region's energy security and decarbonisation;
- resilient business with highly visible cash flows from regulated or long-term contracted activities;
- attractive growth driven by green energy and distribution network investments;
- strong and disciplined financial profile supporting shareholder returns and resulting in a low cost of capital;
- experienced management team with track record of building a sustainable energy platform.

Latvenergo	Debt	
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Latvenergo is actively utilising the domestic bond market to finance various investments.

The first bond issuance by the company was in June 2013, when Latvenergo issued a 7-year bond at the size of EUR 35 million with a coupon rate of 2.8%. Two years later, Latvenergo in July 2015 issued a 7-year green bond, which was also the very first public green bond in Latvia. The size of the issue was EUR 100 million with a coupon rate of 1.9%.⁶⁷ In fact, Latvenergo’s green bond was first state-owned and investment grade green bond in Eastern Europe.

The key intentions behind the issuance of green bonds were the following:

- achievement of climate targets set by Latvia and EU;
- develop a zero-emission and low-emission generation portfolio and contribute to climate change mitigation;

⁶⁷ Nasdaq Baltic. Latvenergo 1.9% 7Y green bond.



- 50% of proceeds from bonds to be allocated for reconstruction of hydropower plants on the river Daugava, which in addition to an increase in their capacity and efficiency will reduce the Group's impact on climate change;
- up to 50% of proceeds to be allocated for improvement of the distribution network to promote high-quality and reliable electricity supply, to reduce the frequency and duration of interruptions in electricity supply and to ensure efficient management of electricity networks;
- up to 1% is planned to be invested in biological diversity preservation projects, including replenishing of fish stocks, protection of white stork, cleaning of salmon spawning rivers and similar environmental projects.⁶⁸

Guntars Baļčūns, Executive management of Latvenergo AS:

“Sustainability and environmental responsibility are at the core of the Group and that has been proven by green bonds issued in 2015 and 2016, which were also rated as Dark green. We have not halted our green growth, moreover – the strategic objective of Latvenergo is development of use of renewable resources, for example, by continuing the ambitious reconstruction of hydropower plants or developing wind and solar power generation. Latvenergo green bond offer has been prepared for those, who just like us care for the environment and its preservation for future generations. The offer is aimed more than anything else at safe and sustainable future[..]”

Lastly, on 28 April 2020, the FCMC has registered the Base Prospectus of the Third Programme for the Issuance of Notes of Latvenergo up to the total nominal amount of EUR 200 million.

Altum	Debt
<p>Altum was the second Latvian SOE, which decided to tap domestic fixed income market for financing company’s investments. In October 2017, Altum issued a green bond in the size of EUR 20 million, at a coupon rate of 1.3%.</p> <p>The key intentions behind the issuance of green bonds were the following:</p> <ul style="list-style-type: none"> • environment-friendly projects and help attain specific environmental objectives, • fund sustainable business projects in the fields of energy efficiency, energy generation from renewable energy resources, green buildings and transport, including energy service companies (ESCO) that provide services to the companies in these fields. <p>In March 2018, Altum emitted EUR 45 million regular 7-year bond at a coupon rate of 1.3%.</p> <p>The key intentions behind the issuance of this bond were the following:</p> <ul style="list-style-type: none"> • maintain long-term participation in the capital markets; • diversify the funding base; • fund sustainable agriculture business projects that are vital for national economy. 	

⁶⁸ Latvenergo. Latvenergo consolidated unaudited condensed interim financial statements.



Reinis Bērziņš, Chairman of ALTUM Executive management about green bonds:

"huge potential for implementation of sustainable green-minded projects," and that the bond would also "diversify Altum's funding base and encourage Baltic debt capital market development."

Reinis Bērziņš, Chairman of ALTUM Executive management regarding regular bonds:

"We are pleased with investors' major interest in the Notes issue, which attests to the correctness of the fundraising strategy chosen by ALTUM and at the same time allows us to issue Notes on good financial terms. We will use proceeds from this Notes issue to expand operations of the ALTUM-run Land Fund to further strengthen the fund's rapid growth in recent years. In less than four years, the Land Fund portfolio has reached its first 10,000 hectares, with the volume of transactions increasing every year. With the new bonds issue programme of EUR 70 million the total funding attracted by ALTUM on capital markets will reach EUR 100 million. In general, the fund raising in capital markets ensures diversified funding sources, helps to be sustainable and self-sufficient in attraction of the funding at the same time promoting the development of the Baltic capital market."

Ignitis grupe

Debt



Ignitis grupe similarly to Latvenergo and Altum practices the approach of financing its investments by dual-listing bonds on domestic markets and on Luxembourg Stock Exchange (important to note that the issuance of green bonds in 2017 and 2018 was made under the name of "Lietuvos Energija, UAB", which only became "Ignitis grupe" on September 2019). Ignitis grupe has had two green 10-year bonds issued as well as senior unsecured 10-year bond.

First 10-year green bonds were listed on July 2017 at a size of EUR 100 million at a coupon rate of 2%.⁶⁹ Second 10-year green bonds were listed on July 2018 at the size of EUR 300 million with coupon rate of 1.875%.⁷⁰

The key intentions behind the issuance of green bonds were the following:

- investments into the wind energy;
- efficiency enhancement of the electricity distribution grid;
- projects on energy production from waste and biomass.⁷¹

Most recent 10-year senior unsecured bond was listed on May 2020, at a size of EUR 300 million with coupon rate of 2%.⁷²

The key intention behind the issuance of bonds was the following:

- refinance banks overdrafts and by new loans obtaining which were used to finance investments to Pomerania, Vilnius CHP, and Kaunas CHP.

⁶⁹ Nasdaq Baltic. Ignitis grupe 2% 10Y green bond.

⁷⁰ Nasdaq Baltic. Ignitis grupe 1.875% 10Y green.

⁷¹ https://nasdaqbaltic.com/market/upload/reports/legr/2018_ar_en_eur_con_00.pdf

⁷² Nasdaq Baltic. Ignitis grupe 2% 10Y bond.

Darius Maikštėnas, ex-Chairman of the Executive management and the CEO of Lietuvos Energija and the current Chairman of the Executive management and CEO of Ignitis Group.

“We strongly believe that one of the best tools to fund these investments are green bonds and that we will continue to be a part of green financing ecosystem. We appreciate our investors support in our journey to become GREEN SMART GLOBAL energy company of the future.”

“We are once again entering the green bond market, as we are seeking to take advantage of the overall favourable conditions to diversify our debt portfolio and boost the visibility among investors. The strategic development trends that we have recently announced, one of the major of which is the green energy development undoubtedly enhances our attractiveness with respect of domestic and foreign investors [...]”

“The interest shown by Lithuanian and foreign investors for this issue of bonds shows confidence and support for business priorities of Ignitis Group. Financial market welcomes focus on sustainable development and decarbonisation of energy sector, which is laid down in the Group's strategy. This is another important assessment that we are on the right track [...]”

Considering the aforementioned examples, there were several common patterns or pre-requisites among the SOEs before tapping the domestic public capital markets. While these are certainly not exhaustive and should not be used as fixed anchor yardsticks, they offer “real-life” tested aspects for a successful financing.

For the two recent IPOs, the following aspects were held in common:

- The **level of free float and ticket size** are sufficient enough to attract large institutional investors and improve the liquidity in the secondary market. The offered percentage of shares has been ca. 33% translating to EUR 147.7 million for Tallinna Sadam, and ca. 27% translating to EUR 450 million for Ignitis grupe.
- The **capital structure and balance sheet** are strong and are supported with strong cash flows, which have grown in the recent past allowing the investors to gain a reasonable level of comfort about the resiliency of underlying business.
- The **management** is highly experienced and **corporate governance** is sound and conforms with the best practices (e.g., ESG).
- **Macroeconomic tailwinds** supporting the future top-line development.
- Both Ignitis grupe⁷³ and Tallinna Sadam⁷⁴ had established transparent **dividend policies** before going public. Ignitis grupe has stated that it will aim to increase the annual dividend by 3% per year, and Tallinna Sadam has put forward a plan to distribute at least 70% of the annual net income in dividends.

Similarly, there were several shared aspects among the bond issues:

⁷³ Ignitis grupe. The new dividend policy of Ignitis Group provides for a growing return to shareholders.

⁷⁴ Port of Tallinn. Offering, listing and admission to trading.



- **Transparency and visibility** on how the company envisions putting the received capital to work.
- A sufficient **bond issue size** that facilitates a diversified investor base, and outweighs the administrative costs incurred by institutional investors in assessing the investment decision.
- A **long enough maturity** profile of the bond to allow potential investors to capture higher term premium and longer period of relatively predictable income.

In sum, it is critically important to have a decent historical financial performance, a well-structured balance sheet and a seasoned Executive management team to warrant a successful entry into the public capital markets. In addition, the size of a bond issue or stock offering should be large enough to attract large institutional investors and enhance the liquidity in the secondary markets. **By fulfilling these aspects, the SOEs will increase the likelihood of experiencing a favourable level of demand and achieving greater valuations or more funds in exchange per one stock/share unit.**

2.2.5. Private capital markets

Private capital markets are markets in which financing takes place without the involvement of public exchanges, thus offering several advantages compared to public capital markets, but also adding a layer of additional risks.

The primary transactions that take place off the public exchanges are related to bond issuances and stock offerings. Similar to the public market space, the types of financing in private markets can take a myriad of different and exotic forms (e.g., asset backed securities, mortgage backed securities, debt with optionality etc.). March 2021, Maxima Grupe launched a EUR 40 million CP issue⁷⁵ that was subscribed by the qualified investors off the exchange, yet the historical popularity of transactions in the private markets has been limited.

Private placements - debt

Private placements in the corporate debt or bond space have become increasingly popular in Europe⁷⁶, especially since 2012 when the French Euro-PP market was formed to provide access to the bond market for unrated mid-cap borrowers with limited financing needs. Over the years, there have been more and more transactions of smaller size, and the volumes have varied from EUR 5 – 250 million, with average maturities of between 5 and 7 years⁷⁷. In the recently published report⁷⁸ by the EC, the relevant policy makers committed to identifying and promoting best practices for private placements. It was highlighted that private placements of debt can broaden the availability of finance for unlisted medium-sized companies if the right mechanism is in place incentivizing and allowing institutional investors to open such exposures. For the companies accessing debt via private placements provide the following benefits:

⁷⁵ Maxima Grupe, UAB. Maxima Grupe successfully placed EUR 40 million issue of Commercial Papers (Short-Term Notes).

⁷⁶ NextFinance. Euronext expands listed private placement bonds offer.

⁷⁷ European Commission. Identifying market and regulatory obstacles to the development of private placement of debt in the EU.

⁷⁸ European Commission. Capital Markets Union: progress on building a Single Market for capital for a strong Economic and Monetary Union.



It offers the companies **flexibility** to choose the most appropriate funding source in terms of maturity, size, covenants etc.

This type of financing has also been observed to be **resilient** in times of economic crisis, where it has remained a viable source of financing during the increased volatility and distress across the markets.

There is a **less time-consumption and administrative expenses** compared to listing bonds on the public exchanges. The necessary documentation for private placements is oftentimes simpler and more flexible relative to direct bank lending, (and certainly) corporate public bonds.

There are also noticeable disadvantages of using private placements to raise debt, such as the following:

A lower number of investors, who are both willing and able to subscribe for the planned debt issuance that, ultimately, might lead to either higher cost of debt or even not fully covered issue.

An additional risk premium, which has to be factored in when contemplating on the expected cost of debt. The bonds issued off the exchange require less transparency and disclosure of information rendering the relevant issue riskier and thus requiring higher expected returns. In addition, private placement bonds do not trade on secondary markets, which also brings a liquidity premium into the overall valuation levels.

Private placements – stock offerings

Private placements in the form of stock offerings, just as private debt issues, have also increased in popularity in the recent years. This rise of private placement stock offerings coincides and to some extent explains the structural decline of the IPO activity around the world. For instance, during the initial outbreak of COVID-19, the IPO market halted for few months⁷⁹, while the private placement stock offerings (inherently less pro-cyclical) continued to take place. The period post Q1, 2020, was characterised with surging number of IPOs closing the year at 3-year record high.

There are two major type of private placement stock offerings that can be characterized by the origin of the shares placed. Namely, the company can place new shares created as part of a capital increase or the existing shareholders can sell the current shares to investors without diluting the ownership structure. In practice, these two types are combined when conducting a private placement offering. The key advantages of private placement stock offerings are similar to those of the private placement bond issues:

A transitional step towards an IPO through a build-up of necessary experience, expertise, and overall visibility for wider investor base.

Private placement stock offerings allow to **better bear market volatility** and provide less sensitive pricing to short-term market fluctuations.

It is **easier to set up a private offering from the administrative and bureaucratic standpoint**. This is mostly due to less stringent transparency and information disclosure requirements.

The corresponding disadvantages of offering stocks via private markets are the following:

There might be a decent amount of demand within the private market's segment, however, it is highly subject to the domestic investor landscape. The less developed the overall capital markets are, the **lower**

⁷⁹ BNP Paribas Wealth Management. The year of IPOs, 2020.



demand one could expect by organizing private offerings compared to regular public issues. Pension and insurance funds are less incentivized to step into non-public market space.

Compressed levels of valuations might occur because of the inherently lower demand that in turn implies less competition for the offered shares, and thus resulting in unfavourable pricing compared to regular public issues.

3. National practices towards overall governance of SOEs and financing decisions

3.1. Best practices in SOE governance

Key takeaways

- The best practice indicates that to ensure professional and effective SOE management, State should act as an active owner. The objective of the active ownership is to establish and communicate clear SOEs ownership expectations and outcomes that are monitored in transparent and accountable manner through qualitative, timely and reliable reporting of SOE performance.
- OECD country experience shows that a comprehensive State ownership policy document is necessary to provide visibility, stability and general understanding of the State expectations.
- The State ownership policy document might be replaced or supplemented by owner's letters of expectations indicating overall SOE ownership expectations and State's expectations towards individual SOEs defining SOE financial and non-financial objectives.
- Understanding SOE significance in establishing good governance trends, more countries are becoming more deliberate in determining their expectations and are imposing an obligation to follow ESG and CSR regulations and guidelines. Often the State's expectations towards sustainability, gender balance, fair compensations are communicated in State ownership policy document.
- Many countries with well-defined capital structure guidelines according to OECD have established some form of segmentation as a tool to define specific objectives, financial objectives or ownership policies accounting for different SOE characteristics.

Analysing OECD and World Bank recommendations for the good SOE governance, as well as OECD country (Norway, Sweden, Finland, the Netherlands, Estonia and Lithuania) practices, governments have established ownership policies providing SOEs, the market, and the general public with predictability and a clear understanding of the state's overall objectives and priorities as an owner. However, having different rationales for SOE ownership and various size SOE portfolios, governments have various approaches expressing their SOE ownership rationale; some jurisdictions may have an explicit ownership rationale, while the objectives for SOE ownership may be implied in others. Many of the countries with explicit ownership rationales tend to have a larger SOE portfolio (with on average more than 100 SOEs).

The **ownership policy should ideally take the form of a concise, high-level policy document that outlines the overall rationales for SOE ownership.**⁸⁰ However in practice, governments tend to complement overall ownership rationale and policy with public policy objectives establishing non-financial objectives for individual SOEs. These **complementary objectives can be expressed, for example, via supplementary legislation, regulations or policies or Owner’s letter of expectations.**

3.1.1. Active ownership

Following OECD Good governance principles, the State should be responsible for overall strategic guidance and the creation of formal environment that facilitates sustainable and comparable performance of SOEs. In the same time, the State should not be involved in a day-to-day management by forcing decisions related to selection of specific supplier, adviser, administrative structure etc.

Box 3.1. – State as an active owner

OECD and World bank suggests that the State should act as an informed and active owner, ensuring that the governance of SOEs is carried out in a transparent and accountable manner, with a high degree of professionalism and effectiveness.⁸¹

To achieve the objectives of an active ownership, State should define its policy for SOE governance and establish a clear purpose and mission for each of the SOE linked to desired objectives and outcomes of SOE ownership. Once formulated, the SOE ownership policy and objectives should be cascaded through dialogue between the SOE shareholder and Executive and Supervisory boards to provide clear direction and accountability for SOE. As public organisations, SOEs need to be transparent and accountable through quality, timely and reliable reporting of SOE performance and activities.

Based on the SOE governance models in OECD countries exist a variety of ways in which the State discharges its active owner role on the SOEs’ Supervisory and Executive boards. Ranging from full participation on the Supervisory board to the Supervisory boards comprising entirely of professionals, with most SOE boards having a mix of both. However, regardless of type of Supervisory board composition, achieving active SOE ownership and management requires that those undertaking shareholder, Supervisory and Executive board roles act with:⁸²

- Capacity – Having the time and resources to conduct their roles well.
- Capability – Having the required and relevant expertise and experience to steer, manage and govern the SOE in order to add value to the enterprise, while maintaining the required degree of independence.
- Clarity – Possessing a clear understanding of the purpose and objectives of the SOE, which should be consistent between the shareholder and Executive and Supervisory boards.
- Commitment to integrity – Serving the society for the purpose of public value creation.

⁸⁰ OECD. Ownership and Governance of State-Owned Enterprises. A Compendium of National Practices. 2015.

⁸¹ OECD. OECD Guidelines on Corporate Governance of State-Owned Enterprises, 2015 Edition, 19.11.2015.

⁸² PwC. State-Owned Enterprises. Catalysts for public value creation, 2015.

The most common aim of SOE ownership policies is to provide predictability for the companies and the capital market, thereby enabling the companies to further develop their businesses and create value.

To ensure efficient corporate governance and fulfilment of State’s interests, governments tend to, firstly, establish objectives based on the segmentation and, secondly, follow private market practices and establish Owner’s letter of expectations on individual SOE level.

For example, the Norwegian SOE ownership policy does not only establish different rationales for owning SOEs that primary operate in competition with others and SOEs that do not primary operate in competition with others, but also segments SOEs in segments based on the government’s objective. Norwegian SOE ownership policy has established three main objectives⁸³ – categories – for its SOEs:

- Category 1 – Goal of the highest possible return over time
- Category 2 – Goal of the highest possible return and special rational for ownership
- Category 3 – Goal of the most efficient possible attainment of public policy goals

Based on the overall SOE ownership policy and specific category objectives, the Norwegian government defines SOE objectives on the individual level for four-year period. While Norwegian government defines clear expectations of the companies throughout its ownership policy, it is the Supervisory board’s and Executive management’s responsibility to assess whether and how the company shall work on the different areas and follow up the work. The Norwegian SOE objectives are largely based on international good practice and recognised international guidelines.

Box 3.2. - The State’s expectations of the companies in Norway

The expectations are structured as follows:

- Elements of corporate governance that are expected to have a bearing on the companies’ long-term value creation/goal attainment:
 - An overarching agenda for sustainable value creation specified in terms of goals and strategies.
 - Factors with a bearing on attainment of the company’s goals and implementation of the company’s strategy: resources, organisation, incentives and responsible business conduct.
 - Performance and risk management as the basis for and assessment of attainment of the company’s goals and implementation of the company’s strategy.
- The Norwegian Code of Practice for Corporate Governance.
- Organisation of the Supervisory board’s work.
- Transparency and reporting.

⁸³ Norwegian Ministry of Trade, Industry and Fisheries. The state’s direct ownership of companies, page 9.

Similarly to Norway, Sweden establishes expectations for its SOEs having clear division of roles and responsibilities among owner, the Supervisory board and Executive management of the company. The State exercises its role as an owner only through the general meeting.

However, to strengthen its SOEs, the State engages in dialogue with the companies other than through the general meeting. **Through the owner dialogue, the State raises matters, ask questions and communicate points of view that the company can consider in relation to its activities and development.** Such dialogue is intended as input to the company, not as instructions or orders. The Norwegian government puts emphasis that the owner’s dialogue does not have a binding nature and is carried out to help SOEs to reach their objectives. It is the Supervisory board’s responsibility to manage the SOE in accordance with the company’s interest and the common interest of all shareholders and must consider and make decisions on concrete matters.

Box 3.3. – Swedish State ownership policy document⁸⁴

The aim of Swedish State ownership policy is to actively manage SOEs to ensure long-term value creation as an overall objective and, where relevant, to ensure that specifically adopted public policy assignments are performed well. Swedish State ownership policy establishes an obligation to manage SOEs considering a long-term approach, giving an opportunity for SOEs to be efficient and profitable, and be given the capacity to develop. The policy imposes an obligation for Swedish SOEs to act in an exemplary way in the area of sustainable business, and otherwise act in such a way that they enjoy public confidence.

Swedish State ownership policy sets out Swedish government’s principles for corporate governance, remuneration and other terms of employment for senior officers of SOEs and external reporting in SOEs. The Swedish government’s management principles mainly follow the OECD Guidelines on Corporate Governance of and Anti-Corruption and Integrity in State-Owned Enterprises, which provide a predictable framework both for the State as owner and for the state-owned enterprises. Additionally, in its ownership policy, the Swedish government sets out mandates and objectives, applicable frameworks and important matters of principle relating to the governance of the SOEs. The State Ownership Policy is applied in all enterprises with majority state ownership. In enterprises with minority state ownership, the State engages in a dialogue with the other owners to have its ownership policy applied.

The State ownership policy also creates an obligation for State to develop an annual report on SOEs to provide an account of how the management of state ownership has developed during the year. The report also sets out how the enterprises are achieving their targets and complying with the Government’s principles for state-owned enterprises.

⁸⁴ Government Offices of Sweden. State Ownership Policy and principles for state-owned enterprises 2020.

Similar as in Norway, the overall SOE ownership policy in Lithuania defines main rationale and objective of state ownership. However, since 2018 Lithuania has abandoned segmentation and generic objective setting of SOEs and have opted for objective setting through the Owner's letter of expectations.

In Lithuania the institutions representing the State set the main expectations (commercial objectives, expectations for the special obligations to be fulfilled, etc.) for individual SOEs for a four-year period in letters of expectation. The letter, in accordance with SOE ownership policy⁸⁵ defines financial and non-financial long-term (strategic) and short-term (tactical) objectives and is intended to set out the state's expectations of a particular SOE's key and other activities, key performance measurement indicators, reporting needs and other relevant information. The introduction of shareholder letters of expectation has introduced greater clarity regarding the state's expectations of SOEs. It has also established a more formal process for communicating these expectations to SOE boards of directors and management.⁸⁶ While the Lithuanian SOE ownership policy provides a detailed content of the Owner's letter of expectations, the nature of the letters is broad giving overall guidance for the SOEs. Prior to submitting the letters to SOEs, they must be shared with the Coordination Institution for comments and suggestions.

Box 3.4. – Example of Owner's letter of expectations in Lithuania⁸⁷

The letters of expectation must outline the State's overarching expectations of the SOE, its main activities, operational priorities, key performance indicators, accountability expectations, any projects of national importance that the enterprise is expected to pursue and information on subsidiaries.

The Owner's letter of expectations is structured as follows:

- **Objective of the letter**

This section encloses general objective of the letter indicating that it presents the shareholder's (as a State) expectations regarding the operation of the company, the objectives prescribed to the company and its operational principles. Additionally, this section enclosed the expected term of the letter of expectations, typically defined for a period of four years. The section also includes disclaimer indicating that for the purpose of implementing the expectations laid down in the letter of expectations the shareholder and Supervisory and Executive boards shall follow the principles of reasonableness, transparency efficiency and cost-efficient management of the assets.

- **The purpose of the Company**

In this section the general purpose, business activities, and functions of the SOE are indicated. The purpose of the company is defined based on the SOE ownership policy and the general strategic objective of the SOE. If any of the SOE business activities or parts of them are commercial, the State's expectations for the profitability of these activities is emphasized. In cases where SOEs carries out

⁸⁵ Governance Coordination Centre. Ownership Guidelines.

⁸⁶ OECD. Lithuania's implementation of corporate governance accession review recommendations.

⁸⁷ Governance Coordination Centre. Setting State expectations for state-owned enterprises.

functions delegated by the State, the State indicates its expectations for the performance of the delegated functions.

- **Financial expectations**

The letter of expectations specifies the purpose of the commercial activity and the fulfilment of the indicators against which the company's performance will be assessed. However, Lithuanian State ownership policy stresses out that the values of the indicators should not be given as an exact target value, but as a sufficiently wide range. SOEs must be encouraged to achieve the highest possible return on capital and dividends, by setting higher performance indicators than the statutory minimum requirements. Shareholders are also encouraged to set a capital structure indicator that shows the State's tolerable financial risk of the SOE. The list of financial indicators can include return on capital, dividends, asset management, liquidity and liabilities.

- **Non-financial expectations**

In addition to the financial expectations, shareholders are required to set non-financial expectations for SOEs. While the non-financial expectations and indicators have to be tailored for each SOE based on the purpose and function of the SOE, the list of non-financial indicators may include market success, innovation and customers service indicators.

- **General expectations regarding the performance principles**

The section of the general expectation includes State's expectation regarding the accountability and reporting of the SOE's financial and non-financial expectations, along with the expectations for application of good corporate governance practice. In addition, if necessary, this section includes information about the State planned changes in the company's activities, for example, reorganization.

Lastly, many governments have started to increasingly appreciate the importance of ESG, sustainable financing and diversity aspects. It is becoming clear that without environmentally friendly operations and a balanced composition of Supervisory board and Executive management and compensation levels, the company cannot generate sustainable returns.

Box 3.5. - Gender balance among Swedish SOEs

A general target for all state-owned enterprises is gender balance on the Supervisory board. The share of women and men has to be at least 40% in the state enterprise portfolio (fully and partly owned enterprises). Women accounted for 48% and men for 52% of directors of state-owned enterprises elected by the annual general meeting as on 1 May 2020. This can be compared with the boards of listed companies, where the figures were 34% women and 66% men.⁸⁸

⁸⁸ Government Offices of Sweden. Annual report for state-owned enterprises 2019.

Box 3.6. – Corporate Social Responsibility (CSR) among Dutch SOEs

The Dutch government maintains an equity stake in a small number of enterprises ensuring that the state participation manages the invested social capital in a responsible and sustainable manner. In 2019 Dutch government has established new CSR policy for the SOEs requiring that all SOEs on the basis of comply or explain principle must follow the OECD Guidelines for multinational enterprises, UN Global Compact, UN Guiding Principles on Business and Human Rights and Dutch Corporate Governance Code. The Dutch government especially emphasizes the CSR goals for the environment, safe working environment, human rights and / or anti-corruption and requires SOEs to report their activities in the respective fields in the annual reports.⁸⁹

OECD countries' SOE ownership policies highlights the importance of transparency and disclosure in an accountability of SOE performance. An effective reporting system requires SOEs to abide by the same reporting, control, and audit frameworks as publicly listed companies. Good reporting and corporate governance practices require significant institutional capacity and resources. Therefore, quite often application of good governance principles might remain as mere intentions for SOEs. The listing SOEs on the stock exchange can help overcome obstacles and embed good corporate governance, including strong reporting and internal control practices. Significant changes in SOE corporate governance can be observed even when the state remains the dominant shareholder, as listing can be a way to sustain the commitment to good governance and financial reporting, including production of externally audited financial reports and their public dissemination, as well as the adoption of shared standards of corporate governance.⁹⁰

Box 3.7. – IPO of Tallina Vesi

Following various questionable activities and losing society's trust, in 2005 Tallina Vesi underwent successful IPO in order to strengthen its corporate governance and limit the political influence in the company's governance. In addition to the strengthened corporate governance in the company prior the IPO, the listing of Tallinna Vesi increased the transparency and accountability of the company allowing to effective and transparent management of the municipality's assets.

3.2.2. Segmentation

The SOE segmentation is a tool to categorize SOEs with similar characteristics into a separate grouping to later steer policy, develop guidelines and monitor SOEs against the backdrop of "group-relevant" and appropriate set of benchmarks and requirements. The SOE segmentation is not a goal itself but a mechanism to support fundamental objectives of the State or policy makers.

In fact, there is a great degree of dispersion how countries have adopted the SOE segmentation (elaborated below). This is because different countries exhibit different structures of SOEs and oftentimes have defined contrasting objectives and expectations on the domestic SOEs.

⁸⁹ Dutch Ministry of Finance. Annual Report Management State Participations 2019.

⁹⁰ World Bank Group. Corporate Governance of State-Owned Enterprises a Toolkit 2014.

While in many cases the key building blocks of the chosen SOE segmentation are similar among the countries, the final form of the SOE segmentation should take into account country-specific conditions. Otherwise, implementing the SOE segmentation on a stand-alone basis (i.e. detached from the domestic conditions) has an increased risk of arriving at inefficient policy that performs well in other country but not in the local economy.

Detailed description about the current SOE segmentation practice in Latvia can be seen in **Annexes 12 and 13**.

Takeaways from other countries

According to the study conducted by OECD “Ownership and Governance of State-Owned Enterprises, a Compendium of National Practices”⁹¹, there is no coherent approach in segmenting the SOEs for the purpose of establishing system wide optimal capital structure strategies and defining viable financing instruments⁹².

The same OECD study has also revealed a group of countries, which have well-defined capital structure guidelines that inform subsequent financing decisions. Given the objectives of this Assignment, a further emphasis and assessment of the countries with a robust approach to capital allocation decisions is deemed crucial. The **Figure 31** encapsulates the general approach to capital structure efficiency of the various OECD countries.

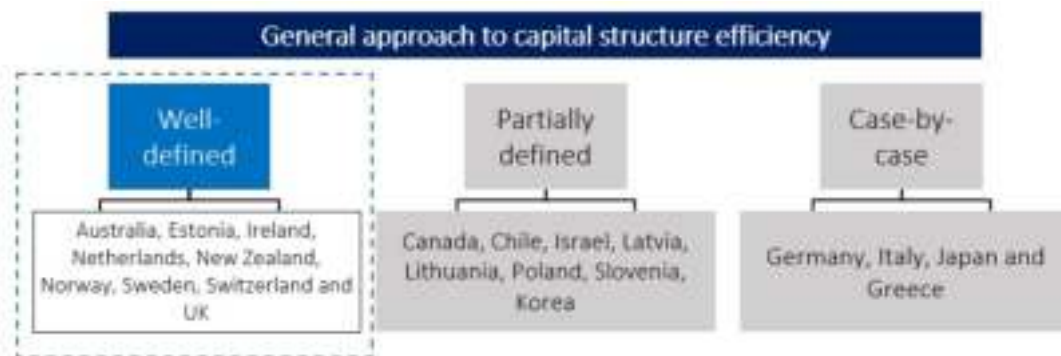


Figure 31. General approach to capital structure efficiency as per OECD, 2013

The main aspects considered in arriving at the conclusions in **Figure 31** are the mechanisms in place to neutralise cheap debt financing (i.e. lower cost of debt based on merits that are related to the fact of being State owned company) and to ensure market consistent State equity financing, rate of return and dividend targets as well as preferential treatments on commercial debt.

The analysis of different forms of SOE segmentation that are used among the countries with well-defined capital structure guidelines reveals that there is no coherent way how the countries classify their SOE. In fact, the analysis also shows that there is no intentionally developed SOE segmentation to be used for

⁹¹ OECD. Ownership and Governance of State-Owned Enterprises.

⁹² Nonetheless, almost all countries have adopted some form of SOE segmentation (in many ways similar to those covered in the section 2.1.) in order to oversee and steer SOEs towards a successful fulfilment of defined objectives.

guiding SOEs on optimal capital structures or specific financing instruments. Instead, the analysed countries (reflected in the **Figure 31** under “well-defined” box) exploit different SOE segmentation mechanisms concurrently to help policy makers and SOEs fulfil different objectives.

However, during the analysis several SOE segmentation forms that are unique or not used in Latvia were identified:

- In **Australia**, the Government Business Enterprises (GBE) that primarily provide services are viewed separately when setting financial goals⁹³. The government imposes service quality standards on service based GBEs as well as replaces the estimation of weighted average cost of capital (WACC) with the required ROE. Only the cost of equity elements is targeted since GBEs that are service-based carry little debt as part of their optimal capital structure.
- A detailed breakdown of SOEs based on the percentage of State ownership⁹⁴ is implemented in the **Netherlands**. The percentage of State ownership SOE segmentation form in the Netherlands provide more layers than compared to that of Latvia. There are six different layers each imposing different set of requirements for the relevant SOEs. Only SOEs with the State ownership above 50% have to comply with the broad level financial guidelines. In addition, the Netherlands distinguish their SOEs according to which shareholder model they belong – either centralised model under the MoF or decentralised model under the Ministry of Economic Affairs or Ministry of Infrastructure and the Environment.
- **Sweden** splits its SOEs into three separate categories depending on the inherent level of public service obligations carried out by individual SOEs. These categories are – fully commercial with no public service obligations, commercial with some public service obligations and mainly public service obligations. There are no explicit guidelines in place that dictate the overall financial targets based on the level of public service obligation grouping.
- **Norway** splits its SOEs based on the government’s objective. Norwegian SOE ownership policy has established three main objectives – categories – for its SOEs: Category 1 – Goal of the highest possible return over time. Category 2 – Goal of the highest possible return and special rationale for ownership. Category 3 – Goal of the most efficient possible attainment of public policy goals

⁹³ Australian Government, Department of Finance. Commonwealth Government Business Enterprises – Governance and Oversight Guidelines.

⁹⁴ Algemene Rekenkamer. The State as Public Shareholder.

3.2. Best practices in SOE financing

Key takeaways

- One of the most critical building blocks of the best SOE financing practices is the presence of competitive neutrality, which itself entails the following conditions:
 - a structural separation of commercial and non-commercial activities within a company;
 - transparency and disclosure around cost allocation – the separation of accounts principle.
 - financial targets similar to comparable businesses;
 - transparent and adequate compensation for non-financial objectives.
- Optimal capital structures are defined by using balance sheet as a proxy and in which the associated benchmarks are either set by the State via fixed values with ranges or by requiring companies to benchmark against comparable peers.
- Rate of return targets are often expressed by using ROE as a proxy of measuring how efficient the SOEs operate State's capital and are usually either determined by benchmarking to peers or set by State via fixed targets.
- Dividend measure takes the form of dividend payout level relative to generated profit, and mostly adjusts taking into account the industry specifics, state of the business cycle and planned capital allocations.
- Requirements as to which financing instrument to choose are not imposed to SOEs as it is considered a day-to-day activity. Instead, the State gets involved when financing is sourced from instruments that affect capital structure such as an IPO.

3.2.1. Competitive neutrality

Achieving competitive neutrality or “level playing field” between SOE and privately owned business is of utmost importance to enable competition to work properly. **All companies should compete on the merits and should not receive an undue advantage due to the underlying ownership structure.** The “level playing field” maintains economy efficient and allows an efficient capital allocation to take place.

Box 3.9. – Building blocks of competitive neutrality

Streamline government businesses in terms of either corporate form or the organisation of value chains. An important question when addressing competitive neutrality is the degree of corporatisation of government business activities and the extent to which commercial and non-commercial activities are structurally separated. Separation makes it easier for commercial activities to operate in a market consistent way. Incorporating public entities having a commercial activity and operating in competitive, open markets, as separate legal entities enhances transparency.

Ensure transparency and disclosure around cost allocation. Identifying the costs of any given function of commercial government activity is essential if competitive neutrality is to be credibly enforced. For incorporated SOEs, the major issue is accounting for costs associated with fulfilling public service obligations (if applicable). For unincorporated entities, problems arise where they provide services in the public interest as well as commercial activities from a joint institutional platform.

Devise methods to calculate a market-consistent rate of return on business activities. Achieving a commercial rate of return is an important aspect in ensuring that government business activities are operating like comparable businesses. If SOEs operating in a commercial and competitive environment do not have to earn returns at market consistent rates, then an inefficient producer may appear cheaper to customers than an efficient one.

Ensure transparent and adequate compensation for public policy obligations. Competitive neutrality concerns often arise when public policy priorities are imposed on public entities which also operate in the marketplace. It is important to ensure that concerned entities be adequately compensated for any non-commercial requirements on the basis of the additional cost that these requirements impose.

In the context of this Assignment, it is of utmost importance to focus on delivering appropriate commercial returns by the SOEs and the necessary target setting mechanism that will help achieve those. To achieve comparable returns to those of the private sector, it is per definition implied that capital structures have to be up to the par with chosen peers, hence supporting a formation of optimal capital structure.

The best practice, according to World Bank⁹⁵ posits that the State should stimulate SOEs to achieve commercial rates of return and assess whether SOEs meet commercial rates of return in their operations and recommend strategies to enforce and monitor such a requirement. SOEs commercial operations and investments are required to have positive net present value, **market consistent rate of returns and to be measured based on private sector performance.**

Interestingly, the notion of delivering market consistent returns, based on private sector performance implies that the fulfilment of public policy objectives would have to be adequately compensated in line with the observed returns in the comparable benchmark.

⁹⁵ World bank. State-Owned Enterprises: Understanding their market effects and the need for competitive neutrality.



3.2.2. Financial targets for capital structures, returns and dividends

Optimal capital structures (capital structure efficiency)

For the SOE financing methodology purposes, an optimal capital structure is defined as rightly structured balance sheet focusing on the portion of assumed debt levels compared to the equity. The right balance sheet structure is largely driven by the corresponding conditions among the relevant peers, and it should consider excessive financial risk caused by too high indebtedness as well as the notion of carrying overcapitalized balance sheet. The excessive levels of debt can limit company's growth and make the company more susceptible to external financial shocks. Conversely, having an overcapitalized balance sheet (i.e. too much equity relative to debt) bring less economic value add to the shareholders.

In general, there are three approaches how an optimal capital structure can be determined, please refer to Box 2.3.

Box 3.10. - Optimal capital structures in other countries

Subject revolving around a formation of optimal capital structures for SOEs was brought up and scrutinized with the representatives of MoF of Estonia, Finland, and Lithuania (answers in writing were shared by Finnish and Lithuanian parties), and Sweden was analysed based on publicly available information⁹⁶:

Finland

The State has targeted that SOEs should have an equity ratio to total capital of 30 to 50 per cent. If the equity ratio remains higher, the company must have a justified reasoning for it. MoF's ownership policy and corporate governance operates on the basis of general principles of company law. In Finland, the state's intervention rights in companies operating on "market terms" are limited to voting at shareholder meetings, although the state may be represented directly on an SOE Supervisory board and sit on a nomination committee to recommend Supervisory board candidates for shareholders' approval. Already in 2011 state ownership policy specifies that "all decision-making powers regarding the business operations are retained by the corporate administrative bodies".

However, similar to the way listed companies engage with major shareholders, the Supervisory board and Executive management of SOEs may choose to consult the Ownership Steering Unit of MoF on key strategic and other matters, such as transactions requiring the issuance of new shares.

Companies entrusted with a special state-defined assignment may not distort competition in their respective fields. Special attention should be attached to this when such a company expands. In accordance with this policy of competitive neutrality, the companies' business conduct, financial structure and return targets must be comparable with those of peer companies engaged in the same line of business. The same principles also apply to state-owned holding companies operating in the investment and financial sector.

⁹⁶ Government Offices of Sweden. Annual report for state-owned enterprises 2019.

Lithuania

Capital structure decisions, by law, rest with the boards of SOEs, where at least half of members must meet independence requirements. There is no information on general requirements of capital structure. The State only indicates that one of the financial goals of the companies should be to strive for an optimal capital structure. Currently, the financial data of SOEs demonstrate that companies often finance their activities in particular conservatively and have surplus assets. In order to encourage companies to optimize their capital structure, there are set capital structure targets for some key companies. This encourages more funding for business development borrowed capital and bring additional funds to the state budget. As a result, in the letters of expectations of the two largest SOEs (Ignitis grupė and EPSO-G) it can be seen that the State Representative Institutions proposed various goals related to capital structure.

- Ignitis grupė shall maintain a high investment credit rating (BBB and above) and the Group of Companies net debt in the medium and long term should not exceed 5 years of annual pre-interest income, taxes, depreciation and amortization (EBITDA).
- Depending on the borrowing market conditions, the implementation of strategic infrastructure projects and the EPSO-G development opportunities, the Group of Companies must strive for 2017-2021 the share of borrowed capital would be 55-60 percent.

Estonia

The State does not impose specific limits or quantitative ranges for SOEs how to optimize capital structures and structure balance sheets. The State formulates owner's letter of expectation for each SOE in which the State / shareholder can, for instance, define a broad guidance as to whether the SOE should become more conservative in structuring the balance sheet or, conversely, assume more debt to fund larger investment projects. The high level MoF estimation is based on investment pipeline, industry averages (Damodaran) and calculations based on max loan capability using EBITDA variability and max probability of default=5%.

The general rule for SOEs is to finance their investment projects from internal sources and debt (SOE is free to choose between loan or bond). Additional equity from the state is the last resort.

Sweden

A capital structure target is set so as to achieve a balance between risk-taking and efficient capitalisation in the enterprises. An appropriate capital structure is achieved by calculating what balance between equity and borrowed capital is theoretically optimal to keep the enterprise's cost of capital down. Industry comparisons and the enterprise's operating risk are taken into account in the calculation in order to find an efficient and resilient capital structure.

The capital structure target has to be long-term, ambitious and realistic, and is generally expressed as a range.



Rate of return targets

Rate of return targets are frequently imposed on the SOEs in order to set and track financial performance, and to, ultimately, assess how efficiently the State's capital is being put at work relative to a pre-defined defined benchmark.

The following are the most common approaches how State defines rate of return targets for the SOEs:

- **Target rates of ROE** either established by the State as shareholder or elaborated by individual Supervisory boards.
- The state ownership body and SOE boards communicate specific details on how to identify the **cost of capital** used as the basis for calculating rate-of-return targets, using sector specific benchmarks
- **Indirectly establish return targets**, or at least influence returns, through tariff or pricing regulations in certain industries.

Box 3.11. – Rate of return targets in other countries

Finland

With regard to SOEs operating on market terms (i.e. like most of Finland's SOEs), the State's aim is to achieve maximum overall financial performance. The attainment of this objective is evaluated in terms of profitability and the long-term increase in shareholder value. Similarly, the goal for special assignment SOEs is that the operations show a profit. With regard to these companies, the State's objectives, as an owner, are defined with a view to the best possible overall social and financial outcome, which is primarily assessed in terms of how effectively and at what cost the SOE is able to achieve its specific social function.

State ownership in different companies will be developed based on the objectives of each holding. Objectives can include strategic ownership, financial interests, or the advancement of growth, jobs and sustainable development by means of state ownership.

All state-owned companies must base their operations on CSR. Companies must take into account in their decision-making the economic factors and the social and environmental impacts of their activities. According to a new resolution on ownership policy, companies need to recognise the CSR risks they are facing in their own operations and across value chains and integrate CSR risks into their risk management regime. Responsibility for compliance with the principles of sound risk management and its organisation rests with the Supervisory board. The Supervisory boards and Executive management must report any major findings to the shareholders.

Lithuania

As of specific targets, there is a Law approved by the Government of Lithuania on setting the expected average annual cost of equity in 2019-2021⁹⁷.

⁹⁷ Republic of Lithuania. Resolution on Determination of Target Profitability Indicators of State-Owned Enterprises for 2019–2021.

The State calculates return-on-equity targets for approximately 40 commercial SOEs, based on Ministry of Economy guidelines that use the capital asset pricing model. The proposed ROE expectations, which are three-year averages, are then submitted to the Government for final approval and communicated to SOEs through the letters of expectation.

Estonia

The State defines rather explicit rate of return targets for SOEs by basing them on CAPM for which the data is derived from Damodaran databases, SOE & State treasury forecasts as well as analysts' consensus estimates for publicly traded SOEs. The SOE rate of return requirements incorporate company specific premiums (e.g., management, client portfolio etc.) in addition to standard CAPM formula. The returns are measured against the average cost of equity of previous 5 years. These estimates for each SOE are defined and calculated by MoF.

Sweden

A profitability target is set for the enterprises for the sake of financial and operational efficiency. To ensure that investments in the enterprises will give the owner reasonable compensation, the cost of capital is used as the floor for the profitability target. Analyses of the enterprises' business plans and industry comparisons bolster the setting of the target. The majority of the enterprises are well served by a return target (on operating capital or equity), while for some, which tie up a relatively small amount of capital, a margin target, such as operating margins, is better.

Dividend policies

The most widely used approached in setting dividend targets for the SOEs are the following:

- **No dividend guidelines or targets** – no dividend guidelines or targets in place, and dividends are negotiated annually between Supervisory boards and the shareholders.
- **Broad guidelines** – identified factors, which should be taken into account when proposing dividend payments.
- **Explicit percentage of net income** – a pre-defined relative portion of the annual profits to be distributed in dividends.
- **Linked to optimal capital structure** – the level of dividends required to maintain an optimal capital structure, as measured by the achievement of a target credit rating, often in the form of investment grade rating.

Box 3.12. – Dividend targets in other countries

Finland

The State sets great store by predictable dividend policies that take into account both the company's financing needs and shareholder interests. As far as dividend policies are concerned, the State values a balance sheet structure comparable to peer companies in the sector involved, as steady a dividend stream as possible as well as a moderate net gearing ratio. When assessing dividend disbursements,

the State weighs a wide range of circumstances affecting the company concerned. In 2015 the State lined out that in SOEs operating on market terms where the State is a sole or majority owner, the target for a dividend pay-out ratio is 50 per cent. This target can be deviated only in justified circumstances.

Lithuania

Depending on their legal form, SOEs pay either dividends or profit contributions to the state budget: SOEs (LCC, LPC or JSC) pay dividends, state entities pay profit contributions. SOEs and state entities pay dividends or profit contributions depending upon distributable profits for the year of reporting. The higher the ROE of the reporting year, the lower is the percentage of the distributable profit for the reporting year to be paid to the state budget. The amount of dividends/profit contributions are determined as follows:

> 85 per cent of the distributable profit of SOE, if the ROE for the reporting year does not exceed 1 per cent; etc.

A SOE may, by a separate decision of the Government, pay lower dividends or profit contributions if:

- implements or participates in the implementation of an economic project of state importance recognized by a decision of the Government or implements or participates in the implementation of - a project of special state importance recognized by a decision of the Parliament of the Republic of Lithuania;
- the amount of dividends or income tax payable by a SOE under the law would jeopardize the financial sustainability of the enterprise.

Estonia

The State has not defined explicit guidelines or quantitative metrics that steer the overall SOE dividend policy. The initial dividend proposals come from SOEs to owners, and then the owners submit a proposal to MoF, which presents the draft order to the government for approval after which in the general meeting may decide the dividends.

Sweden

A dividend policy is adopted for enterprises as guidance about how much of an enterprise's profit to pay in dividends. They should be based on predictable and long-term sustainable financial returns. However, dividends are not the only form for value distribution to the owner. In cases where there are particularly attractive or potentially profitable investment opportunities for one or more enterprises, surplus capital may be retained and used for such investments. The owner then benefits from the increase in the value of the enterprise. Investment plans and growth opportunities therefore form the basis for the dividend policy.

Similar as to the overall SOE corporate governance framework, when considering dividend pay-out State should as much as possible assimilate the same legal requirements as for the privately owned companies avoiding to granting SOEs a privileged status or special protection.⁹⁸ Even more to ensure fair competition

⁹⁸ OECD. Guidelines on Corporate Governance of State-owned Enterprises, 2015



among market participants, the State must profoundly consider whether the set dividend policy does not create unfair competition for the market participants and whether any exceptions from the dividend payout are in accordance with the State aid competition rules.⁹⁹ The State aid may take many forms, such as direct grants, loans, guarantees, direct investment in the capital of enterprises and benefits in kind. However, it is crucial to indicate that the waiving revenue which would otherwise have been paid to the State could also constitute a State aid¹⁰⁰ and therefore should be thoroughly scrutinized. The State may waive its rights to dividends, if the waived revenues are intended to finance State delegated objectives.

Financing instruments

OECD has not distinguished specific financing instruments as preferred ones or that should be used (or not used) for the key policy makers and SOEs. Instead, it has stressed the importance of allowing SOE Supervisory boards to interact with Executive management and contemplate on the more notable future steps in regards where an SOE should be headed and the potential means to do so. In fact, this is also consistent with the guidelines developed by WB and practices in neighbouring countries – Lithuania, Estonia, Sweden, Finland and Norway.

Supervisory board and Executive management are required to discuss important matters affecting the company's operations and shareholder value with the major shareholders. SOEs are expected to engage in a transparent exchange of information and dialogue with the State with due regard to the size of the interest held by the State. As an owner, the State engages in an active dialogue with the SOEs within the limits imposed by law and with due regard to the other shareholders.

The decision, which financing instrument to use is considered a day-to-day activity for the Executive management, and, in certain occasions for the Supervisory board as well. Nevertheless, **in case of embarking on IPOs and financing that impacts ownership structure, the State should play a vital role** in ensuring right regulatory conditions, decision of ownership to be exchanged for capital and providing an overall support for the SOE.

Box 3.13. – Different financing instruments by SOEs in other countries

Finland

In February 2019, Fortum Corporation raised EUR 2.5 billion by issuing Eurobonds listed in Luxembourg Stock Exchange. Bonds were issued in three tranches and had different maturity (4-year, 7-year, and 10-year) and coupon rates (0.875%, 1.625%, and 2.125%, respectively). The funds were used to refinance existing indebtedness and for general corporate purposes.

Lithuania

Ignitis Group (formerly Lithuanian Energy) recently undertook an IPO of 26.9% of its capital. As of 7 October 2020, shares and depository receipts were available for trading on, respectively, the Vilnius

⁹⁹ European Commission. Treaty on the Functioning of the European Union. Article 107 – Article 109

¹⁰⁰ European Commission. Commission Decision (EU) 2017/07 on the State aid SA.40168 — 2015/C (ex SA.33584 — 2013/C (ex 2011/NN)) implemented by the Netherlands in favour of the professional football club Willem II in Tilburg

Stock Exchange and the London Stock Exchange. The company attracted EUR 450 million of proceeds in order to mainly fund ambitious expansion plans into green energy segment.

The same company also organized a second 10-year green bonds issue, listed on July 2018 at the size of EUR 300 million with coupon rate of 1.875%. The objective was to fund investments into the wind energy; efficiency enhancement of the electricity distribution grid; projects on energy production from waste and biomass

Estonia

In June 2018, Tallinna Sadam realized an IPO, which was oversubscribed by more than threefold and which allowed to access EUR 147.7 million of new funds in exchange for 32.97% shares. The Ministry of Economic Affairs and Communications retained 67.03% of the shares. The main objective was to improve the corporate governance of the company as well as to promote local savings culture.

Sweden

Sveaskog, the first pure-play green forest company in Sweden, successfully issued a 5-year green bonds with a total of nominal amount of SEK 1 billion. The bond consists of two tranches with 30% having floating interest of three-month STIBOR +1.2% and 70% having fixed 1.49% coupon rate. Green bonds are specifically designated to acquire funds for climate and environmental projects and as Sveaskog is recognized as a pure-play green company, it was able to use the funds for general financing of operations.

Apart from IPOs, bond issuance and traditional financing sources (bank loans, grant funding, subsidies, retained earning, etc), there exists other arrangements for SOEs to attract financing. Public-private partnership (PPP) and Joint Ventures are settlements between public and private sector to find solutions on important infrastructure issues and fulfil social needs.

Box 3.14. – PPP and joint ventures as viable financing instruments

Public-private partnership (PPP)

Adif, a Spanish state-owned railway infrastructure company, involved in a public-private partnership with Alstom, a rolling stock manufacturer, to build a high-speed railway network. The length of the contract period is set to be 22 years with total cost of the project EUR 271.1 million that includes Alstom to design and install appropriate systems as well as maintain them till the end of the contract. 50% of project was financed through EUR 77.6 million EIB loan (based on trilateral agreement with Adif and Spanish Ministry of Public works) while EUR 53.0 million were sponsored by Adif itself.

Joint Venture (Special Purpose Vehicle)

Ignitis Group together with Fortum Corporation cooperated to create Kaunas cogeneration power plant. The project was created as joint venture with Ignitis Group owing 51% of stake, while the rest 49% are owned by Fortum. The total investment of project is c. EUR 160 million and Fortum came in to the partnership with EUR 27 million direct investment.

4. The methodology



Figure 32. Elements of the methodology

Considering the Latvian SOE ownership model, it is crucial to have clearly defined SOE objectives, target setting and monitoring procedures all of which ensure harmonized and efficient SOE governance. For the State to allow SOEs full operation autonomy in achieving their defined general strategic objectives and to fully introduce a role of an active ownership, it is necessary to first implement **active ownership policy principles** for achieving maximum benefit for the owner (the State) and the society through public policy goals.

In order to maximize shareholder's value and achieve maximum benefit for the State, it is critical to introduce right conditions that allow to translate the State's objectives into ambitious and objective targets. The **SOE financing methodology** contributes to appropriate target setting and provides tools that on the one hand facilitates a formation of optimal capital structures and on the other hand stimulates more active exploration of alternative financing instruments as a means to diversify the risk and become more ambitious.

The proposed methodology is implemented via two separate yet interlinked processes: active ownership principles and SOE financing methodology. The elements of the proposed methodology depicted in **Figure 32** above are based on the best practices established by the OECD, WB, IMF and explored peer countries taking into account the feedback from both SOEs and institutional investors.

4.1. Active ownership principles

4.1.1. SOE ownership policy document



Figure 33. Elements of the SOE active ownership principle

The SOE ownership policy in Latvia is based on various policy documents such as Latvia's sustainable development strategy, Latvia's National Development Plan and the Government's Declaration of the intended activities of the Cabinet of Ministers, SOEL and Conception of management of State capital shares¹⁰¹, Conception of public person's commercial activities,¹⁰² National Security law and the subsequent sectoral policies.

To give an understanding and provide transparency of the SOE ownership all policy objectives and their interdependency should be compiled and clearly defined. **Rather than relying on several policy documents, the unified SOE ownership policy document including an overall SOE ownership strategy and if necessary specific sectoral SOE policy should be developed.**

The SOE ownership policy could be developed as a medium-term policy planning document aligned with the political cycle and government's period of operations aimed at achieving specific objectives of national importance and covering a wide range of issues. The SOE ownership policy and State's objectives towards SOE financing should be subject to public disclosure. The SOE ownership policy should be applied in all SOEs where State has decisive influence. In the companies where State does not have decisive influence the State should engage in a dialogue with the other owners to ensure that the ownership policy is applied. The SOE ownership policy should serve as a foundation to review State's ownership objectives and legal framework establishing SOE corporate governance.

The SOE ownership policy should clearly define State's objectives towards participation in SOEs by clearly establishing SOE segmentation based on the **proposed principles of SOE segmentation**. Additionally, the SOE ownership policy should define **State's objectives towards each of the segments**, for example,

¹⁰¹ Cabinet of Ministers regulation June 4 2012, No.246 On Conception of management of State capital shares.

¹⁰² Cabinet of Ministers regulation June 4 2012, No.245 On Conception of public person's commercial activities.



asserting that commercial SOEs should work in the similar market conditions as private market participants, including but not limited to increasing their profitability and ensuring effective State capital management. Based on the proposed segmentation approach, the State should determine under which segment each of the SOEs should operate.

The SOE ownership policy should include the State's **principles for corporate governance** or refer to the relevant governance guidelines, for example, Corporate Governance Codex¹⁰³. The State should set its principles, at least, for remuneration and other terms of employment for SOE Supervisory board and Executive management and principles for external reporting.

In the State ownership policy document, it should be communicated that **a concrete group of SOEs is subject to a potential IPO process** by which the State's ownership level is expected to decrease allowing the exchange between the capital and shares to take place. Such vision should be backed with precise reasons describing what benefits it will add: e.g., to fund future growth opportunities, bring contributions to State budget (either by future growth or equity reductions), improve corporate governance and / or stimulate domestic savings culture and development of domestic capital markets.

Some form of SOE assessment in relation to how viable an SOE is for an IPO is crucial before deciding to explicitly require the SOE to tap the capital market and issue new shares. This step will help scope the potential IPO candidates, highlight the currently lacking areas that have to be improved, and initiate a fact-based discussion around the IPO. Therefore, it is recommended that in the State ownership policy document the vision on gradual reduction of ownership within a concrete group of SOEs is outlined in conjunction with the obligation to perform an **IPO readiness assessment**. The proposed set of criteria and the corresponding explanation of them are disclosed in **Annex 14**.

In addition to the State's objective towards participation in SOE the SOE ownership policy should establish overall public policy objectives, for example, such corporate governance objective as **sustainability**. As an owner, the State should have high ambitions for sustainable business that would follow objectives set in global Sustainable Development Goals (Global Goals) and the mandatory reporting framework of EU taxonomy¹⁰⁴. The starting point for promoting SOE sustainability is that SOEs have to contribute, through their business models, to value creation in a way that promotes long-term sustainable development. This means that, in the light of their industry and the market which they operate, the SOE have to identify and minimise the risk of negative impacts of their operations, while also taking advantage of new business opportunities and innovative thinking for sustainable value creation. This includes both material sustainability issues and also digitalisation and systematic security work. SOEs have to act in an exemplary way, which includes working strategically and transparently with a focus on cooperation to promote sustainable business practices.

Lastly, SOE ownership policy should enhance Coordination Institution's role in the SOE governance. The role of the Coordination Institution is to act as an advisory institution for SOE Supervisory boards and shareholders respecting their autonomy and giving the necessary guidance. However, to strengthen SOE ownership practices, the Coordination Institution should have an authority to monitor shareholder practices toward implementation of SOE ownership policy. The SOE ownership policy should provide an opportunity for the Coordination Institution after the shareholder's invitation to act as a temporary

¹⁰³ Corporate Governance Advisory Board, Corporate Governance Codex 2020.

¹⁰⁴ European Commission. EU taxonomy for sustainable activities.

Supervisory member for a period up to one year, if (1) the SOE's Supervisory board has been established for its first term or there are significant changes in the SOE Supervisory board, i.e., at least half of Supervisory board members have changed or (2) shareholder has requested a Coordination Institution's assistance in SOE governance. Such practice would follow the Finnish SOE governance practice and would allow to ensure smooth transition of SOE instructional knowledge and governance practices. However, to allow Coordination Institution to ensure necessary guidance, it is necessary to strengthen its institutional capacity by attracting highly skilled professionals that could act as temporary Supervisory board members.

Based on the SOE ownership policy objectives the State should review and adapt the necessary changes in all dependent SOE ownership policy documents. For example, to harmonize ownership practices in all SOEs, the State should review and strengthen the legal framework for obtaining or maintain State's participation in SOE.

Box 4.1. – Evaluation for State's participation in SOE

The existing framework creates an obligation for State to carry out a competitive neutrality and economic assessment to either establish or maintain its participation in SOEs. The process of evaluation of the State's participation needs to (1) follow the State's objectives towards participation in SOE set in SOE ownership policy and (2) focus on the scrutinization of the State's participation in a capital company and active evaluation of alternative solutions how to ensure necessary goods or services. The process of evaluations or re-evaluation of State participation in SOEs should be strengthened by:

- stipulating that a public person has a duty every 5 years to re-evaluate its participation in all SOEs without exception;
- providing precise criteria that must be included in the competitive neutrality and economic assessment. The assessments should be subject to independent binding evaluation by the competent authorities;
- the economic assessment and competitive neutrality assessment should be subject to public disclosure. To protect the commercial secret of the capital company, assessment on continuing participation in the company shall be made public by obscuring information containing commercial secrets.

By evaluating its participation in all SOEs, including SOEs that cannot be expropriated, State would not only harmonize its ownership practice, but could also re-evaluate the use and management of State assets, thus determining whether State assesses have been managed in the most efficient manner¹⁰⁵. Additionally, harmonized ownership practices would allow to effectively respond to necessary public objectives and everchanging market demand by limiting or increasing SOE commercial activities.

As a result of the evaluation for State's participation in SOE the State should determine its interest in participation in the SOE and the general strategic objectives of the SOE. The State's interest for further participation in SOE should be defined in Owner's letter of expectations.

¹⁰⁵ CSCC. Conceptual report "On the ownership policy of state and municipal capital companies, state capital company gradual centralization of the division and management functions of public corporations".

4.1.2. Owner's letter of expectations

Given the State's diverse interests in participation in SOEs and size and variety of SOE portfolio in Latvia, the "one size fits all" solution for the SOE objective setting would not aspire an effective SOE governance.

To establish State's ownership objectives on the SOE level the shareholder should create an **owner's letter of expectation that encompasses and aligns SOE ownership policy objectives and SOE's development ambitions**. As an element of the SOE ownership policy the owner's letter of expectations should be subject to public disclosure. The obligation to create owner's letter of expectation would change the current practices and encourage the State to become more active and involved owner, and also would help track the fulfilment of the pre-defined long-term objectives.

The shareholder would be responsible for the creation of owner's letter of expectation by outlining not only general strategic objective, but also high-level and long-term financial and non-financial objectives that the SOE should strive to achieve over the course of which the owner's letter of expectation is active.

The objectives set in the owner's letter of expectation would be oriented towards **providing a path to which the SOE should be heading and feature sectoral and / or industry specific objectives that the SOE should consider in the process of capital allocation**. For example, the shareholder might realize the necessity of IPO, and in that case, the owner's letter of expectation would serve as a transparent and accountable tool for outlining such path with the corresponding high-level steps that the shareholder would expect from SOE to achieve or consider as to deliver on the newly defined objective (i.e. IPO). Similarly, the shareholder might perceive the environmental objectives of paramount importance, and thus draft such objectives in owner's letter of expectation by assigning a high level of priority for the objective to be achieved.

In essence, the letter should be **tailored to each specific SOE** considering the SOE ownership policy objectives, sector objectives, specific objectives and potential developments of SOE. The shareholder and Supervisory board could also set additional commercial objectives based on approved general strategic objectives. The owner's letter of expectation should be a natural result of the evaluation for State's participation in SOE and should include at least:

- The reasoning for States participation in the SOE;
- Public policy objectives that the State as an owner expects from the SOE, mostly in the form of non-financial objectives;
- Financial objectives regarding rate of return, dividend policy and capital structure based on the proposed SOE financing methodology.

This means that the **shareholder would be responsible for the establishment of high-level long-term financial and non-financial objectives** when evaluating its participation in an SOE. In situation when the State is re-evaluating its participation in SOE, the objective setting would be a shareholder's obligation and should be performed in the cooperation with SOE's Supervisory board and Executive management. While the shareholder would be responsible to develop owner's letter of expectation it should be subject to the review by line ministry and Coordination Institution in order to align non-financial sectorial and SOE public policy objectives, respectively. The Coordination Institution should act as an advisor to shareholder and Supervisory board by giving guidance on the inclusion of the overall SOE ownership public policy objectives, for example, strengthening disclosure of information principles in SOEs

The owner's letter of expectation would entail financial and non-financial objectives more of a long-term nature that would be reviewed once the owner's letter of expectation becomes due. The **determination**



of operational goals would be the subject of SOE's Executive management in medium-term strategy and would be aligned with the Supervisory board and shareholder.

As for the State-dependent non-commercial SOEs, the general strategic objective is an implementation of non-financial objectives. The State should align non-financial objectives and abstain from determination of universal operational financial targets or KPIs set for these SOEs. The objectives should generally aim at increased efficiency of the SOEs as well as ensuring that the specific policy objectives are implemented. Thus, for example, financial objectives could be set as high-level expectation to efficiently spend State subsidies; provide public services for appropriate price, reduce SOE operational costs and ensure sustainable capital structure. Non-financial objectives for the State-dependent non-commercial SOEs can be set as the number of performed medical procedures for hospitals or number of new plays for theatres, number of visitors for museums.

The owner's letter of expectation should be **flexible** - renewed during the re-evaluation of State's participation in SOE or adjusted in cases when there are structural changes in the market or company's commercial and non-commercial activities.

The obligation to establish an owner's letter of expectations **should be stipulated by SASL** imposing clear regulations regarding the aim and content of the owner's letter of expectations. The letter should be subject to public disclosure; however, to protect the commercial secrets owner's letter of expectations shall be made public by obscuring information containing commercial secrets.

Box 4.2. – Structure of OLE

The owner's letter of expectation is established by shareholder (holder of State capital shares) in cooperation with line ministry, Coordination Institution and Supervisory (if applicable) and Executive managements of SOE.

The letter presents the expectations of the State and the shareholder of SOE, regarding the activities, priorities, principles of activities and objectives of SOE

It is believed that the letter will be helpful to the Supervisory boards and Executive management, particularly in its corporate and strategic planning processes, and it is shareholder's intention to issue a similar letter every 5 years.

The specific objectives outlined in the letter should be considered in the context of the State's overall SOE ownership policy objectives and specific industry objectives (*if applicable*).

Reasoning for State's participation in company

The specific sections include information explaining justification for State's participation in the capital company, SOEs strategic objective and identifying SOEs areas of activities.

The reasoning for State's participation in the SOEs must be in accordance with the Article 4 SOEL and Article 88.

The reasoning for State's participation in the company must include the general notions of the economic and competitive neutrality assessments indicating the economic reasoning for State's participation in the company and SOE's impact on the market competition. If applicable, the shareholder also must include necessary actions and safeguards to ensure fair competition in market.

General strategic objectives

The following section lists the general strategic objectives that are imposed on the SOE. The general strategic objectives should be in accordance with the Article 4 and Article 88 of SOEL and general SOE ownership policy. The objectives should be determined on high level distinguishing main areas of activities and expected results.

For example, the general strategic objective of Latvenergo is to provide goods and services in the energy sector in a sustainable, responsible and economically sound manner, which are important for the competitiveness and growth of the economy, as well as to effectively manage resources and infrastructure strategically important for the country's development and security, contributing to energy security.¹⁰⁶

Non-financial objectives

The sectoral policy objectives arise from legal acts and policy planning documents and are related to providing the carrying out of the functions specified for the public person. The other non-financial objectives (ESG related, innovation, for example) can be more SOE specific and tailored for the achievement of distinct path in which the shareholder sees SOE should be heading.

SOE ownership policy objectives

Additionally, the section includes SOE objectives that arise from the general SOE ownership policy and are related to increasing good corporate governance practices among the SOEs.

General objectives should be set in the SOE ownership policy document and should be aimed to uniform and harmonize corporate governance practices among all SOEs. The general objectives can be adjusted to the specific SOE considering the development of its corporate governance framework. The general objectives should include such areas as internal control framework, disclosure of information and transparency, accountability.

Financial objectives

High-level expectations by the State for the financial objectives to be met during the OLE period. The financial objectives are driven by the proposed SOE segmentation (see section 3.2.2.) and include the following three elements to be addressed by the Executive management and Supervisory boards:

- Financial target setting providing a concrete methodology on how capital structure, rate of return and dividend targets should be determined.
- Preferred financing instrument list providing specific financing instruments to be more actively considered during OLE period when contemplating on larger capital allocation projects.
- To perform an IPO readiness assessment to determine whether the company is a good candidate for entering the stock exchange and receiving financing from private investors.

The details of the aforementioned points are laid out in the SOE financing methodology below

¹⁰⁶ The Cabinet of Ministers Regulation No 489 "On the general strategic goal of the joint stock company "Latvenergo", 31.08.2016.

4.2. SOE financing methodology

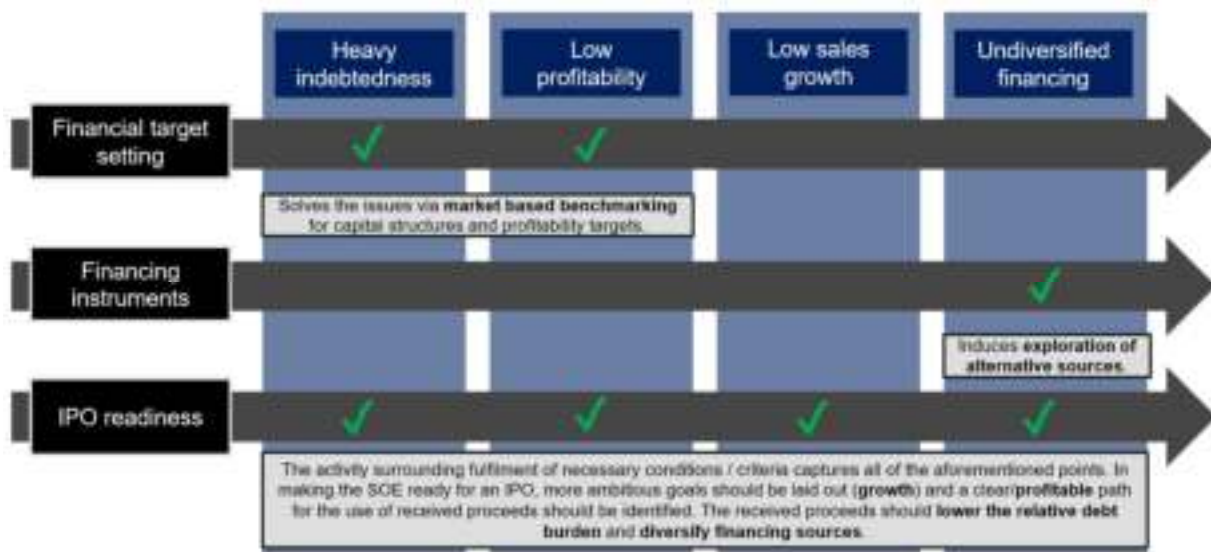


Figure 34. Elements of the SOE financing methodology

The Figure above encapsulates the key areas of concern that are associated with SOE financial standings and historical performance stemming from the assessment made in financial review section. Most SOEs, as analysed on 70 SOEs, exhibit on the one hand elevated debt levels relative to the identified benchmarks, and on the other hand have generated subpar growth and profitability results. In addition, a pronounced pattern was observed among selected sample size of SOEs in using far too less different financing instruments, which are mostly skewed towards traditional forms despite the availability of other, presumably more beneficial, sources of financing. It is vital to tackle all of these issues to foster through a holistic solution – SOE financing methodology.

SOE financing methodology consists of three main elements – financial target setting, list of preferred financing instruments, IPO readiness assessment. It is established with the aim to **stimulate a formation of optimal capital structures and, in general, a more efficient capital allocation**. SOE financing methodology addresses the issues identified during the financial review phase by also taking into account the feedback from the market and findings from the analysis on best practice.

A critical bedrock for the SOE financing methodology is a new form of SOE segmentation that would drive the subsequent decisions made for the following key elements:

SOE financial target setting – introduces a market-based benchmarking in the process of setting financial targets by giving a framework on how to measure and determine optimal capital structures and return targets over a specified time period.

List of preferred financing instruments – a specifically designed spectrum of preferred financing instruments for each SOE segment by considering the identified gaps of financing sources. The aim is to promote a more active use of alternative sources of financing to diversify the current mix and enjoy the benefits offered by the alternatives.

IPO readiness assessment – to induce active ownership and more ambitious goals by providing a set of criteria to be addressed by commercial SOEs. The criteria are designed to render the commercial SOEs more ready and prepared for a potential debut in stock exchange or fixed income market.

4.2.1. Segmentation

The SOE segmentation has been developed by considering the best practices from foreign countries, and the feedback from both local institutional investors and the SOEs of the selected sample. In addition, a valuable feedback from the CSCC and EBRD has been factored in, while developing the segmentation.

The importance of having a segmentation in place for the planned methodology is explained by the sheer number of Latvian SOEs, and the aspects of “one size does not fit all”. As of the Assignment date, there are over 170 SOEs with heterogeneous business profiles, different sizes and State dependency, etc. Therefore, it is important to introduce a specific form of an SOE segmentation that would render the methodology applicable for all SOEs addressing various aspects of different financial characteristics. In the same time, the segmentation should not be overly complex with a plethora of exceptions, caveats and sub categorizations since that would imply an unnecessary layer of bureaucracy and make the methodology more difficult to apply.

The proposed segmentation approach is based on a SOE categorization that distinguishes SOEs by looking at the main source of generated income. As a result, there are two broad categories of SOEs – **State dependent SOEs**, and **commercial SOEs**. The notion of using source of income as the key differentiator for the SOEs segmentation is attributable to the key objectives of the Assignment, namely, to propose a methodology, which would address the formation of optimal capital structures, and the choice of relevant financing instruments given unbiased and well-formed financial objectives. As these objectives entail a high degree of financial focus, the corresponding metrics used for segmenting the SOEs should also take into account financial aspects. The source of income differentiator has the following advantages:

- Easy to gather and interpret when making the actual segmentation.
- Reflects well the dependency on State’s support and the level of commercial activities.
- The source of income plays also an important part in several financing instruments and broad financial targets.

The segmentation also is made on a **consolidated basis**, meaning that all subsidiaries should be classified in the same segment as the mother or concern company. In case the subsidiary exhibits a significantly different nature in terms of discretion over generating commercial returns and does not constitute a notable part of the consolidated company, the shareholder should possess the freedom to determine a different segmentation between mother company and subsidiary. The subsequent criteria applicable for each segment should also be applied on a consolidated basis. The rationale for this lies in the fact that in the process of capital allocation, attraction of larger financing and investors, a company is usually analysed in conjunction with the subsidiaries. This approach also coincides with IFRS reporting, and dividend expectations from an SOE. Lastly, it mitigates the risk of moving capital among the group’s companies to influence the direction of results for a particular subsidiary or mother company.

The proposed segmentation introduces two broad groups of SOEs - commercial SOEs and State dependent SOEs. The State dependent SOE segmentation is further separated in the State dependent commercial

SOEs and State dependent non-commercial SOEs. The **Figure 35** encapsulates the general segmentation approach.

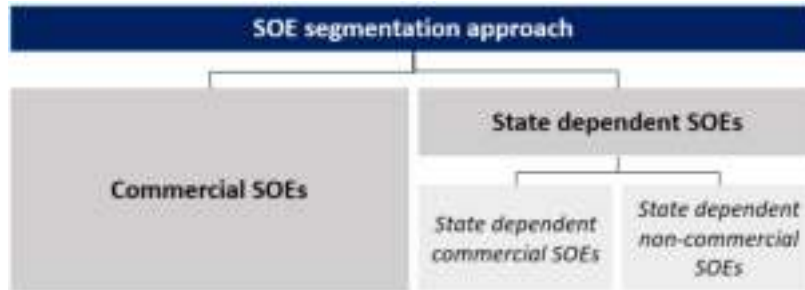


Figure 35. SOE segmentation approach

It should be the shareholder’s responsibility to handle the segmentation process and assign segment on a SOE level. The legal limitations, strategic objectives and Owner’s letter of expectations (see further in the report) in terms of the overall dependency on State financing should be used as a base in choosing the most suitable segment. The SOE segmentation decision, ultimately, reflects the shareholder’s view on how far the SOE should operate as a commercial entity in the foreseeable future. For instance, if a particular SOE as of the date of segmentation decision is classified in the State’s budget and executes mostly non-commercial activities, but in the future aims to become more commercially oriented, then the SOE financing methodology for commercial SOEs could be opted. Similarly, in situations when the industry specific legal framework limits SOE commercial activity, the SOE financing methodology for State-dependent SOEs should be opted for.

The segmentation of SOEs is carried out in three-step approach depicted in **Figure 36**.

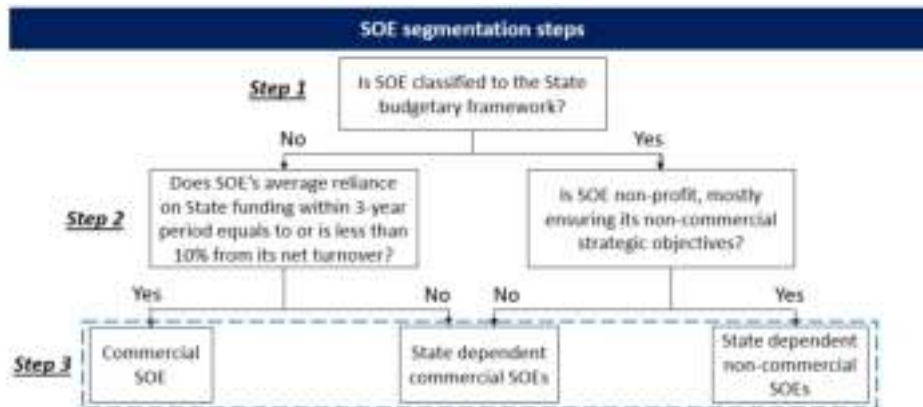


Figure 36. SOE segmentation steps

Box 4.3. – Financial vs non-financial entity

The process of developing methodology should take into account the profound differences between financial companies and standard corporate companies. The differences stretch from distinct financial

reporting, the manner how revenues are being generated to how the balance sheet is structured, and risk management conducted.

In Latvia there is only one financial services SOE – Altum. In theory, Altum should deserve a separate segment and a separate SOE financing methodology. However, considering that the proposed SOE financing methodology for commercial SOEs can be easily and on a justified basis applied to Altum as well, a separate segment is not introduced.

According to **Figure 36**, Altum falls under the State dependent SOE segment due to notable guarantees provided by the State and the conducted business operations across the segments for which there is not a sufficient market presence. However, looking at the exploited financial instruments, diversity of revenue sources and their drivers, the case could be made of Altum being treated as a commercial SOE. As such, Altum is a vivid example of the legitimacy of imposing a discussion process during the SOE segmentation phase.

Step 1 - SOE classification to the State budgetary framework.

The SOE classification to the State budgetary framework is determined by examining the SOE status quo classification by the CSB. Namely, the answer whether SOE is recorded on the State budget is found by looking at the present data published by CSB, classification code: S130130.

SOE applicability to the State budget is covered on the EU level by the European System of Accounts (ESA 2010) and further expanded upon by the EC's Manual on Government Deficit and Debt (MGDD). In general, the underlying process of determining whether an SOE falls within the State budget is cumbersome requiring a complex assessment (e.g., quantitative market and non-market tests). Please refer to **Annex 13** for a more detailed illustration of how the process works in respect to potential classification to the State budget.

The aim of compartmentalizing SOEs according to the belonging on the State budget is essential for developing an SOE financing methodology that appreciates some of the most crucial differences related to the overall capital allocation decisions. An SOE presence in the State budget adds notable constraints on how the capital can be allocated and financing decisions made. Since an incremental debt assumed by an SOE, which is classified in the State budget, affects the State's budget and its balance sheet, the SOE is subject to a more stringent approval process. Consequently, the State's budget classified SOE is less nimble in making significant financing decisions, as the speed of approval process is rather slow (e.g., approval from the MoF and EC). Moreover, such SOEs might be denied a much needed and viable access to finance if the prevailing fiscal environment is tight.

The aforementioned calls for a targeted approach in developing the SOE financing methodology. In fact, such categorization also coincides with the underlying extent to how dependent an SOE is on the financing from the State. The dependency on the financing from State is a critical factor to consider, when developing the methodology. In general, the more reliant the SOE is on the State financing, the less room for large financing manoeuvres the management has.

Step 2 - Commercial vs State dependent non-commercial SOEs.

After it is determined whether an SOE falls within the State's budget, it is necessary to assess the underlying dependency on State financing. It could be so that while an SOE is not included in the State's budget, the nature of the business is highly driven by the amounts of State's financing. For example, an SOE could be classified out of the State's budget due to relatively marginal amounts of commercial activities surpassing the State's financing (i.e. a borderline case).

Assessing the portion of the revenues attributable to the State's financing helps tackle the issue of such borderline cases, and to properly separate commercial from non-commercial SOEs. By applying an extensive analysis (to all SOEs reflected in the CSCC database) and conducting several simulations with different percentages of State's financing from total revenues¹⁰⁷, a threshold level of 10% or less on 3-year average revenue composition is considered optimal. Put differently, an SOE should be treated as a commercial entity in the context of the SOE financing methodology, if the State's financing accounts for 10%¹⁰⁸ or less from 3-year average revenues as of the date of segmentation decision. By extending the period of average sales (e.g., to 5 years) and/or increasing the threshold weight of State's financing (e.g., to 40%), the segmentation of neither the selected SOEs nor broader sample of SOEs (i.e., those reflected in the CSCC database) would not change materially. The 3-year period provides a reasonable period for a smoothed data and normalization of notable deviations, and, in the same time, minimizes the risk of including a period after which there has been a structural shift in the business operations. The 10% level of State's financing from SOE's total revenues could be considered a relatively insignificant part that allows an SOE to substantially influence the financial results without being overly dependent on the State.

However, it should be noted that the aforementioned process entails a fair degree of subjectivity as no quantitative mechanism that is simple to understand, and use can address a plethora of caveats carried by the SOEs. To avoid perplexity and render the segmentation easy to understand, basing segmentation on quantitative metrics is deemed optimal. Additionally, in the situations when the industry specific legal framework limits SOE commercial activity by determining both the source and allocation of income, the same segmentation as for State-dependent SOEs should be applied. In such situations, SOEs are restricted to engage in commercial activities with an aim to maximise their profits but are rather exercising public power¹⁰⁹. For example, the legal framework of Latvijas Gaisa Satiksme has been established by EC Implementing regulation (EU) 2019/317 determining financing of air navigation services, and thus the financing of the SOE.

Lastly, the shareholder liaising with the Supervisory board (if needed) should determine the exact metrics (i.e., period and revenue weight of State's support, or any other relevant measure) used for segmenting SOEs.

Similarly, an additional layer of assessment should be devoted to SOEs, which are classified in the State's budget and are State dependent. There exists a huge diversity among the State dependent SOEs with such

¹⁰⁷ Net income and other income.

¹⁰⁸ To provide an objective picture it is necessary to deduct one-off subsidies (e.g. recognition of one-off compensation in connection with Riga cogeneration plants in October 2017, Latvenergo AS)

¹⁰⁹ State may act either by exercising public powers directly through State administration or indirectly by carrying on economic activities of an industrial or commercial nature by offering goods and services on the market via State-owned enterprises.



SOEs being included as Altum and Pasažieru vilciens on the one hand, and Latvijas Koncerti and CSDD on the other.

It is important to split the State dependent SOEs to make the SOE financing methodology more targeted and applicable to SOEs with different degrees of dependency from the State financing. Consequently, two segments are outlined: State dependent commercial SOEs, and State dependent non-commercial SOEs.

State dependent non-commercial SOEs usually operate purely on non-commercial terms, which embody a significant presence of non-financial objectives. See examples below:

- SOEs ensuring state aid support (in terms of EU funds, guarantees, etc.);
- Companies operating in the culture segment (theatres, opera, orchestras, etc);
- Healthcare providers;
- Educational institutions;
- Sport infrastructure providers.

State dependent commercial SOEs, however, have a more pronounced presence of commercial activities within the overall business activity. As a result, the relevant SOE financing methodology should be tailored differently compared to that of State dependent non-commercial SOEs, which are less flexible in terms of making capital allocation and financing decisions.

Setting a quantitative mechanism for segmentation purposes of State dependent SOEs would be unfeasible and challenging to execute in practice. For example, the State dependent non-commercial SOEs usually are relatively small entities (albeit, some hospitals generate sizeable turnover) with, oftentimes, subpar transparency and the associated account separation. Hence, the process of deciding to which segment an SOE classifies should be carried out by the relevant shareholder and key stakeholders. Points as historical track-record of dividends, profits, proportion of sales attributable to the State financing and business segment should support the final decision of classifying the SOE as State dependent commercial or State dependent non-commercial.

Step 3 – Choosing the appropriate segment.

Step 3 is a final stage in which a shareholder together with the key stakeholders of an SOE choose the most appropriate segment taking into account the assessment made in step 1 and step 2. Here it should be determined whether the SOE is characterized best as mostly commercial entity operating on similar terms and in environment as a privately owned equivalent entity (i.e. commercial SOE), or whether it compares better to a State dependent entity with a high reliance on the State financing (i.e. State dependent commercial SOE, or in the case of a more pronounced State financing – State dependent non-commercial SOE). After the segmentation is made, the relevant SOE financing methodology should be followed.

Lastly, it is important to recognize that the proposed steps for segmenting the SOEs should **serve as a tool and provide a high-level guidance** for the shareholder in deciding which part of the SOE financing methodology should be applied. The proposed approach within the steps (e.g. the level of State financing in total revenues) **should be checked with the key stakeholder of SOE, and adjusted provided that a**

different approach would reflect the substance better (e.g., the level of discretion to influence financial results by the Executive management internally).

4.2.2. SOE financial target setting

The SOE financial target setting methodology is an important element to **quantify and align the expectations set in the State ownership policy document and the OLE further into development of medium-term strategy**. Such methodology should provide right tools and mechanics to set objective and appropriate targets by taking into account the communicated expectations as well as the notion of competitive neutrality (e.g., financial targets similar to comparable private businesses). This way a coherent approach is imposed in the objective and appropriate financial target setting.

The SOE financial target setting offers the following:

- A mechanism that guides Supervisory boards and Executive management teams on setting 5-year financial targets in medium-term strategies that are similar to those of comparable businesses – creating a value (both social and financial) and maximizing the returns on the State’s capital. This is driven by applying credit rating methodology, industry/sector averages and a targeted sample size of comparable peers.
- A performance review at the end OLE and medium-term strategy and at the process of developing the new OLE and performing re-evaluation of ownership that is driven by objective and comparable benchmarks (in the form of pre-set financial targets);
- Provides methodology for specific financial targets to be included in medium-term strategy (which in turn will guide the development of annual plans/ budgets);
- A set of critical financial aspects that have to be factored in to converge to comparable businesses and deliver sufficient returns without excessive risk taking. These financial aspects tackle company’s balance sheet (optimal capital structure), income statement (rate of return targets), and shareholder’s compensation level. This set of financial aspects tackles the most common financial targets set for SOEs as well as assesses a company from a similar perspective as OECD in defining well-defined optimal capital structures.
- Recommended financial metrics to be used for defining appropriate target values for each of the previously mentioned financial aspect.

If an SOE does not have a Supervisory board, the shareholder carries out duties and responsibilities of Supervisory board. However, to ensure efficient SOE governance, it is necessary to evaluate whether shareholder has the necessary institutional capacity to apply the proposed financial target setting. If necessary, shareholders have to strengthen their institutional capacity by attracting more professionals involved in the SOE governance.

Box 4.4. – Points not being addressed by the SOE financial target setting

The SOE financial target setting methodology does not address the following:

- The necessary projections and year-by-year values to achieve the 5-year financial targets. The decisions and tactical capital allocation processes related to how the 5-year financial targets should be better, achieved are left at the discretion of Supervisory board and Executive management team.

- The process and structure around budgets.
- The fulfilment of other objectives laid out in the OLE except for the financial objectives.
- The SOE financial target setting methodology recommends using ROE, D/E (or leverage and coverage factors based on investment grade bond proxy) and dividend pay-outs, respectively, yet, it also offers the possibility for the SOE to substitute any of these metrics with a more relevant and more objective metrics in the context of SOE’s industry. In such case, an appropriate justification must be provided.

The general content of the proposed SOE financial target setting methodology is outlined below, with more concrete steps and technical explanations provided in **Annex 15**.

	Commercial SOEs	State-dependent SOEs	
		Commercial	Non-commercial
Optimal capital structure	<ul style="list-style-type: none"> • Based on leverage and coverage factors stemming from relevant investment grade credit rating (methodology) defined by one of the top-tier credit rating agencies. 	<ul style="list-style-type: none"> • Debt-to-equity (or any other sector specific metric) based on sector or close peer benchmarking. 	<ul style="list-style-type: none"> • Return and capital structure expectations set as to fulfil non-commercial goals in an efficient and sustainable manner, not making losses. • The focus should be given to efficient and sustainable fulfilment of non-financial goals adhering to best corporate governance practice. The formulation of non-financial goals should follow the recommendations outlined in the SOE ownership policy review (Part I).
Rate of return	<ul style="list-style-type: none"> • Return on equity (or any other sector specific metric) based on sector or close peer benchmarking. • Regulated business segment should be subject to benchmarking based on the maximum allowed level of return by the relevant legislation (e.g., nominal WACC). • State subsidised business segment should be subject to sector or close peer benchmarking. 		
Dividend policy	<ul style="list-style-type: none"> • Dividend pay-out ratio (or any other sector specific metric) based on sector or close peer benchmarking. • Dividend pay-out ratio should consider the leverage and coverage factor levels / ranges necessary to achieve or maintain an investment grade credit rating. 	<ul style="list-style-type: none"> • Dividend pay-out ratio (or any other sector specific metric) based on sector or close peer benchmarking. 	<ul style="list-style-type: none"> • Dividends should be determined for each company separately, allowing to make no dividends. • Financial targets should be discretionary and determined on a company-by-company basis.

Figure 37. SOE financial target setting

--Optimal capital structures--

The notion of having established optimal capital structures is critically important in order to mitigate excessive build-up of financial risk, to reduce the likelihood of ad-hoc equity injections from the State, and in the same time to maximize shareholder’s value. Expressed differently, in the case of company’s indebtedness being overly high, the company automatically becomes exposed to myriad of risks – e.g., limited capacity to borrow for future investments plans, constrained access to additional liquidity in times of increasing economic uncertainty, and less cash flow for dividend payments after the subtraction of elevated interest expenses. In the opposite case, when the debt levels are relatively low and the company is overcapitalized, the capital employed runs a risk of not being exploited in the most value-maximizing manner limiting the shareholder to capture an adequate level of return. In addition, the circumstance of debt levels being considerably below the defined benchmarks could imply that the company is not taking the necessary level of risk for future expansion, and thus reduces the future growth potential and puts the company at disadvantageous spot relative to the peers.

State-dependent commercial SOEs

In the formation of optimal capital structures for SOEs, the sectoral/industry benchmarking is recommended or in this case benchmarks of similar SOEs outside Latvia. The balance sheet metrics used for determining the right portion of debt in the company should come from the sector/industry to which the company is exposed to. The necessary balance sheet metrics for benchmarking purposes should be chosen as to fairly reflect the underlying financial risk stemming from debt. For example, the real estate



sector could better opt for AFFO¹¹⁰-to-debt to conduct a correct benchmarking, whereas a more regular corporate entity could use more commonly understandable measures such as debt-to-equity or debt-to-total-assets. The chosen sector/industry should reflect similar business risks to which the company is exposed to. If the company operates in different sectors/industries, a weighted average approach should be applied (e.g., determining the weights based on the sector/industry's contribution to total EBITDA).

Advantages

Accessibility – it is easy to access financial benchmarks on sector/industry level, and in many cases, they are free of charge, and in the same time used in best practice financial analysis.

Simplicity – it is simple to arrive at both the sector/industry and the financial metric that would fairly reflect the company's risks.

Fair reflection of market – the sector/industry approach facilitates a sound comparison against the market and shows the prevailing averages for otherwise equivalent peer samples.

Risks and mitigations

Idiosyncrasies – the company under consideration might exhibit too specific characteristics that render any broad comparisons unjustified. For example, the company might operate in a plethora of business segments, which all entail a high degree of country specific exceptions or additional regulations. If the correct sector/industry benchmark is impossible to determine, the Executive management should define a smaller subset of peers against which the benchmarking process can be applied.

Regulatory environment – certain companies might be exposed to a more stringent regulatory environment, which disables the company from freely allocation capital. The company might be classified to the State budget or governed by higher EU directives that limit the flexibility to assume necessary amounts of debt. Therefore, the Supervisory board in cooperation with the Executive management should propose alternative benchmarks as replacement to the more straightforward sector/industry approach.

Uneven reporting – different sector/industry benchmarks carry different specifics when it comes to the geographic diversity, company size, and reporting standards. For example, a discrepancy might occur between IFRS and U.S. GAAP reporting that impact the reflection of debt levels (e.g., through defined benefit pension liabilities). Hence, the key stakeholder should assess how reasonable the sample are and focus more on EU-level or even CEE region benchmarks.

Commercial SOEs

For commercial SOEs it is recommended to base optimal capital structures on the higher investment grade credit rating subject to credit rating “ceiling” in which one notch below the country's credit rating acts as cap for how strong credit rating a corporate entity can receive (i.e. leverage and coverage factors stemming from an investment grade methodology such as debt-to-EBITDA not exceeding a certain threshold level). For it to happen, the commercial SOEs should apply for an issuer level credit rating from one of the top-tier credit rating agencies (Fitch, Standard & Poor's or Moody's), and also subscribe to a yearly update. The issuer level credit rating does not require the company to have an active bond issue outstanding. The credit rating on an issuer level (an opinion about credit risk, which expresses the agency's opinion about the ability and willingness of an issuer to meet its financial obligations in full and on time) serves as a yardstick for optimal capital structures. If the rating falls below investment grade, the company

¹¹⁰ Adjusted fund from operations (FFO + rent increases - capital expenditures - routine maintenance amounts).



should tailor its business plans and capital allocation decisions with the aim to improve on the underlying business and financial risks

Box 4.5. – Identifying optimal capital structures in Australia

Source: Submission by Australian authorities in response to OECD questionnaire.¹¹¹

Australia's commercial SOEs are called Government Business Enterprises (GBEs). GBEs report to Shareholder Ministries and follow the Commonwealth Government Business Enterprise Governance and Oversight Guidelines (GBE Guidelines). The GBE Guidelines state "each GBE should target an optimal capital structure (the combination of financial liabilities and equity used to fund the assets of the GBE) that is agreed annually between the Supervisory board and the shareholder minister(s) in the corporate plan consultation process."

A GBE's Supervisory board is responsible for development of capital structure as part of the annual corporate planning process. The Corporate Plan is submitted by Supervisory boards to shareholder minister/s each financial year and is the key planning document of the GBE.

The GBE Guidelines advise that an optimal capital structure is one that, in light of economic, industry and GBE specific factors, would provide for an investment grade credit rating, whilst at the same time imposing a discipline on the GBE to optimise efficiency. The target credit rating is BBB.

As part of developing a target optimal capital structure, consideration will be given to the forecast level of capital expenditure in the GBE's annual corporate plan, and appropriate instruments for funding capital expenditure (including via retained earnings or debt). Consideration will also be given to longer term objectives outlined in a GBE's annual corporate plan.

In providing for GBE to expand its capital base through retained earnings, any proposed future capital expenditure should add shareholder value. That is, as a minimum, capital expenditure plans should meet a hurdle rate-of-return (WACC) that is consistent with the GBE's principal financial target.

The capital structure of a GBE reflects the relevant risk of the entity, the environment it operates in and the economic conditions at the time. Capital structures are benchmarked against private sector entities to the extent possible.

Advantages

Unbiased – one of the key advantages by having a credit rating from a top tier credit rating agency is that it provides an objective and commonly accepted assessment of the company's risk profile. The company exhibits very limited discretion in influencing the rating by creatively presenting certain areas better than they are. In addition, ratings are widely used by external users of financial data (e.g., investors, lenders, suppliers), that, ultimately, allows the company as well as other stakeholders to benchmark in an efficient manner.

¹¹¹ Financing State-Owned Enterprises
An Overview of National Practices, OECD



Marketing tool – companies that carry a credit rating that is generally within the investment grade bound can improve their own image. They can use the rating as a marketing tool to create better image in dealing with its customers and suppliers.

Explicit and implicit financial benefits – the explicit financial benefits stemming from a credit rating are linked to lower cost of borrowing because the increased transparency and the reduced risk of bad corporate governance practice reduce uncertainty for the lender, that, in turn, lowers the charged interest rate. The implicit financial benefits are linked to a wider audience in the scenario of bond issue. The demand levels for a bond issue coming from a rated company are higher compared to the company without a credit opinion from reliable agency. Although the presence of credit rating can contribute to better relative pricing compared to an equivalent issuer with no credit rating, it does not reduce credit risk and the corresponding risk premium. All in all, the credit rating eases the work for brokers and financial intermediaries to conduct the necessary due-diligence work; hence, it reduces the costs of a public issue. Additionally, it allows the company to be more prepared for a smooth and efficient IPO process.

Risks and mitigations

Expensive – obtaining a credit rating from one of the top-tier credit rating agencies is a costly exercise, especially for companies of a smaller size. The costs linked to getting a credit rating depend on the company, size, industry and other metrics, but on average are estimated at EUR 150 thousand. To maintain the credit rating, the costs are marginally lower – on average EUR 100 thousand. The workaround for this could be the use of publicly available credit rating guidelines developed for each specific sector/industry. If there is a limited capacity to put in use the publicly available guidelines to determine the approximate rating for the company, external consultants should be assigned, which would decrease costs considerably.

Complexity – the process of receiving and maintaining a credit rating is cumbersome, time consuming, and involves many layers of staff. There are no direct mitigants for this. Nevertheless, the complexities around obtaining a credit rating give a stimulus for the Company to scrutinize and deep dive into its own financials and operational data, oftentimes, leading to improved efficiencies and better management overall. Lastly, the process of obtaining a credit rating consists of many different layers that are mostly segregated into aspects of financial and business risks. Capital structures' aspect is an integral part of the assessment of financial risk, yet in the whole chain of processes capital structures do not solely dictate the final decision in terms of where the company ranks. This might lead to a situation in which the company has formed an optimal capital structure but does not have an investment grade credit rating. However, this situation in itself should not be viewed as an issue because the necessary yardsticks for determining optimal capital structures are still provided by the rating agency making it possible to form capital structures in line with investment grade criteria. In the same time, even if the capital structures are formed optimally (i.e. in line with the investment grade criteria), but the rating is still below investment grade, the remaining steps to achieve investment grade are generally beneficial to the company and shareholders.

Premature – there might be companies for which there might be certain outstanding homework to complete before turning to a credit rating agency. It might also be so that the shareholder together with the Supervisory board have intentionally outlined objectives in the Owner's letter of expectations or in the medium-term strategies that render the capital structure non-optimal for a certain time period.

Hence, under such scenarios, the shareholder could opt for State-dependent commercial SOE financing methodology and deeming this as a transitional phase towards acquisition of credit rating.

--Rate of return targets--

Defined rate of return targets play an important role for shareholders and various levels of management in running the company efficiently. Firstly, rate of return targets allows the shareholder to form justified expectation about the future financial performance of company, and also provide a yardstick against which the company's (or Executive managements) performance could be assessed. Secondly, in the scenario of openly defined rate of return targets, the company itself obtains a good grasp of return expectations from the shareholder that consequently answers what kind of investment projects with what level of expected yields should be targeted. Thirdly, rate of return targets disclosed in a transparent manner serve as an instrument for general public in assessing the company's performance relative to the industry or peers, and, in general, to make justified judgment about the overall capital allocation decisions within the company over a defined period of time.

For the aforementioned aspects to materialize, it is critically important to set economically substantiated and validated rate of return targets. Otherwise, too aggressive rate of return targets could lead to company taking unsustainable capital allocation decision in order to meet return targets at the expense of acceptable level of long-term returns. Conversely, too conservative rate of return targets could disincentivize company to achieve market consistent returns for the shareholder, thus accommodating inefficient allocation of public resources (mostly invested capital).

For the purposes of rate of return calculation, the SOE financial target setting methodology does not instruct separate processes of rate of return calculations between the commercial and State-dependent commercial SOEs. The argument lies in the fundamental basics of SOEs being required to generate market consistent returns irrespective of underlying split of commercial and non-commercial activities. However, considering the practice and present issues, an argument could be made for assigning separate return expectations between commercial and non-commercial activities. For example, according to the SOE feedback, the State financing for the fulfilment of non-financial objectives is sometimes provided at levels that are significantly below market averages or what the private company peers would earn operating in a certain business segment. Similarly, an SOE could be constrained by the regulatory framework in which the business activities are conducted (e.g., regulated pricing).

The proposed tool for setting appropriate rate of return targets and consequently measuring the SOEs performance is return on equity (ROE) formula. ROE is recommended due to wide set of advantages and relatively limited number of disadvantages that it has (as elaborated below). However, as the detailed constituents of SOE financing methodology are based on the principle "comply or explain", Supervisory and Executive managements should exercise their discretion on substituting ROE with a more appropriate metric if the underlying rationale for a such move can be backed with a clear explanation. For example, there might be a situation in which the balance sheet value of equity used as an input for ROE calculation does not reflect the true situation. Usually, this is caused by having off-balance sheet items and assets and / or liabilities that are reflected at cost, not at fair value. Lastly, the recommended period for calculating ROE or any other comparable metric is historical 3-year average from comparable companies. The 3-year historical average is a widely prescribed approach for accounting for any excesses and smoothing effects from any one-offs incurred during the recent past.

Advantages

Simplicity – the process of accessing inputs and calculating the corresponding return on equity are straightforward exercises and commonly understandable for Executive management and general public.

Comparability – the wide use of return on equity as a financial metric of assessing company's returns makes it an easily comparable instrument. This is a crucial property, which most of the comparable metrics do not possess, and which, ultimately, allow for easier scoping of relevant benchmarks.

Reflects shareholder's return – ROE directly shows how much (in relative terms) the shareholders have earned on the invested capital, and thus answering how efficiently the public resources have been employed relative to other comparable peers.

Risks and mitigations

Easy to manipulate – the calculation of ROE is relatively easy to adjust and tailor for the envisioned value. The sample size, time period, and type of equity value can all be easily adjusted and impact the end result. To mitigate this, the reviewer of the calculated target value should demand for the methodology and calculations used in arriving at the submitted target value. The reviewer should become fully aware of the rationale on why, at least, such sample size, time period, and type of equity were chosen.

Subject to accounting caveats – the ROE requires two major inputs for its calculation, namely, the net income and the equity value. Both of these areas are subject to various accounting regulations, and can vary among countries. In the best-case scenario, the party picking right companies within the sample should go through the companies' financial statements and check for any material deviations that could affect a proper comparison.

Agnostic to company's level of maturity – the ROE does not consider the stage in which the company operates. There is a stark difference between a company which has been established a long time ago from a company which has been just recently incorporated. The same applies for major capital allocation and investment decisions that could temporarily skew the company's financial performance from the pre-defined peer group (benchmarks). Under such circumstances, the Supervisory board should communicate to the shareholder the reasons why certain benchmark values are not temporarily relevant, and, instead, propose adjusted benchmark for reasonably benchmarking rate of return targets.

--Dividend policy--

Dividend policy is one of the most important constituents of SOE financing methodology, and, in the same time, a very sensitive topic that is very often discussed and debated in the wider public. On the one hand, companies are interested (albeit not all, but in general) in retaining as much profit as possible to sponsor future growth opportunities and become a more established entity. On the other hand, shareholders are inherently interested in receiving higher amounts of dividends. The shareholder's interest (mentioned aspect) in the context of SOEs is even more prevalent as the ministries are exposed to public pressure to deliver on the promised ambitious goals without creating overly large government deficits.

The stipulated dividend policy should facilitate a balance between the company's interest in retaining non-optimal amounts of earnings, and the shareholder's interest in mandating the company to distribute unsustainable amounts of capital as dividends. In the former case, retaining too much capital within the company could lead to overcapitalization which in turn leads to inefficient capital structures and insufficient returns on equity. In the latter case, too aggressive dividend pay-outs could impede future



growth prospects, increase company's financial risk and weaken the capacity to generate sustainable returns.

The recommendations for the dividend policies in the scope of SOE financing methodology are different between commercial and State-dependent commercial SOEs. This is due to commercial SOEs being exposed (as an aspirational goal or subject to transitional phase) to obtaining and maintaining an investment grade credit that correspondingly dictates the acceptable and / or allowable levels of dividend pay-outs.

State-dependent commercial SOEs

For the State-dependent commercial SOEs it is recommended to follow sectorial / industry specific approach in setting dividend policies. In this approach, the Supervisory board in cooperation with the Executive management should define the most relevant sector / industry reflecting the underlying business operations of the company and assign corresponding dividend pay-out targets.

If there is no exact sector or industry that properly reflect the activities of an SOE, the Supervisory board and Executive management should identify and develop a sample of peer companies that would allow for a better comparison.

In general, it is recommended to apply a historical average of a 3-year historical period as a reflection of defined dividend pay-out targets over the course of newly drafted owner's letter of expectation. The dividend pay-out metric is comprised of yearly profit and the distributed dividends from the profits generated in the same year.

Advantages

Simplicity – determining dividend pay-out levels is a relatively easy exercise since the key input data is often freely available – both in the form of annual financial statements and widely used financial databases (e.g. A.Damodaran). Dividend pay-out level is also simple to calculate and communicate to the general public.

An objective benchmark against peers – established dividend pay-out targets accommodate a relevant benchmarking process that is based on fresh and market driven financials. It provides a range of expected dividend pay-out that is comparable to the companies operating in the same segment as the particular SOE.

Clear picture of expected levels of pay-out and the earnings retention – dividend pay-out metric provides a clear and predictable form of expectation what level of reported earnings the shareholder expects to receive and what level will be left for the company to cover future investments. This is extremely important for the companies to plan ahead larger investment plans and to achieve a comfort of less volatile cash flows when, for example, accessing larger amounts of financing.

Risks and mitigations

Cash flow vs accounting earnings – in setting the dividend pay-out levels, reported annual earnings play a crucial role. However, the reported annual earnings may sometimes not reflect the actual performance of company and the actual amount of cash flow generated during the year. For instance, a larger revaluation of assets might lead to higher earnings that are not backed with the corresponding cash flows. In the event of a more profound deviations, the Supervisory board together with the Executive management should adjust the pay-out ratio to the normalized earnings.

Tactical deviations in the strategy – dividend pay-out levels based on the pre-defined peer group or sector / industry might not match the tactical manoeuvres planned by the company to achieve long-term targets in a sustainable manner. For example, the company could decide to retain higher levels of profit in order to fund more ambitious and necessary goals, or conversely, it might decide to distribute more profit to achieve optimal capital structure. Any deviations should be backed by a transparent argumentation from the Supervisory board.

Subject to accounting caveats – similar to ROE, dividend pay-out metric is subject to various accounting treatments that might differ among different jurisdictions and even industries. The reported annual earnings input is subject to the most to uneven treatment, and thus calls for a more tailored approach when being incorporated in the process of deriving the relevant benchmark values.

Commercial SOEs

For commercial SOEs, it is recommended to use one of the following dividend policy approaches:

1. Tied towards maintaining or achieving an investment grade credit rating (and applicable capital structure).
2. Similar to the approach outlined in the case of State-dependent commercial SOEs provided that Supervisory board justifies the rationale why the first alternative (above) is not chosen, and the standard peer and industry benchmarking approach is preferred.

The dividend policy based on the credit rating serves the purpose for keeping the company financially stable and resilient to swings in the business cycle as well as fostering a sustainable growth. In defining dividend policy that is driven by the investment grade credit rating, the leverage and coverage factors play an important role. The leverage and coverage factors provide a range for what needs to be achieved in order to qualify within investment grade space in the context of company's capital structure. The target range allows the company to extrapolate the permissible increase or decrease of debt portion relative to equity. For instance, if the company has already met the required factor values for an investment grade credit rating, it should consider a dividend payment corresponding to equity part (or amount) that is above to what is necessary to meet the factor value.

Advantages

Safeguards SOEs sustainability and stability – credit rating benchmarks give an objective measure on the permissible level of dividend payment that can be communicated to shareholder. It gives a comfort for SOE that unpredictable extraction of capital will not occur, while the shareholder can more easily decide the optimal level disbursement.

Fosters optimal capital structures – The notion of achieving or maintaining investment grade credit rating in terms of leverage and coverage factors allows the company to arrive at optimal capital structure, thereby capturing the corresponding benefits – e.g., avoidance of overcapitalization (relative to the defined benchmark of leverage and coverage factor) or too high indebtedness.

Mitigates financial risk – dividend policy that is connected to stable and transparent criteria decreases the financial risk of the company. This way the risk of unexpected and significant capital extractions is mitigated as the shareholder is limited to the fulfilment of necessary leverage and coverage factors.

Risks and mitigations

Volatile disbursements – the leverage and coverage factors that dictate the formation of optimal capital structures are usually based on balance sheet and cash flow metrics. Hence, not only the debt and equity

aspects should be scrutinized, but also the cash flows. For example, as of the dividend payment date the leverage and coverage factors might be met, however, if the planned cash flows that would form a leverage and coverage factor for the next dividend payment are predicted to suffer a notable decline, the company should contemplate on reducing the current dividend to be able to meet the required leverage and coverage factor level under the ensuing credit assessment. As a result, in the case of fluctuation cash flows or industry that is exposed to cyclical business patterns, the dividends might also face relatively large swings in order to keep the company financially stable.

Ambiguous – decision on the permissible amount of dividend payment so that leverage and coverage factors for investment grade credit rating are met requires a holistic approach. There are many aspects involved in maintaining or achieving an optimal capital structure and basing dividend decisions on it. Future investments, rate of return targets, planned refinancing activities must be considered in parallel to maintaining or achieving investment grade credit rating when making dividend payment.

Complexity – the process of accessing relevant benchmarks, putting them in the context of company's leverage and coverage factors, and then extrapolating permissible level of dividend payment is cumbersome and requires a high degree of expertise. However, usually larger commercial SOEs have already a robust financial management system and experts, who have the necessary knowledge to carry out such assessments.

4.2.3. Preferred financing instruments

The financial review section in the main body above reveal a pattern of **undiversified financing instruments** among all type of SOEs. The sources of financing used by the SOEs are undiversified and concentrated on State subsidies, retained earnings, and loans from commercial banks.

To solve this issue and increase the underlying diversity in the spectrum of widely used financing instruments, the State ownership policy document and related to State's plans in developing capital markets or other policies should be supplemented with the concept of expected or preferred financing instruments by the State / shareholder.

The preferred list of financing instruments should be defined for each SOE segment separately. Such list would embody State's positive stance towards a more diverse set of financing instruments that are used by the SOEs to cover various investment projects (related to both financial and non-financial objectives). However, there should be no forced obligation for the SOEs to stop using the existing financing instruments if they fall out of the preferred list or to strictly apply for specific financing instruments. Instead, the goal of preferred financing instruments lists would be to **accommodate a more active discussion and assessment around currently not used instruments**. At the end of OLE and medium-term strategy, the shareholder could initiate a discussion on the selected financing instruments and evaluate the SOE management whether a sufficient effort was devoted towards exploring and applying the preferred financing instruments laid out in the State ownership policy.

The list of preferred financing instruments is formed by considering the various pros and cons of each instrument outlined in the **Annex 4**. Each financing instrument is then assessed from the perspective of how it could be applied on the SOE segmentation level considering the distinct characteristics of commercial and State-dependent SOEs.

The **Figure 38** consolidated the preferred financing instruments per each SOE segment and is split between equity financing and borrowings.

	Commercial SOEs		State dependent SOEs																			
	Equity	Debt	Commercial		Non-commercial																	
Preferred financing instruments	<ul style="list-style-type: none"> + IPO and secondary offerings + Preferred shares 	<ul style="list-style-type: none"> + Bonds (including green bonds) + Commercial paper + Borrowings from IFIs 	<ul style="list-style-type: none"> + State subsidies and grants + Retained earnings 	<ul style="list-style-type: none"> + Bonds (including green bonds) + PPP + Borrowings from IFIs 	<ul style="list-style-type: none"> + State subsidies and grants + Retained earnings 	<ul style="list-style-type: none"> + PPP + Borrowings from IFIs 																
Aspects to consider when deciding which financing instrument to choose	<table border="1"> <tr> <td>Financial parameters →</td> <td></td> <td></td> <td></td> <td></td> <td></td> <td></td> </tr> <tr> <td>Specific parameters →</td> <td></td> <td></td> <td></td> <td></td> <td></td> <td></td> <td></td> <td></td> </tr> </table>						Financial parameters →							Specific parameters →								
Financial parameters →																						
Specific parameters →																						

Figure 38. List of preferred financing instruments per each SOE segment

4.2.4. IPO readiness assessment

Some form of SOE assessment in relation to how viable an SOE is for an IPO is crucial before deciding to explicitly require the SOE to tap the capital market and issue new shares. This step will help **scope the potential IPO candidates, highlight the currently lacking areas that have to be improved, and initiate a fact-based discussion around the IPO.** Therefore, it is recommended that in the State ownership policy document the vision on gradual reduction of ownership within a concrete group of SOEs is outlined in conjunction with the obligation to perform an IPO readiness assessment.

	Quantitative measures	Qualitative measures
Higher priority	<ul style="list-style-type: none"> Positive historical and future cash flows sufficient to cover expenses and generate positive returns. Stable, predictable and high-yielding dividend policy. Company's indicative valuation over EUR 100 million. 	<ul style="list-style-type: none"> Good corporate governance standards implemented across the entire organization – in compliance with OECD and best practices. ESG considerations present in the company's current as well as future operations (e.g., CO2 reduction, EU taxonomy, any KPIs set by the Government). Clear reasoning behind IPO ("investment driven" or "ownership driven") Seasoned executive board team and highly experienced and independent supervisory board with no scandals or controversies in the past.
Lower priority	<ul style="list-style-type: none"> Positive growth prospects for the company and industry / sector in which it operates. The market provided healthy valuation levels across the board, and is not in the bear market territory. Meaningful sales exposure in foreign markets. Minimal level of free float at 25% (yet depending on size – the larger the company, the lower the free float could be and vice-versa). 	<ul style="list-style-type: none"> Financial risk is properly managed and not elevated in relation to the peers or sector / industry benchmarks. Credit rating from top-tier agency on an issuer level (also as an aim for an enhanced rating closer to the sovereign). Transparent public reporting with additional (albeit not mandatory) levers of reporting.

Figure 39. Criteria for IPO readiness assessment

IPO readiness assessment includes both quantitative and qualitative measures, and each of the two groups include two tiers of criteria, namely, higher priority and lower priority criteria, that need to be evaluated to determine whether the company is viable for a potential IPO. These criteria stem from the

interviews with institutional investors, the analysis of all of the Baltic SOE IPOs and bond issuances as well as capital market expert opinions on the potential Latvian SOE IPOs.

It is proposed that the recommended criteria (or measures) are filled by Supervisory board in cooperation with executive management by showing whether a certain criterion is met, partially met or not met.

Most of the proposed approaches how to tackle and assess each criteria exhibit a degree of subjectivity and can differ from case to case (especially, for quantitative measures). Therefore, it is also recommended for the Supervisory board to approach the criteria by giving them an appropriate context (industry, company, shareholder). For instance, for the “meaningful sales exposure in foreign markets” it is recommended to have at least 10% of sales outside domestic market to fully meet the criterion. However, for a certain industry or company such level could be structurally impossible to reach for clear reasons that are also understood by the market, and thus the approach in fulfilling the criterion should be relaxed. Please see an example of filled template in **Annex 16**.

4.3. Implementation of active ownership principles and SOE financing methodology

The implementation of proposed active ownership principles and SOE financing methodology is a complex process requiring structural changes in the SOE ownership and management practices. The proposed recommendations should be recognizing as an aggregate and should be implemented collectively, following the logical sequence of the proposed solutions.

4.3.1. Active ownership principles

SOE ownership policy

Following the suggested active ownership principles, State should develop unified SOE ownership policy document complying and **clearly defining State’s overall SOE ownership policy strategy and objectives towards SOEs**. The SOE ownership policy should:

- determine State’s rationale towards participation in companies providing specific criteria and strategic rationale for State’s participation in SOEs;
- scrutinize State’s participation in SOEs and encourage to establish or maintain a participation in an SOE only if the strategic objective for establishing or maintaining participation in SOE cannot be achieved otherwise;
- based on the State’s rationale towards participation in a SOE the SOE ownership policy should clearly establish SOE segmentation process;
- establish clear objectives towards each of the SOE segments;
- include the State’s objectives on a sectoral level in order to provide a clear guidance for the SOEs. Defined sectorial objectives in the SOE ownership policy would allow the SOEs themselves to prepare and take bold steps that are necessary to achieve the envisaged sectorial plans;
- include overall SOE public policy objectives;
- impose an obligation for commercial SOEs to have an IPO assessment evaluating their readiness to tap the capital market;
- include an obligation for SOEs to actively evaluate different financing options based on the appropriate SOE segment;



- as an owner, the State should have high ambitions for sustainable business and conduct the business activities in a socially conscious manner. For example, the implementation of ESG standards, focus on green investments and overall carbon dioxide reductions could be defined as additional objectives for the SOEs. In this respect, SOEs can be encouraged to tap the debt capital markets to ensure their carbon dioxide targets are met in a transparent manner. One such template has been used in Greece by PPC – leading utility SOE – which issued the first high yield sustainability linked bond¹¹² (SLB) out of Europe. As part of the SLB structure, PPC committed in a transparent manner to reduce CO2 emissions by 40% in the upcoming two years. If the firm fails to do so, then there is a step-up coupon and the cost of funding will increase as per prospectus;
- enhance Coordination Institution’s role in the SOE governance. The State Ownership Policy should allow the Coordination Institution to act as a temporary Supervisory member for a period up to one year, if (1) the SOE’s Supervisory board has been established for its first term or there are significant changes, i.e., at least half of Supervisory board members have changed in the SOE Supervisory board or (2) shareholder has requested Coordination Institution’s assistance in SOE governance;
- assign a dedicated working group consisting of Coordination Institution, shareholders, line ministries and SOE higher management to discuss more concretely the concept of SOE corporate governance index. The working group should jointly determine the expected benefits and the corresponding constraints of such index, where Coordination Institution could oversee the overall SOE alignment to the best corporate governance practices.

Based on the established SOE ownership policy document and State’s ownership objectives significant changes should be implemented in the SOE corporate governance framework requiring potential amendments in SASL, SOEL and their dependent legal acts and documents. For example, the legal framework should be strengthened by amendments in the evaluation of State’s participation in SOE.

¹¹² EBRD. EBRD invests in PPC’s sustainability-linked bond issue in Greece.

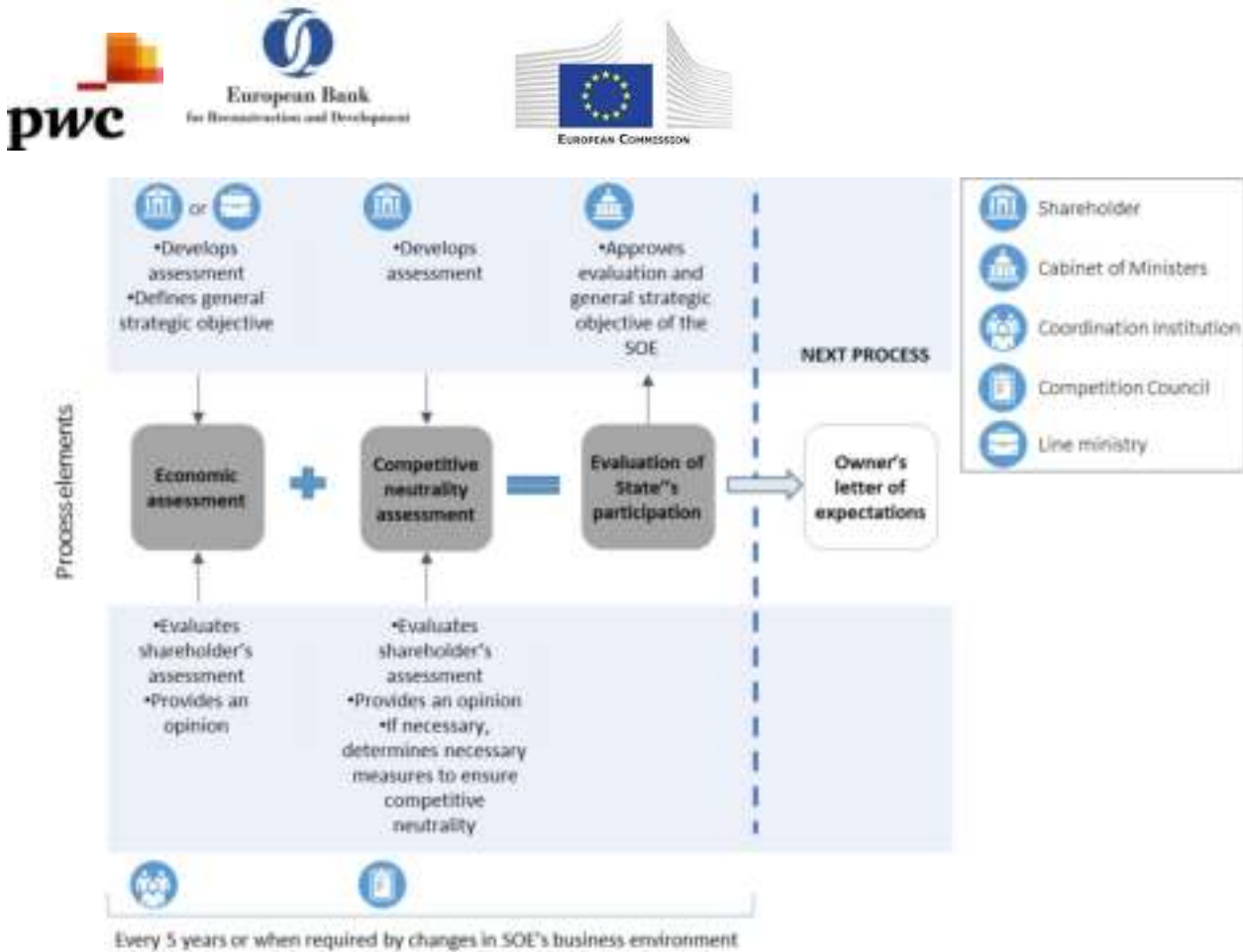


Figure 40. Proposed process for evaluation of State's participation in SOEs

The process of evaluation of the State's participation needs to be harmonized and strengthened by (1) requiring an evaluation in all SOEs and (2) providing precise criteria and requirement for evaluation of competitive neutrality and economic assessments.

As a result, shareholder would be required to harmonize their ownership practices and perform deliberate and objective evaluations for the State's participation in SOE that would further used in the development of owner's letter of expectations.

Roles of the involved parties in the evaluations of State's participation in SOE

- Shareholder – defines SOE's strategic aim, develops economic and competitive neutrality assessments;
- Line ministry – together with shareholder defines SOE's strategic aim, develops economic and competitive neutrality assessments;
- Coordination Institution – evaluates economic assessment and provides its opinion;
- Competition Council – evaluates competitive neutrality assessment and provides its opinion, if necessary, establishes criteria to ensure competitive neutrality for State's participation in SOE;
- Cabinet of Ministers – approves evaluations and SOE's strategic aim, decides on the State's participation in SOE.

For detailed legal recommendations please see an **Annex 17**.

Owner's letter of expectations

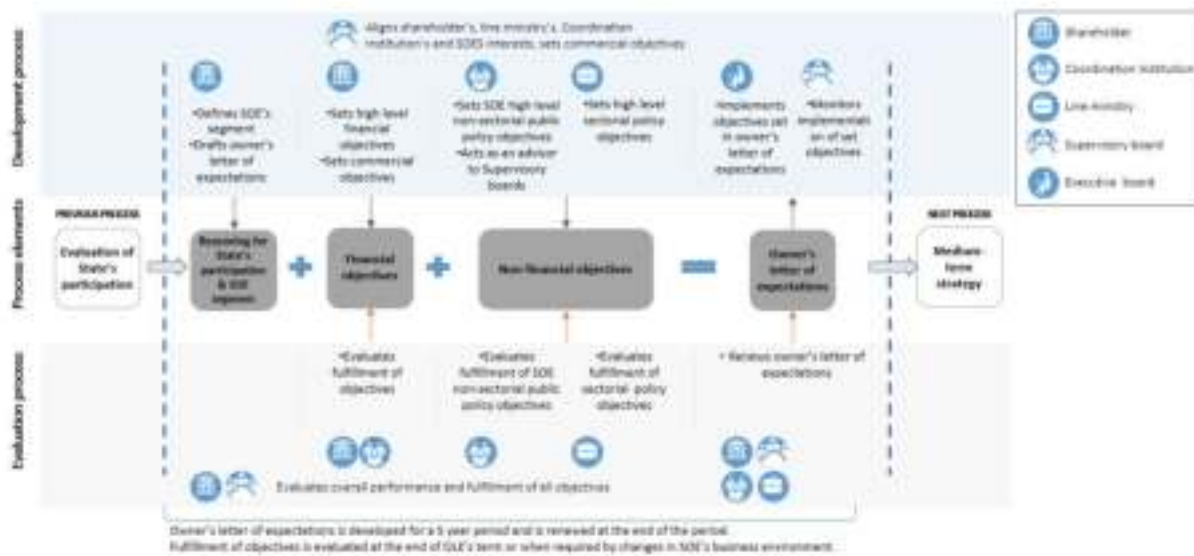


Figure 41. Proposed process for development and evaluation of owner's letter of expectations

The **owner's letter of expectation** should be a **natural result of the evaluation for State's participation** in SOE and thus should be tailored to each specific SOE considering the SOE ownership policy objectives, sectoral objectives, specific objectives and potential developments of SOE.

The OLE should outline the **general strategic objective and high-level long-term financial and non-financial objectives** that the SOE should strive to achieve over the OLE's term. While the shareholder in cooperation with Supervisory board would be responsible to develop OLE, it should be subject to the review by line ministry and Coordination Institution in order to align non-financial objectives.

Roles of the involved parties in development of OLE:

- Shareholder – defines SOE segment, sets high level financial and commercial objectives, in cooperation with Supervisory board drafts OLE;
- Coordination Institution – defines high level non-financial SOE ownership policy objectives, if necessary, acts as an advisor to Supervisory board;
- Line ministry – defines high level non-financial sectoral policy objectives;
- Supervisory board – sets commercial objectives, in cooperation with shareholder drafts owner's letter of expectations by aligning shareholder's, Coordination Institution's and line ministry's interests with the interests of the SOE. Over the term of OLE monitors the implementation of objectives;
- Executive management – implements objectives set in OLE.

If an SOE does not have a Supervisory board, the shareholder carries out duties and responsibilities of Supervisory board. However, to ensure efficient SOE governance, it is necessary to evaluate whether shareholder has the necessary institutional capacity. If necessary, shareholders have to strengthen their institutional capacity by attracting more professionals involved in the SOE governance.

The evaluation of fulfilment of objectives set in OLE should be connected to the same cycle as the State's obligation to re-evaluate its participation in the SOE. In practice, **the evaluation of fulfilment of the objective set in OLE, should be carried out at the least year of the OLE's term together with the SOE yearly performance review.**

For commercial SOEs the long-term performance should be assessed by the fulfilment of the objectives set in the OLE:

- Fulfilment of strategic objectives set by the State;
- Fulfilment of financial objectives regarding rate of return, dividend policy and capital structure;
- Fulfilment of any additional commercial target set by shareholder or Supervisory board.

For the State-dependent commercial and non-commercial SOEs the long-term performance evaluation should be based on the assessment of the fulfilment of:

- general strategic objectives;
- subsequent non-financial objectives;
- additionally, it should be determined whether SOE has increased its efficiency in ensuring goods or services set by general strategic objective.

Roles of the involved parties in evaluation of objectives set in OLE:

- Shareholder – in the yearly SOE performance evaluation evaluates overall SOE performance, evaluates fulfilment of all objectives set in OLE;
- Coordination Institution – evaluates the fulfilment of non-financial SOE ownership policy objectives and fulfilment of financial objectives;
- Line ministry – evaluates the fulfilment of non-financial sectorial policy objectives;
- Supervisory board – in the yearly SOE performance evaluation evaluates overall SOE performance, evaluates fulfilment of all objectives set in OLE.

The OLE should be reviewed and adjusted in cases when there are structural changes in the market or company's commercial and non-commercial activities.

Lastly, to introduce the OLE as one of the main SOE corporate governance elements, the following actions should be taken:

1. The obligation to establish an owner's letter of expectations should be stipulated by the SASL or SOEL imposing explicit aim and content of the owner's letter of expectations. The letter should be subject to public disclosure; however, to protect the commercial secrets of Sue's, owner's letter of expectations shall be made public by obscuring information containing commercial secrets.
2. SOEL should be amended by imposing an obligation to carry out evaluation of fulfilment SOE long-term objectives as a part of State's evaluation for participation in the SOE. SOEL and subsequent legal acts should clearly establish an obligation for the shareholders, line ministry and Coordination Institution to evaluate SOE performance and define SOE long-term objectives.
3. SOEL should be amended by imposing an obligation for SOEs to follow expectations set in the owner's letter of expectations.

For detailed legal recommendations please see an **Annex 17**.

4.3.2. SOE financing methodology

Medium-term strategy

5 years for owners letter of expectation and medium-term strategy



Figure 42. OLE’s interplay with medium-term strategy

Following the existing framework SOEs should continue to develop medium-term strategies determining SOE financial and non-financial targets. However, the activities and targets determined in the medium-term strategies should be aligned with the financial and non-financial objectives set in the owner’s letter of expectation. The aim of medium-term strategy is to clearly cascade the objectives set in the owner’s letter of expectations and define activities and targets on an operational basis.

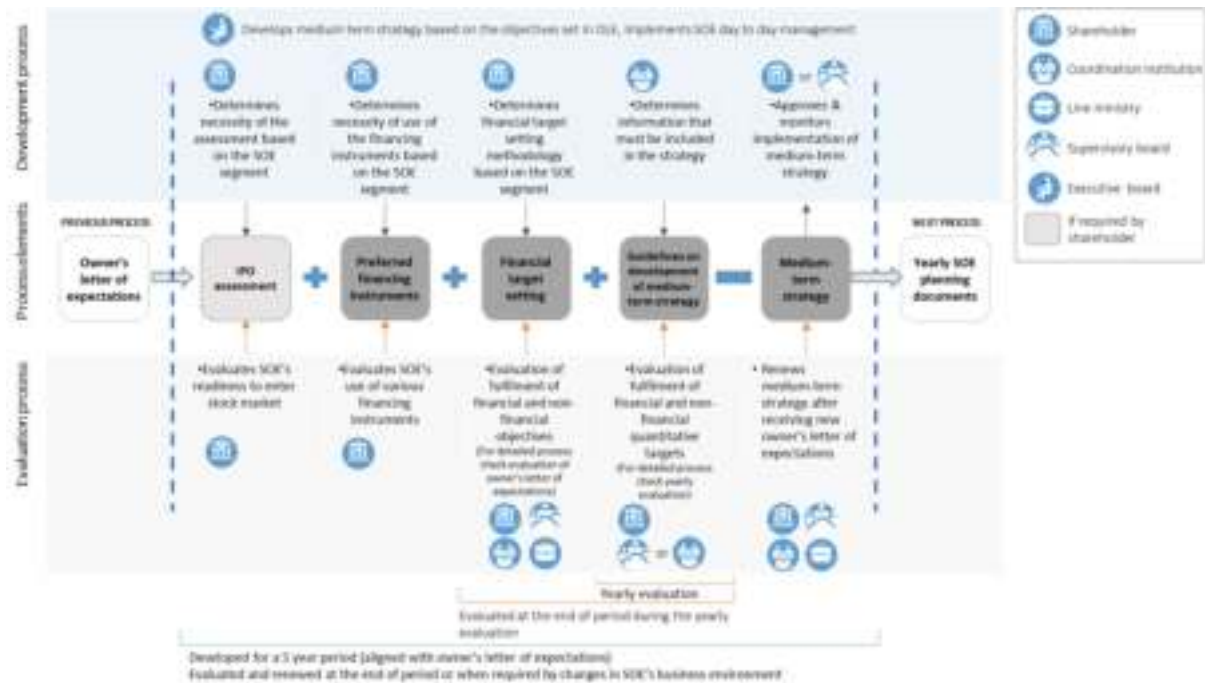


Figure 43. Proposed process for development and evaluation of medium-term strategy

Following the existing framework, the Executive management is responsible for development and fulfilment of medium-term strategy. When developed, the strategy is aligned with Supervisory board and shareholder ensuring that the operational targets and activities set in medium-term strategy are in line with the objectives set in owner’s letter of expectations. To strengthen SOE corporate governance and shareholder capacity, Coordination Institution should act as an advisory institution for SOE Supervisory boards. If an SOE does not have a Supervisory board, the Coordination Institution should provide its opinion on whether the medium-term strategy is aligned with the objectives set in Owner’s letter of expectations.

Roles of the involved parties in development of the medium-term strategy:

- Shareholder – agrees on defined financial and non-financial objectives;
- Line ministry – agrees on defined non-financial objectives;
- Supervisory board – approves medium-term strategy, monitors implementation of the objectives set in OLE;
- Executive management – develops medium term strategy based on the objectives set in OLE and using SOE financing methodology and CSCC guidelines on the development of the strategy; implements SOE day to day management;
- Coordination Institution – (if applicable) provides an opinion on whether the medium-term strategy is aligned with the objectives set in Owner’s letter of expectations.

If an SOE does not have a Supervisory board, the shareholder carries out duties and responsibilities of Supervisory board.

The evaluation of the targets set in medium-term strategy is connected with the **evaluation of fulfilment of the objective set in OLE and SOE yearly performance evaluation** and described in detail in each of the processes. The **medium-term strategy should be reviewed and adjusted according the changes in the owner’s letter of expectations.**

To implement the proposed SOE financing methodology the existing legal framework should be amended by:

- 1) Imposing an obligation that the medium-term strategies should be developed for a 5-year period and should be aligned with the objectives set in the owner’s letter of expectations;
- 2) amending guidelines on development of State capital company medium-term operation strategies including the proposed SOE financial target setting methodology.
- 3) imposing an obligation for SOEs to comply to follow the proposed methodology or explain any derogations form the proposed approach.

For detailed legal recommendations please see an **Annex 17.**

IPO readiness assessment

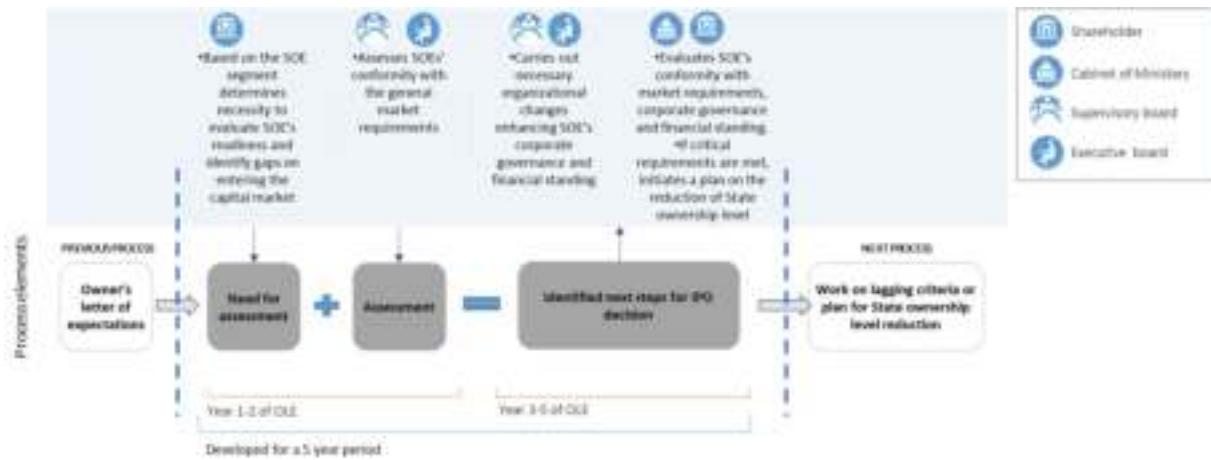


Figure 44. Proposed process for IPO assessment

Based on the SOE segmentation and the objectives set in owner's letter of expectations, SOE might be required to perform an IPO readiness assessment to determine its readiness and potential obstacles to enter the capital market. An obligation to perform the IPO assessment is set by the SOE ownership policy and shareholder. Based on the SOE segment, shareholder might determine necessity for SOE to evaluate its readiness and identify gaps on entering the capital market. If the IPO potential has been determined, all involved parties have to agree on the next steps for SOE to enter the capital market. **The readiness assessment must be carried out during the term of OLE and is evaluated by shareholder at the end of the assessment or at the end of the OLE's term** together with the evaluation of other objectives set in OLE. The implementation of the IPO readiness assessment is a responsibility of SOE Supervisory board and Executive management. While the SOEs need to join the capital market is a decision of all parties involved.

Roles of the involved parties in IPO assessment:

- Shareholder – defines the obligation to carry-out IPO readiness assessment and identify gaps on entering capital market, evaluates SOE's conformity with market requirements, corporate governance and financial standing. If critical requirements are met, initiates a plan on the reduction of State ownership level.
- Executive management, Supervisory board – carries-out IPO readiness assessment and implements necessary organizational changes to enhance SOE's corporate governance and financial standing.

Preferred financing instruments



Figure 45. Proposed process for evaluation of preferred financing instruments

SOE ownership policy determines the preferred list of financing instruments for each of the SOE segments imposing an obligation for SOEs to evaluate various financing instruments to diversify their financing sources. The list of the financing instruments is not mandatory and is aimed to initiate a discussion between the shareholder and Executive management on the selected financing instruments. **The assessment must be carried out during the term of OLE for each of the investment projects and is evaluated by shareholder at the end of the OLE's term** together with the evaluation of other objectives set in OLE. The Executive management is responsible for evaluation and implementation of various financing instruments.

Roles of the involved parties in evaluation of preferred financing options:

- Shareholder – defines the obligation to evaluate various financing instruments, evaluates whether a sufficient effort was devoted towards exploring and applying the preferred financing instruments;
- Supervisory board – monitors whether Executive management regularly evaluate use of various financing instrument,
- Executive management - evaluate use of various financing instrument for each of the investment projects.

Financial target setting

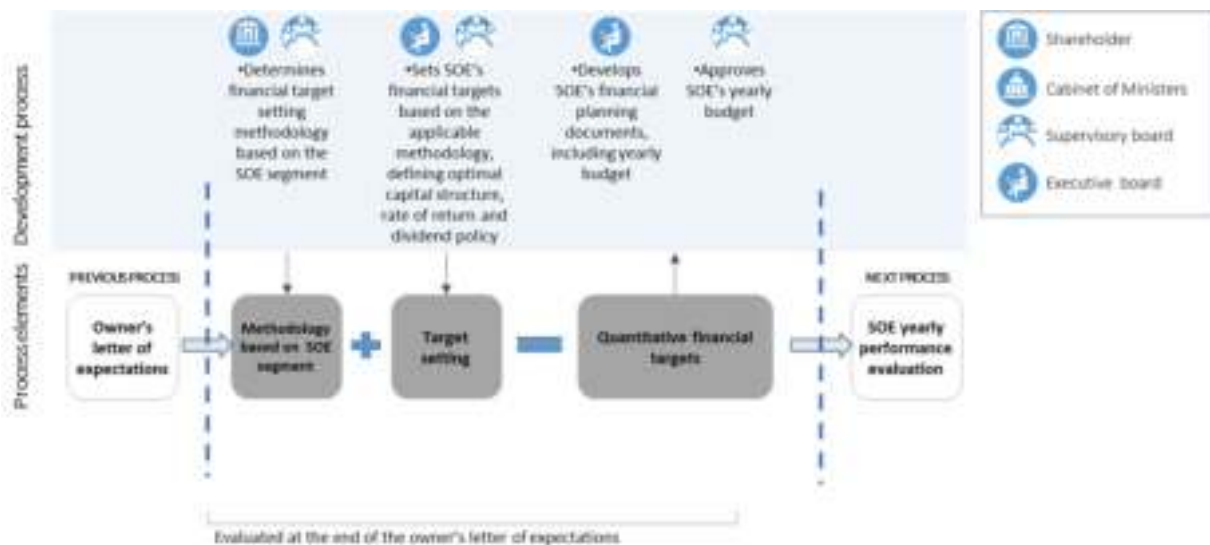


Figure 46. Proposed process for financial target setting

When establishing medium-term strategy and operational targets, SOEs are required to apply SOE financial target setting methodology based on the SOE segmentation. The SOE financial target setting methodology **quantifies the expectations set in the State ownership policy document and the OLE**.

When establishing OLE, shareholder and Supervisory board is responsible for the determination of the applicable target setting methodology based on the chosen SOE segment and provided high-level financial objectives.

In close cooperation SOE Supervisory board and Executive management applies the target setting methodology to set 5-year financial targets in medium-term strategies that are similar to those of comparable businesses and maximizes the returns on the State's capital. **It is the Executive management's responsibility to select and apply comparable benchmarks for the determination of the SOE financial targets**, such as optimal capital structures, rate of return and dividend level. The Supervisory board is responsible for monitoring the application of objective comparable benchmarks. Detailed example of the target setting can be examined in **Annex 18**.

The evaluation of the set is carried-out during the **evaluation of fulfilment of the objective set in OLE and SOE yearly performance evaluation** and described in detail in each of the processes. SOEs are required to **review and adjust financial targets according to the changes in the owner's letter of expectations**.

Roles of the involved parties in evaluation of preferred financing options:

- Shareholder – defines the applicable methodology by setting SOE segment;
- Supervisory board – monitors the application of financial target setting methodology, approves SOE's yearly budget;
- Executive management – applies the financial setting methodology when establishing SOE medium-term targets and subsequent yearly operational target.

SOE yearly performance evaluation

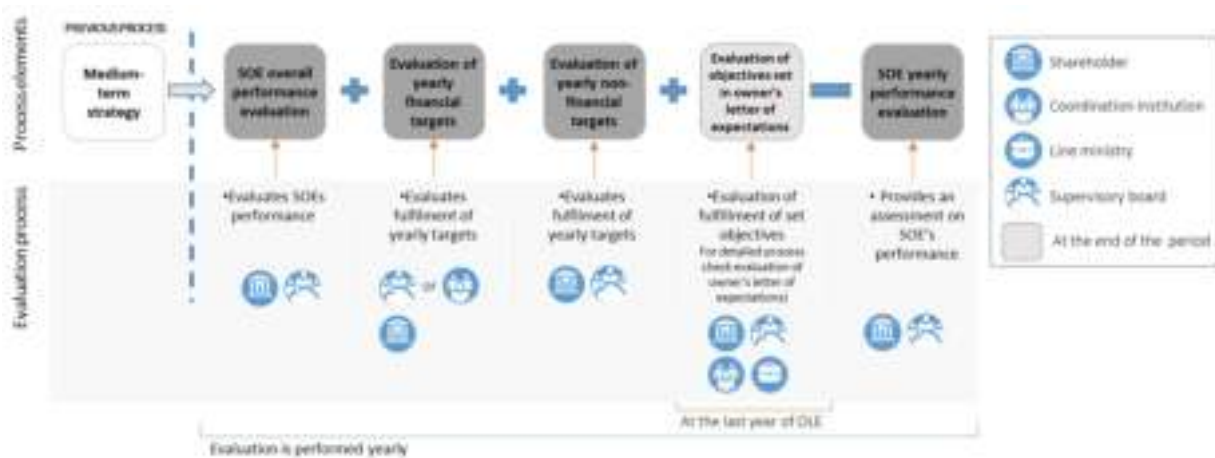


Figure 47. Proposed process for SOE yearly performance evaluation

Continuing the existing good governance practices the SOEs must have an operational autonomy balancing company's and State's interests. While the SOEs have an autonomy in determining the operational plans and targets, to secure its interests the State has established a process of SOE yearly performance evaluation.

While the proposed SOE financing methodology requires adopting changes in setting SOE operational targets and it encourages to **continue evaluation of the fulfilment of the yearly financial and non-financial targets set in medium-term strategies. The fulfilment of financial and non-financial objectives set in owner's letter of expectations should be evaluated at the last year of the OLE.** Thus, the evaluation of objectives set in owner's letter of expectations is done at the last year of the OLE as a part of the respective year's yearly performance evaluation.

Roles of the involved parties in the SOE yearly performance evaluation:

- Shareholder – evaluates SOE's overall performance and fulfilment of yearly financial and non-financial targets, provides an assessment of SOE performance;
- Supervisory board – evaluates SOE's overall performance and fulfilment of yearly financial and non-financial targets, provides an assessment of SOE performance;
- Coordination Institution – provides an opinion of the fulfilment of the yearly financial targets, if SOE does not have Supervisory board.

The existing yearly SOE performance evaluation should be continued and strengthened by the following activities:

- 1) The SOE yearly performance evaluation should be continued and provide an adequate notion on the SOE's operations. The SOE operational results should be compared with the SOE's set short-term (yearly) target set in the budget or operational action plan and compared with the medium-term objectives set in the strategy.
- 2) Understanding the complexity and commercial nature of the SOEs, the short-term performance evaluation should be performed by the Supervisory board and shareholder. This would indicate a trust in the SOE management and Supervisory boards and leave an operation autonomy to the

SOEs. Additionally, the practice would promote similar accountability standards as for public companies.

- 3) For SOEs not having Supervisory boards, the existing SOE performance evaluation process should be strengthened by providing Coordination Institution access to the SOE budgets or operational actions plans allowing to evaluate SOE short-term performance.

To ensure more accurate SOE financial and non-financial target evaluation, if necessary, SOEs are encouraged to review and, if needed, update the financial indicators and targets to display SOE’s financial and market situation. The changes in medium-term strategy should be in accordance with the objectives set in OLE. Consequently, in case of material changes in the market conditions (mostly influenced by low frequency external events), the Supervisory board is encouraged to initiate a dialogue with the owner explaining the prevailing circumstances of why the OLE should be reviewed and updated.

For detailed legal recommendations please see an **Annex 17**.

4.4. Potential risks for implementation of the active ownership principles and SOE financing methodology

The implementation of the proposed active ownership principles and SOE financing methodology anticipates significant legislative changes requiring stakeholder involvement and political will. Understanding the complex nature of the proposed solutions several potential risks for the adoption and implementation of the proposed recommendations can be determined.

The potential risks have been assessed by their impact on the potential solutions and proposed framework and by the likelihood of the event.

Risk matrix (Likelihood x Impact)	Impact (changes in conditions as a consequence of inputs)				
		Minor	Moderate	Major	Extreme
Likelihood (probability of suffering major changes in the conditions as a consequence of inputs)	Likely	Low-Risk No specific management action is required.	Moderate-Risk Specific management monitoring needed	High-Risk Increased management actions needed	High-Risk Increased management actions needed
	Possible	Low-Risk No specific management action is required.	Moderate-Risk Specific management monitoring needed	High-Risk Increased management actions needed	High-Risk Increased management actions needed
	Unlikely	No-Risk No management actions required	Low-Risk No specific management action is required	Moderate-Risk Specific management monitoring needed	Moderate-Risk Specific management monitoring needed
	Remote	No-Risk No management actions required	No-Risk No management actions required	Low-Risk No specific management action is required	Low-Risk No specific management action is required

Figure 48. Risk assessment matrix legend

Risk Assessment Matrix			
No.	Risk level	Risk	Necessary actions to mitigate risks
Risks related to overall implementation of the recommendations:			
1	High-Risk	Insufficient institutional (CSCC and shareholder) capacity to drive proposed changes	Increase institutional capacity or outsource implementation to external consultants. It is necessary to allocate necessary budgetary resources, to finance the drive of proposed changes. It is highly advised to establish clear project ownership roles and activity drivers.
2	High-Risk	Lack of political will to implement proposed SOE active ownership principles and SOE financing methodology	Organize individual meetings to discuss and explain the proposed changes and their benefits. Organize a media campaign to explain the benefits of the proposed changes to the society. It is necessary to establish Executive sponsorship at the political level to drive proposed changes.
3	Moderate -Risk	Low stakeholder (shareholders, SOEs) interest to implement proposed changes	Organize several stakeholder events to discuss and explain the proposed changes and its impact on the stakeholders.
Risks related to implementation of the active ownership principles:			
4	High-Risk	Lack of political will to promote IPO processes for SOEs thus not changing the Privatization Law and sectoral laws limiting SOE expropriation and limiting the possibility to implement several SOE financing methodology elements.	Organize individual meetings with politicians to discuss and explain the proposed changes and their benefits. Organize a media campaign explaining the benefits for the SOE IPO process to the society.
5	Moderate -Risk	Only parts of the proposed active ownership principles are introduced regardless of the comprehensive nature of the solutions	If only a part of the proposed recommendations are implemented, evaluate the impact on each of the active ownership and SOE financing methodology elements and adjust accordingly, without losing the substance of the proposed element.
6	Moderate -Risk	SOE ownership policy is developed by compiling existing legal framework and corporate	If SOE ownership policy does not include the proposed recommendations, it is necessary to evaluate other legal forms / documents and how

		governance practices not including proposed corporate governance recommendations – SOE segmentation, ESG and sustainability criteria, IPO readiness assessment, etc.	the proposed changes can be implemented and binding to SOEs.
7	Moderate Risk	Lack of institutional capacity to implement proposed active ownership practices leading to formal SOE ownership maintaining status quo and setting conservative ownership objectives	When evaluating the fulfilments of objectives set in the OLE, Coordination institutions should provide its opinion on the SOE ownership practices.
Risks related to implementation of the SOE financing methodology:			
8	Moderate Risk	The dividend pay-out levels set in OLE and medium-term strategies will not be respected, and during the development of the yearly State budget the largest dividend payers will be required to distribute profit in absolute figure to fulfil the needs of State budget.	Organize individual meetings with politicians, the Ministry of Finance and other respective civil servants to discuss and explain the proposed changes in the amount of dividends and their benefits. It is the shareholder responsibility to ensure that the objectives set in OLE are respected or corrected.
9	Moderate -Risk	The Supervisory board and Executive management will not use the preferred financial instruments finding different justification for traditional forms of financing.	Organize several stakeholder events to educate and explain benefits for each of the proposed financing instruments.
10	Moderate -Risk	The risk of bad precedent and wide media resonance, if SOE will unsuccessfully try to use previously not used	Organize several stakeholder events to educate and explain the benefits for each of the proposed financing instruments. Coordination Institution should provide continuous support for implementation of non-traditional

		financing instruments and will not have done the necessary homework, resulting in an inefficient and problematic process.	financing instruments for SOEs having lesser experience and institutional capacity.
11	Low-Risk	Due to potential risks of under fulfilment of the yearly State budget, the Cabinet of Ministers regulations determining the SOE dividend pay-out level is not amended.	Organize individual meetings with politicians and civil servants to discuss and explain the proposed changes and their benefits.
12	Low-Risk	In the process of setting financial targets, Executive management will manipulate with the selected sample / benchmarks to adjust values to achieve more conservative goals.	The Supervisory board is responsible for monitoring the fair application of the financial target setting methodology when reviewing and approving SOE medium-term strategies.
13	Low-Risk	The State funding for implementing State delegated functions will not be increased to an adequate level.	Organize individual meetings with politicians and civil servants to explain the proposed changes and their benefits. It is shareholder responsibility to ensure that State funding is adequate for SOE to fulfil objectives set in OLE.
14	Low-Risk	Capital markets will be in a deep recession phase, where the IPO process could be seen as unfavourable due to the risk of low valuation.	The State should evaluate benefits of IPO process, if IPO is deemed favourable shareholder should explain the reasoning for the process to society. If the IPO process is unfavourable, shareholders together with SOEs should look for alternative financing options.

Figure 49. Risk assessment matrix

5. Case study and testing the methodology

5.1. Feedback from the market, SOEs and other key stakeholders

The market sounding exercise was carried with the intent to understand the current perception of larger institutional investors (e.g., pension funds, investment funds and investment banks) on the SOE financing opportunities. In addition, fundamental building blocks of the SOE financing methodology (e.g., segmentation, target setting, IPO and bond potential) were tested with the institutional investors to get their opinion on whether it would be well-received by the market.

Similarly, a series of interviews were made with the selected sample of SOEs to understand the initial thoughts on the current practice, and what would be the key focus areas for the SOE financing methodology. Later, in a second round of interviews, the same SOEs were interviewed to find out their views and potential suggestions on the SOE financing methodology, already in a more granular level.

Lastly, several other stakeholders deemed important and relevant in the context of the Assignment were interviewed. The focus with these interviews was to get high-level opinions on the prevailing practice and the most critical areas of improvement.

In total, 14 SOEs interviews of two separate rounds, 5 institutional investor interviews, and three other key stakeholders were conducted.

5.1.1. The SOE feedback on financing methodology

“The SOE financing methodology should be driven by an appropriate benchmarking process that is tied to similar private sector peers... There is a risk of subjective manipulation in the process of gathering correct samples. The underlying process should address this.” SOE

The SOEs stressed the importance of having a robust benchmarking process in place as this serves well for shareholders and Supervisory boards to determine and evaluate SOE financial performance appropriately, and also allows the Executive management to run the company for the achievement of realistic goals. Private sector comparisons, and the impetus to converge to them are vital to run SOEs sustainably and create a long-term value.

Several SOEs mentioned that while this is indeed a necessary exercise and a private sector benchmarking process should exist, there needs to be a well-thought process behind the actual comparisons. Certain sectors and industries exhibit a highly diverse environment in which each company carries its own specific characteristics against which meaningful private or even public sector benchmarks do not exist. It was recommended to create a benchmarking process that would clearly show the process how each metric should be obtained, and in the same time allow the Executive management to make small and reasonable deviations provided that new workaround reflects the peers better.

“Obtaining an issuer level rating could be too expensive for relatively smaller SOEs or SOEs which are already operating on thin margins.” SOE

SOEs which already have obtained a bond rating and some other commercial SOEs pinpointed to a potential issue that obtaining a bond rating could be too expensive (ca. EUR 150 thousand for obtaining a



credit rating and EUR 100 thousand for maintaining it¹¹³), and that the associated expenses could in some instances evaporate a large part of the yearly net income provided that the company in question is already operating on thin margins and low absolute levels of net income.. SOEs which acknowledged this to be overly expensive were open to a solution that would incorporate publicly available guidelines on estimating the approximate rating, and from which there would be clear the necessary optimal capital structure ratios that are needed for obtaining an investment grade credit rating.

“Implementing some form of transition period for commercial SOEs on obtaining an issuer level credit rating would allow the Executive management to prepare the internal capacity and, in general, gradually position the company for a successful and efficient credit rating process.” SOE

The interviewed SOEs, especially the commercial ones with an already obtained credit rating, highlighted a potential issue of requiring all commercial SOEs to apply for an issuer level credit rating. Namely, the process of communicating with credit rating agency, responding with the necessary data, and then maintaining high level standards requires a well-established and vigorous internal process by the SOEs (e.g., financial reporting, economic justifications, budget analysis, scenario analysis etc.). Some SOEs might not be ready for a such exercise in the near-term and forcing them to apply for credit rating regardless of the underlying readiness could introduce many risks and, ultimately, lead to suppressed credit rating. However, obtaining a credit rating is strongly encouraged to accommodate transparency, visibility and a more successful financing in the event of bond issuances or IPOs.

“The notion of separating SOEs by those with more commercial activities, and those with more reliance on State financing is acceptable and well-structured considering the planned financing methodology.” SOE

SOEs confirmed that there should be a separate financial methodology with different level of expectations when it comes to the broad SOE segments. The SOEs which enjoy a larger degree of freedom in generating income by directly competing with private peers should, in general, be mandated to deliver similar financial results to those of the corresponding peers. The non-commercial SOEs, on the other hand, should be mandated to fulfil non-financial objectives in the most efficient manner. The SOEs which do not enjoy a meaningful level of discretion within the space of commercial activities should not be required to follow stringent financial benchmarks (due to specifics stemming from the fulfilment of non-financial objectives and the associated effects it leaves on the financial performance).

“The proposed SOE financing methodology is adequate from the investment fund’s side because we expect SOEs to target and if possible outperform their peers; and to do so objective and transparent benchmarking procedures are vital .” Buy-side FMP

The majority of the interviewed institutional investors deemed the SOE financing methodology adequate and appropriate given the context of currently most often used financing instruments by the SOEs. The active benchmarking process to the comparable business (e.g., ownership structure, sector, size etc.) was highlighted as the key element for a successful and optimal methodology. For institutional investors the financial performance that is comparable to the peers and, if possible, outperformance that is achieved

¹¹³ According to the interviewed SOEs with an experience in bond issuances.



in a sustainable manner are the key elements for long-term value creation. Hence, benchmarking, transparency, and predictability are critical aspects for SOEs to capture favourable financing conditions.

Similarly, many of the interviewed institutional investors stated that obtaining a credit rating for larger SOEs could enhance the companies' transparency, reduce corporate governance risks, and, ultimately, encourage better financial performance. The credit rating allows institutional investors to analyse the company more easily by relying more on the reported data, easing the screening process, and calculating the risk reward ratios.

5.1.2. Market consistent financing

“The part of the income related to the State financing does not factor in any return targets. It consists of the estimated costs plus some marginal amount for the possible improvements and repairs.” SOE

“There should be a stronger focus on the determination of expected return targets in calculating the right levels of State support.” SOE

“We are often required to cross-subsidize the non-financial objectives from our commercial segments.” SOE

SOEs, and especially the State dependent ones, have repeatedly cited the level of received State financing as a problem by being insufficient to achieve financial results that would be comparable to the private sector peers. Oftentimes, the State financing for the fulfilment of non-financial objectives is so low that the company is forced to record losses or cross-subsidise from other operational segments.

There were two main reasons mentioned for this: (1) the general stance taken by the shareholder (State) towards not providing higher levels of financing for the fulfilment of non-financial objective as otherwise it would lead to higher dividends in any case; (2) existing regulations and regulatory environment that prohibits SOEs from charging higher rents, asking for higher pricing etc.

It is critical to understand that SOEs have to be exposed to similar conditions and financing environment as private sector peers, and that the financing received by fulfilling non-financial objectives should be based on market consistent terms. The concept of not providing high enough (or market consistent) State financing for SOEs to deliver on the set non-financial objectives is fundamentally incorrect from the unbiased competitive standpoint. The State financing should be provided at a level that incorporates the associated expenses and allows the SOEs to generate profit that is comparable to the defined benchmark of private sector peers. Then, in the case of increased retained earnings, the shareholder could decide how and what portion to distribute in dividends. Similarly, the State should make sure that there are no laws and regulations that inherently disfavour SOEs and hinder them from being fully competitive entity relative to the private sector peer universe.

5.1.3. Performance review

“The requirement to involve long-term financial objectives in the process of short-term performance evaluation is unnecessary and lacks any rationale substance.” SOE

While the process of short-term target and long-objective evaluation is separated, meaning that there exist different metrics against which the performance is reviewed, many SOEs expressed their concerns on the involvement of long-term objectives in annual review. In the case of 15% deviation in the long-term objectives from the initially stipulated target value, SOEs are required to submit justification for that. This may lead to more constrained administrative resources from the SOE’s side as the oftentimes the process of justification becomes time consuming and complicated. The consensus among the SOEs was to exempt long-term objectives (mostly financial) from the annual review and leave only the annual review of financial metrics (i.e. short-term targets linked to operational data). The review or evaluation of long-term objectives was proposed to execute in conjunction with the final review of existing medium-term strategy or the creation of a new one.

“The process of confirming annual performance and in the case of a bit more pronounced deviations to draft materials for explanation are overly time consuming and administratively burdensome.” SOE

Both commercial and State dependent SOEs have admitted that the process related to annual performance review can get overly complicated and time consuming. In the event of more significant deviations from the pre-specified targets, SOEs have to prepare rigorous explanatory materials to justify the incurred deviations. To avoid potentially repeated streams of additional reporting, the suggestion was to exempt short-term results from the performance review processes with the CSCC. Instead, SOEs suggested that a longer period should be assigned for SOEs to review and confirm the pre-specified financial targets.

5.1.3. SOE financial target setting

“Theoretically, an argument could be made that SOEs are not fully interested in formulating ambitious goals since in the case of not achieving them, the compensations levels get affected accordingly... Instead, it is possible to set more conservative targets, and receive a more complete package of possible bonuses.” SOE

A notable number of SOEs commented on some of the flaws inherent in the SOE goal setting mechanism. The current goal (target) setting mechanism and the corresponding bonus packages implicitly disincentivize SOEs from being ambitious.

“We would like to see a more active involvement from the shareholder’s side in determining and explaining the long-term goals and the overall path where the company should be heading.” SOE

Currently, SOEs have a good grasp of the objectives and targets that have to be met in the short-term and in the 3-7-year period depending on the chosen tenure of the medium-term strategy. However, SOEs have mentioned that in some instances they lack a clear long-term guidance (beyond the confirmed medium-term strategy) on where the company should be heading. Communication in terms of whether the company should consider acquisitions, disposals, expansion plans in other regions, IPOs and other similar aspects were mentioned as examples that SOEs would hope to receive from the relevant shareholder.



5.1.4. IPO and bond markets for SOEs

“Many of the larger and more commercially oriented SOEs are mature enough to at least begin to consider tapping capital markets” Sell-side FMP

All of the interviewed institutional players stressed the gap between Latvian SOEs and the rest of developed world in terms of the company interaction with the public capital markets. Low growth, lack of innovation, and transparency were cited as consequences of this.

Many of the institutional investors agreed that several of the larger SOEs are in a stage of business, which requires considerable investments to move forward in a sustainable manner. IPOs by selling minority interest were mentioned as the most optimal solutions. In the same time, investors acknowledged that the process should be smooth and not overly rapid. Certain institutional investors proposed that SOEs initiate dedicated working groups (involving stakeholders from ministry, exchange, and potential investors) with the focus of exploring IPO as potential tool to stimulate growth, enhance corporate governance, and pave the way for other corporate entities to domestic capital markets.

“Dividends are very important to our fund. We strongly prefer stable, predictable, and growing dividends” Buy-side FMP

Stable, predictable and, preferably, growing dividends were mentioned as vital part of the overall offering. Ideally, investors would expect the dividends to be stipulated in a formal dividend policy memo so that the Fund could have better visibility of the future cash flow.

“We see no obstacle if an SOE receives a reasonable chunk of its income in the form of State subsidies. However, the subsidies should be transparent, stable, and offer a visibility on the expected future streams” Buy-side FMP

Many of the interviewed institutional investors acknowledge that State subsidies should not be a hurdle for SOEs to avoid turning to the capital markets. In general, investors look at the historical record, and assess the realized level of unexpected deviations in the subsidy amounts. In other words, it is critically important to have a good history of the received State financing before an SOE seeks private investment. An equally important aspect is the offered visibility and comfort from the State in regard to the future streams of State financing.

“One of the most crucial elements is the valuation. The SOE could be organized perfectly, but if the price asked is too high, we will pass the opportunity” Buy-side FMP

Valuations were named as the most crucial factor from both sell-side and buy-side if an SOE wants to receive a healthy demand and be able to sell all the intended package of shares. The interviewed institution investors presented several examples in which they decided not to participate due to valuations being too high, even though the corporate governance practice and the Executive management team were up to the par. It was suggested that SOEs tackle this step diligently, and actively involve investment banks to determine the optimal level of pricing.

“ESG aspects are becoming more and more important. The more it is thought about the environmental impact and social aspects, the higher the multiple can get” Sell-side FMP



Climate neutrality, green investments, and strong social agenda are becoming increasingly important among pension funds and global investment funds. These aspects were highlighted as essential to support healthy levels of valuation and/or achieve a broader base of investor subscribing for the offer.

“We want to see a management team, which is with good reputation, keen on expanding the business, and also with a deep understanding of how finance and capital allocation work” Buy-side FMP

Seasoned Executive management team with a profound understanding of finance is one of the many important aspects, which investors evaluate when making investment decisions. In the most cases, investors seek expanding business and growing cash flows to support a steadily rising dividend. For this to happen, the Executive management team has to be professional and with already proven record of accomplishment.

The investors cited a lack of understanding in finance among many SOEs as a key hurdle to use capital markets. Going public and/or issuing bonds entail a higher degree of complexity and require deeper understanding in finance to, first, comprehend the potential benefits and need for it, and second, execute the process in a successful manner.

“Increasing financial comprehension should be defined as one of the most imminent objectives” Commercial bank

There have been some observations indicating a limited financial knowledge among the Executive management and even the representatives of SOE financial departments. This has crystalized through processes in which SOEs, especially the smaller ones, apply for relatively extensive investment projects that require a complex explanation, and robust financial forecasts. Insufficient financial knowledge and limited understanding around the many important inputs necessary in accessing financing can lead to SOE receiving the requested financing on worse terms.

5.1.5. Domestic public capital markets

“The secondary market’s liquidity does not play a crucial role when we contemplate on making investments locally. We are long-term investors, and have no intent to perceive certain investment as a trading opportunity Speaking of bonds, all of the trading is happening over-the-counter, so the issue of close to zero turnover in the fixed income segment is not relevant” Buy-side FMP

The institutional investors argued that low trading activity in the secondary market does not play a huge role for larger investors when deciding how to allocate the capital. Some mentioned that pan-Baltic capital markets do not constitute a large portion of their portfolio, and that the allocations made in the Baltics are considered “satellite” investments, which hardly affect the overall liquidity profile of the fund. The notion of illiquidity premium was also named as benefit for long-term investors that, ultimately, allows expecting higher returns.

The illiquidity patterns in the fixed income space were collectively perceived as not imposing any negative effects on the pricing or demand, as these markets per se are illiquid with most of the trading happening OTC.

“The pan-Baltic investment banks have the necessary capacity to carry out sizeable issues both in the equity markets and the bond markets” Capital markets’ side

The key stakeholder from the capital market’s side expressed confidence in the pan-Baltic level investment banks as having right experience and knowledge to steer large IPOs and bond issuances. The argument was further strengthened by the notion of carrying a good reputation and trust among institutional banks. Hence, the alignment of interest is already implicitly embedded, minimizing the risk of false expectations, and unsuccessful offers.

The interviewed investors, and especially the representatives of sell-side, claimed that cross-listing should not be used as a base case for SOEs when either going the IPO way or issuing bonds. The argument was supported with elevated expense levels, an additional layer of administrative burden, and the weak track-record. Namely, in a number of times, the costs have not outweighed the benefits since usually most of the subscription has come from pan-Baltic players, retailers, and foreign investors attracted by pan-Baltic investment banks.

5.2. SOE financial target setting methodology

The SOE financial target setting methodology encompasses a market based benchmarking on three financial aspects: capital structure (balance sheet), rate of return and dividend policy. A more detailed breakdown of the proposed SOE financial target setting methodology can be found in section 4.2.2., with the company specific analysis done in **Annex 16**.

For each of the aforementioned financial aspects, there is a defined benchmark that either consists of sectorial / industry comparable, median benchmark values stemming from closest peers or a mix of both. In cases of commercial SOEs, where an investment grade credit rating was deemed relevant, the corresponding benchmark value was driven by the associated leverage and coverage factor, necessary to maintain or achieve an investment grade credit rating.

“SOEs should firstly consider domestic capital markets as a tool for attracting private investment. The experience shows that cross-listing can turn out to be overly administrative, more expensive, but without a decent value-add.” Sell-side FMP

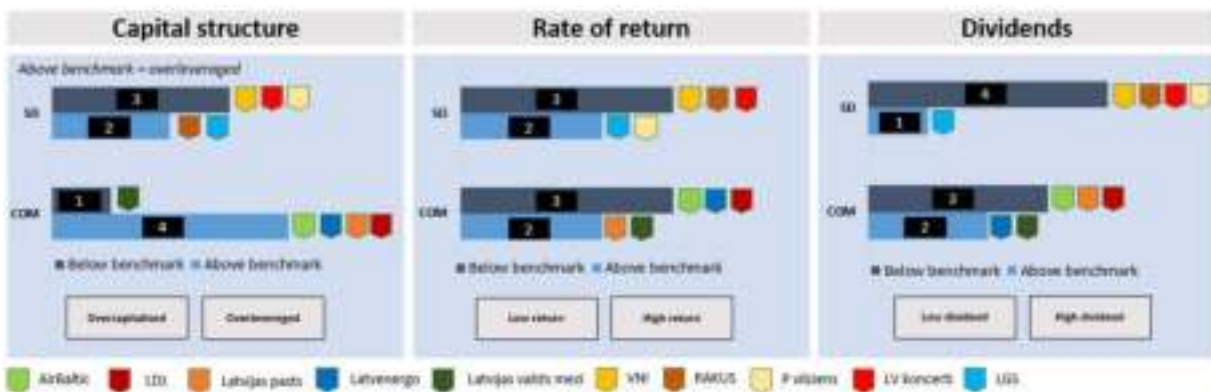


Figure 50. Financial benchmarking of the selected SOEs as of 2019

The **Figure 50** reflects a summary of how 10 tested SOEs rank in relation to the defined benchmarks in year 2019. The following conclusions can be drawn from the analysis:

- There are **clear signs of overleveraged commercial SOEs**, which as of 2019 have assumed more debt than those companies of the relevant benchmark group. The most important implications for this could imply heightened financial risk and limited flexibility in covering notable expansion plans going forward. The State dependent segment of SOEs exhibits a rather diverse results in which some companies fall short of the benchmark value (meaning that debt is lower than for the peers), and some have taken higher debt amounts than deemed optimal.
- Most of the **State dependent and commercial SOEs have failed to meet the benchmarked rate of return targets** in 2019. The sole variable used in judging this was ROE, which reflects how efficiently the equity has being employed. For the **commercial SOEs this aspect magnifies the problem since the balance sheet are on average more indebted** than those of the peers, but generated returns lower. In other words, the higher leverage profile and the corresponding cost of debt have not been fully justified by higher yielding investment that are in line with the market.
- Most of the **SOEs fail to distribute sufficient levels of dividend** from the generated earnings. This is especially the case for State dependent SOEs

5.3. Financing instruments

An overview of how the preferred financing instruments, described in section 4.2.3, have been historically used by 15 of the selected SOEs.

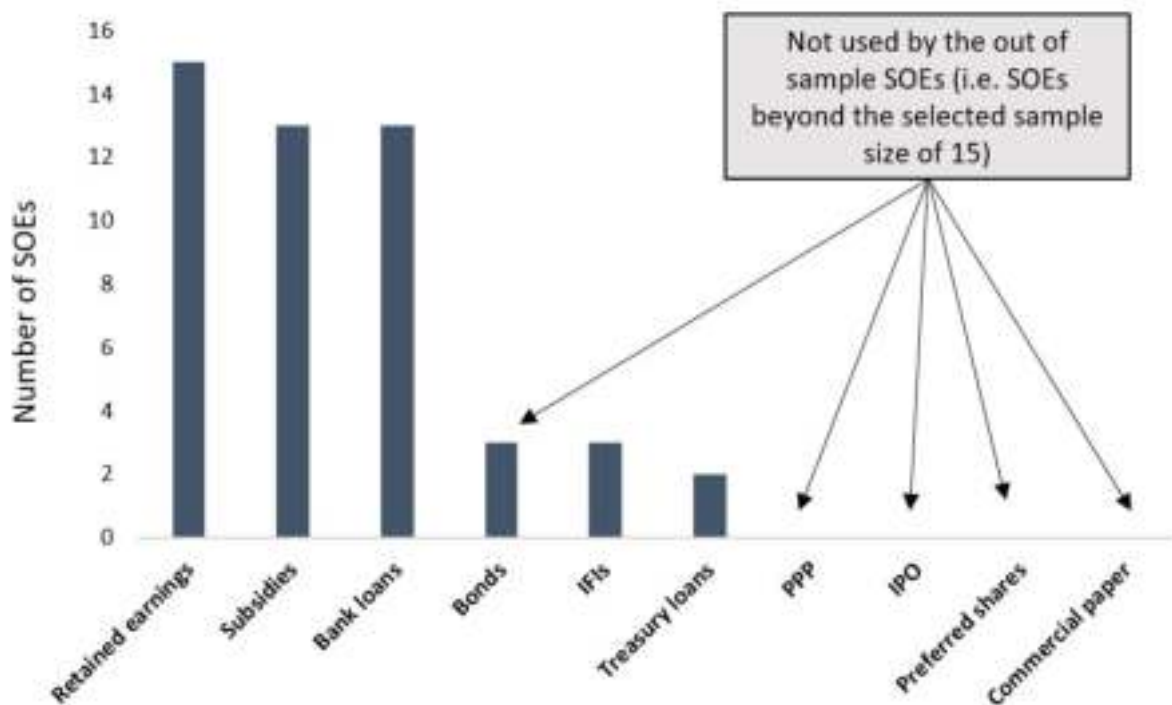


Figure 51. Selected SOEs and their use of preferred financing instruments in 2019

From the **Figure 51**, several important inferences can be observed:



- **Traditional forms of financing dominate** the total financing spectrum of SOEs, that is closely aligned with the findings presented in the **Figure 51**. Retained earnings and subsidies are the most often used financing instruments by the SOEs (traditional bank loans as well, yet not disclosed here due to no classification as a preferred financing instrument).
- Bonds and IFIs are second most popular group of financing instruments. Yet, it must be noted that **bonds and IFIs constitute even narrower share of the total instruments used on the out of sample SOEs**.
- Other financing instruments, which involve **private participation either via ownership purchases or debt subscription, are completely neglected** by the SOEs. The same conclusion could be extended to the out of sample SOEs.

5.4. Capital markets potential

The assessment of selected SOEs on their **prospects for a successful entrance into public capital markets** has been done based on the proposed criteria within the IPO readiness assessment framework (refer to section 4.2.4.). The information analysed stems from the 2019 financials and encompasses both high-level quantitative and qualitative review. Additionally, the IPO readiness assessment is meant to be imposed on commercial SOEs only due to their discretion at generating commercial returns, lesser extent of reliance on State financing as well as better overall prospects for turning to the capital markets and receiving appropriate valuations.

Some of these criteria cannot be technicality scrutinized in this stage since it requires input from shareholders (e.g., clear reasoning behind IPO), and some of them are common to all SOEs (e.g., the prevailing valuation conditions in the broader public capital markets). Furthermore, qualitative criteria carry a high degree of subjectivity and are not quantifiable, however, in making the necessary judgments, the publicly available information has been interpreted, as closely as possible, against the backdrop of how FMPs would consider these elements.

The most important driver of conclusions on the likely prospects for a successful use of public capital markets is the degree of fulfilment of the defined criteria. The applied **approach in making conclusions is on the conservative end to warrant a higher margin of safety**. This is done as to mitigate IPO execution risk and limit the odds of receiving unfavourable pricing for the State capital.

Lastly, if an SOE is deemed not ready for an IPO, it does not imply that the SOE should not tap the capital markets. Instead, it provides a snapshot of the SOE's current state (as of 2019) in relation to the conditions that would be required to warrant favourable valuations.

From the commercial SOEs of the selected sample size, there are two companies, which exhibit the necessary characteristics for a successful IPO receiving relatively high multiples. **Latvenergo and Latvijas valsts meži meet majority of the criteria defined in the IPO readiness assessment and what would be expected from the FMPs (potential investors)**. At the same time, other three SOEs meet the defined criteria in an uneven manner in which for each SOEs there are certain higher priority areas, which are not sufficiently fulfilled.

Box 5.1. – Potential bond issuances for selected SOEs

The analysis made in **Figure 54** can also serve as a proxy in evaluating whether an SOE is a good candidate for a bond issuance. In general, the applied criteria should be assessed by assigning less stringent measurements since bond issuances do not impose a risk of suffering permanent foregone opportunity cost by tendering the ownership rights at too low price.

For an SOE to issue bonds, corporate governance elements should be functioning according to best practice and what is commonly accepted by the FMPs in public capital markets. Just as equally important there needs to be a clear reasoning behind a new debt issue and the business viability factors should be in place (e.g., properly managed financial risk, sufficient cash flows to cover the proceeds and meet the set covenants). However, the growth prospects and dividend policies do not play a major role in attracting institutional investors covering the planned debt proceeds. The creditors do not participate in profit sharing and are concerned of having sound financial conditions of the company in order to warrant timely and complete repayment of principle and the associated interest expense (coupon).

Positive factors serving as a tailwind for a successful entrance into public capital markets:

- The market valuation metrics indicate a **favourable timing of attracting private capital** at relatively high valuations. Several valuations metrics (e.g., Shiller PE ratio¹¹⁴), and broad equity and fixed income indices are trading close the their all-time peaks – Europe Stoxx 600¹¹⁵, OMXBBGI¹¹⁶ - Baltic equity benchmark - (for equity markets), and S&P Eurozone Investment Grade Corporate Bond Index¹¹⁷ (for fixed income), respectively. This would increase the chances of attracting higher competition from FMPs and, ultimately, receiving better pricing for each unit ownership stake sold.
- All the selected commercial SOEs have an **exposure to foreign markets that facilitates a more diversified stream of income**, thereby reducing systematic risk premium assigned by the FMPs.
- Most of the SOEs are placed in a **growing industry contributing to higher consensus expectations** in terms of the future cash flows set by the FMPs and potential investors.
- All of the SOEs have estimated market¹¹⁸ **values above EUR 100 million** warranting a sufficient ticket size for attracting larger institutional investors and receiving a notable amount of proceeds to finance growth, repay debt or dividends.
- Most of the SOEs have **strong overall corporate governance procedures** in place mainly stemming from the existent bond issuances and strong regulatory framework imposed by the State.

Negative factors serving as a headwind for a successful entrance into public capital markets

- Several SOEs **do not generate positive cash flows and do not provide a stream of dividend payments for the shareholder**. The conditions in which cash flows are unpredictable and even negative, the risk premium assigned by the FMPs increases dramatically resulting in compressed valuations. The same applies for dividends, which tend to provide a more visible path of the expected cash flows for the shareholder and can be of utmost importance in relatively illiquid markets, where the realization of capital gains comes with a heightened bid-ask discount risk.

¹¹⁴ Shiller PE Ratio.

¹¹⁵ Stoxx Europe 600.

¹¹⁶ Nasdaq. Baltic market indexes.

¹¹⁷ S&P Down Jones Indices. S&P Eurozone Investment Grade Corporate Bond Index.

¹¹⁸ Preliminary valuations made using 2019 financial and valuations multiples (e.g., P/E, EV/EBITDA) from publicly traded companies in the respective sector to get a preliminary / rough estimate of the indicative valuation.



- Similarly, **financial risk is observed to be assumed too high** relative to the closest peers for some of the SOEs. The increased financial risk leads to more volatile cash flows, reduced opportunities to initiate large and necessary investment projects, and, ultimately, reignited risk of ownership dilution related to new equity injections.
- Several SOEs have not issued bonds previously and hence there are **no credit rating available**. The absence of credit ratings makes the preparatory work for a potential IPO more complex and time-consuming as many aspects of the company (e.g., robust financial reporting, controls, compliance staff) need to be introduced before turning to the FMPs. Also, an **absence of ESG reporting** limits the potential competition by the FMPs.

Annex

Annex 1. Selected sample size of 90 European SOEs

Name	Country	Industry
Oil Terminal S.A. (BVB:OIL)	Romania	Energy
AB Kauno Energija (NSEL:KNR1L)	Lithuania	Energy
Eesti Energia	Estonia	Energy
Bulgarian Energy Holding EAD	Bulgaria	Energy
Polskie Górnictwo Naftowe i Gazownictwo S.A. (WSE:PGN)	Poland	Energy
AB Klaipėdos nafta (NSEL:KNF1L)	Lithuania	Energy
Equinor ASA (OB:EQNR)	Norway	Energy
Jastrzebska Spółka Węglowa S.A. (WSE:JSW)	Poland	Energy
Societatea Conpet S.A. (BVB:COTE)	Romania	Energy
S.N.T.G.N. Transgaz S.A. (BVB:TGN)	Romania	Energy
Grupa LOTOS S.A. (WSE:LTS)	Poland	Energy
MOL Magyar Olaj- és Gazipari Nyilvánosan Mukodo Reszvenytársaság (BUSE:MOL) - MOL Magyar Olaj és Gazipari Nyilvánosan Mukodo Reszvenytársaság	Hungary	Energy
VERBUND AG (WBAG:VER)	Austria	Energy
Vattenfall AB	Sweden	Energy
SNGN Romgaz SA (BVB:SNG)	Romania	Energy
CNTEE Tranelectrica SA (BVB:TEL)	Romania	Energy (Utilities)
ENEA S.A. (WSE:ENA)	Poland	Energy (Utilities)
Elektro Ljubljana d.d. (LJSE:ELOG)	Slovenia	Energy (Utilities)
Elektro Gorenjska, d.d. (LJSE:EGKG)	Slovenia	Energy (Utilities)
AB Ignitis grupe (NSEL:IGN1L)	Lithuania	Energy (Utilities)
Elektro Maribor d.d. (LJSE:EMAG)	Slovenia	Energy (Utilities)
CEZ, a. s. (SEP:CEZ)	Czech Republic	Energy (Utilities)
S.N. Nuclearelectrica S.A. (BVB:SNN)	Romania	Energy (Utilities)
Ørsted A/S (CPSE:ORSTED)	Denmark	Energy (Utilities)
Electricité de France S.A. (ENXTPA:EDF)	France	Energy (Utilities)
A2A S.p.A. (BIT:A2A)	Italy	Energy (Utilities)
BKW AG (SWX:BKW)	Switzerland	Energy (Utilities)
Fortum Oyj (HLSE:FORTUM)	Finland	Energy (Utilities)
ACEA S.p.A. (BIT:ACE)	Italy	Energy (Utilities)
Cyprus Forest Industries Public Ltd (CSE:CFI)	Cyprus	Forestry
VĮ Valstybinių miškų urėdija	Lithuania	Forestry



Name	Country	Industry
Croatian Forests	Croatia	Forestry
Sveaskog AB	Sweden	Forestry
Antibiotice S.A. (BVB:ATB)	Romania	Health care
Státní léčebné lázně Bludov	Czech Republic	Health care
UAB Universiteto vaistinė	Lithuania	Health care
Apoteket AB	Sweden	Health care
Poste Italiane SpA (BIT:PST)	Italy	Health care
SNCB SA (ENXTBR:001062148)	Belgium	Railroads
Infrabel S.A. (ENXTBR:626591203)	Belgium	Railroads
VĮ Turto bankas	Lithuania	Real Estate
Permanent TSB Group Holdings plc (ISE:ILOA)	Ireland	Real estate
Polski Holding Nieruchomosci S.A. (WSE:PHN)	Poland	Real estate
Statens Bostadsomvandling AB SBO	Sweden	Real Estate
Hellenic Republic Asset Development Fund	Greece	Real Estate
Banque Cantonale de Genève SA (SWX:BCGE)	Switzerland	Real estate
Riigi Kinnisvara AS	Estonia	Real Estate
Specialfastigheter Sverige Aktiebolag	Sweden	Real Estate
VĮ Registrų centras	Lithuania	Real Estate
Nordica Aviation Group	Estonia	Transportation
Green Cargo AB	Sweden	Transportation
Aeroports de Catalunya	Spain	Transportation
Attiko Metro	Greece	Transportation
London and Continental Railway	UK	Transportation
Córas Iompair Éireann	Ireland	Transportation
Aerodrom Nikola Tesla a.d. (BELEX:AERO)	Serbia	Transportation
Serbian Railways Infrastructure	Serbia	Transportation
Eusko Trenbideak – Ferrocarriles Vascos	Spain	Transportation
Administrador de Infraestructuras Ferroviarias	Spain	Transportation
Civil Aviation Authority	UK	Transportation
Rába Járműipari Holding Nyrt. (BUSE:RABA)	Hungary	Transportation
Renfe Operadora	Spain	Transportation
AB Lietuvos geležinkeliai Group	Lithuania	Transportation
MÁV Magyar Államvasutak Zrt.	Hungary	Transportation
Finavia Oyj	Finland	Transportation
Eesti Raudtee	Estonia	Transportation




Name	Country	Industry
Adriatic Croatia International Club d.d. (ZGSE:ACI)	Croatia	Transportation
Swedavia AB	Sweden	Transportation
VĮ Oro navigacija	Lithuania	Transportation
VĮ Klaipėdos valstybinio jūrų uosto direkcija	Lithuania	Transportation
FNM S.p.A. (BIT:FNM)	Italy	Transportation
Infranord AB	Sweden	Transportation
Finnair Oyj (HLSE:FIA1S)	Finland	Transportation
České dráhy	Czech Republic	Transportation
Aéroports de Paris SA (ENXTPA:ADP)	France	Transportation
Luka Koper d.d. (LJSE:LKPG)	Slovenia	Transportation
Tallinn Airport	Estonia	Transportation
ENAV S.p.A. (BIT:ENAV)	Italy	Transportation
Port of Tallinn	Estonia	Transportation
AS Tallinna Sadam (TLSE:TSM1T)	Estonia	Transportation
Svevia AB	Sweden	Transportation
Dublin Airport Authority	Ireland	Transportation
Autobahnen- und Schnellstraßen-Finanzierungs-Aktiengesellschaft	Austria	Transportation
BREMER LAGERHAUS-GESELLSCHAFT -Aktiengesellschaft von 1877- (DB:BLH)	Germany	Transportation
As Operail	Estonia	Transportation
Letiště Praha	Czech Republic	Transportation
IAR S.A. (BVB:IARV)	Romania	Transportation
Copenhagen Airports	Denmark	Transportation
Arlandabanan Infrastructure AB (AIAB)	Sweden	Transportation
The Hellenic Railways Organisation (OSE)	Greece	Transportation

Annex 2. Selected sample of SOEs (not tested in grey lines)

Segment	Segmentation criteria	SOE	
Commercial SOEs	Not classified to State's budget, and 3-year average proportion of State financing to net turnover is less than 10%.	Latvenergo AS	
		AirBaltic Corporation AS	
		Latvijas valsts meži VAS	
		Latvijas dzelzceļš VAS	
		Latvijas Pasts VAS	
		Altum AS	
		LDz Cargo AS	
		Sadales tīkls AS	
State-dependent commercial SOEs	Classified to State's budget and 3-year average proportion of State financing to net turnover is more than 10%.	Latvijas Gaisa Satiksme VAS	
		Pasažieru vilciens AS	
		Valsts nekustamie īpašumi VAS	
State-dependent non-commercial SOEs	Classified to State's budget and executes mostly non-commercial activities (from public service agreements). <i>The difference in the State dependent commercial and State dependent non-commercial segmentation phase embodies a fine line that is mostly punctuated by the shareholder's discretionary view as to what elements of the proposed methodology suit the</i>	Rīgas Austrumu klīniskā universitātes slimnīca SIA	
		Latvijas Koncerti VSIA	
		Ceļu satiksmes drošības direkcija	



	<i>particular SOE best. Namely, less reliance on quantitative criteria and more on qualitative judgment on the particular SOE's suitability to the proposed methodology.</i>		
Derived public person		Rīgas brīvostas parvalde	



Annex 3. Detailed information of selected SOEs

Please see document – Snapshots of the selected SOEs.

Annex 4. Advantages and disadvantages of various equity financing instruments

In equity financing the capital is sourced internally (e.g., via undistributed profits, retained earnings) or by receiving external capital, which has not defined maturity level or set date when it has to be repaid. The conventional forms of equity financing do not presume any interest-bearing constituents. However, there is implicitly embedded “opportunity cost” in the realm of equity financing. This cost is directly linked to the owners (or shareholders) compensation, which is expected as an exchange for the assumed risks and foregone capital allocation opportunities.

IPO and secondary offering	
Overview	<p>The IPO is a form of equity financing in which a company is exchanging a certain percentage of the ownership for a specific amount of money. The IPO, specifically, refers to an initial entry into the public equity markets where the company’s shares are offered to the public for the first time.</p> <div style="text-align: center;"> </div> <p style="text-align: center;">Figure. Overview of the IPO process</p> <p>Once the IPO is made and the shares are floated in the public market, the company has an option to return to the equity market in an attempt to raise additional capital via the issuance and sale of more shares – similarly the SOEs can buy-back some of the outstanding shares. In addition to the secondary offering, some countries allow for shelf offering. This is a process in which companies are allowed to sell additional shares (i.e. pre-agreed amount) without a separate prospectus.</p>
Advantages	
<u>Financial capacity</u>	<p>By offering shares, the company receives cash. The increased cash position lowers the overall indebtedness (e.g., debt-to-equity ratio) and thus leads to wider investment and borrowing instruments at more favourable terms – at the expense of decision-making process depending if the state remains the majority owner. Furthermore, in the event of broader economic turmoil and / or company-specific financial hardships, the company can relatively quickly turn to capital markets and access additional equity to close the cash flow gap (e.g., service the outstanding debt). By conducting an IPO, the shareholders are also exposed, in general, to potentially higher valuations due to reduced risk profile (e.g., liquidity premium, corporate governance risks, enhanced transparency, more clear financial strategy etc.). The higher valuations can lead to more capital being obtained on a per share basis in the case of either IPO or additional share issuances.</p>
<u>Maturity</u>	<p>The shares offered to the public market are perpetual and do not have a fixed maturity date. The shares can be de-listed by the company conducting a share-repurchase program, or in the event of bankruptcy.</p>

<p><u>Miscellaneous</u></p>	<p>The company can boost the motivation and incentivize the employees and Executive management by establishing compensation schemes related to the underlying performance of the company, where the company’s stock price serves as a sound proxy in determining the long-term results. Also, going public oftentimes is a catalyst for strengthened corporate governance. The transformative event of the IPO forces the company to comply with high-standards set by the exchanges and implement “best-practices” for the corporate governance. In addition, the company can leverage the exchange and the fact of being a publicly traded company to raise the awareness of notable customers and access large suppliers. Lastly, public companies can use their stock as acquisition currency granting them the flexibility to avoid heavier indebtedness.</p>
<p>Disadvantages</p>	
<p><u>Bureaucratic element</u></p>	<p>As indicated in the Figure above, the IPO as well as the subsequent process of being a listed company involves continuous administrative work and extra compliance. In many instances, the company is required to hire additional staff and introduce new internal policies, increasing the overall bureaucratic work. <i>Nevertheless, it must be highlighted that the additional compliance renders positive benefits for the overall corporate governance, transparency, liability of Executive management etc. While the bureaucratic element is marked as a disadvantage, in the long run the benefits of it exceed the near-term drawbacks.</i></p>
<p><u>Administrative costs</u></p>	<p>The costs of entering public market are significant, both during the pre-IPO phase and after a complete IPO. Depending on the context, the pre-IPO phase can cost up to 7 – 10 % of the total offering subject to the actual offer placed. However, this is highly subjective and varies case by case since an IPO involves a certain degree of fixed costs which for larger rounds of new equity issues could be brought down on a relative basis due to “economies of scale” effect.</p>
<p><u>Disclosure of information</u></p>	<p>Being a listed company requires making certain financial statement and critical information open to the public on a regular basis. The consequences of publicly circulating such sensitive information can lead to potentially reduced competitive advantage and foregone growth opportunities (e.g., out crowded by the competitors, which have scrutinized the publicized information).</p>
<p><u>Cost of capital</u></p>	<p>The average rate of cost of capital¹¹⁹ for the share offerings is generally higher than other alternatives, which rank higher in the capital structure. This is because the owners assume more risk and thus require higher compensation for that. In Latvia, the average cost of capital (which in this case is cost of equity) is 9-10%. In case of private offering, the cost of capital can exceed the one under the IPO route.</p>
<p><u>Miscellaneous</u></p>	<p>Once the company becomes publicly listed, it falls under the radar of many financial market participants (FMPs), who are profit and growth oriented. Any negative deviation from the FMPs’ consensus estimates might cause the company’s share price to plummet, and thus question the Executive management team and the current strategy in place. This is why it is critical to assess the envisaged free float depending on the commercial and strategic role of the SOE. If the respective SOE is</p>

¹¹⁹ Aswath Damodaran. Data 2017 Update 6: the cost of capital.

The weighted average of the cost of equity and after-tax cost of debt weighted by the market values of equity and debt. Cumulated market values used for weights.

	deemed critical from a national strategy perspective then the State could aim to keep the majority ownership and only list a minority stake.
LV context	<p>The Latvian IPO market has been relatively inactive during the past decade with the local Nasdaq Riga featuring the lowest number of listed securities compared to regional peers in Lithuania and Estonia.</p> <p>Moreover, there has been no successful IPO for the Latvian SOE in the past 10-year period. In fact, Latvia has only one publicly traded SOE (albeit not theoretically a SOE due to minimal share ownership by the State), which went public in 1999 and in which the state ownership is lower than 0.01%.</p> <p>However, the seemingly sluggish Latvian IPO market and the limited size of the total capital market is not an indicative of the underlying instrument's efficiency.</p> <p><i>“We appreciate that the stock market is an additional driving force and motivator for continued growth ... For example, because of being listed on the stock exchange, we have captured notable customers” (Uldis Iltners, Managing Director of MADARA Cosmetics)</i></p> <p>The IPOs made by Latvian companies have resulted in a success. All of the offerings have been fully subscribed, and the subsequent benefits have been material.</p> <p><i>(please refer to the capital market's section for a more elaborate explanation)</i></p>
Preferred capital	
Overview	Preferred capital or preference shares is a hybrid form of financing that has certain characteristics of equity and certain attributes of debentures. Preference shares are securities issued by a company that do not carry voting rights like ordinary or common shares. However, they entitle their holders to a fixed dividend and have a set tenure, after which the company redeems the principal. Holders of preference shares get priority over those who own ordinary shares if the company is wound up. Preference shares can be convertible (into ordinary shares) as well as non-convertible. Convertible preferred shares include an option for the holder to convert shares into a fixed number of common shares after a predetermined date.
Advantages	
<u>Financial capacity</u>	By offering preference shares, the company receives cash. The increased cash position lowers the overall indebtedness and thus leads to wider investment and borrowing instruments at more favourable terms. The amount of preference does not affect the creditworthiness in the eyes of lenders because the lenders rank higher in the capital structure and thus have the right to receive debt service payments before common and preferred dividends.
<u>Maturity</u>	Preferred shares are predominately structure in either of the two ways – as perpetual or non-perpetual. The former closely resembles the infinite nature of common shares whereas the latter can take various maturities but usually that are longer than five years.
<u>Miscellaneous</u>	The company can defer preferred dividend payments if it falls into a period of tight cash flow or other financial hardship. This feature of preferred stock increases the flexibility of the company in servicing the debt in a sustainable manner. Moreover,

	preference shareholders do not enjoy the voting rights, and thus, there is no dilution of control.
Disadvantages	
<u>Bureaucratic element</u>	The process of being a listed company involves continues administrative work and extra compliance. In addition, when offering preferred shares, the company has to develop a listing prospectus burdening the internal resources. <i>Nevertheless, it must be highlighted that the additional compliance renders positive benefits for the overall corporate governance, transparency, liability of Executive management etc. While the bureaucratic element is marked as a disadvantage, in the long-run the benefits of it exceed the near-term drawbacks.</i>
<u>Administrative costs</u>	Particular financing option does not impose additional administrative costs, except costs described per IPO section.
<u>Disclosure of information</u>	Similar to section IPO section.
<u>Cost of capital</u>	Similar to section IPO section.
<u>Miscellaneous</u>	Preferred stockholders must be fully paid before common shareholders can receive any distributions. If the company does not pay or skip the preference dividend for a longer period, then the preference shareholders oftentimes carry the rights to acquire an unfavourable amount of voting rights.
LV context	As at 5 June 2020, none of the Latvian, Lithuanian or Estonian companies held listed preferred shares on the Nasdaq Baltic stock exchange. In fact, there has not been a precedent among the Baltic companies in sourcing the capital via public preference shares. The only preference share issues in the Baltics have taken place via private markets ¹²⁰ .
State subsidies and grants	
Overview	Subsidies and grants are one of the many ways in which governments stimulates economic activity. Grants usually do not have to be repaid but are to be used for defined purposes or specific projects. Subsidies, on the other hand, refer to direct contributions, direct payments, loan guarantees, special tax breaks and other special assistance that governments provide businesses to use the money to offset operating and management costs.
Advantages	
<u>Financial capacity</u>	Grants provide “free” money for expansion and development of the company if the pre-defined project obligation are met. Grants can be compared to fresh equity without a dilution of ownership rights. Subsidies, on the other hand, can be considered a lifeline to the company as in many cases the subsidies substantially unburden the company’s cash flow and warrant going concern.
<u>Maturity</u>	As subsidies and grants are bound to a specific purpose, whether set by the beneficiary or governments they are perpetual and do not have to be repaid.
<u>Disclosure of information</u>	Disclosure of information is discreet between a grant issuer/subsidies provider and a grantee/subsidised company. Yet, the fact of obtaining this type of financing, requires

¹²⁰ <https://www.capitalia.com/web/file/Statutes,%202016-09-23.pdf>

	companies to disclose the key financing terms in the annual reports (e.g., maturity, total amount).
<u>Cost of capital</u>	Grants and subsidies do not have to be repaid and do not require ownership in exchange. The cost of capital in this case is non-existent for an SOE as a receiver of the funding. Nevertheless, there is both implicit and explicit cost for the State in granting and subsidizing the SOEs.
<u>Administrative costs</u>	The cost of paperwork mostly depends on the complexity of the projects, however, the associated cost levels are insignificant relative to the overall cost structure and the future benefits.
<u>Miscellaneous</u>	Grants do not require a specific purpose and can be used at the discretion of the beneficiary. Moreover, grants and subsidies tend to have so called a <i>waterfall effect</i> , once the company has received funding, it is very likely that the company will receive it again.
Disadvantages	
<u>Bureaucratic element</u>	Grants and subsidies are usually available at specific time windows, mostly annually, which can make the planning of business operations process challenging. Although grants and subsidies are free money, they foresee plenty of restrictions and conditions to be met. Grants and subsidies are not always renewed.
<u>Miscellaneous</u>	Subsidies and grants are bound to a specific purpose. Overreliance on state and EU subsidies can lead to a reduced incentive to cut company's costs.
LV context	<p>According to data¹²¹ gathered by Cross-Sectoral Coordination Centre of Republic of Latvia, grants and subsidies received by Latvian SOEs from the State budget were:</p> <ul style="list-style-type: none"> • EUR 660,340,152 in 2018 • EUR 1,122,441,411 in 2017 • EUR 598,038,619 in 2016 <p>As for the EU funding, at the end of 2019 absorption of the EU funds operational program "Growth and Employment" for the period 2014 - 2020 constituted 85.6% with 1,698 projects in implementation. The total pool of absorbable EU funds for the particular program is EUR 4.4 billion¹²², encompassing SOEs as well as other corporate entities.</p>
International financial institutions (IFIs) – equity part	
Overview	<p>IFIs play a major role in the economic development programs. This role includes counselling and funding large-scale and critical development projects as well as assisting with the implementation procedures.</p> <p>Most of the IFIs share common objectives such as reduction of poverty, improvement of living conditions and standards, support of sustainable economic, institutional and social development, promotion of regional cooperation and integration.</p> <p>The following IFIs have a strong presence in the overall economy of Latvia.</p>

¹²¹ State-Owned Enterprise Governance.

¹²² Eiropas Savienības struktūrfondi un Kohēzijas fonds. ES fondu vadošās iestādes ziņojumi Eiropas Komisijai 2014.-2020. Gada plānošanas period.

	<p>EIB (the European Investment Bank) is widely perceived as the <i>lending arm</i> of the EU. The EIB is the largest multilateral financial institution in the world and one of the broadest providers of climate finance. The EIB group has two parts – the EIB and the European Investment Fund (EIF). The EIB’s client base consists of both private and public sector companies, while the focus for EIF is SMEs specifically.</p>	<p>EBRD (the European Bank for Reconstruction and Development) operates in 38 economies across three continents, and provides financing for private sector projects, generally, in a range from EUR 5 million to EUR 250 million, both in the form of loans or equity investments.</p>	<p>NIB (the Nordic Investment Bank) is owned by 8 countries where starting from 2005 all three Baltic countries have been members of it. The NIB's authorised capital amounts to approximately EUR 6.1 billion, which is mostly used for co-financing projects together with other IFIs and public and private lenders.</p>
Advantages			
<u>Cost of capital</u>	The cost of capital associated with the IFIs’ equity financing is highly subject to the underlying project and varies depending on the inherent risk profile. However, the level of required compensation (i.e. the capital vs ownership) is lower than that of PE and VC funds. In many cases, sourcing equity financing is cheaper than going directly to the market, which can be illiquid or temporary subdued.		
<u>Disclosure of information</u>	Disclosure of information is discreet between an IFI and the company, yet the fact of obtaining the financing itself is usually publicly disclosed on the IFI databases.		
<u>Miscellaneous</u>	IFIs tend to avoid burdening themselves with an overwhelming administrative role in the particular company - the equity investment is limited to the minority share.		
Disadvantages			
<u>Financial capacity</u>	The equity investment is limited to the minority share where the shareholding usually ranges from 10 - 30%. The lower bracket of equity financing starts from around EUR 20 million leaving many SMEs out of the scope. However, the several IFIs are already aiming to address this via equity funds that can invest into SMEs (e.g., EBRD & CMDAF).		
<u>Maturity</u>	The equity financing part of IFIs has an envisaged timeline of usually 5-7 years that is subject to each investor’s appetite and market conditions. On the maturity date, IFIs can exit through joint sale with other shareholders to a third party, or sale back to existing shareholders or desirable via the public market.		
<u>Bureaucratic element</u>	Constructing a convincing proposal for IFIs equity financing can be a challenging task. It puts a pressure on the relevant stakeholders to fulfil all of the requirements. The subsequent reporting after a successful proposal can put an additional burden on the stakeholders. <i>Yet, similar as with the IPO and preferred capital, in the long-run the benefits of additional disclosure and compliance usually outweigh the near-term complexity.</i>		
<u>Administrative costs</u>	Because of the complex nature of the proposal, the company is usually indirectly required to hire expensive external consultants in order to comply with best practices		

	in terms of disclosure and transparency. <i>Yet, as per above, the benefits have the potential to outweigh near-term complexity / costs.</i>		
Miscellaneous	Compliance with IFIs financing instruments requires prerequisites as experienced shareholders and Supervisory board and Executive management, well-structured financing plans, sound financial basis, a credible business plan, willingness of corporate governance sharing with IFI, etc. While all these elements add value, complying with them oftentimes requires more administrative resources and time.		
LV context	EIB	EBRD	NIB
	<p>EIB has financed 47 projects in Latvia by investing total of EUR 2.79 billion. Top five of EIB activities in Latvia by sector since start of operations covers – Credit lines (23%), Energy (18%), Transport (14%), Composite infrastructure (13%) and Services (11%).</p> <p>As of 31 December 2019, Latvia holds 0.1% (subscription of EUR 267 million) shares of EIB.</p> <p>EIB Investment Survey data¹²³, the average shares of investment in different asset types in 2018 (Latvia) were as follows:</p> <ol style="list-style-type: none"> 1. Machinery and equipment - 51.13% 2. Land, business buildings, infrastructure – 16.54% 3. Software, data, IT networks and website activities – 15.27% 4. Training of employees – 8.66% 5. Research and development – 5.61% 6. Organisation and business process improvements – 2.8% 	<p>EBRD has financed 89 projects in Latvia, by investing EUR 789 million. As of 30 March 2020, there are 34 ongoing projects amounting EUR 262 million with a 44% equity share of portfolio. Particular portfolio consists of 50% financial institution financing, 33% industry, commerce and agribusiness financing and 17% sustainable infrastructure financing.</p> <p>As of 31 December 2019, Latvia holds 0.4% (EUR 30 million) shares of EBRD.</p>	<p>NIB has agreed single a loan agreement with a Latvian counterparty in 2019. NIB and AS Latvenergo has signed EUR 100 million (repayable within 15 years) loan agreement to finance AS Latvenergo subsidiary – AS Sadales Tikls.</p> <p>As of 31 December 2019, Latvia holds 1.3% (EUR 82 million) shares of NIB.</p>

¹²³ European Investment Bank. EIB Investment Survey.

Retained earnings	
Overview	Retained earnings arise as a result of undistributed profits kept within the company. These funds can finance daily operations, allow for acquisitions, capital investment, and pay down debt.
Advantages	
<u>Financial capacity</u>	The more profitable the company is, the greater the reinvestment potential considering dividend distribution policy. Any earnings left within the company enhances the capital structure decreasing the relative portion of debt on the balance sheet.
<u>Maturity</u>	Retained earnings as an own financing form does not entail any subsequent repayment and is deemed perpetual.
<u>Bureaucratic element</u>	There are no bureaucratic aspects associated with the decision to keep the profits undistributed. The decision itself is limited to only shareholder approval.
<u>Administrative costs</u>	There are no material administrative costs.
<u>Disclosure of information</u>	Retaining earnings within the company does not impose a need of any disclosure except for the public companies in the form of meeting notes from the general shareholder meeting.
Disadvantages	
<u>Cost of capital</u>	Retained earnings exhibit the same required return patterns as described in the case of IPOs. Cost of equity in this case is the highest among the alternative financing instruments, and in Latvia ranges on average from 9-10%.
<u>Miscellaneous</u>	In many cases, the level of future retained earnings is unpredictable and is subject to external factors. The amount of the option is highly dependent on the structure and interest of the company's shareholders where the controlling shareholders can use the company just as a "milking cow" preventing the possibility of reinvestment.
LV context	As per EIB Investment Survey data ¹²⁴ , retained earnings make up a significant portion of overall composition of investment finance. The composition of investment finance, by source in 2018 (Latvia) is: <ul style="list-style-type: none"> • Internal funds or retained earnings – 69.67% • External finance – 30.3% Intra-group funding – 0.13%

¹²⁴ European Investment Bank. EIB Investment Survey.

Advantages and disadvantages of various borrowing instruments

Loans from traditional banks	
Overview	Latvia, similar to the rest of the Baltic and EU countries, is a loan-based economy, in which enterprises rely heavily on loans from the traditional banking sector. There are over 15 commercial (traditional) banks in Latvia with the largest ones coming from Scandinavian (e.g., Swedbank, SEB Bank and Nordea). By March 2019, the total loan portfolio issued by banks in Latvia was EUR 13.8 billion, with Swedbank carrying the largest loan portfolio ¹²⁵ .
Advantages	
<u>Financial capacity</u>	Companies have the opportunity to get financing and increase the capital without diluting ownership; however, this comes with the increased indebtedness (e.g., debt to equity ratio) and riskiness of the company.
<u>Administrative costs</u>	Accessing loans does not demand additional administrative costs other than internal resources preparing the necessary documents for loan approval.
<u>Disclosure of information</u>	The company is not required to disclose sensitive information apart from the trial financial statements and certain contracts deemed important by the lender.
<u>Bureaucratic element</u>	The largest bureaucratic elements in respect to the loan financing from traditional banks is usually the subsequent compliance with loan covenants. The associated complexity and ensuing burden is low compared to the other financing instruments.
<u>Miscellaneous</u>	The loan principal amount to be re-paid is fixed, therefore, company's profits do not have to be shared with the lenders. Having a solid history with a banker (creditor) can increase the accessibility of debt financing during turbulent market times when the other similar companies yet without a loan history might experience more difficulties in accessing liquidity.
Disadvantages	
<u>Maturity</u>	The maturity profile of commercial loans in Latvia stretches to maximum 5 years. Such a short duration financing forces the companies to periodically rollover debts where the future outcomes of that are unpredictable. During financial crisis, the newly re-financed loan could have higher interest rate, stricter covenants or, worst, be rejected by the existing lender.
<u>Cost of capital</u>	In the cases of collateralization, the loan interest rate is pushed lower freeing up the company's cash flows. However, the average interest rate levels received by the companies exceed those of bonds or IFIs financing, making loans from traditional banks relatively unattractive.
<u>Miscellaneous</u>	One fourth of Baltic companies consider it difficult to obtain traditional bank financing, including but not limited due to necessary collateral levels, guarantees and high interest rates. In the case of company's bankruptcy or liquidation, creditors can become active members and exercise certain decision-making powers.
<u>LV context</u>	Latvian economy similarly to the EU is very banking focused. After the financial crisis, banks have worked to develop their operations further and their loan book value have gradually increased.

¹²⁵ Finance Latvia Association. Operating Results of Latvian Commercial Banks: 1st quarter 2019.

	<p>In the second half of 2018, Latvian banking sector experienced new turmoil when the ABLV bank's voluntary liquidation was approved by the FCMC¹²⁶.</p> <p>One year later, the local regulators and the ECB deemed PNB Banka insolvent and, effectively, shut down the bank.</p> <p>The issues within the Latvian traditional banking sector were compounded by a series of money laundering scandals in some of the largest Scandinavian banks.</p> <p>As a result of the aforementioned negatives, the overall traditional banking sector in Latvia has fallen many steps back in trying to establish a more credible profile since the great financial crisis.</p>
Loans from State Treasury	
Overview	State Treasury is an institution of direct administration operating under MoF, with its main objective being effective distribution and management of State financing. State Treasury works also with government's budget and debt management, EU financing instruments and loan administration, SOEs, which have more than 50% state ownership and municipalities.
Advantages	
<u>Financial capacity</u>	The loans taken from State Treasury resemble those of the traditional banking, where the company is offered a fixed maturity date, defines repayment schedule with the associated interest rate costs. The taken loans increase the company's leverage and constrain pre-debt service cash flows.
<u>Maturity</u>	The offered maturity profile is more beneficial to the company if compared to the traditional loans or even bonds. The maximum tenure of the loan stretches up to 30 years.
<u>Cost of capital</u>	The loans from State Treasury are cheaper than those of provided by the traditional banks. Both fixed and floating interest rates can be set. The website of State Treasury has an automated system, which shows the possible fixed and floating rates for each possible maturity of SOE loans. For a 10-year loan the fixed rate is at 1.174% and the floating 1.2% + 6 or 12-month EURIBOR ¹²⁷ .
<u>Administrative costs</u>	Service cost on loans provided to Latvian SOEs is 0.5% (already factoring in the before-mentioned interest rates).
<u>Disclosure of information</u>	The level of disclosure is very similar when applying for the traditional loan. The company has to provide financial statements, business plans and other ancillary (minor) documents specific to the State Treasury ¹²⁸ .
<u>Miscellaneous</u>	There are no commissions the company has to pay for making amendments to the loan contract. Furthermore, the State Treasury has developed an online platform where all the necessary documents for loan application can be filled and all processes finished.
Disadvantages	

¹²⁶ Finanšu un Kapitāla Tirgus Komisija. FCMC in control of ABLV Bank AS voluntary liquidation procedure.

¹²⁷ Valsts Kase. Aizdevumu likmes valsts kapitālsabiedrībām, zinātniskajām institūcijām, ostu pārvaldēm.

¹²⁸ <https://likumi.lv/ta/id/308726-kartiba-kada-ministrijas-un-citas-centralas-valsts-iestades-ieklauj-gadskarteja-valsts-budzeta-likumprojekta-valsts-aizdevumu>

<u>Bureaucratic element</u>	Cabinet of Ministers regulation Nr.362 differentiates the process of applying for State Treasury loans for different legal entities. For SOEs it is specified that they have to apply for State Treasury loan till the respective year's 15 th November ¹²⁹ , limiting the flexibility of a such financing type.
LV context	State's Treasury works with different organisations and institutions, including municipalities and SOEs. On several occasions, different institutions have received loans from State Treasury, for example, in 2010 Jēkabpils municipality received LVL 1.5 million loan for road reconstruction in the city ¹³⁰ .

PPP

Overview	<p>Public – private partnership (PPP) is a long-term agreement / contract between the government and an organisation in the private sector, where the private sector promises to provide public assets or services in exchange for a pre-agreed commission for a finite period.</p> <p>The economic ownership of the PPP assets is decided by analysing financing provided by the public and private partners, and the risks they take on¹³¹. Therefore, following EIB-Eurostat Guide to Statistical Treatment of PPPs (2016) regarding project's risk division, it is possible to have the project off-balance sheet for the government.</p> <div style="display: flex; flex-wrap: wrap; justify-content: space-around;"> <div style="border: 1px solid black; padding: 5px; width: 45%;"> <p style="text-align: center;">Step 1: Public partner</p> <p>Inform the CFCA about developing the Financial-economic calculations. Submit calculations to MoF and CFCA</p> </div> <div style="border: 1px solid black; padding: 5px; width: 45%;"> <p style="text-align: center;">Step 2: CFCA</p> <p>Evaluate the calculations and assumptions, and provide feedback. Give advice on the PPP related topics.</p> </div> <div style="border: 1px solid black; padding: 5px; width: 45%;"> <p style="text-align: center;">Step 3: MoF</p> <p>Evaluate the impact the project would have on the fiscal space.</p> </div> <div style="border: 1px solid black; padding: 5px; width: 45%;"> <p style="text-align: center;">Step 4: CoM & Public partner</p> <p>If CFCA and MoF do not approve, the CoM decides about starting the PPP. If CFCA and MoF approve, the public partner decides</p> </div> </div>
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Figure. PPP approval process

Advantages

<u>Financial capacity</u>	PPPs let the government (i.e. the company) escape large capital expenditures at the beginning of a project and spread the initial amount of required investment across the whole duration of the PPP contract. The PPP contract and the related financial aspects of it can take many forms. The key pre-requisite to the feasibility of the underlying form is whether there is a sufficient risk transfer from the public partner to the private and whether the value-of-money of a PPP exceeds that of a traditional procurement (e.g., loans from traditional banks). The two most popular forms of PPP
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¹²⁹ <https://likumi.lv/ta/id/308726-kartiba-kada-ministrijas-un-citas-centralas-valsts-iestades-ieklauj-gadskarteja-valsts-budzeta-likumprojekta-valsts-aizdevumu>

¹³⁰ Jēkabpils laiks. Jēkabpils pilsētas pašvaldība saņēmusi Valsts kases aizdevumu 1.5 miljonu latu apmērā.

¹³¹ Three main risks that need to be divided between the partners are construction, availability and demand risks.

	are DBFM and DBFOM, where the private partner is responsible for <i>design, build, finance and maintain</i> of the project, and in the latter case takes a further responsibility for <i>operation</i> part.
<u>Maturity</u>	The PPP contract has a set maturity and the operational payments made by the government to the private partner are calculated bearing in mind the duration of the contract. MGDD (2019) states that the average length of a PPP contract is 20 years. In Latvia such contract can last anywhere from 5 to 30 years, and in specific occasions longer than 30 years.
<u>Miscellaneous</u>	PPP contracts can be applied to both construction of new and renovation of already existing assets. This model provides a chance for the government to use private sector's know-how to implement new and more forward-looking solutions.
Disadvantages	
<u>Bureaucratic element</u>	The legal process of establishing a working PPP contract is long and cumbersome. The Eurostat-EIB Guide (2016) has several chapters and lists of risks that have to be split between the contracting partners. There are several steps that a PPP tender has to fulfil and go through with the Latvian governmental institutions (MoF, CFCA, etc.)
<u>Administrative costs</u>	The costs of developing a PPP contract are significant. The process tends to be intricate and lengthy, often requiring outside services (external consultants). The administrative costs are often the key drawback holding public sector back from accessing PPP financing.
<u>Cost of capital</u>	PPP can be viewed as a hybrid of equity and debt instrument. The underlying investment usually involves a direct equity injection by the private partner as well as a notable use of debt. Hence, the cost of capital should be viewed from two angles – cost of equity and cost of financing. The former is set by the private partner and usually ranges from 5 – 15% depending on the assumed risks, while the latter lands at a range of 0.9 – 2.5%.
<u>Disclosure of information</u>	Developing a PPP contract involves a high level of information disclosure by both contracting parties. Public partner (i.e. the company) has to provide detailed financial projections of the project, make available the internal financial capacity, reveal the existing debt covenants and any potential liabilities (e.g., lawsuits) etc.
<u>Miscellaneous</u>	The PPP contract is developed to provide public assets, which also means that the assets under PPP contract have to be mainly utilised by the public sector. The European level PPP guidelines therefore sets a limit to what part of the revenue generated from the PPP assets can be from third parties.
<u>LV context</u>	As of now there have been several attempts to develop PPP projects in Latvia and various projects are also in the pipeline. Kekavas bypass is considered the first PPP project in Latvia. The initial capex expectations for this project were around EUR 80 to 100 million, with the maintenance period at 20 years, and it was planned to be off balance sheet for the government ¹³² . However, the project had several unsuccessful tenders, potential investors saw problems with the overall confusing process, its transparency, and the complicity of legislation covering PPPs.

¹³² Deloitte. PPP P roject “Kekava Bypass”.

	Nonetheless, Latvian government has come forward and published an additional work plan to popularise the concept of PPP projects in Latvia.
International Financing Institutions (IFIs) – borrowing part	
Overview	All of the aforementioned IFIs (EIB, EBRD and NIB) provide borrowing opportunities for both private and public sector companies as well as governments and municipalities.
Advantages	
<u>Financial capacity</u>	IFIs give the opportunity to obtain financing for large and capex intensive projects. Oftentimes the loan amount provided by the IFIs is greater than what the traditional banks are able to offer. While the same bankable and commercially driven standards underpin the IFI approach, the prevailing conditions in the local banking industry (e.g., reduced willingness to provide large loan tickets and loan policy largely dictated by the mother company based outside Latvia) render IFI borrowings to SOEs and other public authorities more attractive.
<u>Maturity</u>	The loan maturities usually are of a longer duration than the ones provided by traditional banks. Depending on the IFI, the maximum duration can range from 15 – 30 years.
<u>Cost of capital</u>	Interest rates can be set both on fixed and floating basis. The interest rate includes a relatively small margin meant to cover the risks faced and costs incurred by the IFI when administrating project financing. In certain situations, IFIs provide financing by establishing syndicates with commercial banks to limit risk and facilitate market driven pricing. The cost of capital under syndicate structures is usually at the par with the levels provided by commercial / traditional banks.
<u>Disclosure of information</u>	The information disclosed in the process of due diligence and contract signing is kept confidential between the borrower and the IFI, therefore, no information on specific project interest rates, maturity and other details can be found.
<u>Miscellaneous</u>	Accessing loan financing from the IFIs requires compliance with high standards and forces the company to scrutinize many vital aspects in the context of the relevant project. This, in turn, results in a better awareness of the risks and potential bottlenecks in the project.
Disadvantages	
<u>Bureaucratic element</u>	Obtaining a loan from IFI is a lengthy process. For instance, EIB discloses seven steps that have to be fulfilled before receiving a loan. The project appraisal process can last from 6 weeks to several months ¹³³ .
<u>Administrative costs</u>	The starting process of developing a proposal takes resources from the applicant itself and, many times, requires external assistance.
<u>Miscellaneous</u>	IFIs loans cover only up to 50% of the project cost and can require government co-financing. There is a minimum project size requirement below which no loan financing is provided.
<u>LV context</u>	Latvia has long established relationship with different IFIs, with many completed projects developed using loans from them.

¹³³ <https://www.eib.org/en/infocentre/faq/index.htm>

	<p>For example, in 2010 AS Latvenergo signed loan contracts with EBRD and EIB for EUR 150 million and EUR 100 million respectively. These loans were part of the financing for Gas Turbine unit development in Riga¹³⁴.</p> <p>In 2017, EIB also went into agreement with University of Latvia, when they provided EUR 30 million for the 2nd stage development of university's buildings.</p>
Bonds	
Overview	Bonds are fixed income instruments which can be traded publicly, over the counter and privately. The price of bond depends on several variables, for example, bond maturity, face value, coupon rate, market interest rate and the associated credit risk.
Advantages	
<u>Financial capacity</u>	By issuing a bond the company receives cash, which can be further used to finance its operations and investments. However, bond coupon payments, similarly to loan interest payments, tie a certain part of the company's resources towards servicing the interest expense. At the bond's maturity date, the company has to make sure that it has either a sufficient liquidity to redeem the bonds or a robust financial capacity to refinance the maturing bond.
<u>Maturity</u>	The maturity of the bond varies from 3 months to even 100 years. However, the most common maturity range for companies lies in the range from 3 – 15 years, which is significantly longer if compared to the traditional loan financing.
<u>Cost of capital</u>	The cost of financing for the company depends on similar aspects as when applying for a loan from a traditional bank (e.g., existing leverage profile, duration, credit risk, interest rate level etc.). The obtained cost of financing via bond issues is usually lower than that of traditional loans because of such factors as reduced illiquidity premium, potentially more bids and improved transparency.
<u>Miscellaneous</u>	The company has a possibility to embed an optionality in its issued bonds in order to warrant more flexibility for either itself or the lenders. The company might issue callable bonds, which depending on the option type (American or European type) allows the company to redeem the bonds before the maturity date at a pre-specified price. Similarly, the company can offer the opportunity for the lenders to force the company to payback the bonds before the maturity date. In such a case (i.e. puttable bond), the company achieved more favourable pricing for the bond as the associated risks are reduced for the lending party.
Disadvantages	
<u>Bureaucratic element</u>	The level of bureaucratic complexity is significantly higher compared to traditional loans or even borrowings from IFIs. Issuing bonds entails a preparation of bond prospectus, communication with the intermediaries and potential bidders. When bonds are floated, the subsequent reporting standards and immediate disclosure of material information put an additional burden on the company.
<u>Administrative costs</u>	The fulfilment of the aforementioned bureaucratic elements is relatively expensive. Hiring third parties, external consultants and additional staff is required to meet the criteria and develop the necessary documents (e.g., prospectus, robust reporting, corporate governance reports etc.). However, the obtained cost of financing via bond

¹³⁴ <https://www.ebrd.com/work-with-us/projects/psd/latvenergo-riga-chp2.html>



	issues can potentially offset the associated administrative costs and on a net total basis provide still lower costs relative to traditional financing.
<u>Disclosure of information</u>	The company has to report financial statements on at least quarterly basis include detailed information in the prospectus and make any material information available on the exchange.
<u>Miscellaneous</u>	Bond issues are subject to the supply and demand dynamics within the capital markets. Under a serious market distress, the probability of successfully rolling over the maturing debt on the capital market is reduced leading to potentially higher cost of financing or, worst, bankruptcy due to lack of liquidity.
LV context	<p>On the Nasdaq Baltic, there are 7 listed Latvian Government bonds (the rest 20 government bonds issued by Lithuanian government), and several corporate bonds issued by companies registered in Latvia.</p> <p>One of them being Latvenergo, who has issued a green bond in 2015, with maturity in 2022 (7-year bond). Bonds face value is EUR 1000 and the coupon rate 1.9%¹³⁵. Now in an article published on Latvenergo website, they state that a new green bond with the total nominal value of up to EUR 200 million, is planned to be issued¹³⁶.</p> <p>Altum is another institution that has issued public bonds on the Nasdaq Baltic. Altum issued a 7-year green bond in 2017 with the total nominal value at EUR 20 million¹³⁷ and another, however, not green, in 2018. Both bonds with coupon rates of 1.3% and face value EUR 1000.</p>

¹³⁵ <https://nasdaqbaltic.com/statistics/en/bonds>

¹³⁶ <https://latvenergo.lv/en/jaunumi/preses-relizes/relize/latvenergo-will-issue-green-bonds-highest-category-shading-cicero>

¹³⁷ <https://www.altum.lv/en/investors/bonds-altum/5980/7-gadu-zalas-obligacijas/>

Annex 5. Disclosure of information by the Ministries by 21.05.2020

Legend						
The ministry has displayed information according to criteria	x					
The ministry has not displayed information according to criteria	-					
	Ministry of Transportation	Ministry of Finance	Ministry of Economics	Ministry of Culture	Ministry of Health	Ministry of Agriculture
The legal name, legal address, amount of share capital, level of State's participation in the SOE	x	x	x	x	x	x
Conformity of State participation in the company with the Article 4 of SOEL	-	The reasoning of the participation is not in conformity with Article 4 of SOEL	The reasoning of the participation is not in conformity with Article 4 of SOEL	*	-	The reasoning of the participation is not in conformity with Article 4 of SOEL
SOEs participation in other companies and its conformity with the Article 4 of SOEL	The reasoning of the participation is not in conformity with Article 4 of SOEL	x	The reasoning of the participation is not in conformity with Article 4 of SOEL	not applicable	The reasoning of the participation is not in conformity with Article 4 of SOEL	The reasoning of the participation is not in conformity with Article 4 of SOEL
Representative of the holder of State capital shares in the SOE	x	x	x	x	x	x
Approved annual report of the SOE	The Ministry has made a reference to the required information by providing a link to the SOE's web page	The Ministry has made a reference to the required information by providing a link to the SOE's web page	The Ministry has made a reference to the required information by providing a link to the SOE's web page	x	The Ministry has made a reference to the required information by providing a link to the SOE's web page	x
Dividends paid by the capital company to the State and payments made to the State budget	The Ministry has made a reference to the required information by providing a link to the SOE's web page	The Ministry has made a reference to the required information by providing a link to the SOE's web page	The Ministry has made a reference to the required information by providing a link to the SOE's web page	x	The Ministry has made a reference to the required information by providing a link to the SOE's web page	x
If applicable, information that the State has intended to terminate participation in the company	not applicable	not applicable	not applicable	not applicable	not applicable	not applicable
Information regarding the initiated reorganisation or transformation of the capital company	not applicable	not applicable	not applicable	not applicable	x	not applicable
Other information, which the holder of State capital shares considered as necessary for publishing or which is determined in the guidelines set by the Coordination Institution	The Ministry is providing strategic aim for each of the SOEs and the Agreement delegating the public administration tasks.	The Ministry is providing strategic aim for each of the SOEs, as well as, the name and last name for the Executive and Supervisory board members in each of the SOEs.	The Ministry is providing information about the SOEs' Supervisory board and Executive managements (excluding the Supervisory board of Latvenergo)	The Ministry is providing strategic aim for each of the SOEs and the Agreement delegating the public administration tasks.	The Ministry has also provided information about the evaluation of its participation in the enterprises	not applicable

Annex 6. Level of information disclosure by the State-owned enterprises by 21.05.2020.

Legend																
SOE has displayed information according to criteria		x														
SOE has not displayed information according to criteria		-														
Not applicable		N/A														
SOE		Latvenergo	Latvijas valsts meži	Latvijas Pasts	Latvijas Dzelzceļš	AirBaltic	CSDD	Latvijas Gaisa satiksme	Latvijas Koncerti	Pasažieru vilciens	Valsts nekustamie īpašumi	RAKUS	LDZ Cargo	Sadales tīkls	Altum	Rīgas Brīvostas pārvalde
General strategic objectives		x	x	x	x	The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 1 of SOEL	x	x	x	x	x	x	The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 1 of SOEL	x	The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 1 of SOEL	x
The types of commercial activity		x	x	x	x	The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 1 of SOEL	x	x	x	x	x	x	x	x	The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 1 of SOEL	x
For at least the last five years*	The results of implementation of financial and non-financial objectives	x	The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 1, Sub-clause (a) of SOEL	The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 1, Sub-clause (a) of SOEL	x	x	The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 1, Sub-clause (a) of SOEL	x	The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 1, Sub-clause (a) of SOEL	The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 1, Sub-clause (a) of SOEL	The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 1, Sub-clause (a) of SOEL	The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 1, Sub-clause (a) of SOEL	The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 1, Sub-clause (a) of SOEL	x	The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 1, Sub-clause (a) of SOEL	The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 1, Sub-clause (a) of SOEL

	The payments made in the budgets	x	The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 1, Sub-clause (b) of SOEL	The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 1, Sub-clause (b) of SOEL	The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 1, Sub-clause (b) of SOEL	The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 1, Sub-clause (b) of SOEL	x	x	The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 1, Sub-clause (b) of SOEL	The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 1, Sub-clause (b) of SOEL	The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 1, Sub-clause (b) of SOEL	The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 1, Sub-clause (b) of SOEL	The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 1, Sub-clause (b) of SOEL	The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 1, Sub-clause (b) of SOEL	The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 1, Sub-clause (b) of SOEL
	The received funding and its distribution from the state	x	The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 1, Sub-clause (c) of SOEL	The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 1, Sub-clause (c) of SOEL	Information is not indicated on the SOE's webpage	x	x	The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 1, Sub-clause (c) of SOEL	The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 1, Sub-clause (c) of SOEL	Information is not indicated on the SOE's webpage	The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 1, Sub-clause (c) of SOEL	Information is not indicated on the SOE's webpage	Information is not indicated on the SOE's webpage	The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 1, Sub-clause (c) of SOEL	Information is not indicated on the SOE's webpage
	Approved annual reports and unapproved interim and annual reports	x	x	x	x	The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 2, Sub-clause (a) of SOEL	x	x	The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 2, Sub-clauses (a) and (b) of SOEL	x	x	The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 2, Sub-clause (a) of SOEL	x	x	The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 2, Sub-clause (a) of SOEL
	The procurements		The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 3, Sub-clause (d) of SOEL	The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 3, Sub-clause (d) of SOEL	x	x	Information is not indicated on the SOE's webpage	x	x	Information is not indicated on the SOE's webpage	x	x	x	x	The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 3, Sub-clause (d) of SOEL

	Each donation made/received; its recipient/ contributor	The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 3, Sub-clause (c) of SOEL	x		Information is not indicated on the SOE's webpage	x		Information is not indicated on the SOE's webpage	x	The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 3, Sub-clause (c) of SOEL	Not allowed	Information is not indicated on the SOE's webpage	The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 3, Sub-clause (c) of SOEL	Information is not indicated on the SOE's webpage	Information is not indicated on the SOE's webpage	Not applicable	Information is not indicated on the SOE's webpage	
	The strategy and procedures for donating	The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 3, Sub-clause (k) of SOEL	x		The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 3, Sub-clause (k) of SOEL	x		Information is not indicated on the SOE's webpage	x	The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 3, Sub-clause (k) of SOEL	Information is not indicated on the SOE's webpage	Not allowed	Information is not indicated on the SOE's webpage	Not applicable	Information is not indicated on the SOE's webpage	Information is not indicated on the SOE's webpage	Not applicable	Information is not indicated on the SOE's webpage
	Property and organisational structure	x	x	x	x	x	x	x	x	Information is not indicated on the SOE's webpage	x	x	x	x	x	x	x	
	Articles of association	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	
	The by-laws of the executive and Supervisory boards; their members and their remunerations*	x	x	x	x		Information is not indicated on the SOE's webpage		x	Information is not indicated on the SOE's webpage	x	x	Information is not indicated on the SOE's webpage	x	The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 3, Sub-clause (g) of SOEL	x	x	

Information about the members of the Supervisory board and the Executive management: professional work experience, education, positions in other capital companies, term of office	The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 3, Sub-clause (h) of SOEL	The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 3, Sub-clause (h) of SOEL	x	The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 3, Sub-clause (h) of SOEL	The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 3, Sub-clause (h) of SOEL	x	The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 3, Sub-clause (h) of SOEL	x	x	The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 3, Sub-clause (h) of SOEL	The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 3, Sub-clause (h) of SOEL	x	x	x	The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 3, Sub-clause (h) of SOEL
All the shareholders meetings*	The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 3, Sub-clause (i) of SOEL	Information is not indicated on the SOE's webpage	Information is not indicated on the SOE's webpage	Information is not indicated on the SOE's webpage	Information is not indicated on the SOE's webpage	Information is not indicated on the SOE's webpage	Information is not indicated on the SOE's webpage	Information is not indicated on the SOE's webpage	Information is not indicated on the SOE's webpage	Information is not indicated on the SOE's webpage	Information is not indicated on the SOE's webpage	Information is not indicated on the SOE's webpage	Information is not indicated on the SOE's webpage	Information is not indicated on the SOE's webpage	The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 3, Sub-clause (i) of SOEL
The principles of remuneration policy, including the salaries of each of the board members	x	The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 3, Sub-clause (j) of SOEL	The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 3, Sub-clause (j) of SOEL	The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 3, Sub-clause (j) of SOEL	Information is not indicated on the SOE's webpage	The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 3, Sub-clause (j) of SOEL	x	x	The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 3, Sub-clause (j) of SOEL	The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 3, Sub-clause (j) of SOEL	The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 3, Sub-clause (j) of SOEL	Information is not indicated on the SOE's webpage	Information is not indicated on the SOE's webpage	The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 3, Sub-clause (j) of SOEL	The information indicated partially complies with the conditions laid down in Article 58, Paragraph one, Clause 3, Sub-clause (j) of SOEL
Other important information	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x

* - Until January 1st, 2020 (when the amendments for the SOEL entered into force) that was not required

Since January 1st, 2020 the SOEs must disclose additional information in case if their net turnover is greater than 21 million euro and the balance sheet total is greater than 4 million euro.

SOE	Latvenergo	Latvijas valsts meži	Latvijas Pasts	Latvijas Dzelzceļš	AirBaltic	CSDD	Latvijas Gaisa Satiksme	Pasažieru vilciens	Valsts nekustamie īpašumi	RAKUS	LDZ Cargo	Sadales tīkls	Altum	Rīgas Brīvostas pārvalde
Expected risk factors	x	x	x	x	x	x	x	x	x	x	x	x	x	x
The main elements for internal control and risk management in preparation of the financial statements	x	x	x	x	Information is not indicated on the SOE's webpage	x	x	x	x	x	Information is not indicated on the SOE's webpage	x	x	x
The composition and functioning of the regulatory bodies and their committee	x	x	x	x	x	x	x	x	x	x	x	x	x	x
The objectives, implementation measures and results of the diversity policy in the composition of its management bodies (if applicable)	Information is not indicated on the SOE's webpage	Information is not indicated on the SOE's webpage	Information is not indicated on the SOE's webpage	Information is not indicated on the SOE's webpage	Information is not indicated on the SOE's webpage	Information is not indicated on the SOE's webpage	Information is not indicated on the SOE's webpage	Information is not indicated on the SOE's webpage	Information is not indicated on the SOE's webpage	Information is not indicated on the SOE's webpage	Information is not indicated on the SOE's webpage	Information is not indicated on the SOE's webpage	Information is not indicated on the SOE's webpage	Information is not indicated on the SOE's webpage
The Supervisory Board Committee and the Audit Committee (the by-laws, members)	x	Not applicable	Not applicable	Not applicable	Not applicable	Not applicable	Not applicable	Not applicable	Not applicable	Not applicable	Not applicable	Not applicable	x	Not applicable
The key policies with respect to risk management, conflict of interest, anti-	x	Information is not indicated on the	x	x	Information is not indicated on the	x	x	x	Information is not indicated on the SOE's webpage	x	Information is not indicated on the	x	Information is not indicated on the	Not applicable



corruption,
corporate
governance etc.

SOE's
webpage

SOE's
webpage

SOE's
webpage

SOE's
webpage

The atypical or
significant
transactions with
related parties** x

Not
applicable

Not
applicable

Not
applicable

Information
is not
indicated
on the
SOE's
webpage

Not
applicable

Not
applicable

Not
applicable

Not
applicable

Not
applicable

*

Not
applicable

Not
applicable

Not
applicable

** - for the publicly listed SOEs in the regulated market (according to the Article 51.9 of Financial Instrument Market Law)



Legend

SOE has displayed information according to criteria	x
SOE has not displayed information according to criteria	-
Not applicable	N/A

Analysis of SOE annual reports

SOE	Latvenergo	AirBaltic	Altum
Audited financial statements	x	x	-
Management report in accordance with the local legislation	x	x	-
Statement of the management's responsibility	x	x	-
Corporate governance statement	x	-	-
Non-financial statement	x	Partially fulfilling requirements set out in Article 56, paragraph 1, clause 4 of FIML	N/A
Payment statement	x	-	Partially fulfilling requirements set out in Article 56, paragraph 1, clause 6 of FIML

Analysis of additional requirements for annual report of SOEs which shares are traded in the regulated market

SOE	Latvenergo	AirBaltic	Altum
Capital structure	x	x	x
Classes of shares	x	-	x
The rights and obligations arising from each class of shares and their percentage from the share capital	x	-	x
Information about restrictions for disposal of shares or necessity to receive a consent of the capital company or other shareholders for the disposal of shares	-	-	-
Persons which have major holdings acquired directly or indirectly in the capital company, as well as a percentage of the holding of such persons	x	x	x
Shareholders having specific control rights and descriptions of such rights	-	-	-
The manner in which the voting rights arising from shares of employees will be exercised, if the employees themselves do not exercise them	N/A	N/A	N/A
Restrictions of voting rights in the cases when maximum amount of voting rights is determined regardless of the number of owned shares with voting rights, as well as the rights of shareholders to a part of profit, which is not related to a percentage of shares proportionally owned thereby, and other similar restrictions	-	-	-
Agreement of shareholders which are known to the capital company and which may cause restrictions for transfer of the shares or voting rights owned by the shareholders to other persons, as well as conditions which provide for prior approval of such transfer	-	-	-
Provisions governing election of members of the board of directors, changes in the composition of the board of directors and amending the articles of association	-	-	-
Authorisation of the members of the board of directors, including authorisation to issue or buy back shares	-	-	x
All other material agreements and contracts entered into by a target company and in which it is intended that in case of change of the control type they enter into effect, the validity of which has expired or which are amended, and consequences of entering into effect, termination or amending thereof. If disclosure of such information could seriously harm the commercial company, the Commission is entitled, upon request of the company, not to disclose the above-mentioned information	-	-	-
All agreements between a capital company and members of the board of directors thereof, which provide for compensation in cases when they resign from their position, they are dismissed without any justified reason or they are dismissed after a share buy-back offer is made	-	-	-

Analysis of SOE corporate governance statements:

SOE	Latvenergo	AirBaltic	Altum
Reference to corporate governance guidelines which are applied by the company, or information regarding corporate governance practice which is applied additionally to the above-mentioned guidelines	x	-	x
Information on where guidelines applied by the company can be available in public	x	-	x
If the company does not apply individual principles included in the corporate governance guidelines, regarding the non-applied principles the company must provide justification for such action, providing a sufficiently clear, accurate, and comprehensive explanation	x	-	-
If the capital company does not apply corporate governance guidelines, the company must provide justifications for such action	-	-	-
Information on key elements of internal control and risk management system which are applied in drawing up of financial statements	x	-	x
Information about persons who have major holding acquired directly or indirectly in the capital company	x	x	-
Information about shareholders having specific control rights and description of such rights	x	-	-
Information about restrictions of voting rights in the cases when maximum amount of voting rights is determined regardless of the number of owned shares with voting rights, as well as the rights of shareholders to a part of profit, which is not related to a percentage of shares proportionally owned thereby, and other similar restrictions	x	-	-
Information about provisions governing election of members of the board of directors, changes in the composition of the board of directors and amending the articles of association; authorisation of the members of the board of directors, including authorisation to issue or buy back shares	x	-	x
The administrative body, as well as composition and description of activities of its committees	x	-	x
If the capital company implements policy in relation to diversity of the composition of members of Executive and Supervisory body - a description regarding objectives of such policy, implementation measures and results in the reporting year	Information has not been provided.	N/A	N/A



Analysis of SOE non-financial statements

SOE	Latvenergo	AirBaltic
Short description of the model of commercial activity of the company including general information regarding the main types of economic activity and geographic markets, cooperation partners, clients, the most important resources to be used, flow of expenses and income, and other information characterising the commercial activity of the company	x	Partially fulfilling the requirement set out in Article 56 ³ , paragraph 2, clause 1 of FIML
Description regarding policies of the company which are implemented in relation to the fields of corporate social responsibility, including a description on what procedures have been introduced in the company in order to ensure sufficient attention to the implementation process of such policies	x	-
Information regarding the implementation results of the referred policies	x	-
Information regarding the main risks related to the fields of corporate social responsibility, information regarding the risks which arise from the legal transactions concluded within the scope of the commercial activity of the capital company or are related to the goods manufactured or services provided, and which may cause negative consequences in the fields of corporate social responsibility, as well as regarding management of such risks by the capital company;	x	Partially fulfilling the requirement set out in Article 56 ³ , paragraph 2, clause 4 of FIML.
Main non-financial indicators which are characteristic to the particular capital company and sector in which it is operating.	x	x



Analysis of SOE atypical and significant transactions with related companies

SOE	Latvenergo	AirBaltic	Altum
Related party (for a natural person - name, surname; for a legal person - name, registration number and country of registration);	*	Partially fulfilling the requirements set out in Article 59 ¹ , paragraph 4, clause 1 of FIML	Partially fulfilling the requirements set out in Article 59 ¹ , paragraph 4, clause 1 of FIML
The nature of the relationship between the capital company and its related party;	*	*	*
The date of the transaction, the amount of money received or payable in the transaction, the value of the assets acquired or disposed of or the liabilities of the company arising from the transaction or likely to arise in the future; including the amount of money expected to be received or paid in future periods, the maturity of the transaction or liability, as well as interest receivable or payable (if any);	-	-	-
The impact of the transaction on the commercial and operating financial results of the company;	-	-	-
The effect of the transaction on the shareholders of the company who are not related parties in the said transaction;	-	-	-
Whether the opinion of the Audit Committee or the opinion of an independent expert has been received (if requested).	Partially fulfilling the requirement set out in Article 59 ¹ , paragraph 5 of FIML	Partially fulfilling the requirement set out in Article 59 ¹ , paragraph 5 of FIML	Partially fulfilling the requirement set out in Article 59 ¹ , paragraph 5 of FIML



Analysis of SOE remuneration policy report

SOE	Latvenergo	AirBaltic	Altum
Description of the components of the fixed and variable remuneration (including any bonuses and other benefits of any kind) and their relative (percentage) of the total remuneration	Partially fulfilling the requirements set out in Article 59 ³ , paragraph 3, clause 1 of FIML	-	-
Explanation of how the remuneration policy and its specific remuneration components will contribute to the implementation of the strategy, long-term interests and sustainability of the company	-	-	-
Explanation of how the remuneration and employment conditions of the employees of the company have been taken into account in the development of the remuneration policy	-	-	-
The criteria for granting variable remuneration (if any), the performance criteria of the capital company used to determine it, methods for determining compliance with these criteria, deferral periods of variable remuneration and information on the ability of the capital company to claim variable remuneration	-	-	x
The key terms of the remuneration, if any, associated with the allocation of shares, including vesting periods and the right to retain shares after vesting	-	-	-
The terms of office of the board and council members and the applicable withdrawal periods, the main features of supplementary or accelerated retirement plans, termination clauses and payments to board and council members	x	-	Partially fulfilling the requirements set out in Article 59 ³ , paragraph 3, clause 1 of FIML.
The conditions for determining, reviewing and applying the remuneration policy	-	-	-
Measures to avoid or eliminate conflicts of interest	x	-	-
The role of the remuneration committee or other body of the capital company (if any) in determining, reviewing and applying the remuneration policy	x	-	-
Description and explanation of any significant changes in the remuneration policy and how the new remuneration policy takes into account the vote of the shareholders' meeting and the shareholders' views on the remuneration policy and the remuneration reports considered at the shareholders' meeting after the previous shareholders' meeting voting	N/A	N/A	N/A



Annex 7. Partiality of SOE Supervisory boards by 21.05.2020.

To assess the impartiality of the Supervisory boards the publicly available resources where examined, and the impartiality of the Supervisory board members where examined by assessing:

1. members of the Supervisory board have not been a member of the Executive management, controller, employee, procurator or trustee of the respective company or a related company (dependent company, controlled company of a public company), external auditor or employee of the external company serving as a council member;
2. the member of the Supervisory board or his/her family members (spouse, children, parents) does not receive and for the last three years have not received remuneration from the relevant company or its dependent company;
3. has not been a member of the Supervisory board for the last three years:
 - a. an official or employee of the shareholder (stockholder) or of an institution subordinated thereto,
 - b. a member of the board of directors of a company or its dependent company or its parent company held by a shareholder (stockholder).

Impartiality from the line ministry is necessary in order to prevent political interests from interfering in the choices of the Supervisory board members during decisions and operation of SOE. Table 3 includes a list of the selected SOE Supervisory board impartiality.

During the assessment of the Supervisory board member independence, it was determined that due to the discrepancies in the Supervisory board member statements in their State official's return, the criteria on Supervisory board income statement from the SOE cannot be taken into account. While the Supervisory board members in their State official's return must indicate that they receive only payment for performing the duties of the member of the Supervisory board, quite often Supervisory board members indicate that they receive salary giving wider interpretation and thus not providing precise justification for the received remuneration.

State-owned enterprise	Number of Supervisory board members	Number of independent Supervisory board members	Independent / dependent
Latvenergo	3	0	Dependent
Latvijas valsts meži	5	4	Independent
Sadales tīkls	n/a	n/a	n/a
Latvijas Pasts	3	3	Independent
Latvijas Dzelzceļš	5	3	Independent
LDz Cargo	n/a	n/a	n/a



Air Baltic		4	-	n/a
Altum		3	0	Dependent
CSDD		3	2	Independent
Latvijas Satiksme	Gaisa	3	1	Dependent
Pasažieru vilciens		3	3	Independent
Valsts Īpašumi	nekustamie	3	1	Dependent
Latvijas Koncerti		n/a	n/a	n/a
RAKUS		3	2	Independent
Rīgas pārvalde	Brīvostas	n/a	n/a	n/a

Sadales tīkls and LDz Cargo and Rīgas Brīvostas pārvalde does not meet the requirements for the necessity of the Supervisory board; therefore, the impartiality of the boards is not examined.

Regarding Air Baltic information about two of the Supervisory board members is not publicly available; therefore, it is not possible to objectively assess the Supervisory board's impartiality. Due to the fact that RAKUS has recently established Supervisory board members, it is not possible to fully assess the boards impartiality.

Additionally, the Supervisory boards of Latvenergo and Altum fully consist of the representatives of the line ministries which have been selected by the shareholder of the SOEs. Therefore, in practice there is a lack of impartiality regarding the nomination of the Executive management as the Supervisory board has complete discretion over the nomination of the candidates. Moreover, **there is no clear separation between the Ministries fulfilling the ownership function and the policy maker function.** As the Supervisory boards consist of employees from the line ministries there is an incentive to act in the interest of the ministry rather than the SOE.

Amendments within the SOEL require that starting 2020 SOEs disclose the salaries of Supervisory board members as well as their benefits. Currently few SOEs have provided such information which results in a lack of transparency regarding the management of the SOEs. As the legal norms provide the possibility for the SOEs to publish information on monthly or annual basis it is expected that all SOEs will disclose the information by 2021.

	1	2	3	Conclusion
1 AS Latvijas valsts meži				
Gaigals Mārtiņš	OK	OK	OK	Independent
Jansons Jurgis	OK	OK	OK	Independent
Muižnieks Arnis	OK	OK	OK	Independent
Pilvere Irina	OK	OK	OK	Independent
Švēde Elmārs	OK	OK	OK	Independent
2 VSIA Latvijas Koncerti				
No Supervisory board				
3 SIA Rīgas Austrumu klīniskā universitātes slimnīca				
Ābols Valts	OK	-	X	Dependent
Kukka Tīna	OK	OK	OK	Independent
Molder Erki	OK	OK	OK	Independent
4 VAS Latvijas Pasts				
Ikvīds Andris	OK	OK	OK	Independent
Nātriņš Andris	OK	OK	OK	Independent
Vītols Aigars	OK	OK	OK	Independent
5 VAS Latvijas Gaisa Satiksme				
Merirands Dins	OK	OK	X	Dependent
Ozoliņš Andris	OK	OK	X	Dependent
Zālīte-Rukmane Zinta	OK	OK	OK	Independent
6 CSDD				
Bērziņš Juris	OK	OK	OK	Independent
Godiņš Kristiāns	OK	OK	X	Dependent
Ķēniņš Andris	OK	OK	OK	Independent
7 SIA LDZ Cargo				
No Supervisory board				
8 AS Pasažieru vilciens				
Kalniņa Lita	OK	OK	OK	Independent
Liepa Inta	OK	OK	OK	Independent
Šteins Sandis	OK	OK	OK	Independent
9 AS Sadales tīkls				
No Supervisory board				
10 VAS Latvijas Dzelzceļš				
Ceplis Reinis	OK	OK	OK	Independent
Laizāns Aigars	OK	OK	OK	Independent

	1	2	3	Conclusion
Lange Jānis	OK	OK	X	Dependent
Liepiņš Andris	OK	OK	OK	Independent
Maldups Andris	OK	OK	X	Dependent
11 AS Attīstības finanšu institūcija Altum				
Kļaviņa Līga	OK	OK	X	Dependent
Soms Kristaps	OK	OK	X	Dependent
Šnore Jānis	OK	OK	X	Dependent
12 VAS Valsts nekustamie īpašumi				
Braunfelde Ieva	OK	OK	X	Dependent
Garisons Jānis	OK	OK	OK	Independent
Komisare Inta	OK	OK	X	Dependent
13 AS Air Baltic Corporation				
Āboliņš Kaspars	OK	OK	X	Dependent
Bulmanis Nikolajs Sigurds	OK	OK	OK	Independent
Siliņš Toms	OK	-	-	-
Thuesen Lars	OK	-	X	Dependent
14 AS Latvenergo				
Bērziņa Irēna	OK	OK	X	Dependent
Šaicāns Edijs	OK	OK	X	Dependent
Valantis Edmunds	OK	OK	X	Dependent
15 Rīgas Brīvostas pārvalde				
No Supervisory board				

Annex 8. Internal control standards

The variety of approaches to Internal control measures is a worldwide discussion but certain trends can be traced. ISO 31000 and COSO are the two leading internal control / risk management standards in the world today but none are fully publicly available. The International Organization of Supreme Audit Institutions (INTOSAI)¹³⁸ developed guidelines for internal control standards incorporating the COSO model that is publicly available. Guidance for Reporting on the Effectiveness of Internal Controls: Supreme Audit Institutions Experiences in Implementing and Evaluating Internal Controls¹³⁹ is observed in public sector audits. One list of standards applicable to SOEs is provided by the International Finance Corporation¹⁴⁰ and is a matrix of assessment of Internal Control environment which is designed and maintained in accordance with the highest international standards, including but not limited to IIA¹⁴¹, COSO, ISO 31000, ISO 19600¹⁴², ISO 37001¹⁴³, and ISO 27001¹⁴⁴.

ISO 31000:2018(en)¹⁴⁵ Risk management — Guidelines focus to on risk management. Managing risk is based on the principles, framework and process. These components might already exist in full or in part within the organization, however, they might need to be adapted or improved so that managing risk is efficient, effective, and consistent.¹⁴⁶

They write that This document is for use by people who create and protect value in organizations by managing risks, making decisions, setting and achieving objectives and improving performance. Organizations of all types and sizes face external and internal factors and influences that make it uncertain whether they will achieve their objectives.

Managing risk is iterative and assists organizations in setting strategy, achieving objectives and making informed decisions. Managing risk is part of governance and leadership and is fundamental to how the organization is managed at all levels. It contributes to the improvement of management systems.

Managing risk is part of all activities associated with an organization and includes interaction with stakeholders. Managing risk considers the external and internal context of the organization, including human behavior and cultural factors.

¹³⁸ INTOSAI. Available at: <https://www.intosai.org/>

¹³⁹ INTOSAI. Guidance for Reporting on the Effectiveness of Internal Controls: SAI Experiences In Implementing and Evaluating Internal Controls. Available at: http://www.psc-intosai.org/data/files/44/97/89/C7/1E927510C0EAOE65CA5818A8/intosai_gov_9110_e.pdf

¹⁴⁰ International Finance Corporation. IFC Corporate Governance Progression Matrix for State-Owned Enterprises. Washington, 2019. Available at: https://www.ifc.org/wps/wcm/connect/812fc0d8-d5ca-4cb9-840f-96e9c4f9f4b4/IFC_CG_Progression_Matrix_SOE_043019.pdf?MOD=AJPERES&CVID=mGbrfJ5

¹⁴¹ The Institute of Internal Auditors standards and related promulgations

¹⁴² ISO 19600:2014. Compliance management systems. Available at: <https://www.iso.org/standard/62342.html>]

¹⁴³ ISO 37001. Anti-bribery management systems, Available at: <https://www.iso.org/iso-37001-anti-bribery-management.html>

¹⁴⁴ ISO 27001. Information Security Management, Available at: <https://www.iso.org/isoiec-27001-information-security.html>

¹⁴⁵ ISO 31000:2018. Risk management Available at: <https://www.iso.org/obp/ui/#iso:std:iso:31000:ed-2:v1:en>

¹⁴⁶ Ibid.

“Three lines of defence model” helps to understand whether there is a sound risk management organization. IIA¹⁴⁷ and FERMA¹⁴⁸ endorse this as an important tool for integrating, coordinating and aligning all support and assurance functions within an entity¹⁴⁹. They support this idea by a lesson learned from the financial crisis when there were need for a cohesive, coordinated approach to risk. Limited risk and control resources may not be deployed effectively, and significant risks may not be identified or managed appropriately if efforts are not coordinated. See **Figure** below.

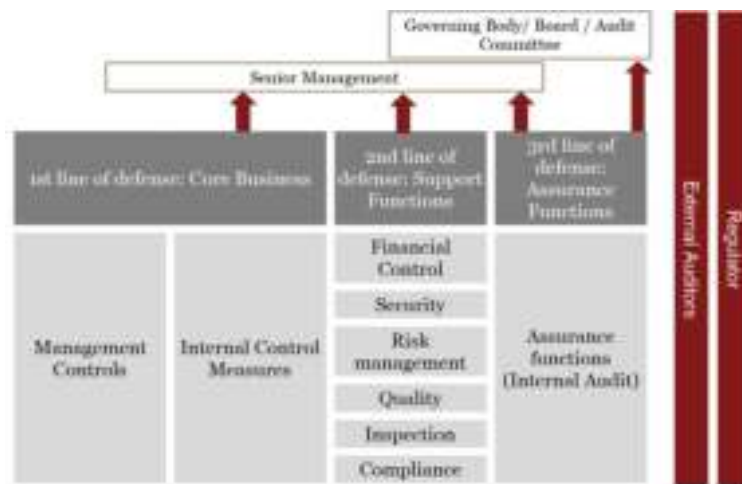


Figure: Lines of Defence Model to be (potentially) addressed by Internal Controls¹⁵⁰

Components and principles of COSO 2013 and COSO ERM 2017. COSO 2013 Internal Control – Integrated Framework¹⁵¹ is the best known by 17 internal control principles organised under 5 internal control components. Some parts of COSO 2013 are not included in the 2017 update¹⁵², but at the same time the COSO 2017 framework integrates risk considerations into the design and implementation of internal controls and strategic objectives demonstrating that internal control is not fixed just at-risk management level. The basic processes of internal controls are integrated with design and implementation of strategy. An optimal internal control environment currently requires an integrated approach that flows from strategy to performance metrics.

¹⁴⁷ The Institute of Internal Auditors standards

¹⁴⁸ Federation of European Risk Management Associations

¹⁴⁹ ECIIA, FERMA. Audit and Risk Committees, News from EU Legislation and Best Practices, 2014. Available at: https://www.eciia.eu/wp-content/uploads/2019/02/ECCIA_FERMA_Brochure_v8_HD1.pdf

¹⁵⁰ FERMA. Guidance on the 8th EU Company Law Directive, Article 41. Available at: <https://www.ferma.eu/blog/2014/10/ferma-ecila-respond-corporate-transparency-requirements-launch-new-guidance-document/>

¹⁵¹ COSO. Available at: <https://www.coso.org/Pages/default.aspx>

¹⁵² For example: Control Environment



Figure: COSO 2013 elements of an effective (Compliance) risk management

There is no direct legal requirement to ensure comprehensive internal controls in SOEs as such and Internal Audit Law is not applicable to SOEs but apply to ministries and institutions of public administration, however several SOEs express different levels on control.

Altum: Apart from mentioning of some control elements in SOEL¹⁵³ the only regulation regarding SOEs assessed what explicitly refers to internal controls is Development Finance Institution Law, part 2 of the section 5, which stipulates that in addition to the provisions of the SOEL the general meeting of shareholders of Altum need to approve the internal control system.

CSDD: Nevertheless, the most developed SOEs carry out and could prove a substantial internal control system. Based on information that, according to the SOEL, should be made public, it is possible to determine that the CSDD is the only of SOEs assessed that clearly refers to implementation of ISO GUIDE 73:2009¹⁵⁴ Risk management.

Latvenergo: The risk management policy of the Latvenergo group could be associated with certain Internal Control systems but it is not clearly stipulated.

It is more difficult to determine other SOE's track record on implementation of any worldwide known Internal Control system like guidelines of COSO, ISO 31000:2018(en), or others but certain elements are ensured in each organisation.

Regarding elements of internal controls there are a variety of perspectives and experiences in Latvia. Establishment of internal controls in general for SOE's in Latvia is mainly triggered by financial reporting and compliance and avoidance of sanctioning. Common elements of internal controls include external compliance to the legal framework quoted in the Law PSFRP: **Closely related to the financial accountability is the duty to apply the PSFRP Law that is applicable to all SOEs and provides certain requirements and restrictions for SOEs**, especially in respect of handling of the assets and financial resources as shown in table below. The State Audit office performs external audits based on requirements of PSFRP Law, the Procurement Monitoring Bureau performs oversight on implementation of all

¹⁵³ Article 15. The Law On Governance of Capital Shares of a Public Person and Capital Companies. Latvijas Vēstnesis, 216, 31.10.2014. Available at: <https://likumi.lv/ta/id/269907>

¹⁵⁴ ISO GUIDE 73:2009. Risk Management. Available at: <https://www.iso.org/standard/44651.html>

procurement regulation (except regarding Air Baltic) and the Corruption Prevention and Combating Bureau monitors prevention of conflicts of interest in activities of public officials.

In observed SOEs, risk management regarding financial risks and legal compliance is top priority. These risk management systems are obviously dealt with and regularly monitored. There is a high level of automation in financial risk management (dedicated software support). First, the introduction of internal financial controls is stipulated in general by provisions of the Law on Annual Financial Statements and Consolidated Financial Statements General and Law on Accountancy. It defines Principles for Preparation of a Financial Statement (Section 14), need for accounting policy, the management report in certain cases which states objectives and policy of the financial risk management, and approved risk management policy in respect to each type of significant foreseeable future transaction to which risk limitation should be reflected in accounting. The SOEL¹⁵⁵ envisages an annual account to be checked by a sworn auditor. Second, sanctions on management are established by Section 168 of Commercial Law: Members of the board of directors and the Supervisory board, a proctor or a person with a commercial power of attorney shall not be liable in accordance with Paragraph two of this section if they prove that they were acting as honest and careful managers. This norm with a high level of abstraction is one of incentives to establish such kinds of internal controls that protect the board from liability.

SOE's Internal control elements are not balanced with materiality and impact of risks, but due to external regulation some areas of risk are disproportionately addressed and highlighted. Examples are public procurement, lease of assets, corruption prevention and whistleblower protection. Others, mainly related to achieving a strategic objective or the policies, processes, tasks, behaviors and aspects of a company that taken together to facilitate its effective and efficient operation lag.

Internal controls mainly are focused on compliance, as in certain areas there are some regulations highlighting risk management in place. An overview of the legal framework and guidelines¹⁵⁶:

Abbreviation	Legal acts applicable in the area of internal controls	Area of application
CmL	The Commercial Law:	Section 168. Section 268. Regarding the election and recall of members of the Supervisory board, the auditor, the company controller.
	Criminal Law	Section 70. ¹ provides for the specific type of the legal person liability in case of insufficient supervision or control.
DFIL	Development Finance Institution Law	Part 2 of the section 5 stipulates creation of internal control system and internal audit function.
Law PCOI	Law "On Prevention of Conflict of Interest in Activities of Public Official"	Restrictions and obligations applicable to persons who have status of public official in the SOE.

¹⁵⁵ Article 58(1)(b). The Law On Governance of Capital Shares of a Public Person and Capital Companies. Latvijas Vēstnesis, 216, 31.10.2014. Available at: <https://likumi.lv/ta/id/269907>

¹⁵⁶ The list is not exhaustive.



Law PSFRP	Law "On Prevention of Squandering of the Financial Resources and Property of a Public Person"	Applicable to all SOE's assessed
Law RPU	Law "On Regulators of Public Utilities"	Applicable to utility sector SOE's assessed
Law SAO	State Audit Office Law	Applicable to all SOE's assessed
PPL	Public Procurement Law	Applicable to SOE's which are not utility providers, except capital company controlled by a public person.
PSPPL	Public Service Providers Procurement Law	Applicable to utility provider sector SOE's assessed
SOEL	Law "On Governance of Capital Shares of a Public Person and Capital Companies"	Applicable to all SOE's assessed Article 1) b) of Part 1 ¹ , Section 58 and Article 2 of Part 1 ¹ , Section 58 ¹⁵⁷ , Publishing of Information Regarding the key elements of the internal control and risk management systems applied in the preparation of the financial statements and a SOEs internal controls' key policies of the corporation that define the principles of the corporation's operations in terms of risk management, conflict of interest, anti-corruption, corporate governance and other issues.
	Law on the Annual Financial Statements and Consolidated Financial Statements	All provisions, specifically Chapter XI, Management Report
Regulation No 20	Cabinet of Ministers Regulation No 20 "Nomination procedure of the Executive management and Supervisory board members in the capital companies, in which shares are owned by the State or by a public body" (07.01.2020.)	Applicable to all SOE's assessed
Regulation No 63	Cabinet of Ministers Regulation No 63 "Regulations on the Number of Members of the Executive management and Supervisory board of Public Limited Companies and Public Private Companies and the Maximum Monthly Remuneration of Members of the Executive management and Supervisory board" (04.04.2020.)	Issued pursuant to Section 31, Paragraph 10 and stipulates that the professional qualification or experience that together all members of Supervisory board have to ensure covers such areas as financial issues and auditing; risk management and internal control system; strategy development and implementation and corporate governance
Regulation No 326	Cabinet Regulation No. 326, Adopted 8 May 2012, Regulations Regarding the Internal Control System in Institutions of Direct Administration	Issued pursuant to Section 17, Paragraph six of the State Administration Structure Law

¹⁵⁷ This Section of Law "On Governance of Capital Shares of a Public Person and Capital Companies "Entered into force on 01.01.2020.

Regulation 585	No	Cabinet of Ministers Regulation No 585 <i>Regulation Regarding the Conduct and Organisation of Accounting</i> (21.10.2003)	Issued pursuant to Section 15, Paragraph one of the <i>Law On Accounting</i> and especially its Chapter V <i>Control of Accounting</i> oblige to ensure effective functioning of accounting control.
Regulation 630	No	Cabinet of Ministers Regulation No 630 <i>Regulations Regarding the Basic Requirements for an Internal Control System for the Prevention of Corruption and Conflict of Interest in an Institution of a Public Person</i> (17.10.2017)	Issued pursuant to Section 20, Paragraph eight of the law <i>On Prevention of Conflict of Interest in Activities of Public Official</i> <i>Implementation includes systematic control of planned operational activity's compliance with results. Main Key Performance Indicators of an entity are essential part of evaluation of fulfilment of strategic targets and goals within specified timeframe.</i>
		Guidelines from Corruption Combating Bureau (prepared together with the CSCC) on internal control system basic requirements for elimination of corruption and conflict of interest ¹⁵⁸	
Regulation 806	No	Cabinet of Ministers regulation No 806 "Procedures by which State Capital Companies and Public Private Companies in which the State is a Member (Shareholder) Predict and Determine Dividend Profit and Make Payments to the State Budget for the Use of State Capital" (22.12.2015.)	Applicable in area of financial internal controls
CSCC Guidelines		Guidelines for the Development of Medium-Term Operational Strategies for State Capital Companies by the "Cross - sectoral Coordination Centre" ¹⁵⁹	Guidelines in detail gives instruction to SOE's on how to prepare medium - term operational strategy (Establish certain internal control requirements)
OECD Guidelines		Guidelines "OECD Good Practice Guidance on Internal Controls, Ethics, and Compliance"	Adopted 18 February 2010. This Good Practice Guidance was adopted by the OECD Council as an integral part of the Recommendation of the Council for Further Combating Bribery of Foreign Public Officials in International Business Transactions of 26 November 2009. ¹⁶⁰

Figure. Legal framework for SOE's Internal Control in Latvia applicable to all SOEs

¹⁵⁸ Cross-Sectoral Coordination Centre Available at:

[http://www.valstskapitals.gov.lv/images/userfiles/knab_vadlinijas_iekseja_kontrole_pdf\(1\).pdf](http://www.valstskapitals.gov.lv/images/userfiles/knab_vadlinijas_iekseja_kontrole_pdf(1).pdf)

¹⁵⁹ Cross-Sectoral Coordination Centre. Guidelines for setting general strategic objectives for public participation.

Available at: <https://www.pkc.gov.lv/sites/default/files/inline-files/vid%20term%20darb%20strat%20vadlinijas%2028082018.pdf>

¹⁶⁰ OECD. Good Practice Guidance on Internal Controls, Ethics, and Compliance. 18.02.2010. Available at:

<https://www.oecd.org/daf/anti-bribery/44884389.pdf>



Law PSFRP: Closely related to the financial accountability is the duty to apply the PSFRP Law that is applicable to all SOEs and provides certain requirements and restrictions for SOEs. The State Audit office performs external audits based on requirements of PSFRP Law, the Procurement Monitoring Bureau performs oversight on implementation of all procurement regulation (except regarding Air Baltic) and the Corruption Prevention and Combating Bureau monitors prevention of conflicts of interest in activities of public officials.

Financial Controls	Asset controls
<ol style="list-style-type: none"> 1) Duty to Lawfully and Rationally Administer the Financial Resources and Property 2) Restrictions on the Granting of Credits, Issuing of Loans, Provision of Suretyship and Guarantees 3) Control of Utilisation of Financial Resources and Property 4) Prohibition to Acquire Property in Ownership or for Use, or Utilise Services or Work for an Increased Price 5) Restrictions of Commissioning Research 	<ol style="list-style-type: none"> 6) Prohibition to Transfer a Public Person's Property for Use without Compensation 7) Provisions Regarding Transfer of a Capital Company's Property for Use without Compensation 8) Provisions Regarding the Use of Road Transport 9) Provisions for Lease of a Public Person's Property 10) Management of a Public Person's Immovable Property 11) Lease of Property Necessary for Ensuring a Public Person's Activity from a Private Individual or Capital Company 12) Lease of the Capital Company's Immovable Property and Lease of the Immovable Property Necessary for Ensuring a Capital Company's Activity from Other Persons 13) Prohibition to Alienate a Public Person's Property for a Reduced Price 14) Prohibition to Transfer a Public Person's Property for Use with the Intermediation of Private Individuals 15) Restrictions to Pledge Property
Legal controls	Controls in area of donations and gifts
<ol style="list-style-type: none"> 16) Restrictions in Relation to Conclusion of Agreements on Issues Solving which is the Duty of Officials or Employees of an Institution 	<ol style="list-style-type: none"> 17) Restrictions on Giving Financial Resources and Property as a Gift (Donating) 18) Public Access to the Information Granting of Gifts (Donations). 19) Provisions for Giving Gift (Donation)

Figure. Four areas of internal controls according to provisions of the PSFRP Law

Criminal Law: Basis for the Application of a Coercive Measure to a Legal Person established by Section 70.1 of the Criminal Law provides for the specific type of the legal person liability in case of insufficient supervision or control.

For criminal offences provided for in the Special Part of the Criminal Law, a court or in the cases provided by the Law – a public prosecutor may apply a coercive measure to a legal person governed by private law, including a state or local government capital company, as well as partnership, if a natural person has committed the offence in the interests of the legal person, for the benefit of the person or as a result of insufficient supervision or control, acting individually or as a member of the collegial authority of the relevant legal person:

1. on the basis of the right to represent the legal person or act on the behalf thereof;
2. on the basis of the right to take a decision on behalf of the legal person;
3. in implementing control within the scope of the legal person.

Although there is no clear definition of sufficient internal controls in terms of Criminal Law, Latvia has adopted Regulation No 630 that is binding to Latvian SOEs and covers internal control matters regarding corruption prevention. Lack of competence in the area of risk management is causing certain confusion regarding the place of anti-corruption measures in the internal control general framework. For example, Latvijas Pasts on their website¹⁶¹ publishes a risk management policy under activities performed regarding corruption risk prevention. Although, in fact anti-corruption measures are just part of risk management policy.

In other OECD countries authorities prescribe certain principles to be followed. For example, the Dutch Public Prosecutor's Office formulated in the Ministry of Justice Guidance the six principles – i.e.: proportionate procedures, top-level commitment, risk assessment, due diligence, communication (including training) and monitoring and review, that could also be taken into consideration.¹⁶² These principles are in line with COSO framework.

OECD Guidelines for Multinational Enterprises recommend that companies develop and adopt adequate internal controls, ethics and compliance mechanisms based upon a risk assessment addressing the company's individual situation, to prevent and detect bribery¹⁶³.

DIRECTIVE 2014/95/EU: In certain cases SOEs in Latvia fall in the scope of Financial Instrument Market Law, where are transposed stipulations by the Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014 amending Directive 2013/34/EU. It requires disclosure of non-financial and diversity information by certain large undertakings and groups and should provide management report according to

¹⁶¹ Latvijas Pasts. Measures to prevent corruption risk implemented by VAS "Latvijas Pasts" (Latvijas Pasta veiktie pasākumi korupcijas riska novēršanai). Available at:

https://www.pasts.lv/lv/par_mums/par_latvijas_pastu/latvijas-pasta-veiktie-pasakumi-korupcijas-riska-noversanai/

¹⁶² Recht.nl. The criminalization of public and private corruption: what is allowed and what is not allowed? Available at: <https://www.recht.nl/vakliteratuur/europa/artikel/332169/de-strafbaarstelling-van-publieke-en-private-corrupctie-wat-mag-wel-en-wat-mag-niet/>

¹⁶³ OECD. OECD Guidelines for Multinational Enterprises, 2011 Edition, 29.09.2011, p.47. Available at: <http://dx.doi.org/10.1787/9789264115415-en>



Section 55 of the Law on the Annual Financial Statements and Consolidated Financial Statements. The preamble of the directive makes reference to different international frameworks such as the United Nations (UN) Global

Compact, the Guiding Principles on Business and Human Rights implementing the UN ‘Protect, Respect and Remedy’ Framework, the Organisation for Economic Co-operation and Development (OECD) Guidelines for Multinational Enterprises, the International Organisation for Standardisation's ISO 26000, the International Labour Organisation's Tripartite Declaration of principles concerning multinational enterprises and social policy, the Global Reporting Initiative, or other recognised international frameworks.

Analysing the internal controls of several SOEs, one can observe a rather large presence of elements of public administration. For example, the same procurement rules, prevention of squandering of assets and conflict of interest requirements must be met.

This leads to the conclusion that the internal control framework in SOEs has historically been very similar to that of public administration. Historically the concept of internal controls developed in Latvia stem from sources related to public administration: on one hand, introduction of regulatory framework for finance and asset management, including internal audit function and on another hand anti-corruption efforts. As a result, SOEs are often obliged to fit measures into the context of public sector control rather than focusing on the business sector-specific ones that will control business growth. In the case of Latvijas valsts meži adherence to the public procurement framework makes procurement management identical to public administration. Similar to public administration, procurement is organized with a priority towards accountability, transparency and free competition to all bidders, but not profitability and cost efficiency.

There is no obligation by any regulation to have internal audit function or audit committees in SOEs, however, most large SOEs surveyed perform regular audits (internal, quality, contract, project, compliance audit) which include the assessment of the internal control’s activity at least every two years. According to the Institute of Internal Auditor of Latvia¹⁶⁴, the process of establishing internal audit in Latvia started in 1999. On 11 February 2010 the first Internal Audit Law was adopted. Although this law is not applicable to SOEs, the concepts used could affect a wider scope of public sector related organisations. The purpose of the law was to determine the legal regulations for the establishment, operation and co-ordination of the internal audit system in a ministry and institution. Consequently, the definition of internal control was narrowed to public service: system, to be established by the State Secretary of a ministry or the head of an institution. Understanding of internal control in Latvia as defined by the IA Law 2013¹⁶⁵ (See table below) is similar to outdated approach that states “head of institution is responsible” instead of wider scope of process owner. as for example in COSO ERM 2017.

IA Law 2013	COSO ERM 2017
Internal Control system	Internal Control
an aggregate of risk management, control measures, administrative measures	a process

¹⁶⁴ The Institute of Internal Auditors (IIA). History (Vēsture). Available at: <https://iai.lv/lv/vesture-1>

¹⁶⁵ Not applicable to SOE’s in Latvia



for the establishment of which head of institution is responsible	effected by an entity's board of directors, management and other personnel
the task of which is to ensure continuous, economic, efficient and rational operation of a ministry or an institution	designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting, and compliance.

Figure. Comparison of elements of concepts of Internal Controls by IA Law 2013 and COSO ERM 2017

Worldwide shift of the goal of Internal Control towards promotion of “the achievement of objectives relating to operations, reporting, and compliance” is not reflected in regulatory enactments of Latvia.

Even though there are no obligation to perform an Internal Audit function, SOEs such as Latvenergo (including Sadales tīkls), LDz Cargo, Latvijas Dzelzceļš, Latvijas Gaisa Satiksme, Latvijas Pasts, Latvijas valsts meži, ALTUM have established such a function. Partially, internal audit is performed at RAKUS and CSDD. Riga Free Port Authority has an internal audit unit but the scale of activities is not known. An audit committee is established in Latvenergo (including Sadales tīkls) and Latvijas Gaisa Satiksme. Information is not available about Air Baltic.

Annex 9. Assessment of established Internal Control System in selected SOEs

Key takeaways

- There is no full assurance that, in most assessed companies, the full range of Internal Control activities is an integral part of business operations, of daily practice and interlink with execution of business strategy. Mostly it is the task of specially appointed employees in risk management.
- The most advanced are financial controls and area of compliance to external legal regulation. Resistance to negative economic trends or frequent changes, standardization of complex processes, ability to ensure that no employee or group is in a position both to perpetrate and to conceal errors or fraud in the normal course of their duties are the least popular control objectives set by the SOEs.
- Review of policies of internal controls in combination with regulatory framework in selected SOEs show substantial differences between organisations that is basically caused by applicable regulation and different size, capacity, sources of financing and profile of organisations.
- The external regulatory framework on procurement for Type IV SOEs is as stringent as it is for public administration institutions, so Internal Control plays a key role in ensuring compliance. Therefore, the main focus of Internal Control is more on compliance of operations or human resource management.
- Type I companies operate with relatively broad discretion, so the main focus of Internal Control systems could be on achieving SOE management goals or attaining the entity's strategy and business objectives.

The current assessment of Internal Controls is based on the evaluation of publicly available information¹⁶⁶, survey on Internal Control Elements in State Owned Enterprises and summarised in the Matrix of the Internal Control System, Internal Audit Function, Risk Governance and Compliance for State-Owned Enterprises (herein afterwards – Matrix).

The Matrix Integrating Environmental, Social, and Governance Issues is developed by the World Bank Group's International Finance Corporation Corporate Governance Progression team¹⁶⁷.

The Questionnaire on Internal Control Elements in State Owned Enterprises is elaborated in a way that addresses selected components and principles of INTOSAI general standards, COSO 2013 and COSO ERM 2017 framework. Unfortunately, not all SOEs provided answers, therefore we greatly appreciate and thank the capital companies¹⁶⁸ that allowed us to gain insight into the organization of their internal processes.

¹⁶⁶ Article 58. The Law on Governance of Capital Shares of a Public Person and Capital Companies. Latvijas Vēstnesis, 216, 31.10.2014. Available at: <https://likumi.lv/ta/id/269907>

¹⁶⁷ International Finance Corporation. IFC Corporate Governance Progression Matrix for State-Owned Enterprises. Washington, 2019. Available at: https://www.ifc.org/wps/wcm/connect/812fc0d8-d5ca-4cb9-840f-96e9c4f9f4b4/IFC_CG_Progression_Matrix_SOE_043019.pdf?MOD=AJPERES&CVID=mGbrfJ5

¹⁶⁸ SOEs which took part in the survey are CSDD, Latvenergo, Ldz Cargo, Latvijas Dzelzceļš, Latvijas Gaisa Satiksme, Latvijas Koncerti, Latvijas valsts meži, RAKUS, Sadales tīkls



The disadvantage of a self-evaluation questionnaire is the desire to provide socially acceptable answers, which is a considerable limitation of such an evaluation. Nevertheless, the benchmarking allowed us to identify blank spots if such exist and set far reaching goals for internal controls.

The application of the above-mentioned Internal Control frameworks fully could be regarded as the highest international standard. At the same time robust Internal Controls could cause an extreme burden to smaller

companies. Therefore, a cost effective and balanced approach for internal controls is the hardest choice for companies to make. The assessment will cover aspects such as the following:

1. defining general features of legal compliance framework in selected SOE's
2. which controls according to the self-assessment of particular Internal Control components are in place in SOEs and which of controls are common to most of the companies evaluated.

By compiling responses, it was possible to get an opinion which are the most common elements of internal control implemented by most organizations. Thus, a model of a typical internal control system of SOE was constructed. Then based on characteristics of the model results was summarised in the Matrix of the Internal Control System, Internal Audit Function, Risk Governance and Compliance for State-Owned Enterprises¹⁶⁹.

The Matrix with three levels of the overall assessment of Internal Controls of a typical SOE is provided:

1. **“As-is assessment”** (majority of features of the typical internal control system of SOE correspond to this stage) – **labelled in yellow,**
2. **“Desired state – in short term”** (it could be feasible that in period of up to three years majority of features of the typical internal control system of SOE could be raised to this stage) – **labelled in grey;**
3. **“Desired state – long term”** (it could be feasible that in period of up to ten years majority of features of the typical internal control system of SOE could be raised to this stage) – **labelled in red.**

The arrow is used as a directional indicator, from poor practice to the highest level of excellence.

¹⁶⁹ Available at: https://www.ifc.org/wps/wcm/connect/812fc0d8-d5ca-4cb9-840f-96e9c4f9f4b4/IFC_CG_Progression_Matrix_SOE_043019.pdf?MOD=AJPERES&CVID=mGbrfJ5

● As is assessment ● Desired state – short term ● Desired state – long term

	1. Basic Practices	+ 2. Intermediate Practices	+ 3. Good International Practices	+ 4. Leadership
Internal Controls	1. The SOE has established documented internal control policies and procedures.	1. The audit committee ensures corrective actions on control deficiencies identified in Management Letters.	1. “Three lines of defence” model of risk management, internal control and internal audit has been adopted. ¹⁷⁰	1. Control environment in accordance with highest international standards, including but not limited to IIA171, COSO, ISO 31000, ISO 19600 ¹⁷² , ISO 37001 ¹⁷³ , and ISO 27001 ¹⁷⁴ .
	● ●	●	●	
Internal Audit	2. The SOE has an in-house or outsourced internal audit function. 3. The state audit institution, if any, interfaces with the internal auditors.	2. Internal audit function regularly interfaces with external auditors and is accountable to the board.	2. Head of internal audit reports to the audit committee and administratively to management. 3. The Internal audit function is independent, objective, risk-based, and has unlimited scope of activity.	2. The internal audit function meets standards of the Institute of Internal Auditors (IIA). 3. The audit committee ensures that the internal audit function is subject to periodic quality assessment by third party.
	● ●	●	●	

¹⁷⁰ Namely, management is the first line of defence, risk management and compliance function are the second line of defence, and internal and external audit as independent assurance providers are the third line of defence.

¹⁷¹ The Institute of Internal Auditors standards and related promulgations

¹⁷² ISO 19600:2014. Compliance Management Systems. Available at: <https://www.iso.org/standard/62342.html>

¹⁷³ ISO 37001. Anti-bribery Management Systems, Available at: <https://www.iso.org/iso-37001-anti-bribery-management.html>

¹⁷⁴ ISO 27001. Information Security Management. Available at: <https://www.iso.org/isoiec-27001-information-security.html>

Risk Governance		3. The Board receives and reviews information on key risks.	4. The Board approves risk appetite. 5. The SOE has established risk-management framework with a chief risk officer (CRO) or equivalent with unfettered access to the Board.	4. The board routinely monitors risk management and compliance with policies and procedures and discloses risk appetite information. 5. The CRO reports to board-level risk management committee or equivalent.
		●	●	●
Compliance		4. A designated compliance officer is appointed.	6. Comprehensive compliance program annually reviewed, with mechanisms to report wrongdoing and misconduct.	6. The chief compliance officer reports to the audit committee and administratively to management.
		●	●	●
External Audit		4. The SOE is audited by an independent external auditor (EA) irrespective of any state audit conducted. 5. Written Management Letters provided by an EA.	5. The audit committee is responsible for the selection of the External Audit and ensures their independence, including in relation to the provision of non-audit services.	7. Audit committee owns relationship with external auditor; agrees on scope and audit fees, has an early discussion on key audit matters and generally, oversees the conduct of the external audit.
		●	●	●

Subsidiary Governance		6. The SOE has policies and procedures to control the creation and dissolution of subsidiaries.	8. A formal, merit-based, and transparent process for the selection and nomination of board members of subsidiaries, such as a board nomination policy is in place and disclosed.	8. The board of the holding SOE exercises oversight over the corporate governance framework of its subsidiaries.
			● →	● ●
Integrating of Environmental & Safety (E&S)		7. The SOE has established industry practices in its E&S risk management practices.	9. Comprehensive ESMS integrated in risk-management framework, and E&S risks are part of establishing the risk appetite. 10. E&S/sustainability head has unfettered access to senior management and CRO.	9. The board or sustainability committee ensures corrective actions on E&S issues. 10. The head of ESG175 reports to the board's E&S / sustainability committee. 11. ESMS is consistent with international standards (e.g., ISO 14001 Environmental Management).
		●	●	●

Figure. Overview of the overall assessment in line with the Matrix of the Internal Control System, Internal Audit Function, Risk Governance and Compliance of majority of selected SOE's (Source: analysis, interviews and self-assessment replies)

Observations drawn from the assessment of selected 15 SOEs:

- Elements of Internal Controls in most of the assessed SOEs either fully or partially **meet the Basic level of Practices of the Matrix**, cases of Intermediate level or Good practices level are rare. CSDD and Latvenergo are the leaders in transparency and maturity of their internal control systems.
- Most of the SOEs and stakeholders interviewed and surveyed believe that their administrative organization and **internal controls are organised properly**. At the same time there are no or is very limited public information available to establish that assessed companies are in control.
- Some SOEs **ignore public access to information requirement** by SOEL completely. Transparency of policy assures that the company is in control increase the trust in predictability of its figures. In

¹⁷⁵ Environmental, Social, and Governance



case of listed companies, transparency could result in a higher rating from the rating agencies because they do look at the quality of the internal controls. With this higher rating, companies can raise capital and it increases the value of the company. On the other hand, if company does not demonstrate that it is in control, it is impossible to eradicate the impression that unseen money can leak out.

- Not all SOEs reported that there is an indication on the efficiency of the internal control in the **annual management report**.
- All companies report that they examine their internal control as part of the financial reporting. **Financial control is well established**, prompt and proper recording of transactions and events, deploys (control activities) through policies and procedures. Focus on proper financial reporting is important but at the same time provides just a fixed picture of a particular moment, like the annual or semi-annual accounts. The administrative processes and structural internal control could remain underexamined.
- **External compliance** is one of the top priorities of internal control system of SOEs. The responses show that the control environment of the compliance with legal requirements is ensured by management control activities. Both strategy and organizational behaviours and desired culture demonstrates full attention to regulatory compliance.
- As is provided by the responses, controls are designed and in place but **are not always adequately documented**, the completeness of the records on regular check of the particular control is not assured. Consequently, some part of internal controls is informal and mostly dependent on people.
- **No formal training** or communication of control activities to all staff is regularly provided by all SOEs.
- Every company in line with its size has laid down how the administrative organization and Internal Control must function. But there is no full assurance that at most of those companies, the Internal Control is an **integral part of business operations**, of daily practice and interlink with execution of business strategy.
- There is no certainty that the risk monitoring is provided **at the process owner level**. Instead, it is more possible that Internal Control policy is defined by the top-level management, monitored by the special audit units and does not always correspond to the level of risks involved. Even if the ownership and accountability within the business cycles is formally assigned to only one individual (e.g., Head of Department), additional responsible people (Risk Champions, Risk Members) should be assigned and made accountable for managing and verifying the risks under their supervision. Otherwise, this can lead to gaps in controls and inefficiencies within a process going undetected and unresolved.
- It was not part of this review to assess whether detailed **business process control matrices** were developed and continuously updated, as the business evolves.
- Most probably many **elements of control environment are in accordance** with the highest international standards, including but not limited to IIA, COSO, ISO 31000, ISO 19600, ISO 37001, and ISO 27001 are in place. Full compliance is neither requested by the State, nor is information of compliance made public. At the same time, SOEs admit that their Internal Control processes could not always be regarded as simple as possible, not complicated, not burdensome. This leads to resistance to the introduction of new controls where their management is complicated.



- Although **standardisation** has begun, there are further opportunities for processes and systems at the divisional level to be simplified and standardised.
- **Systems and processes remain complex**, disparate and lack alignment, which can result in high system maintenance costs and create challenges for management to access comparable business information across the entities.
- Establishing of an **Audit Committee** is not a common practice in the SOEs although three of the surveyed SOEs have it. It would be recommended to ensure that in all large SOEs that the Audit Committee ensure corrective actions because monitoring the adequacy and effectiveness of risk responses, accuracy, and completeness of reporting, and timely remediation of deficiencies could be achieved just by implementation of all three lines of defence.
- **Due diligence activities** are not structured, and new business partners could be taken on without due diligence, especially in the utility sector of SOEs where procurement procedures are less restrictive.
- There is a **big difference between the procedure of prevention of conflicts of interest**, declaration of conformity, limitation of spare-time activities, restrictions of competition for public officials and other employees. SOEs should be encouraged to align these requirements and procedures to ensure integrity for all persons employed.
- It is not clear how those stipulations of Article 5 of NASDAQ principles of Corporate Governance¹⁷⁶ which cover prohibited conflicts of interest that go beyond the provisions of the law On Prevention of Conflicts of Interest in Activities of Public Officials are addressed.
- Data or public information of **external assessment of Internal Control systems** is not provided. Once an internal risk assessment is conducted it is important to confirm the chosen perspective and receive recommendations for how to enhance the efficiency of controls.

Differences across organization of internal controls in assessed SOE's

External legal requirements and control mechanisms define the basis of internal controls and establish a compliance framework. The level of compliance usually is regarded as high at assessed organisations. The only exception with negative publicity used to be Riga Free Port Authority according to the State Audit Office audit report dated 25 May 2016.

To define the general features of legal compliance framework in selected SOE's, 15 SOE's are classified in four types according to specific features of their internal control systems. To understand the differences between organizations, it is useful to evaluate the regulatory framework that applies to all the SOEs assessed. The only differentiator is applicable procurement policy that triggers internal compliance measures. The PPL allows for a much more robust, rule based and slower procurement management system than PSPPL.

Assessment by type of the internal control related to the average staff size in selected SOE's, type of organisation, state budget financing available, procurement regulation, turnover, per 2018 in order of average staff size:

¹⁷⁶ NASDAQ QMX Rīga. Principles of corporate governance and Recommendations on their implementation, 2010. Available at: https://www.nasdaqbaltic.com/files/riga/corp_gov_May_2010_EN.pdf

SOE classification 177	Internal Control type	The SOE	Average staff size.	Turnover (EUR)	State budget financing, grant, subsidy or compensation (EUR)	Applicable procurement regulation	Type or organisation ¹⁷⁸	Audit Committee	Self assessment ¹⁷⁹	SOEL publications ¹⁸⁰
A2	II	VAS Latvijas Dzelzceļš	10,400	365,044,000	2,000,000	PSPPL	Large	-	X	X
B3	IV	SIA Rīgas Austrumu klīniskā universitātes slimnīca	4,422	118,515,728	111,501,439	PPL	Large	-	X	X
A2	I	VAS Latvijas Pasts	3,948	89,110,531	5,877,452	PSPPL	Large	-	X	X
A1	I	AS Latvenergo	3,508	878,008,000	92,651,000 ¹⁸¹	PSPPL	Large	X	X	X
A2	I	SIA LDZ Cargo	2,214	275,288,353	-	PSPPL	Large	-	X	X

¹⁷⁷State ownership policy review in Latvia. Final report, 4 January 2019, KPMG, p. 71. Available at: http://www.valstskapitals.gov.lv/images/userfiles/SOE_Review_LV_Final_report.pdf

¹⁷⁸ The term SME in the Report is used in line with the Cabinet Regulation No. 776 of 16 December 2014 Procedures by which Commercial Companies Declare Their Compliance with the Status of Small (Small) and Medium-Sized Commercial Companies and fall in the scope of Law On Control of Aid for Commercial Activity. For the purposes of these rules, an SME is to be defined in accordance with the provisions of the Commission Regulation (EU) No 651/2014 of 17 June 2014 declaring certain categories of aid compatible with the internal market in application of Articles 107 and 108 of the Treaty ('Commission Regulation No 651/2014').

¹⁷⁹ The Company provided answers on PwC questionnaire

¹⁸⁰ The information what should be made public according to SOE is provided

¹⁸¹ Compensation for electricity installed in TEC in the profit and loss account. Recognition of one-off compensation for CHP plants In October 2017, the parent company applied for a one-off compensation from the State while refusing to continue receiving 75% of the annual electricity payments for the TEC-1 and TEC-2 CHP plants.

A1	I	AS Sadales tīkls	2,094	323,7 34,00 0	-	PSPPL	Large	-	X	X
A2	I	AS Air Baltic Corporation	1,514	402,0 45,00 0	-	N/a	Large	182	-	-
A1	III	AS Latvijas valsts meži	1,321	333,3 46,42 2	-	PPL	Large	-	X	-
B2	II	AS Pasažieru vilciens	1,056	69,95 2,288	50,419, 760	PSPPL	Large	-	-	X
N/a	II	Riga Free Port Authority	285	47,49 0,783	-	PSPPL	Middle	-	-	N/a
B1	III	CSDD	783	48,13 8,474	187,800 183	PPL	Middle	-	X	X
B2	IV	VAS Valsts nekustamie īpašumi	532	39,26 8,156	17 124 428	PPL	Middle	-	-	Not clear
B1	III	VAS Latvijas Gaisa Satiksme	352	30,20 8,288	-	PPL	Middle	-	X	X
A2	III	AS Attīstības finanšu institūcija Altum	227	14,35 0,000	33,269, 700	PPL	Middle	X	-	X
B2	IV	VSIA Latvijas Koncerti	118	1,609, 577	3 736 257	PPL	Middle	-	X	X

Figure. Assessment by type of the internal control related to the average staff size in selected SOE's, type of organisation, state budget financing available, procurement regulation, turnover, per 2018 in order of average staff size.

SOEs are grouped according to their size and the level of how heavily regulated their activity is. If an SOE has wider discretionary power and it is larger, it is classified as Type I. If the SOE should follow more

¹⁸² This is an assessment of the accountability of the internal control system, therefore information known from other sources what are not publicly available is not taken into consideration, including that AS Air Baltic Corporation has Revision Committee.

¹⁸³ State budget funding for compensation of losses related to the performance of the delegated public administration task for the maintenance of the national charging infrastructure



restrictive regulation and is to a large extent public financed, then it is classified as Type IV. Intermediate states are classified as Type II and Type III according to the features listed below:

- **Type I** – large company, external control limited, no public financing – importance of internal controls relatively high, the procurement regulation is applicable at relatively high thresholds.
- **Type II** – large company, external control limited, public financing provided – importance of internal controls high, some aspects of compliance important, the procurement regulation is applicable at relatively high thresholds.
- **Type III** – large or middle-sized company, external control relatively tough, no public financing provided – compliance is substantial part of internal controls, the procurement regulation is strict and applicable at relatively low thresholds
- **Type IV** – large or middle-sized company, external control relatively tough, public financing provided – compliance dominated internal controls, applicable procurement regulation is the same as for public administration (Public procurement law) what is strict, ensures high level of transparency and administrative appeal mechanism, applicable at relatively low thresholds.

The external regulatory framework on procurement for Type IV SOEs is as stringent as for public administration institutions, so Internal Control plays a key role in ensuring compliance. Usually in this type falls SOEs funded from the state budget what are obliged to ensure compliance with Public Procurement Law. Consequently, these organisations are under more scrupulous examination of the State Audit Office and Procurement Monitoring Bureau. Therefore, the main focus of Internal Control is more on compliance of operations or human resource management. Meanwhile, Type I companies operate with relatively broad discretion, so the focus of Internal Control system could be on achieving SOE management goals or attain the entity's strategy and business objectives.

Classification of SOEs made by KPMG¹⁸⁴ in some occasions do not match the classification of internal controls and compliance types. There is a greater need for internal control for companies that do not have strong external controls – Type I and Type II. Some SOEs included in groups A1 and A2 like Latvijas Dzelzceļš, Latvijas Pasts, Latvenergo match Type I and Type II, but Altum and Latvijas valsts meži have much stricter external supervision due to the need to apply Public Procurement Law, therefore fall into internal control Type III. This leads to the conclusion that either the KPMG classification needs clarification or that the external regulation of these two companies may be too restrictive.

¹⁸⁴ State ownership policy review in Latvia. Final report, 4 January 2019, KPMG, p. 71. Available at: http://www.valstskapitals.gov.lv/images/userfiles/SOE_Review_LV_Final_report.pdf

Monitoring practices at the individual level of SOEs

Key takeaways

- Elements of Internal Controls in most of the assessed SOEs either fully or partially meets the Basic level of Practices of the Matrix. In some cases, SOEs exhibit the higher level of Intermediate or Good practices level. CSDD, Latvijas Pasts and Latvenergo are the leaders in transparency and maturity of their internal control systems.
- From observations performed and documented, CSDD, Latvenergo, Latvijas Pasts, Latvijas Gaisa Satiksme, Latvijas Dzelzceļš risk management structure is the most transparent.

This chapter covers a brief assessment of the following qualitative aspects of internal control in each analysed capital company:

1. the system in place, the structure, work processes, its accountability to the management, board (and committees),
2. its integration with the activities of the compliance officer (if any), the external auditors and the regulator;
3. reporting of the internal audit function, independence, and their compliance with best practices,
4. if a policy of conflict of interest/Ethics Code and Code of Conduct/exist and the effectiveness of their monitoring and implementation.

This assignment is limited to publicly available information on risk management policy and a few interviews or/and self-assessments of SOE's who agreed to share the information. For that we needed to have access to elaborated risk management policy of the particular company. This is the reason why it was possible to analyse in details the risk management policy only of a few SOEs: CSDD, Latvenergo, Latvijas Pasts, Latvijas Gaisa Satiksme, Latvijas Dzelzceļš. The audit report of the State Audit Office shows that the created public impression may be misleading. During the in-depth assessment of the internal control system of Latvijas Dzelzceļš, the State Audit Office has found that the internal control system in project management is formal¹⁸⁵.

Two SOEs remained outside the analysis, for which only indirect information on the risk management system can be obtained. Description about financial risk management policy of Air Baltic could be obtained from the document "Presentation of certain financial information"¹⁸⁶. That is indirect source therefore not suitable for comparative analysis.

Regarding ALTUM it is possible just to read in the publicly available ALTUM medium-term operation strategy 2019-2021¹⁸⁷ the information that ALTUM has established internal control system, including performing risk analysis, but in the absence of any other source of information, it is not possible to draw any conclusions about the qualitative features of this risk management system.

Risk management system of Latvenergo is the best of all SOEs that we have conducted and received answers and/or had the opportunity to interview. Therefore, other companies are benchmarked against

¹⁸⁵ Available at: http://www.lrvk.gov.lv/uploads/reviziju-zinojumi/2018/2.4.1-15_2018/zinojums%2002.04.2020/Rev%C4%ABzijas%20zi%C5%86ojums.pdf

¹⁸⁶ Available at: https://www.airbaltic.com/about/investors/final-prospectus-66072893_1-.pdf

¹⁸⁷ Available at: https://www.altum.lv/files/altum_strategija_20190718_21844.pdf

the practice of Latvenergo. The order of the SOEs described below has no relation to the quality of the internal control system.

Latvenergo

The professional approach to managing risk in achieving strategic goals is demonstrated by the range of materials available and the responses to the survey.

The Latvenergo Group has introduced a risk management policy that is available online¹⁸⁸. It says that it is based on best international practices. Unfortunately, it does not explicitly refer to the internal control system.

For the purposes of risk management, the group classifies risks into five groups: strategic, operational; financial; legal and compliance risks and risks of fraud and corruption. The operational risks of the group are continuously identified and managed.

The risk management policy of Latvenergo (Latvenergo koncerna Risku vadības politika, available just in Latvian¹⁸⁹) establishes common risk management principles and responsibilities within the Group. The document mainly lists the responsibilities of each party (Board, Supervisory board, Internal Audit, Audit Committee, Directors, Risk Management Committee, Risk Manager, Heads of Unit and Employee.).

It clearly separates the duties of the Audit Committee (Revīzijas komiteja in Latvian), the Executive management and the Supervisory board. Article 5.1.3. of it stipulates that the Supervisory board annually reviews the report of Latvenergo Audit Committee on effectiveness of the risk management system of the Group.

Contrary to this, The Internal control, risk management and compliance chapter of Corporate Governance report 2018 of Latvenergo is presented in a very concentrated manner¹⁹⁰. It could be a reason that the description of duties of Latvenergo Supervisory board and the Audit Committee gives the impression that duties are overlapping in ensuring the supervision of the system of the internal control, risk management and compliance.

Compared to most of the other listed companies, the Latvenergo Corporate Governance report contains much less detailed and reader friendly information.

It would be recommended to expand the competence of the Supervisory board and envisage that it has overall responsibility not only for the Latvenergo risk management, but internal control system as well independently assesses the effectiveness of established system of controls

It would be advisable that the Supervisory board delegate to the Audit Committee more expanded competence like:

- review the adequacy and efficiency of the Latvenergo internal audit function;
- review the enterprise risk management approach;
- approving Latvenergo risk tolerance.

Following the best international practice would be that Internal Audit reports to the Audit Committee and supporting the Audit Committee in reviewing effectiveness of internal controls system that currently is not addressed.

¹⁸⁸ Latvenergo. Risk management policy of the Latvenergo Group, 27.02.2019. Available at:

https://latvenergo.lv/storage/app/media/uploaded-files/2019.02.27_Risku%20vadibas%20politika.pdf

¹⁸⁹ Adopted by Latvenergo Supervisory Board, 27.02.2019

¹⁹⁰ Latvenergo. Corporate Governance Principles of Latvenergo Group. Available at:

https://latvenergo.lv/storage/app/media/uploaded-files/LE_korp_parv_principi_2018_ENG.pdf

Senior management and business functions where risk ownership is established should ensure that salient risks are highlighted to the Audit Committee, along with the status of actions taken to manage these risks. While this is self-evident, it must be made clear that in the situations where incidents are resolved at the process owner level also require reporting.

The Conflict of Interest prevention matters are detailed in article 5 of the Code of Ethics¹⁹¹. Although stipulations by the Code of Ethics are appropriate for employees it is not clear how those are addressed in stipulations of Article 5 and 8.2. of NASDAQ principles of Corporate Governance¹⁹² which cover prohibited conflicts of interest that go beyond¹⁹³ the provisions of the law On Prevention of Conflicts of Interest in Activities of Public Officials. Article 7 of the same document stipulates publishing of information on website about elected Supervisory board members like additional position and obligations, if any.

CSDD

Although there is not any legal requirement to provide such information publicly CSDD risku vadības politika (CSDD Risk Management policy) is published on their website¹⁹⁴. It is updated annually.

It is not mentioned in the document but is clearly visible that ISO 31000:2018(en) principles, framework process is applied to it. Several references are made to ISO GUIDE 73:2009 Risk Management – Vocabulary.

The document is detailed, but at the same time user friendly as it provides practical information for the reader, for example links to necessary sources.

CSDD defines Internal Control and describes control objectives. The structure and competence of involved parties establishes a framework in line with the Three-line defence model. A Special Risk management group is responsible for strategic risk management and identifies and analyses strategic risks and their controls and reports to both executive and Supervisory boards.

Internal Audit independently examines risks and control activities and reports to the board.

CSDD has risk register and reporting obligation by each staff member, although whistleblowing channels are not mentioned. An asset is Annex to the Risk Management policy with overall risk classification.

Latvijas Pasts

VAS “Latvijas Pasts” Risku vadības politika (Latvijas Pasts Risk Management Policy) is issued on 19 December 2019 and available online in webpage on anti-corruption activities.¹⁹⁵ A separate document – Risk management regulation is not made public.

¹⁹¹ Latvenergo. The Code of Ethics of the Latvenergo Group. Available at:

https://latvenergo.lv/storage/app/media/faili/etika/LE_etikas_kodekss_2019.pdf

¹⁹² NASDAQ OMX Riga. Principles of corporate governance and Recommendations on their implementation, 2010. Available at: https://www.nasdaqbaltic.com/files/riga/corp_gov_May_2010_EN.pdf

¹⁹³ Wider concept of the relative, including kinship of second degree or brother-in-law of first degree, or persons with whom the board member has had a common household for at least one year; supposed conflicts of interest.

¹⁹⁴ CSDD. CSDD Risk Management Policy. Available at:

https://www.csdd.lv/cck?Itemid=213&collection=fails&file=doc_fails&id=2581&task=download&xi=1

¹⁹⁵ Latvijas Pasts. Risk Management Policy of VAS “Latvijas Pasts”. Available at:

https://www.pasts.lv/lv/par_mums/par_latvijas_pastu/latvijas-pasta-veiktie-pasakumi-korupcijas-riska-noversanai/

Compared to other risk management policies available Latvijas Pasts is the only one that defines in detail risk appetite management. Thus, it opens a discussion on risk appetite and considers whether it aligns with its expectations on Strategy and Objective Setting.

Latvijas Pasts is cautious about delegating full monitoring responsibility to the process (risk) owner and retains it under the responsibility of the Internal Audit and Risk Management Department, although according to information provided in the interview independency of Internal Audit currently is being strengthened. Policy stipulates that monitoring and controlling of the risk management process is a set of activities carried out by the Internal Audit and Risk Management Department's responsible staff to coordinate and oversee the implementation and progress of the risk management process within the Latvijas Pasts. This is clear shortcoming of the policy as lack of separation of responsibility causes a self-review risk.

Although further in document the three line of defence model is well described, the risk register is maintained and responsibility of promotion of sound risk management is allocated to the Internal Audit and Risk Management Department not to the "first line of defence".

Latvijas Dzelzceļš

"Latvijas Dzelzceļš" koncerna risku vadības politika¹⁹⁶ (Concern risk management policy) briefly describes similar principles as done in the above-mentioned policies. The two pages that are made public does not give insight to the competence of involved parties. However, this policy outlines the division of responsibilities between group companies.

To ensure effective implementation of risk management within the Group, the policy establishes levels of responsibility in both policy oversight and day-to-day implementation. Thus, the Supervisory board of Latvijas Dzelzceļš oversees the establishment and operation of the risk management process in Latvijas Dzelzceļš and the Group as a whole and regularly reviews the reports submitted by the Management Board on the implementation of the risk management and mitigation plan. The Board of Directors of each Group company is responsible for the implementation and successful operation of the risk management process in its company, while the risk managers appointed by each company carry out its practical implementation and cooperate with the risk supervisors and risk owners in their areas of responsibility. The overall risk management structure and process is coordinated by the Group Risk Manager, who oversees the development of the policy and its amendments, reporting to the Board, support to the Group affiliates, organization of risk management training, etc.

Nothing is said about role of auditors, so it is not possible to, with certainty, establish whether there is proper division of powers between internal audit and process (risk) owners.

Latvijas Gaisa satiksme

The best approach of control is performed by Latvijas Gaisa Satiksme on website briefly describing its Risk policy¹⁹⁷. Overall, the publication describes the risk management approach and provides an insight into the list of risks that are really relevant to the company, rather than technically referencing well-known phrases in risk management theory.

¹⁹⁶ Latvijas Dzelzceļš. Risk management policy of the Latvijas Dzelzceļš Group. Available at: <https://www.ldz.lv/lv/risku-vad%C4%ABbas-politika>

¹⁹⁷ Latvijas Gaisa satiksme. Risk policy. Available at: <https://www.lgs.lv/korporativa-informacija/par-lgs/risku-parvaldiba/>

They write boldly that the occurrence of any risk has a direct impact on Latvijas Gaisa Satiksme performance and achievement of goals. Latvijas Gaisa Satiksme defines 15 risks grouped in 4 groups and looks like all are evaluated with the same impact and probability.

Latvijas Gaisa Satiksme provides that the management of risks within the sphere of influence of the corporation by minimizing the probability of the occurrence of a risk or the negative consequences of its occurrence is ensured by the operation of the internal management and control system, which is constantly being improved, as well as the safety management system.

It is an interesting attempt to combine quality management, internal controls and corruption prevention activities but lacks coherence.

	<i>Count</i>	<i>The most widespread practices of internal controls in SOEs assessed: components and selected control elements (7 – 9 positive answers)</i>	<i>Count</i>	<i>The least popular practices of internal controls in SOEs assessed: components and selected control elements (6 and less positive answers)</i>
Area 1: THE EXTERNAL COMPLIANCE	8	Reviews Risk and Performance Regulatory risks of business processes are fully assessed, and compensatory mechanisms are introduced (e.g. if the regulation is unclear, inappropriate, ambiguous, confusing, judgemental or is a subject to changes)	3	Evaluates Alternative Strategies Resistance to negative economic conditions
	7	Reasonable assurance Analyses Business Context Regulation of the respective business process is identified, there are no problems in complying with regulatory requirements.	5	Defines Risk Appetite Monitoring of other external threats prevents from crises
	7	Analyses Business Context Compliance with the principles of free competition is ensured: to protect, conserve and develop free, fair and equal competition		
Area 2: MANAGEMENT POLICY	9	Formulates Business Objectives (Considers Risk while Establishing Business Objectives, Defines Acceptable Variation in Performance) Tactical action plans correspond to the strategic objectives	6	Exercises Board Risk Oversight Internal control policy defined by the top-level management corresponds to the level of risks
	9	Implements (Identifies and Selects) Risk Responses Everyday activities, orders contribute to the implementation of strategy	7	Communicates internally Communicates Risk Information Internal communication of management decisions is appropriate (all staff is introduced to the policy)
	9	Formulates Business Objectives (Considers Risk while Establishing Business Objectives, Defines Acceptable Variation in Performance) Performance indicators and expected results are monitored		
Area 3: ORGANISATIONAL COMPLIANCE	9	Establishes Operating Structures The organisational structure and the allocation of responsibilities are in line with the strategy	1	Reviews Risk and Performance Develops Portfolio View Execution of the processes is technically simple - they have simple scope of the processing, low deviation, each process is centralized within its place or function
	9	Control Activities	3	Selects and develops control activities High regularity of processes, routine work (risks,

		Responsibility is delegated to the process owners according to the level of hierarchy in order to ensure internal control		which are caused by manual / automatic operations and by specific use of IT, and influence execution of the process, are prevented)
	8	Risk-based thinking (identification and execution of the countermeasures) is integrated into the organisational culture	3	Reviews Risk and Performance Develops Portfolio View Processes are stable, embedded in time and unchangeable
Area 4: Compliance of the HUMAN RESOURCE management policy – a risk that is arising from the expertise, skills and abilities of the people/ target audience involved in the process	9	Establishes Operating Structures Attracts, Develops and Retains Capable Individuals People involved in the process have sufficient knowledge, all executors are familiar with the process	5	Attracts, Develops and Retains Capable Individuals Adequate workload, low staff turnover; no lack of staff or other stress factors
	9	Establishes structure, authority and responsibility (competence of the entity's people) managers who accept primary responsibility for effective controls Employees at management level (department managers) are responsible for the process / high degree of control, processes are fully, internally and directly governed at management level	7	Attracts, Develops and Retains Capable Individuals Staff appraisal boosts productivity
	9	Establishes structure, authority and responsibility (competence of the entity's people) Posts are created, responsibilities are allocated, resources are divided according to the business objectives	7	Attracts, Develops and Retains Capable Individuals The remuneration policy is motivating
	9	Defines Desired Culture (Organizational Behaviours) Demonstrates Commitment to Core Values (Integrity and Ethics Enforces Accountability) Definition of ethical requirements, prevention of conflicts of interest, declaration of conformity, limitation of spare-time activities, restrictions of competition		
Area 5: Risk management	8	Reviews Risk and Performance Risks belong to their owners, to whom risk prevention is reported	6	Identifies and analyses risk Identification and assessment of risks is sufficient in order to reduce the impact of error on the results
			6	Reviews Risk and Performance Risk prevention measures are audited at least every five years
Area 6: Control measures	9	Analyses Business Context Compliance with legal requirements is ensured	4	Exercises Board Risk Oversight No employee or group is in a position both to perpetrate and to conceal errors or fraud in the normal course of their duties.
	8	Reasonable assurance The established business procedures include appropriate internal control	6	Implements (Identifies and Selects) Risk Responses Supervision and control performed by direct managers contribute to the fast identification of errors
	8	Deploys (control activities) through policies and procedures Appropriate control measures are implemented in all processes where necessary (e.g., mutual approval, inclusive decision-making, 4-eyes principle, notification of activities, documentation, change of tasks, staff rotation, division of		

		responsibilities, obscuration of responsibility, deprivation etc.)		
Area 7: Appropriate financial and technical resources for implementing control measures	9	Establishes Operating Structures Distribution of financial and human resources in the planning and budget making processes is in line with the business objectives	4	Selects and develops control activities Execution of process is uniformed, with a maximally high degree of standardization
	7	Selects and develops general controls over technology Ensure software and online environments are permanent functional	5	Deploys (control activities) through policies and procedures Automated controls are supported by technical means or mutually integrated applications
	7	Leverages Information and Technology Other technical surveillance modes ensure the control, e.g., video or audio registration, video monitoring, GPS monitoring	6	Selects and develops control activities Premises and working environment are adjusted, e.g., adjusted premises, work environment, open offices where possible
Area 8: The economic activity (operations)	9	Authorization and execution of transactions and events Procurements (identification of needs, choice of the most suitable proposal) are authorised in an appropriate way	4	Reviews Risk and Performance Sales orders are not handled if the lending limit is exceeded
	8	Implements (Identifies and Selects) Risk Responses Non-disclosure of a commercial secret and intellectual property protection is ensured	6	Assesses Severity of Risk Clients solvency is controlled and secured by the provision of guarantees if necessary
			6	Analyses business context Brand capital (reputation) is protected, brand presence is expended according to its value
Area 9: FINANCIAL CONTROL	9	Selects and develops control activities Accounting procedures and reports can be used to make efficient decisions		N/a
	9	Prompt and proper recording of transactions and events Accounting is organized in a structured and precise way		
	9	Deploys (control activities) through policies and procedures Taxes are correctly applied, calculated and paid; errors are identified at an early stage		
	9	Leverages Information and Technology Ensure application systems provide audit logs of significant transaction activity		
	9	Separation of duties Financial control function is separated from the main activity in all areas		
Area 10: INCIDENT MANAGEMENT	9	Communicates Risk Information Whistle blower protection is ensured		N/a
	8	Communicates Risk Information The process of receiving and reviewing complaints is efficient		
	8	Implements (Identifies and Selects) Risk Responses Corrective actions contribute to achieving long-term effects		
Area 11: MONITORING	8	External inspections and checks are conducted if necessary	3	Conducts ongoing and/or separate evaluation An audit committee is established
			5	Develops Portfolio View An integrated system of the internal control is supported by the management real-time monitoring and is continuously improved
			5	Auditing of function performance is randomised

Area 12: REVIEWS	9	Reviews Risk and Performance Timely and objective information on the situation in an organization is provided to managers and is	5	Documentation Control process is documented as far as it is possible to prove it was conducted
	7	Communicates Risk Information Information to monitor performance is easily accessible, of good quality, timely, visually perceptible and transparent	6	Communicates externally There is an indication on the efficiency of the internal control in the annual management report
Area 13: THE NATURE OF TRANSACTIONS / ACTIVITIES - a risk that is posed by quantitative and qualitative characteristics of the process and that determines the control intensity	9	Assesses Severity of Risk There are special control procedures for a high-risk area (the process is related to the public security, public policy or public health, hygiene, food safety, tax area)	5	It is easily verifiable if an information is distorted; a low risk that it can be hidden or used for unintended purposes
	9	Assesses fraud risk The protection against fraud, wastage and squandering of resources, embezzlement or other infringements is sufficiently secured		
	8	Assesses Severity of Risk Control intensity is in line with the scale of risk in high-risk activities and in processes with systematic risk exposures		
Area 14: RECENT EXPERIENCE IN MONITORING AND CONTROLLING - indications on possible long-term risks based on experience in managing infringements in the last 3 years	9	Evaluates and communicates deficiencies Accounting errors or irregularities are avoided (there have been no known significant incidents or fraud)	6	Evaluates and communicates deficiencies The adjustments made by the management are not significant due to its small scope / routine nature / small sums of money
			6	Reviews risk and performance There are no significant deviations in the execution of processes, or they are not significant / no reason to involve top-level management

Figure. Summary of self-assessment questionnaire (selected areas and elements of controls)

Annex 10. SOEs by segment

Commercial SOEs	State-dependent commercial SOEs	State-dependent non-commercial SOEs
AirBaltic Corporation AS	Dailes teātris VSIA	Aknīstes psihoneiroloģiskā slimnīca VSIA
Attīstības finanšu institūcija Altum AS	Jaunais Rīgas teātris VSIA	Autotransporta direkcija VSIA
Augstsprieguma tīkls AS	KREMERATA BALTICA VSIA	Bērnu klīniskā universitātes slimnīca VSIA
Elektroniskie sakari VAS	Latvijas Gaisa Satiksme VAS	Bērnu psihoneiroloģiskā slimnīca Ainaži VSIA
Latvenergo AS	Latvijas Lauku konsultāciju un izglītības centrs SIA	Bobsleja un kamaniņu trase Sigulda SIA
Latvijas Dzelzceļš VAS	Latvijas Nacionālais metroloģijas centrs SIA	Ceļu satiksmes drošības direkcija VAS
Latvijas elektriskie tīkli AS	Pasažieru vilciens AS	Daugavpils psihoneiroloģiskā slimnīca VSIA
Latvijas Jūras administrācija VAS ¹⁹⁸	Sporta centrs Mežaparks SIA	Daugavpils teātris VSIA
Latvijas Loto VAS	Standartizācijas, akreditācijas un metroloģijas centrs SIA	Eiropas dzelzceļa līnijas SIA
Latvijas Pasts VAS	Tenisa centrs Lielupe SIA	Hiponia SIA
Latvijas valsts meži VAS	Valsts nekustamie īpašumi VAS	Iekšlietu ministrijas poliklīnika VSIA
Latvijas Valsts radio un televīzijas centrs VAS		Kultūras un sporta centrs Daugavas stadions VSAI
Latvijas Vēstnesis VSIA ¹⁹⁹²⁰⁰		Latvijas autoceļu uzturētājs AS
LDZ Cargo SIA		Latvijas Koncerti VSIA
LDZ infrastruktūra SIA		Latvijas Leļļu teātris VSIA
LDZ Ritošā sastāva serviss SIA		Latvijas Nacionālā opera un balets VSIA
Meliorprojekts VSIA ²⁰¹		Latvijas Nacionālais simfoniskais orķestris VSIA
Sadales tīkls AS		Latvijas Nacionālais teātris VSIA
Starptautiskā lidosta Rīga VAS		Latvijas Proves birojs VSIA
TET SIA		Latvijas Radio VSIA
		Latvijas Standarts SIA
		Latvijas Televīzija VSIA
		Latvijas Valsts ceļi VSIA
		Latvijas Vides, ģeoloģijas un meteoroloģijas centrs VSIA
		Liepājas Simfoniskais orķestris VSIA
		Ludzas medicīnas centrs SIA
		Mihaila Čehova Rīgas Krievu teātris VSIA
		Nacionālais rehabilitācijas centrs Vaivari VSIA
		Paula Stradiņa klīniskā universitātes slimnīca VSIA
		Piejūras slimnīca VSIA
		Publisko aktīvu pārvaldītājs Possessor AS
		Rīgas Austrumu klīniskā universitātes slimnīca SIA

¹⁹⁸ Even though according to the proposed segmentation approach, SOE falls under the Commercial SOE segment, shareholder is suggested to consider changing SOE's segment to State-dependent commercial SOE.

¹⁹⁹ State financing has significantly increased; therefore, SOE segment should be re-evaluated.

²⁰⁰ Even though according to the proposed segmentation approach, SOE falls under the Commercial SOE segment, shareholder is suggested to consider changing SOE's segment to State-dependent commercial SOE.

²⁰¹ Even though according to the proposed segmentation approach, SOE falls under the Commercial SOE segment, shareholder is suggested to consider changing SOE's segment to State-dependent commercial SOE.



		Rīgas cirks VSIA
		Rīgas psihiatrijas un narkoloģijas centrs VSIA
		Rīgas Tūrisma un radošās industrijas tehnikums VSIA
		Šampētera nams VSIA
		Slimnīca Ģintermuiža VSIA
		Strenču psihoneiroloģiskā slimnīca VSIA
		Tiesu namu aģentūra VAS
		Traumatoloģijas un ortopēdijas slimnīca VSIA
		Valmieras drāmas teātris VSIA
		Valsts Akadēmiskais koris Latvija VSIA
		Veselības centrs Biķernieki SIA
		Vides investīciju fonds VSIA
		Zemkopības ministrijas nekustamie īpašumi SIA

Annex 11. Equity markets

Markets' size

It is commonly accepted to compare the total equity market capitalization to the country's GDP to assess the relative integration and to determine the overall reliance of companies on its domestic equity markets as a source of funding. NASDAQ Baltic²⁰² provides market capitalization as an aggregate amount of the Latvian equities, and the Central Statistical Bureau of Latvia (CSB)²⁰³ provides nominal GDP figure. The aggregate amount of the Latvian publicly traded equities sums the market capitalization of all Latvian companies, which are listed on either Baltic Main list, Baltic Secondary list or First North Baltic list. Investment funds, unit trusts, and companies whose only business goal is to hold shares of other listed companies are excluded.

See **Figure** below for the historical development of Latvian equity markets in terms of the number of companies listed on the exchange as well as of their respective market capitalization.

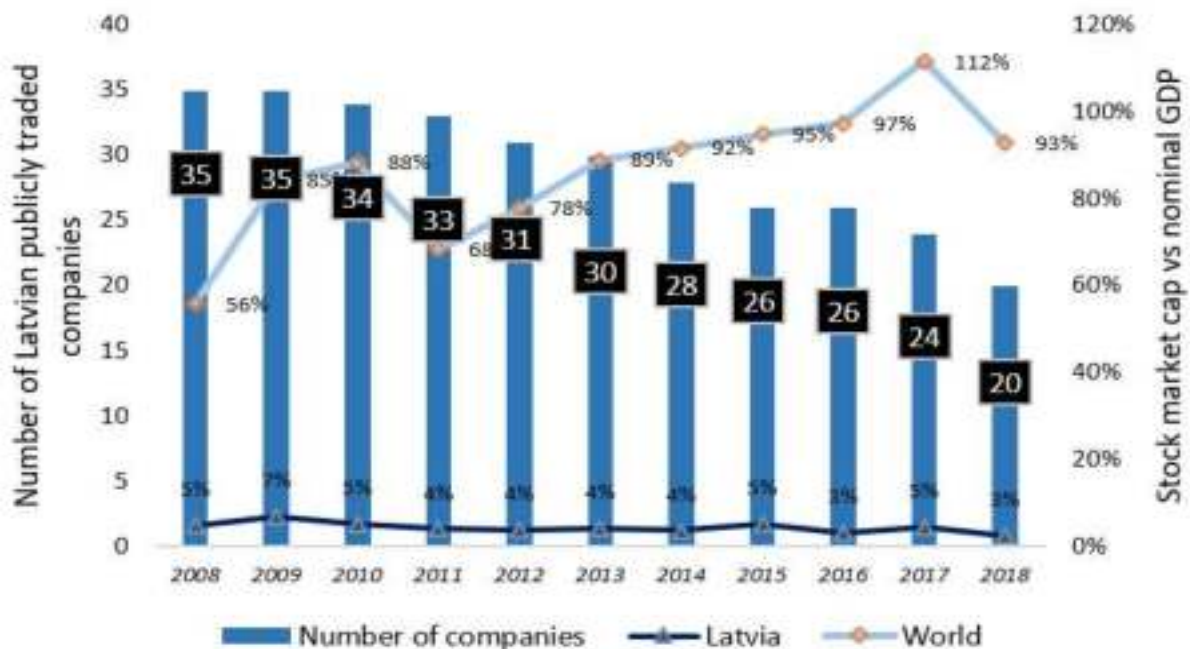


Figure. Latvian equity market capitalization vs world and total number of listed Latvian companies, during 2008 - 2018²⁰⁴

The Latvian equity market capitalization as well the number of Latvian companies listed on the exchange has been on a gradual decline since 2008. Already judging from the base year figures (i.e. 2008), when the underlying scale was larger, the market capitalization of the Latvian equity market vs the nominal GDP

²⁰² Nasdaq Baltic. Capitalization. <https://www.nasdaqbaltic.com/statistics/en/capitalization>

²⁰³ Central Statistical Bureau of Latvia. GDP up by 4.8 % in 2018 and by 5.1 % in Q4. 28.02.2019.

<https://www.csb.gov.lv/en/statistics/statistics-by-theme/economy/gdp/search-in-theme/2538-gross-domestic-product-2018>

²⁰⁴ Nasdaq Baltic. Statistics. <https://nasdaqbaltic.com/statistics/en/statistics>



has been significantly below that of the world average²⁰⁵. In fact, the subsequent development of this ratio has exhibited a notable divergence, where the world's average equity market capitalization has increased relative to the nominal GDP, while the Latvian equity market has become even smaller.

The decreasing number of companies listed on the Latvian stock exchange to some extent explains the aforementioned trend. In 2008, there were 35 publicly listed companies on the Latvian domestic stock exchange, and 10 years later (in 2018), this number had plunged to only 20 companies. In relative terms, this results in an approximately 40% drop. Moreover, there have been no years during the 10-year period in which there have been net new public equity offerings – there have been only two years (2009 and 2016) where the number of listed companies has remained unchanged (i.e. not fallen).

For instance, there have been three major equity de-listings from the Riga Stock Exchange in the past 5-year period – Ventspils Nafta AS, Latvijas Kuģniecība AS and Latvijas Tilti AS. The total amount of lost market capitalization due to these de-listings was approximately EUR 250 million, which corresponds to ca. 15% of the total market capitalization of all Latvian equity listings. All of the de-listing has been made through mandatory share repurchase with the intent to take the companies private.

Furthermore, there are no Latvian SOEs, whose shares are listed on the Baltic Main list. In the meantime, Estonia has two SOE's – Tallinna Sadam AS (one of the largest cargo- and passenger port complexes in the Baltic Sea region, and also operates in shipping and waste management business) and Tallinna Vesi AS²⁰⁶ (the largest water utility in Estonia, providing drinking water and wastewater disposal services) – that are listed on the Baltic Main list. Lithuania has the largest number of publicly traded SOEs. It has one listed SOEs on the Baltic Main list and two SOE's, which are trading on the Baltic Secondary list. The Lithuanian SOE, which is listed on the Baltic Main list is Klaipėdos Nafta AB (one of the most modern oil terminals in Europe). The other two Lithuanian SOEs listed on the Baltic Secondary list are Litgrid AB (high voltage power transmission; management of power transmission system and development of infrastructure; electricity market development), and Kauno Energija AB (supply of thermal energy to the customers, manufacture of electricity and thermal energy).

²⁰⁵ The World Bank. Market capitalization of listed domestic companies (% of GDP).

<https://data.worldbank.org/indicator/CM.MKT.LCAP.GD.ZS>

²⁰⁶ Tallinna Vesi is a classic example of a company transforming itself from a 100% municipally owned water company, through a privatization in 2001, to a listing on the Tallinn Stock Exchange in June 2005. Currently, 35.3% of the Company is owned by UU Tallinn B.V., 34.7% by the City of Tallinn and 30% of shares are freely floated.

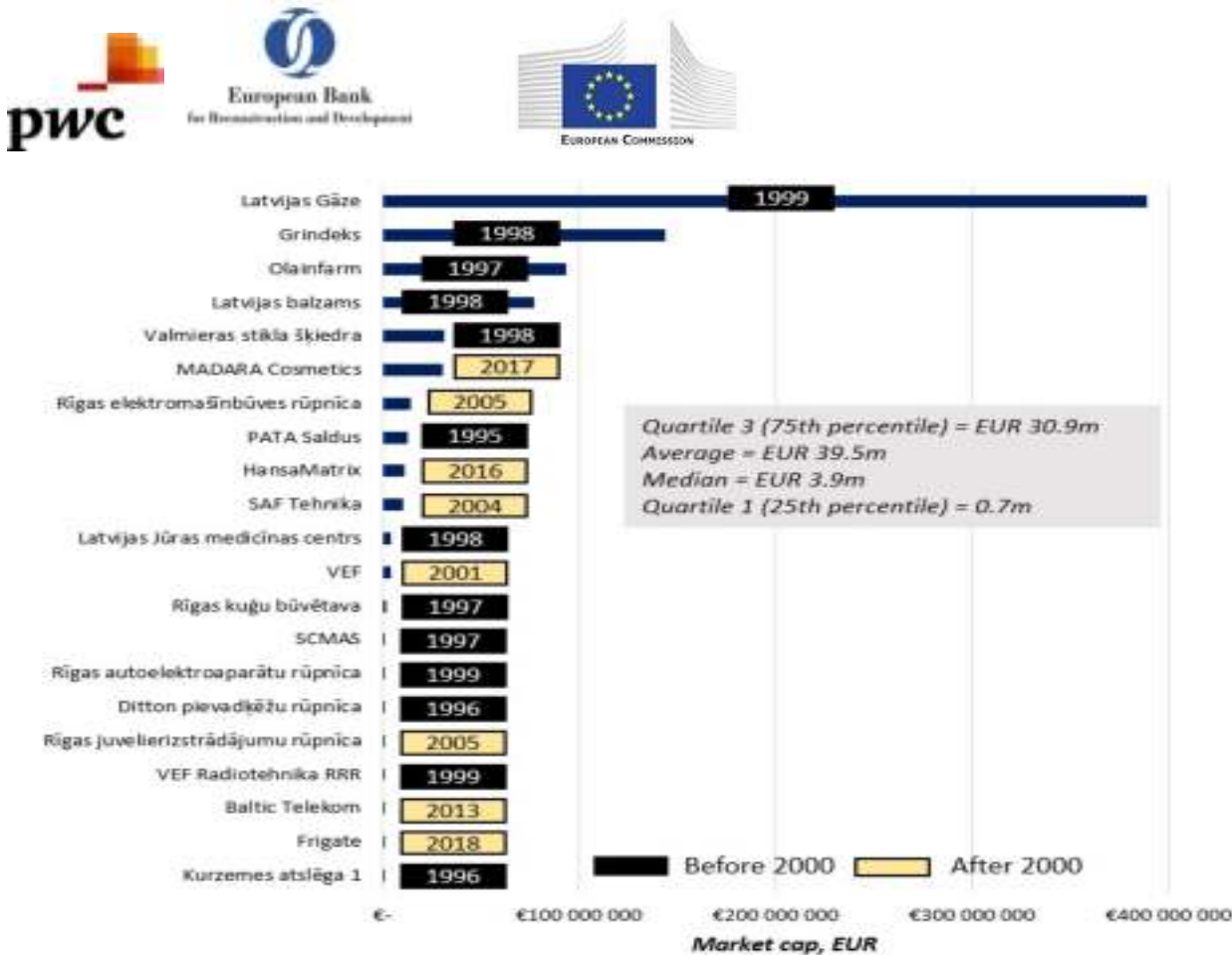


Figure. Latvian listed companies by market capitalization and their listing dates, 28 February 2020

More than half of the publicly listed Latvian companies were listed more than two decades ago. In fact, all of the Top 5 companies in terms of the market capitalization had their IPO date before 2000. In the period from 2000 – 2020, there have been only eight IPOs and whose shares are still traded on the Nasdaq Baltic exchange. In the past three-year period, there have been only two IPOs on the Latvian equity market (First North Baltic) – Madara Cosmetics AS and Frigate AS.

Figure above also shows the overall dispersion of the market capitalization of Latvian publicly listed companies. There are only two companies – Grindeks AS and Latvijas Gāze AS – whose market capitalization exceed the EUR 100 million mark. Besides Olainfarm AS and Latvijas Balzams AS, the market capitalization of the remaining 17 companies does not reach EUR 50 million. Even further, the median market capitalization of all publicly listed Latvian companies amounts to EUR 3.9 million.

Markets' liquidity

The market liquidity of the equity markets is measured by exploiting the same technique as for the fixed income markets. Both the number of trades made and the corresponding level of turnover are important metrics to consider in assessing how liquid the equity markets are.

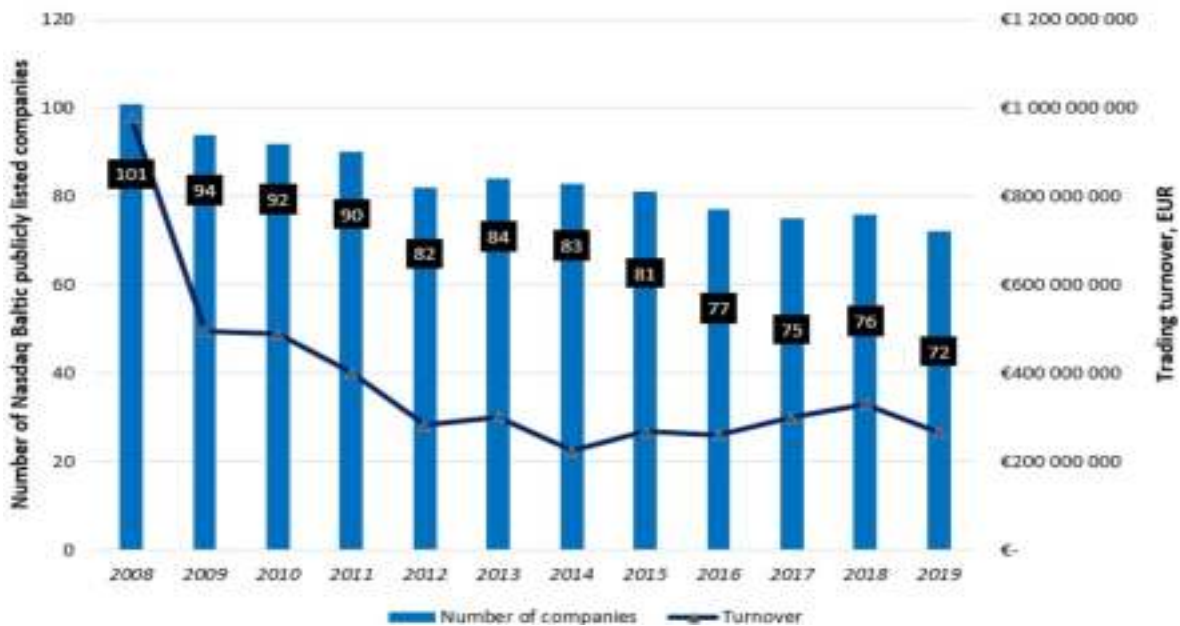


Figure. Nasdaq Baltic equity market’s trading turnover and number of companies listed during 2008 – 2019

The liquidity profile of equity markets is closely correlated with the number of companies listed on a particular market. The Baltic equity markets in aggregate, as with the Latvian equity market, have experienced a declining number of publicly traded companies. From 2008 to 2019, there were net 29 companies, which delisted their shares from the Baltic equity markets. At the end of 2019, there were only 72 listed companies – summing together those that are traded on the Baltic Main and Secondary list as well as on the First North Baltic list.

As a result of the steep decline of listed companies, the level of equity trading turnover has fallen dramatically. In 2008, the total trading turnover amounted to just above EUR 1 billion, while in 2019 it dropped to EUR 266 million. This translated to a more than 70% drop of total equity trading turnover in all of the three Baltic States. Relative to the total market capitalization of the Baltic equity markets as of year-end 2019, the annual level of turnover accounted for only 3%. In Latvia, the ratio was even lower with 2% in the comparable period.

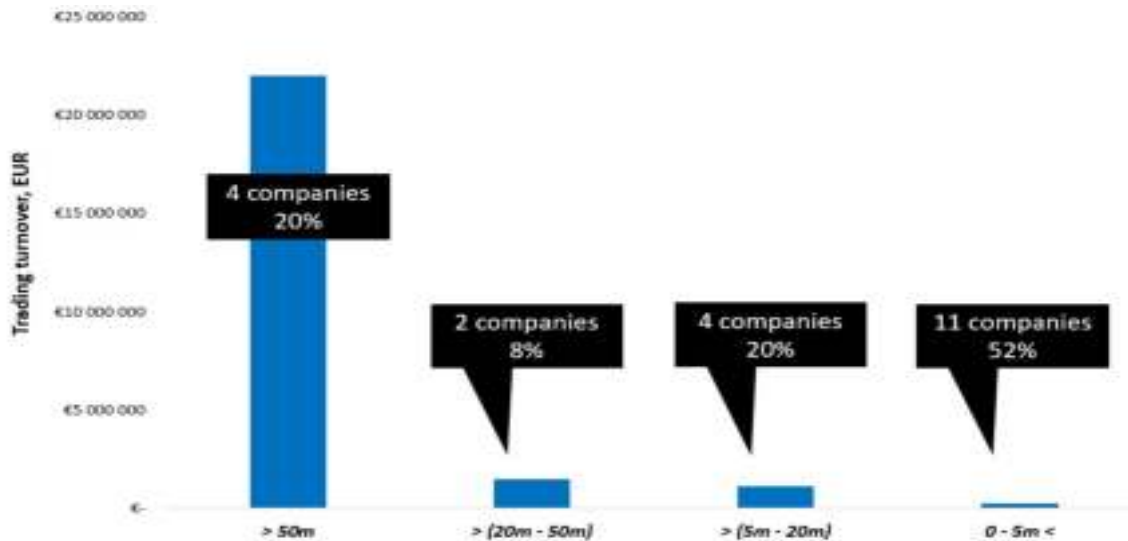


Figure. Latvian publicly traded companies' trading turnover split into different market capitalization groups, during 2019

Figure above shows how the number of Latvian publicly traded companies is split into different market capitalization groups and the percentage of companies placed in each group relative to the total number of Latvian publicly traded companies. It also shows the total amount of turnover that each bucket had during 2019.

The Latvian equity market is extremely concentrated. It is evident that the Top 4 biggest companies, which correspond to 20% of the total number of listed companies, comprise the majority of the equity trading volume. The trading volume of company market capitalization bucket of EUR 20 – 50 million and EUR 5 – 20 million amounts to approximately EUR 2.5 million, which is significantly below the trading turnover exhibited by the companies with above EUR 50 million market capitalization. The smallest market capitalization bucket of up to EUR 5 million includes 52% of the total number of Latvian publicly listed companies. While this percentage is the highest here, the total trading turnover accounts for less than 1% of the total trading turnover in 2019.

2.2.4. Bond markets

Markets' size

The Nasdaq Baltic fixed income market consists of 44 corporate bond issues, 28 government bond issues and 10 First North corporate bond issues (as of February 28, 2020). Yet, the total number of corporate issuers is notably lower than the number of bond issues. In Latvia, there are 15 corporate bond issues outstanding, while the number of issuers is 10, which indicates that some companies have sourced the debt financing via public markets more than once, and without the intent to retire the already outstanding bonds. For instance, Latvenergo has two bond issuances outstanding – one with the maturity date set at 22.05.2020, and the other one maturing at 10.06.2022. In fact, one of these bonds is a green bond. Moody's investor service has affirmed the green bond assessment of Latvenergo green bonds – GB1 (excellent), indicating to a well-defined organizational structure and decision-making process for selecting

eligible projects, as well as the comprehensive description of the projects included in the green bond report (2017).



Figure. Split within fixed income issuers by the corresponding home market and the type of bond issue

Figure above clearly shows that relative to Estonia and Lithuania, Latvia has a notable number of both issuers and listed bonds. In the meantime, however, the Latvian corporate bond market maturity profile indicates that more than half of the outstanding issues will mature in the coming 2-year period. If there are not any new corporate bond issues in the Latvian corporate bond market during 2020 and / or 2021, the overall corporate bond market capitalization is expected to fall significantly, placing the size the Latvian corporate bond market at the bottom compared to that of Lithuania.

As of February 28, 2020, the total market capitalization of the Latvian fixed income market was EUR 1.5 billion²⁰⁷ of which 82% accounts for government bonds and the remaining 18% for corporate bonds (only EUR 1.5 million attributable to the First North Corporate bonds). These figures imply that the market capitalization of the total Latvian government bond issues significantly outweigh that of the corporate bonds.

Figure below illustrates the market capitalization of the outstanding debt for each Latvian company, which has at least one active outstanding bond issue as of 28 February 2020.

²⁰⁷ Nasdaq Baltic. Statistics. <https://nasdaqbaltic.com/statistics/en/statistics>

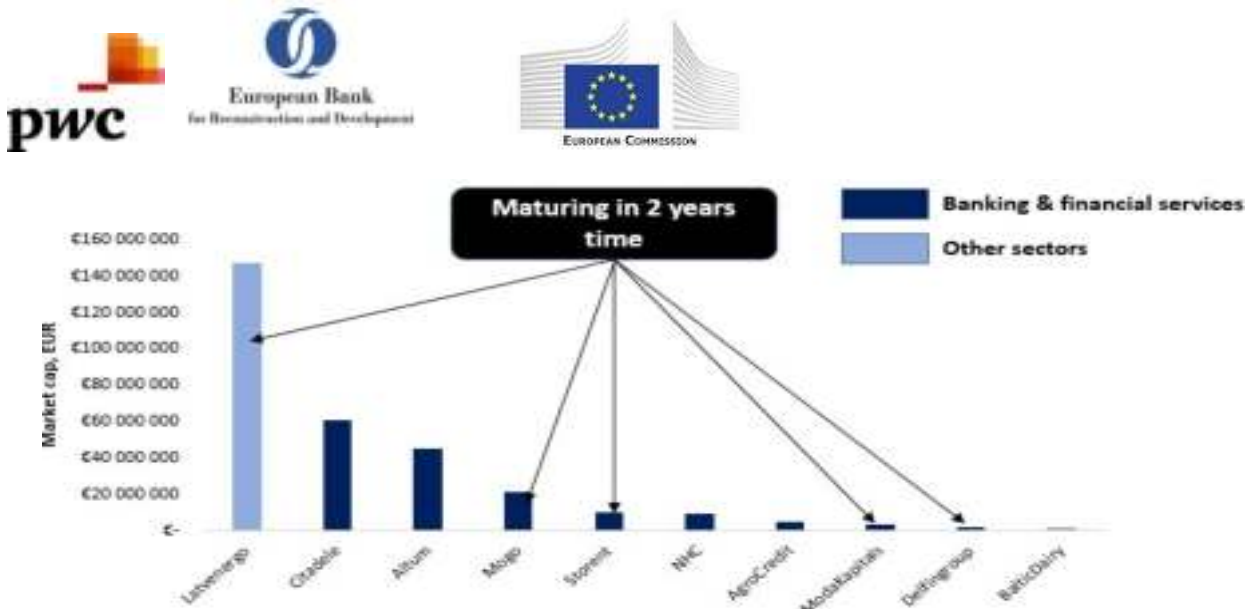


Figure. Latvian corporate bonds listed on the Nasdaq Baltic and their market capitalization accompanied by the relevant sector classification

Figure above also shows the magnitude of the imminent bond maturities. Assuming no new corporate bond issues take place 2020 and 2021, the corporate bond market will lose more than half of the current market capitalization, with Latvenergo having the most considerable impact – EUR 146 million in bonds. However, Latvenergo, the largest corporate bond issuer, has already acknowledged²⁰⁸ that it will issue bonds up to EUR 200 million under a new bond-offering programme. The decision is based on positive bond issue experience and the opportunity provided by the capital market to continue the successful diversification of Latvenergo funding sources by attracting funding on favourable terms and conditions. While this decision will benefit Latvian fixed income market, the risk of one or few companies cutting their funding source from the local fixed income market, and hence decreasing the total market capitalization remains high.

Moreover, it is evident that 6 out of 10 issuers are from the banking and financial services sector. This can be explained by the significant growth that the local non-bank lending companies have enjoyed over recent years. In order to maintain the elevated growth levels, non-bank lending companies have actively sought ways to increase their capital base to continue issuing more loans. As a result of stringent loan requirements from local commercial banks (i.e. increased regulatory environment and increased risk-aversion of major banks), these non-bank lending companies have increasingly turned to the local fixed income markets for additional borrowing. Yet, it should be noted that the Financial and Capital Market Commission (FCMC) has informally indicated that non-bank lending companies might be required to obtain a banking license if they raise funds on the capital market on a continuous basis. Such a requirement would impose additional headwinds in terms of maintaining or growing the existing market capitalization of the Latvian fixed income market.

Finally, the most recent bond issues of the two SOEs (i.e. Altum and Latvenergo) have been significantly oversubscribed. For instance, the issuance of Altum's bonds attracted a great deal of interest from investors in Latvia, Lithuania and Estonia and was oversubscribed 13 times²⁰⁹. A similar result was

²⁰⁸ Latvenergo AS plans to continue the issuance of bonds in the Baltic market. 10.10.2019.

²⁰⁹ Altum. Issue of bonds. <https://www.altum.lv/en/investors/bonds-altum/upcoming-issue-of-bonds/upcoming-issue-of-bonds/>

observed for the Latvenergo bond issue for which the demand exceeded supply by 5.8 times²¹⁰ the planned issue amount. This indicates a strong and existing appetite from [pan-Baltic regional] investors for Latvian SOEs investment opportunity (i.e. with a low credit risk).

Markets' liquidity

The liquidity of fixed income capital markets is measured through metrics such as the number of trades made during certain time period, and the level of associated turnover, which is a product of number of trades and the respective trade volume. Trade volume is calculated as the number of securities (i.e. bonds) traded times the price of the security.

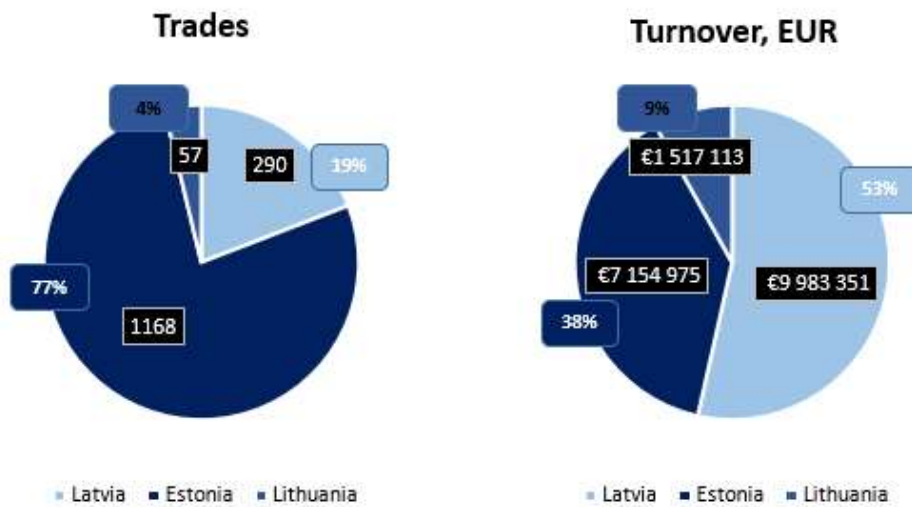


Figure. Nasdaq Baltic corporate bond market's number of trades and turnover split by country, during 2019

While the number of trades conducted during 2019 of the Estonian corporate bonds significantly exceeded that of the Latvian corporate bonds, the overall turnover of the Latvian corporate bonds surpasses that of the both neighbouring countries. This confirms the conditions shown in **Figure above** in which Latvia has the greatest number of corporate bonds outstanding. Estonian corporate bond trades constitute a significant part of the total number Baltic corporate bond trades. This is, to a large extent, explained by the lower face values of the Estonian bond issues, and the lower volumes per each trade.

The annual turnover of EUR 10 million in Latvian corporate bonds shown in **Figure above** comprised less than 1% of the Latvian corporate bond total market capitalization as of February 28, 2020. For Estonia and Lithuania, the corresponding ratio is approximately the same – less than 1%. However, such shallow trading volumes are common for fixed income markets in general as most of the trading takes place OTC and institutional investors such as pension funds and insurance companies tend to hold these securities to maturity to match the duration and convexity profile between assets and liabilities.

²¹⁰ Latvenergo. Latvenergo AS issued green bonds in the amount of EUR 25 million. 15.04.2016. <https://cns.omxgroup.com/cdsPublic/viewDisclosure.action?disclosureId=706164&messageId=883967>

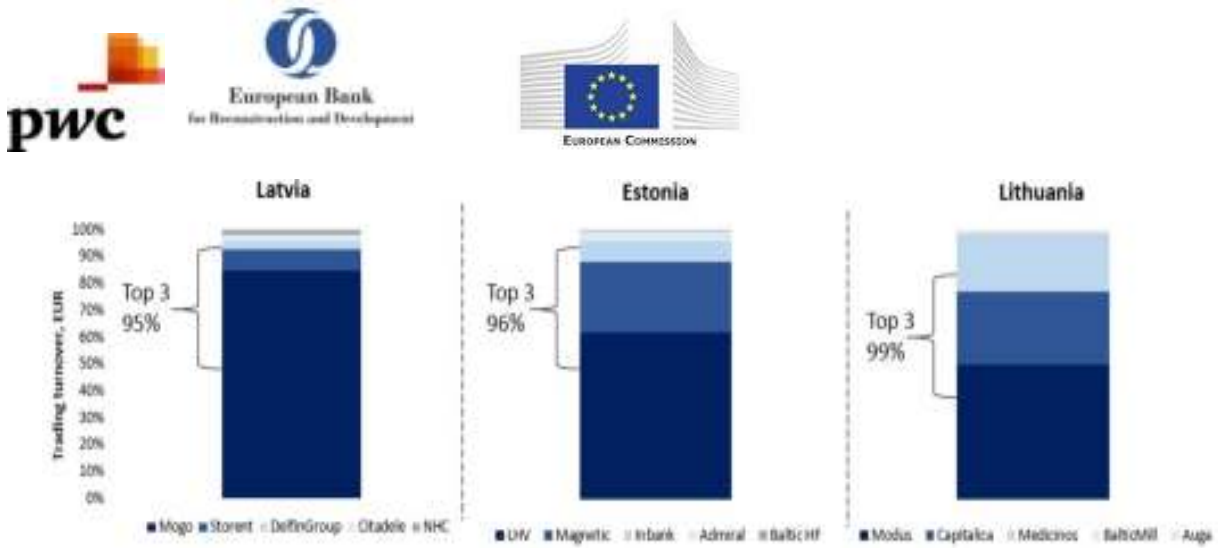


Figure. Nasdaq Baltic corporate bond market's trading turnover split by companies and the corresponding countries, during 2019

Figure above illustrates how the Baltic corporate bonds trading turnover is concentrated between several companies (on a country level). While there exist minor differences between the Baltic States, in all three countries the Top 3 highest turnover bond issues represent almost the entire corporate bond turnover of each country's exchange.



Annex 12. The current SOE segmentation practices in Latvia

In Latvia there is no formal SOE segmentation in place that explicitly governs the decisions pertaining to which financing instruments to choose and which capital structures to implement. However, there exist a broad set of stand-alone SOE segmentations, which are used to track and assess various SOE metrics. The lion's share of these informal (i.e. not stipulated by the law) categorizations stems from the CSCC's initiatives. Below is a list of the most actively used SOE segmentation forms that also resemble best practices of how other countries have approached this.

Sectoral split is made available at the CSCC database and is predominately used when assessing the overall performance of SOEs. Five sectors – energy, transportation, healthcare, forestry and communication - constitute 93% of the SOE aggregate revenues. However, the SOE segmentation that is based on sectoral split is subject to concentration bias with a small set of companies bearing a disproportionate impact on the results. For instance, the energy sector accounts for 43% of the SOE aggregate revenues despite the fact that only two SOEs are classified as energy companies.

Ownership type split entails a segmentation based on the State's influence over the governance of the company providing that the State has a decisive or indecisive influence over the company's governance. The difference between decisive and indecisive ownership lies in the State's influence over the company's governance, where in the former group State holds at least 51% of the company's capital shares and thus imposes corporate governance framework that is set in the SOEL. In the case, where the State has a decisive influence over the holding company, it also has a decisive influence over its subsidiaries. In the latter group the State holds less than 51% of the company's capital shares and the same level of corporate governance and management standards as for the private companies. Therefore, the detailed framework for SOE financing instruments can be examined only for the companies where the State has a decisive influence, i.e., SOEs where the State is either a sole owner or holds a majority.

SOE objective split is closely linked to the SASL Article Clause 88.1, which lists three situations that allow the State to form a new SOE or acquire participation in already existing private company. These three cases are easily identifiable, separable and sufficient on a stand-alone basis supporting a SOE segmentation as a reflection of the same list:

- Companies aimed at fixing a market failure.
- Companies that offer service or product of a strategic importance for the development of the administrative territory of the state, local government or for national security.
- Companies that manage physical assets that are of strategic importance for the development of the administrative territory of the state, local government or for national security.

The State's and SOE corporate governance practices on disclosing SOE objective do not fully follow the defined SOE objective split partly due to some SOEs being established (non-privatization clauses) before the current version of SASL. Therefore, the SOE segmentation based on the State's and SOE objective would not ensure a coherent result and would be difficult to implement within a system-wide framework.

Commercial vs non-commercial split is derived from the CSCC guideline documents²¹¹ that were developed with the intent to help policy makers articulate new strategic objective for SOEs. Dividing SOEs into different groups based on the underlying business activity (e.g., reliance on State financing, level of free competition) can serve as a fundamental starting point for developing SOE segmentation for the purpose of decision making on financing instruments and optimal capital structures. For example (a hypothetical case), the likelihood for commercial SOE competing in free market to access public equity market is considerably higher than for partially commercial SOE with majority of revenues stemming from State funding.

The relevant groupings are listed below:

- Commercial entities that do not receive budget funding, operate in free market conditions, sell goods and provide services in a sector where also private sector companies operate. Such entities should include the following as strategic goals: international competitiveness and growth, the development of the respective industry, the impact on the environment and the economy, the public benefit provided, good management principles and future trends for the industry the entity is operating in.
- Partially commercial entities that receive budget funding, provide statutory services as defined in the law, operate in a limited or free market environment and can be distinguished from private sector entities and their operations. Such entities should include the following as strategic goals: the set out goals and priorities by the state in the respective industry, the impact on the environment and the economy, good management principles, SOE international competitiveness and revenue generating instruments and define why the private sector cannot fulfil the set out strategic goals and fill in the market gaps.
- Entities with special tasks, which are not part of the abovementioned groups and provide necessary services to the society and which are not available in the market. As these services in many cases are not otherwise provided by the market, the balance between SOEs impact on the environment, society and economics of the country shall be used for the strategic goal setting.

Economic role split has emerged from the report “Evaluation of Criteria for Deciding on Purpose, Necessity and Status of Ownership in Shareholding by Public Entity” published in 2012 by the State Chancellery of Republic of Latvia. The report suggests a new SOE segmentation that is predicated on SOE’s business activity in relation to the free market. The report also proposes a three pillar SOE segmentation where each group is subdivided depending on the SOE characteristics mainly associated with the level of State ownership and sector type.

Economic role	Index		Characteristic
Group A Natural monopolies and private good	A1		Nationally important infrastructure
	A2	A2.1	State share 100%
		A2.2	State share <100%
	A3		Not nationally important infrastructure and capital investment
	A4		Real estate management

²¹¹ Pārresoru koordinācijas centrs. Valsts līdzdalības vispārējo stratēģisko mērķu noteikšanas vadlīnijas.

Group B	<i>B1</i>		Self-financed
	Public good	<i>B2.1</i>	Significant State budget funding (>60%)
		<i>B2.2</i>	Significant State budget funding (15-60%)
		<i>B2.3</i>	Insignificant State budget funding (<15%)
Group C	<i>C1</i>		State aid support
	<i>C2</i>		Culture
	<i>C3</i>		Healthcare
	<i>C4</i>		Education
	<i>C5</i>		Sports

Figure. SOE segmentation – economic role split

Despite a deliberate attempt by the State Chancellery of Republic of Latvia to motivate policy makers to implement a comprehensive and formal SOE segmentation, the economic role split has not received a wide acceptance and is not formally used in Latvia.

Box 3.8. – Segmentation proposed in the State ownership policy review document

In 2019, the EC, Structural Reform Supportive Service supported an assignment²¹² on the State ownership policy review in Latvia. The aim of the assignment was to enhance the operational capacity of CSCC of Latvia in its role as coordinator of the State’s holdings in SOEs, in collaboration with other stakeholders such as line ministries, SOEs and other state agencies.

Through a consolidation of a wide range of different “SOE-relevant” parameter (e.g., role in the market, national security), the assignment proposed a new form of SOE segmentation.

While the proposed approach provides a detailed SOE segmentation from which a further SOE classification can be based on clearly identifiable and separable characteristics, the policy makers have not formally adopted it. The proposed approach in State ownership policy review assignment currently takes the form as a broad level recommendation as to how the key policy maker should classify the SOEs.

²¹² KPMG Baltics. State ownership policy review in Latvia.

Annex 13. Process of classification to the State budget

The proposed segmentation approach includes categorization of the SOEs based on the main source of the income generate by the SOE, thus categorizing SOEs in commercially self-sufficient SOEs and SOE classified in State budgetary framework strongly relying on the State funding.

To categorize SOEs it is necessary to, firstly, examine their applicability to the state budgetary framework as the applicability significantly impacts SOE financing instruments. Secondly, it is necessary to determine the criteria for SOEs to be considered as fully commercial.

SOE applicability to the State budgetary framework

SOE applicability to the State budget is covered on the EU level by the European System of Accounts (hereafter ESA 2010) and further expanded upon by the European Commission's Manual on Government Deficit and Debt (hereafter MGDD).

SOEs can be understood as a part of the State budget and as independent commercial institutions by providing the delimitation of the “general government sector”. The general government sector is defined as following:

“the general government sector consists of institutional units which are non-market producers whose output is intended for individual and collective consumption, and are financed by compulsory payments made by units belonging to other sectors, and institutional units principally engaged in the redistribution of national income and wealth.”

Therefore, allowing to pinpoint the criteria (described in figure below) to qualify of SOEs as a part of the “general government sector”:

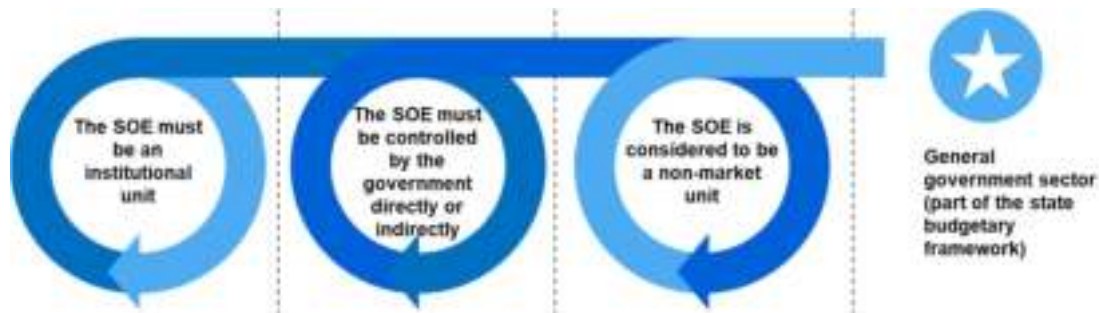


Figure. Criteria to qualify SOE as a part of the “general government sector”

Due to the corporate governance framework of the State-owned enterprises, all SOEs qualify with the criteria - being institutional unit and is controlled by the government directly or indirectly. Therefore, to determine SOE applicability to the Sate budgetary framework the quantitative market/non-market test must be carried out.

Definition of market/non-market unit

“Non-market producers provide all or most of their output to others free of charge or at prices that are not economically significant. Economically significant prices are prices which have a substantial influence on the amounts of products producers are willing to supply and on the amounts of products that purchasers wish to acquire.”

Therefore, in order to be classified as a non-market unit the SOE should comply with the following two criteria:

1. If the revenue source is above 50% from the private market it must be assessed whether the prices are of “significant price”.

2. Economically significant price is determined based on quantitative market/non-market test by using the ratio of sales to production costs. To be a non-market producer, the non-market unit covers less than 50% of its costs by its sales over a sustained multi-year period. Which makes it necessary to consider the following variables:

2.1. [...] sales of goods and services correspond to sales receipts, in other words to the market output increased by payments for non-market output, if any. Own-account production is not considered as part of sales in this context. Sales exclude also all payments received from government unless they are granted to other producers undertaking the same activity.

2.2. Production costs are the sum of intermediate consumption, compensation of employees, consumption of fixed capital and other taxes on production. For the purpose of the market/non-market test, production costs are increased by the net interest charge and decreased by the value of any imputed production, notably own-account production. Subsidies on production are not deducted.

Thus, the non-market unit is assessed through whether the sales of the producer cover a minority of the production costs.

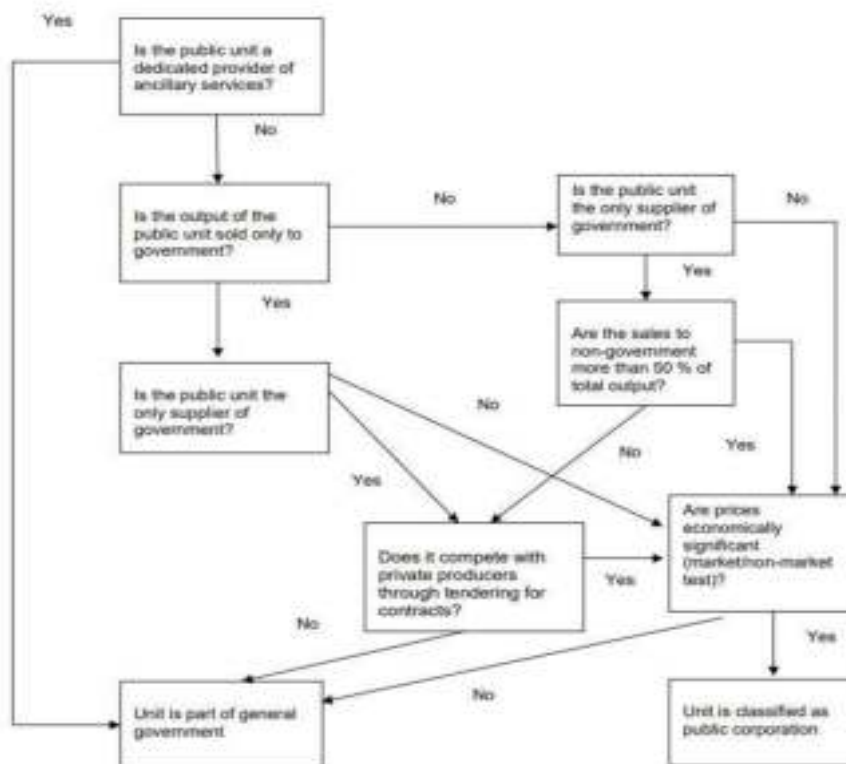


Figure. Market – no-market unit test

For the purpose of this Assignment the assessment of SOE classification to the State budgetary framework has not been carried out. For the SOE segmentation the status quo classification by the Central Statistical Bureau of Latvia is used (classification code: S130130).

Annex 14. Criteria for IPO readiness assessment

Quantitative measures

Higher priority

- 1. Positive historical and future cash flows sufficient to cover the expenses and generate positive returns.**

In the context of this methodology, this criterion would be considered fulfilled if the company has had a positive cash flow in the last three financial years and has a trustworthy forecast for a positive cash flow in the upcoming financial years. Additionally, the ROE is expected to be in the same range as the SOE's private sector competitors (or defined benchmark value).

Cash flow of a company is used to evaluate its performance and economic value, it represents the value available to be reinvested in the company or distributed to the shareholders depending on the company's future growth opportunities and the dividend policy the company applies as a result. Company's cash flows are used to determine value; therefore, low cash flows after the appropriate discounting process can result in a low company valuation, lower the possibility of attracting investors and securing a favourable pricing as a result.

- 2. Stable, predictable and high yielding dividend policy.**

Having a dividend pay-out ratio of at least 50% over multiple year period without large changes or deviations in the pay-out ratio is assumed to signify a stable and predictable, high yielding dividend policy.

Dividend policy is an important factor for any company, because it has a strong signalling effect to shareholders, market, and it reflects the financial performance of the company. A stable dividend pay-out policy signals both company's present stability and future growth and has an impact on the valuation of the company. Dividend pay-out policy is also an important factor in keeping the management of the company accountable, as there is a certain level of profit that needs to be paid out in dividends. Several pan-Baltic institutional investors pinpointed to the fact that a high yielding dividend policy is a very crucial factor for them when contemplating on investing in Baltic stock exchange. It was argued that dividends are the only viable way how to enjoy cash flows from Baltic investments as making divestments typically brings some form of liquidity discount.

- 3. Company's indicative valuation over EUR 100 million.**

For a company to be able to perform a successful IPO by attracting a diverse investor base and have a stimulative effect on the overall development of domestic capital market, it has to reach a certain valuation, size. Company's indicative valuation is suggested to be calculated using valuation ratios like price to earnings (P/E), price to cash flow (P/CF) or price to book (P/B). These metrics are widely used to evaluate companies and, therefore, can be easily compared within a peer group, and in the same time provide an easy way to gauge the approximate valuation levels.



Lower priority

4. Positive growth prospects for the company and industry / sector in which it operates.

The company and the sector it operates in is perceived to have positive growth prospects if the management expectation for the sector's compounded annual growth rate (CAGR) in the foreseeable future would be higher than the inflation rate.

The positive growth prospects are important in the IPO process, because they have an impact on the way how potential investors evaluate the company. If the growth prospects of the company or the sector it represents are not well perceived and imply negative growth patterns, the forecasted cash flows might be assumed to shrink over time. Therefore, the company value, being the discounted cash flows, could be subject to low valuation levels.

5. Healthy market valuation levels, and not bear market.

A company should not perform an IPO when the market is in a decline or can be described as a bear market. Market can be called a bear market if it experiences a long period of price declines, more precisely, when security prices have fallen more than 20% from their 52-week highs. In a depressed market, investors are likely to be overly risk averse when deciding on investment strategies.

6. Meaningful sales exposure in foreign markets.

In order for a company to fulfil this criterion sales to foreign markets as a percentage of total sales should be at least 10%. Sales to foreign markets bring different advantages to the company and its future development. First, company's presence in other countries opens up the possibility to attract more customers and increase total sales. Second, similar to customer attraction, the company also has a benefit of being able to attract more diverse talent pool, third, exposure to foreign markets can give competitive advantage in markets which competitors have not yet entered. And finally, presence in foreign markets provides great business diversification opportunities and mitigates the damages an event in one country / market can have on the company which is present in several different markets. Some examples of risks that diversification can mitigate are exchange rate risk and interest rate risk.

7. Minimal level of free float at 25%

In terms of IPOs and public companies free float is defined as the amount of company's shares that are freely tradable in the secondary market. Free float is calculated by subtracting the restricted shares and closely held shares of the company from the total number of outstanding shares. Restricted shares often being the shares held by the management, and closely held shares being owned by long-term shareholders, therefore, not available to be freely traded. For an SOE planned to become publicly traded, the free float should be too far below 25%.

Free float restricts the ownership proportion that can be left to the government organisations and provides the necessary volume of outstanding shares for institutional investors to be interested in trading these shares. Shares with low free float percentage are often more volatile with low liquidity and bigger bid-ask spread, which forces institutional investors to assign liquidity discounts.

Qualitative measures

Higher priority

1. Good corporate governance standards implemented across the entire organisation – in compliance with OECD and best practices.

OECD have well developed corporate governance principles, which now have been adopted as the international benchmark. Application of good corporate governance standards are important to provide a transparent view on the company and its organisational processes and build stakeholder trust, in turn fostering company's economic growth and performance. In result, presence of good corporate governance standards is associated with higher total gain, company's attractiveness in the eyes of potential investors and public.

2. ESG considerations present in the company's current as well as future operations.

ESG covers environmental, social and governance related details / concepts. Environmental criteria looking on the impact company has on nature and the surrounding environment, social criteria on the relationship management with stakeholders, for example, customers and employees, and governance criteria on the transparency of company's policy and processes, for example, accounting.

The existence and standards of ESG criteria are evaluated by potential investors who are socially conscious, and, therefore, the existence of ESG considerations can influence their investment decision. In the last decade the presence of ESG considerations have become more and more important, which is also expected from most of the larger pan-Baltic investors.

3. Clear reasoning behind IPO ("Investment driven" or "ownership driven").

To execute IPO properly it is critically important for the key stakeholders (shareholder, supervisory board and executive management) to understand the underlying goal of IPO. Otherwise, lack of clarity on why the IPO is conducted might introduce several detrimental risks that could lead to unmet expectations from the IPO. For example, the proceeds could be inadequately used (used in not value maximizing way) or the overall structuring of pre-IPO phase could suffer from miscommunication and weak dialogue with the market.

The supervisory board should ensure that it has received sufficient information and clarity around the IPO rationale – why it is conducted, what benefits it will bring, and how it is tied to the long-term development of company. In general, there exist two broad reasons behind IPO: one which is investment driven and other which is focused more on improving the ownership and corporate governance.

4. Seasoned executive board team and highly experienced and independent supervisory board with no scandals or controversies in the past.

Experienced executive board and supervisory board with clean past are important for any company, especially when preparing for an IPO. It becomes especially important in the pre-IPO period, because any details with bad underlining tone (like scandals) can have an indirect negative influence on the company's valuation. Company can experience a weak valuation due to the lack of boards' lack of credibility and investor confidence in them.



Lower priority

5. Financial risk is properly managed and not elevated.

Company's financial risk is related to the debt and overall leverage levels, financial risk management can be assessed by evaluating company's capital structure, credit profile and, more generally, performance and management's actions when operating company's cash flows, and its response to different market wide changes / events. It is important for the company to have proper risk mitigation action plan in place, for example, hedging against interest rate or exchange rate changes.

Financial risk can arise due to unforeseen outside forces, and can have an impact on the entire company, which would be hard to overcome, therefore, financial risk management is important for the company to be able to respond to market changes.

6. Credit rating from a top-tier agency on an issuer level.

In the pre-IPO period, it comes as advantage if a company has already obtained a credit rating from a well-established and known credit rating agency. The fact that a company has received a credit rating in itself speaks of how robust the organization is and that a transparency is not an issue. Although it is important to receive a credible credit rating before an IPO, the rating level is not proven to have a significant effect on company's valuation.

7. Transparent public reporting with additional (albeit not mandatory) levels of reporting.

Financial reporting is considered transparent when the information is trustworthy, high quality and clearly laid out for potential investors to obtain and use in the decision-making process. Both the quality and amount of information published by the company is important.

Transparent reporting is of great importance, because its existence influences investors' decision to invest or not in the company. Lack of information provided can create suspicion about details the company might want to hide and put off potential investors. Furthermore, complex businesses and, therefore, their financials are seen as riskier investments.

Annex 15. SOE financial target setting walkthrough

The main goal of the walkthrough is to explain and visualize proposed target setting methodology.

<i>Fillable information</i>	
<i>Auto-populated information</i>	

CY – last reported year

SOEs details and segmentation

SOE DETAILS	
Company name	<i>Name of the SOE</i>
Industry	<i>Damodaran split used</i>
Is the Company classified to the State budget?	<i>Y / N</i>
Has Company issued bonds?	<i>Y / N</i>
Credit rating (if applicable)	<i>Y [Select] / N/A</i>
Market type	<i>Regulated / Partially regulated / Unregulated</i>

If a commercial SOE has significant IPO potential, it should pursue target setting methodology based on the credit rating approach, otherwise the SOE should follow State dependent commercial methodology.

Applicable credit rating methodology	<i>Example: Unregulated Utilities and Unregulated Power Companies</i>
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Source used in target setting – Rating Methodologies (source free of charge, **registration necessary**), <https://www.moodys.com/researchandratings/methodology/003006001/rating-methodologies/>.

Applicable benchmark base	<i>Credit rating OR Industry average and peer group / Industry average and peer group</i>
---------------------------	---

Credit rating approach used for Coverage and Leverage target setting.

Budget financing, grants or subsidy / Net turnover [last 3-year average, %]	<i>State budget financing ratio is calculated based on manual data inputs from SOE FINANCIALS part</i>
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Is SOE non-profit, mostly ensuring its non-commercial strategic objectives?	<i>Y / N</i>
---	--------------

Based on the information provided, SOEs are segmented into one of three segments.

Segment	<i>Commercial / State dependent commercial / State dependent non-commercial</i>
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Although not mandatory, though advisable that state dependent non-commercial SOEs would consider capital structure, return and dividend policy (if applicable) target setting based on the state dependent commercial SOE methodology.



SOE FINANCIALS				
	CY	CY-1	CY-2	CY-3
Net turnover				
Net income				
Budget financing, grants or subsidy				
Paid dividends				
D E				
ROE				
Dividend pay-out ratio				

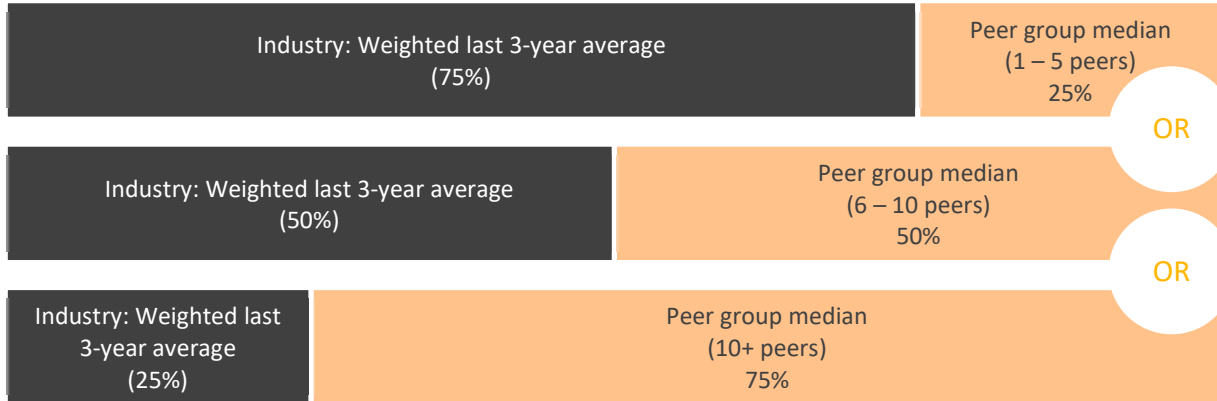
Particular SOEs operate in regulated markets or part of the operations is financed by the State. In order to properly benchmark business, commercial operation should be segregated and benchmarked separately from other (regulated / State financed) operations.

<i>Segmented operations (if applicable)</i>	CY	CY-1	CY-2	CY-3
Net turnover (commercial)				
Net turnover (regulated)				
Net turnover (state financed)				
ROE (commercial)				
ROE (regulated)				
ROE (state financed)				

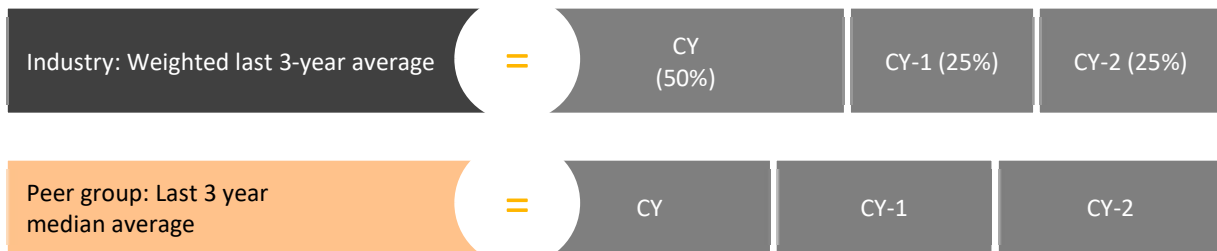
Segments should be attributed according to diversified and traceable operations of the Company correctly reflecting the corresponding amounts.

SOEs benchmarking

Suggested structure of weighted 3-year benchmark (industry and peer group)



Benchmarking in general should be performed against the industry SOE operates in as well as the peer group in order to minimize extremes impact. Suggested benchmarking includes application of weights for the year of the industry benchmark as well as the weights for industry and peer group proportion based on the size of a peer group.



Weights selection

If reasonable concerns arise over the suggested weights, methodology foresees discretionary weight setting that can be used if agreed upon with the Coordination Institution.

Weights	Discretionary	
Peer group size*	Discretionary	
	Suggested	Discretionary
	Peer group (1 - 5 peers)	Peer group (1 - 5 peers)
Industry weight	75%	
Peer group weight	25%	
	OR	OR
	Peer group (6 - 10 peers)	Peer group (6 - 10 peers)
Industry weight	50%	
Peer group weight	50%	
	OR	OR
	Peer group (11 - 15 peers)	Peer group (11 - 15 peers)



Industry weight	25%	
Peer group weight	75%	
	AND	AND
Industry (CY)	50%	
Industry (CY-2)	25%	
Industry (CY-1)	25%	

Industry average (Damodaran)²¹³

Average D E ratio CY	
Average D E ratio CY-1	
Average D E ratio CY-2	

Average ROE CY	
Average ROE CY-1	
Average ROE CY-2	

Average dividend pay-out ratio CY	
Average dividend pay-out ratio CY-1	
Average dividend pay-out ratio CY-2	

Peer group

Peer group constituents' structure should be coordinated with the Coordination Institution.

Company	D E (CY)	D E (CY-1)	D E (CY-2)	ROE (CY)	ROE (CY-1)	ROE (CY-2)	Dividend pay-out ratio (CY)	Dividend pay-out ratio (CY-1)	Dividend pay-out ratio (CY-2)
Company 1									
Company 2									
Company 3									
...									
Company X									
<i>Median</i>									

Suggested weights of the peer group are dependent on the size of the group (1-5, 6-10 and 11+).

Segmented ROE approach

If an SOE has other operations rather than commercial – regulated or state financed, applicable benchmarks should be used.

Benchmark value (regulated)	
<i>Example (Latvenergo): "Par kapitāla atdeves likmi elektroenerģijas pārvades sistēmas un elektroenerģijas sadales sistēmas pakalpojumu tarifu projekta aprēķināšanai"</i>	
Benchmark value (state financed)	

²¹³ Source used in target setting – Current data / Archived data, <http://pages.stern.nyu.edu/~adamodar/>

Credit rating with example

The SOE should choose the leverage ratio and criteria (value range) available in the credit rating methodology against which comparison should be made. Please refer to the available ratios per specific methodology.

Example: Latvenergo

Leverage factor used:	RCF / Net debt
Company's CY RCF / Net debt	17.10%
Company's CY-1 RCF / Net debt	14.90%
Company's CY-2 RCF / Net debt	47.30%
Company's CY-3 RCF / Net debt	44.50%
Target credit rating	Baa
RCF / Net debt (Lower margin)	15.00%
RCF / Net debt (Upper margin)	25.00%
Average margin	20.0%



MOODY'S INVESTORS SERVICE INFRASTRUCTURE AND PROJECT FINANCE

Key indicators

Exhibit 2
Latvenergo's credit metrics will likely remain robust, supported by improved hydrology and positive effects on its cash flow from the transfer of its transmission grid assets

	Dec-15	Dec-16	Dec-17	Dec-18	Dec-19	LTM Mar-20	12-18 month forward view
(CFD Pre-W/C + Interest) / Interest	16.1x	24.1x	30.5x	28.8x	28.4x	29.4x	19x - 24x
FFO / Debt	35.9%	44.1%	45.0%	32.0%	30.1%	32.8%	27% - 32%
FFO / Net Debt	40.9%	57.2%	62.8%	37.7%	34.6%	40.6%	31% - 36%
FCF / Net Debt	30.3%	44.5%	47.3%	14.6%	17.1%	21.7%	17% - 22%
FCF / Net Debt	3.5%	12.4%	2.2%	-13.6%	-0.8%	-12.0%	-8% - +4%

Ratios are based on Adjusted financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. For definitions of Moody's most common ratio terms, please see the accompanying [User's Guide](#). Source: Moody's Financial Metrics™

3-year Average	Min	Q1	Q3	Max	Min	Q1	Q3	Max	Sub-Factor Weighting
(CFD Pre-W/C + Interest) / Interest	<15%	15% - 16%	16% - 18%	18% - 30%	25% - 42%	25% - 42%	42% - 42%	>1%	10%
(CFD Pre-W/C) / Net Debt	<40%	40% - 40%	40% - 40%	40% - 40%	40% - 40%	40% - 40%	40% - 40%	<1%	10%
FCF / Net Debt	<40%	40% - 40%	40% - 40%	40% - 40%	40% - 40%	40% - 40%	40% - 40%	<1%	10%

Acceptable deviation

In accordance with the Guidelines for the Development of Medium-Term Operational Strategies for State Capital Companies by CSCC, insignificant deviations from the target value are allowed but must not exceed the 15% mark. In order to avoid insignificant deviations due to small ratio, adjusted deviation applied²¹⁴:

- 1) Benchmark < 6.5% or 0.065, applicable deviation 25%
- 2) Benchmark >= 6.5% or 0.065, applicable deviation 15%

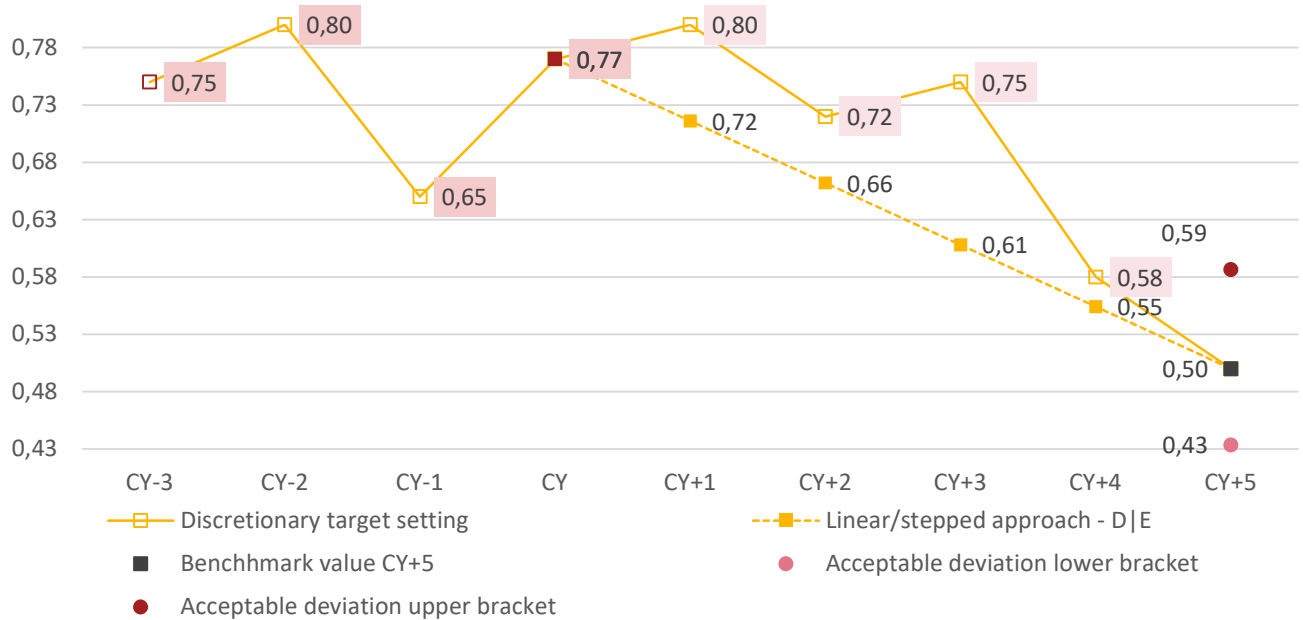
Discretionary target setting for intermediary periods

Example (Capital structure)

D E	0.50	Benchmark value CY+5								
	CY-3	CY-2	CY-1	CY	CY+1	CY+2	CY+3	CY+4	CY+5	
Discretionary target setting	0.75	0.80	0.65	0.77	0.80	0.72	0.75	0.58		
Linear/stepped approach - D E				0.77	0.72	0.66	0.61	0.55		
Benchmark value CY+5										0.50
Acceptable deviation lower bracket										0.43
Acceptable deviation upper bracket										0.59

²¹⁴Source: Valsts kapitālsabiedrību vidēja termiņa darbības stratēģijas izstrādes vadlīnijas, http://www.valstskapitals.gov.lv/images/userfiles/vid_term_darb_strat_vadlinijas_28082018.pdf

In order for the company to be able to follow the progress towards achieving target ratios in the interim, both the linear step method is offered, as well as the option to adjust the ratios towards the targeted value if the company has reasonable forecasts of the impact of specific events.



Methodology for setting financial goals *illustrative sample [1/7]*

SOE Details	
Company name	Commercial SOE
Industry	Transport (Railway)
Is the Company classified to the State budget?	No
Has Company issued bonds?	No
Credit rating (if applicable)	Not applicable
Market type	Partially regulated
Applicable credit rating methodology	Rail and bus passenger transport
Applicable benchmark base	Credit rating OR Industry average and Peer group
Budget financing, grants or subsidy / Net turnover (last 3y average, %)	50%
Is SOE non-profit, mostly ensuring its non-commercial strategic objectives?	No
Segment	Commercial SOE

Illustrative sample (Commercial SOE)

Based on the data provided, the sample Commercial SOE belongs to the commercial segment, where the credit rating and industry average, as well as the Peer group (group of comparable companies) are used as a basis for calculating benchmarks. For demonstrative purposes, it is assumed that the company operates in the transport (railway) sector.

Information to be filed in information populated automatically

Segmentation

Based on the parameters provided by SOE (classification to the state budget, ratio of state budget financing / grants / subsidies, fulfillment of non-commercial strategic goals) and DLE (owner's letter of expectation), the SOEs are segmented into particular segments:

1. Commercial SOE
2. State-dependent commercial SOE
3. State-dependent non-commercial SOE

Methodology

Optimal capital structure – In order to determine the optimal capital structure of a commercial SOE, it would be advisable to use a credit rating approach, which involves comparing the coverage ratios with the values specified in the relevant credit rating methodology. If an SOE does not envisage, for example, a bond issuance or an IPO, SOE capital structure should be compared to the industry and a peer group, if not the methodology for determining the optimal capital structure for state dependent commercial SOEs should be used. However, if the SOE is planning a new bond issue or IPO but has not issued bonds before, then the company's capital structure coverage should be compared against publicly available credit rating methodologies, where coverage target values are defined at the investment grade level.

Return-On-Equity (ROE) – should be compared to the industry and a peer group. The industry breakdown is corresponds with the industry breakdown methodology prepared by Aswath Damodaran (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2222222).

Dividend policy – should be compared to the industry and a peer group, hence comparison should be reviewed in the context of maintaining or obtaining an investment grade credit rating (BBB and above), which has a direct impact on coverage.

Financing instruments – should be reviewed based on the specifics of a particular segment. The optimal capital structure, return and dividend policy of state dependent SOEs are compared to industry and a peer group, regardless of the credit rating approach.

Input values *illustrative sample [2/7]*

SOE input values	CY - Current year	CY-1	CY-2	CY-3
Net turnover	60,500,225	75,258,758	78,100,909	62,200,900
Net income	5,328,900	4,754,750	4,704,900	2,988,900
Budget financing, grants or subsidy	5,600,000	6,200,000	4,900,000	3,900,000
Paid dividends	3,500,000	2,300,000	1,800,000	1,200,000
RCF / Net debt	0.70	0.92	0.88	0.84
RCE	4.54%	3.16%	2.89%	4.20%
Dividend pay-amount ratio	71.8%	48.2%	42.5%	78.2%
Degmented operations (if applicable)				
Net turnover (commercial)	68,425,191	65,808,153	42,480,900	69,348,673
Net turnover (regulated)	12,075,034	9,762,598	15,620,000	13,152,128
RCE (state financed)				
RCE (commercial)	6.25%	5.18%	5.75%	6.12%
RCE (regulated)	2.14%	1.98%	2.07%	2.23%
RCE (state financed)				

Illustrative sample (Commercial SOE)

It is assumed that the sample SOE operates in a partially regulated market, where the regulated market share is determined by tariff restrictions, which in turn limits the company's ability to profit in the context of an unregulated industry.

In the example, the SOE keeps appropriate records of its activities, as a result of which it is possible to separate the commercial activities of the SOE from regulated activities and calculate the return on the commercial and regulated activities.

Input values to be provided in the SOE:

- Net turnover
- Net income
- Budget financing, grants or subsidy
- Paid dividends
- Coverage ratio (credit rating methodology) - e.g. RCF / Net Debt, Debt / EBITDA, FFO / Debt, etc. if applicable
- Debt-to-equity ratio (DER), if applicable
- RCE
- Dividend pay-amount ratio

Commercial SOE should be able to provide information (e.g. RCF / Net Debt) that would be comparable to the values specified in the credit rating methodology.

If an SOE operates in a semi-regulated market, the SOE should be able to separate regulated activities from commercial activities. In addition, if the SOE receives state financing for particular activities, these activities should also be separable per financial accounts. The classification of activities should be traceable, correctly reflecting the amounts per operation segments.

The benchmark for regulated activities could be rooted in, for example, Decisions of the Council of the Public Utilities Commission regarding the rates of return on capital for the calculation of tariffs.

Information to be filled in
Information populated automatically

Benchmark weighing *illustrative sample [3/7]*

The benchmarking should be done in the context of the relevant industry, as well as against the comparable group of companies (a peer group), in coordination with the CSOC, in order to reduce extreme impacts and provide a more objective result.

The proposed benchmarking involves the application of weights in both industry and group contexts, using the size of the peer group (1 - 5, 6 - 10 and 11+) as the weight selection lever.

Structure of recommended weights (depending on the size of the peer group)



If reasonable concerns arise about the application of the recommended weights, the methodology foresees **discretionary** (optional) weights that can be used in coordination with the CSOC.

Illustrative sample (Commercial SOE)

To reflect the use of discretionary weights, a weight of 70% is applied to the industry against 30% of the peer group, based on the size of the peer group - 10 companies. Discretionary weights are also applied to the industry indicators - CY: 70%, CY-1: 20% and CY-2: 10%.

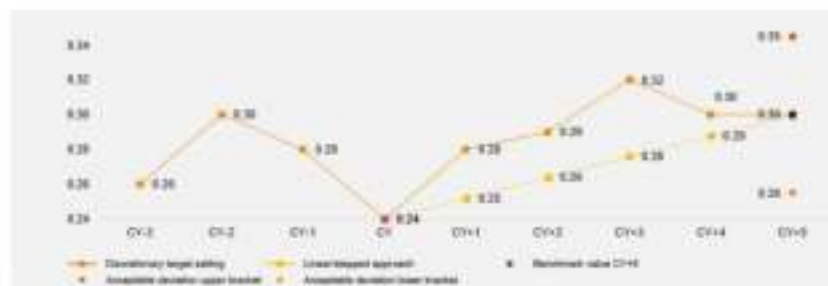
Weights	Discretionary	
Peer group (number of constituents)	10	
	Suggested	Discretionary
	Peer group (1 - 5)	Peer group (1 - 5)
Industry weight	75%	
Peer group weight	25%	
	OR	OR
	Peer group (6 - 10)	Peer group (6 - 10)
Industry weight	30%	30%
Peer group weight	70%	70%
	OR	OR
	Peer group (11+)	Peer group (11+)
Industry weight	25%	
Peer group weight	75%	
	AND	AND
Industry (CY)	70%	70%
Industry (CY-1)	20%	20%
Industry (CY-2)	10%	10%

Information to be filled in
Information populated automatically

Capital structure *illustrative sample [4/7]*

The level of SOEs liabilities against the ability to generate cash flow at the beginning of the medium-term strategy is higher than the allowable norm for achieving an investment credit rating, which indicates a possible increased financial risk, and unprofitable investments. The objective for the SOEs capital structure foresees that over the medium-term strategy, the level of SOEs liabilities should be reduced by making investments that are able to generate high cash flow over a 5-year period, reducing dividends paid and / or raising additional equity (IPO).

	Budget reviews								
	CY-3	CY-2	CY-1	CY	CY+1	CY+2	CY+3	CY+4	CY+5
Discretionary target setting – RCF / Net debt	0.26	0.30	0.28	0.24	0.28	0.29	0.32	0.30	
Linearstepped approach – RCF / Net debt				0.24	0.25	0.26	0.26	0.26	
Benchmark value CY+5									0.25
Acceptable deviation lower bracket									0.26
Acceptable deviation upper bracket									0.25



According to CSOC guidelines 15% deviation from the target is acceptable. In order to avoid insignificant deviations due to small ratio, adjusted deviation applied:

-) if benchmark = 0.0% val 0.065, applicable deviation 25%
-) if benchmark >= 0.5% val 0.065, applicable deviation 15%

ROE – Commercial segment *illustrative sample [5/7]*

The return (return on equity, ROE) of the SOE at the beginning of the medium-term strategy lags behind the average return of the sector / industry and its closest competitors, indicating low-return investments or an excessively high cost base in the context of the commercial segment. The SOEs return target foresees that the SOE could increase the return results over a 5-year period by making sufficiently profitable investments and / or optimizing the cost base.

	Budget reviews								
	CY-3	CY-2	CY-1	CY	CY+1	CY+2	CY+3	CY+4	CY+5
Discretionary target setting – ROE (Commercial)	2.14%	1.94%	1.74%	1.99%	2.46%	2.76%	2.94%	3.19%	
Linearstepped approach – ROE (Commercial)				1.99%	2.17%	2.31%	2.46%	2.62%	
Benchmark value CY+5									2.62%
Acceptable deviation lower bracket									2.28%
Acceptable deviation upper bracket									3.00%



According to CSOC guidelines 15% deviation from the target is acceptable. In order to avoid insignificant deviations due to small ratio, adjusted deviation applied:

-) if benchmark = 0.0% val 0.065, applicable deviation 25%
-) if benchmark >= 0.5% val 0.065, applicable deviation 15%

ROE – Regulated segment *illustrative sample [6/7]*

The return (return on equity, ROE) of the SOE at the beginning of the medium-term strategy lags behind the permissible maximum. This indicates low-return investments or an excessively high cost base also within the regulated segment. The EQS return target is that the EQS increases the return results over a 5-year period by making sufficiently profitable investments and / or optimizing the cost base.



According to CSOC guidelines 15% deviation from the target is acceptable. In order to avoid insignificant deviations due to small ratio, adjusted deviation applied.

)} If benchmark < 0.5% var 0.065, applicable deviation 25%

)} If benchmark >= 0.5% var 0.065, applicable deviation 15%

Dividend policy *illustrative sample [7/7]*

The dividend payout ratio of the SOE relative to net income at the beginning of the medium-term strategy is significantly higher than the average dividend payout level of the sector / industry and its closest competitors. This indicates a potentially increased financial risk, unsustainable growth and a lack of (or inability to define) profitable investments. The goal of the SOE dividend policy foresees that the SOE reduces the amount of dividends paid over a period of 5 years, which will help achieve the objectives of the capital structure and stimulate new investments in order to meet the set return targets.



According to CSOC guidelines 15% deviation from the target is acceptable. In order to avoid insignificant deviations due to small ratio, adjusted deviation applied.

)} If benchmark < 0.5% var 0.065, applicable deviation 25%

)} If benchmark >= 0.5% var 0.065, applicable deviation 15%



Annex 16. Methodology testing on the selected sample of SOEs

Please see document – Methodology testing of the selected SOEs.

Annex 17. Proposed legislative changes

Proposed legislative changes to implement SOE ownership policy	Stakeholders involved in the legislative procedure:
<p>1. State should develop unified SOE Ownership Policy document complying and clearly defining State’s overall SOE ownership policy strategy and objectives towards SOEs. The SOE ownership policy should compile States ownership strategy expressed in Latvia's sustainable development strategy, Latvia’s National Development Plan and the Government’s Declaration of the intended activities of the Cabinet of Ministers, SOEL and Conception of management of State capital shares, Conception of public person’s commercial activities, National Security law and the subsequent sectoral policies.</p> <p>The SOE Ownership Policy should be developed as medium-term policy planning document aligned with the political cycle and government’s period of operations and aimed at achieving specific objectives of national importance and covering a wide range of issues. The SOE Ownership Policy and State’s objectives toward SOE should be subject to public disclosure.</p> <p>The State Ownership Policy should:</p> <ul style="list-style-type: none"> • determine State’s rationale towards participation in companies providing specific criteria and strategic rationale for State’s participation in SOEs; • scrutinize State’s participation in SOEs and encourage to establish or maintain a participation in an SOE only if the strategic objective for establishing or maintaining participation in SOE cannot be achieved by exercising its public power directly through the State administration or by encouraging private market participants to ensure delivery of the necessary goods or services; • based on the State’s rationale towards participation in a SOE the SOE Ownership policy should clearly establish SOE segmentation process; • establish clear objectives towards each of the SOE segments; • include the State’s objectives on a sectoral level in order to provide a clear guidance for the SOEs; • include overall SOE public policy objectives; • impose an obligation for commercial SOEs to have an IPO assessment evaluating their readiness to tap the capital market; • include preferred list of financing options for each of the SOE segment; • include an obligation for SOEs to actively evaluate different financing options based on the appropriate SOE segment; 	<p>Developer of Policy document: CSCC & Line ministries</p> <p>Approved by: Cabinet of Ministers</p> <p>Adopted by: Cabinet of Ministers</p> <p>(Developer of SOEL amendments: CSCC & Line ministries</p> <p>Approved by: Cabinet of Ministers Adopted by: Parliament)</p>

<ul style="list-style-type: none"> • as an owner, the State should have high ambitions for sustainable business and conduct the business activities in a socially conscious manner. For example, the implementation of ESG standards, focus on green investments and overall carbon dioxide reductions could be defined as additional objectives for the SOEs. • enhance Coordination Institution’s role in the SOE governance. The State Ownership Policy should allow the Coordination Institution to act as a temporary Supervisory member for a period up to one year, if (1) the SOE’s Supervisory board has been established for its first term or there are significant changes in the SOE Supervisory board i.e., at least half of Supervisory board members have changed or (2) shareholder has requested Coordination Institution’s assistance in SOE governance; • assign a dedicated working group consisting of Coordination Institution, shareholders, line ministries and SOE higher management to discuss more concretely the concept of SOE corporate governance index. The working group should jointly determine the expected benefits and the corresponding constraints of such index, where Coordination Institution could oversee the overall SOE alignment to the best corporate governance practices. 	
<p>2. Amend the current version of SOEL Section 22(2), stipulating that the Coordination Institution shall act as a temporary Supervisory member up to twelve month period after the shareholder’s invitation, if (1) the SOE’s Supervisory board has been established for its first term or there are significant changes in the SOE Supervisory board, i.e., at least half of Supervisory board members have changed, requiring successful transfer of institutional knowledge or (2) shareholder has requested Coordination Institution’s assistance in SOE governance;</p>	<p>Developer of draft law: CSCC Approved by: Cabinet of Ministers Adopted by: Parliament</p> <p>Budget law: additional financing for new function Developer of draft law: CSCC Approved by: Cabinet of Ministers Adopted by: Parliament</p>
<p>3. Amend the current version of SOEL Section 7(1), stipulating that a public person has a duty, not less than once in five years, to re-evaluate each of its direct participations in a capital company and the conformity thereof with the conditions of Section 4 of the SOEL. It is necessary to stipulate that the law does not provide any exemptions for the situations when the public person is permitted not to re-evaluate its participation in the SOE.</p>	<p>Developer of draft law: CSCC Approved by: Cabinet of Ministers Adopted by: Parliament</p>
<p>4. Amend the current versions of Section 29(2) of SOEL establishing that in addition to the existing provisions the holder of State capital shares on its website publishes the evaluation for establishing/acquiring or continuing participation in the capital company. The evaluations must include the economic and competition neutrality assessments.</p>	<p>Developer of draft law: CSCC Approved by: Cabinet of Ministers Adopted by: Parliament</p>



<p>To protect the commercial secret of the capital company, assessment on continuing participation in the company shall be made public by obscuring information containing business secrets.</p>	
<p>5. Amend SASL Section 88 (2) and SOEL Section 7 stipulating that the evaluation for establishing/acquiring or continuing participation in the capital company must be performed in accordance with the Regulations of the Cabinet of Ministers or CSCC Guidelines determining the procedure for creating economic and competition neutrality assessments.</p>	<p>Developer of draft law: CSCC Approved by: Cabinet of Ministers Adopted by: Parliament</p>
<p>6. Develop Cabinet of Ministers Regulations or CSCC Guidelines, determining the procedure for creating and evaluating economic and competition neutrality assessments for establishing/acquiring or continuing participation in capital companies. The Cabinet of Ministers Regulations and minimum requirements for evaluations should be developed by CSCC and the Competition Council.</p>	<p>Developer of draft regulation or Guidelines: CSCC, Competition Council Approved & Adopted by: Cabinet of Ministers</p>
<p>7. Amend the Law on the Privatization of State and Local Government Property lifting prohibition to expropriate SOE shares. Additionally, based on the SOE Ownership Policy amend SOEL and relevant sectorial laws, for example Energy Law, Law on Forests, lifting prohibition to expropriate SOE shares and allowing all SOEs going public. Additionally, when establishing SOE or gaining participation in a company, the State should avoid limiting SOEs options to enter public market by determining the precise distribution of the stocks among shareholders. As in case of Law on Development Finance Institution.</p>	<p>Developer of draft law: CSCC, Line ministries Approved by: Cabinet of Ministers Adopted by: Parliament</p>
<p>8. Amend SOEL Section 36 <i>Information disclosure</i> indicating that SOEs in their Annual reports must provide transparency and disclosure around cost allocation and indicate precise information identifying the costs of any given function of commercial government activity and separating such costs from non-commercial activity.</p>	<p>Developer of draft law: CSCC, MOF, Line ministries Approved by: Cabinet of Ministers Adopted by: Parliament</p>



Proposed legislative changes to implement owner's letter of expectations	Stakeholders involved in the legislative procedure:
<p>1. Amend SASL Section 88 or SOEL Chapter V stipulating that when establishing or maintaining participation in the SOE, the shareholder is required to provide owner's letter of expectations indicating the SOE strategic and commercial objectives.</p> <p>The owner's letter of expectations should include the main notions of the economic and competitive neutrality assessments and must be drawn up based on the strategy and segmentation principles set in the SOE ownership policy and the Guidelines for setting the overall strategic objectives of public participation.</p> <p>Owner's letter of expectation should be aligned with the evaluation for State's participation in SOE and should be subject to the review every 5 years or in situations when the market changes require changes in SOEs operation or SOE is expanding its business activities.</p>	<p>Developer of draft law: CSCC</p> <p>Approved by: Cabinet of Ministers</p> <p>Adopted by: Parliament</p>
<p>2. Amend Section 3 of Guidelines for setting the overall strategic objectives of public participation including principles for the SOE classification – Commercial, State-dependent commercial and State-dependent non-commercial SOEs.</p>	<p>Developer of draft Guidelines: CSCC</p> <p>Approved by: Council of Coordination Institution</p> <p>Adopted by: CSCC</p>
<p>3. Amend Guidelines for setting the overall strategic objectives of public participation including general principles of the Owner's letter of expectation.</p> <p>The shareholder is responsible for the creation of owner's letter of expectation by outlining general strategic objective and high-level and long-term financial and non-financial objectives that the SOE should strive to achieve over the owner's letter of expectation term. The objectives set in the owner's letter of expectation should be oriented towards providing a path to which the SOE should be heading and feature sectoral and / or industry specific objectives that the SOE should consider in the process of capital allocation.</p> <p>The owner's letter of expectations should be tailored to each specific SOE considering the overall SOE ownership policy objectives, sector objectives, specific objectives and potential developments of SOE. The owner's letter of expectation should be a natural result of the evaluation for State's participation in SOE and should include at least:</p> <ul style="list-style-type: none"> • The reasoning for States participation in the SOE; • General strategic objectives; • SOE classification; • Non-financial objectives – strategic SOE ownership and sectorial policy objectives 	<p>Developer of draft Guidelines: CSCC</p> <p>Approved by: Council of Coordination Institution</p> <p>Adopted by: CSCC</p>

<ul style="list-style-type: none"> Financial objectives regarding rate of return, dividend policy and capital structure based on the proposed SOE financial target setting methodology <p>The owner’s letter of expectation should be renewed during the re-evaluation of State’s participation in SOE or adjusted in cases when there are structural changes in the market or company’s commercial and non-commercial activities.</p>	
<p>4. Develop Cabinet of Ministers Regulations on procedures for evaluation of objectives set in owner’s letter of expectations of a capital company in which the state has a decisive influence. The evaluation of fulfilment of objectives set in Owner’s letter of expectations should be carried out together with the evaluation of State’s participation in the SOE. The commercial SOE long-term performance should be assessed by the fulfilment of the objectives set in the Owner’s letter of expectations:</p> <ul style="list-style-type: none"> Fulfilment of strategic objectives set by the State Fulfilment of financial targets regarding rate of return, dividend policy and capital structure. Fulfilment of any additional commercial target set by shareholder or Supervisory board. <p>For the State-dependent commercial and non-commercial SOEs the long-term performance evaluation should be based on the assessment of the fulfilment of:</p> <ul style="list-style-type: none"> general strategic objectives; subsequent non-financial objectives; additionally, it should be determined whether SOE has increased its efficiency in ensuring goods or services set by general strategic objective. <p>The Supervisory board and shareholder should evaluate the overall performance of the SOE, including the fulfilment of the non-financial and financial objectives, as well as fulfilment of all objectives set in owner’s letter of expectations.</p> <p>Line ministry should provide its evaluation regarding the fulfilment of non-financial objectives and general strategic objectives set in Owner’s letter of expectation.</p> <p>Coordination Institution should provide its evaluation of the fulfilment of the financial objectives and general fulfilment of non-sectorial public policy set in owner’s letter of expectation with the specific focus on corporate governance objectives.</p> <p>For the State-dependent non-commercial SOEs the long-term performance evaluation should be based on the assessment of the fulfilment of general strategic objectives and subsequent public policy objectives, including non-financial objectives. Additionally, it</p>	<p>Developer of draft regulation: CSCC</p> <p>Approved & Adopted by: Cabinet of Ministers</p>



<p>should be determined whether SOE has increased its efficiency in ensuring goods or services set by general strategic objective.</p>	
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<p>Proposed legislative changes to implement SOE financing methodology in SOE medium-term strategies</p>	<p>Stakeholders involved in the legislative procedure:</p>
<p>1. Amend Guidelines on development of State capital company medium-term operation strategies stipulating that:</p> <ul style="list-style-type: none"> • medium-term guidelines should be developed for 5-year period and should be aligned with the objectives set in the Owner’s letter of expectations; and • SOE should follow financial target setting methodology based on the SOE segmentation described in Guidelines for setting the overall strategic objectives of public participation. <p>The financial target setting methodology should be applied on the explain or comply basis. If SOE decides not to follow financial target setting methodology, it is required to explain its applied target setting methodology.</p> <ul style="list-style-type: none"> • that in addition to the yearly performance evaluation medium-term strategy’s objectives are evaluated once in the strategy period. The evaluation of the medium-term strategy should be carried out together with the evaluation for State’s participation in the SOE. <p>The evaluation of the medium-term financial and non-financial objectives should follow the existing practices. I.e. the SOE should provide an overview for each of the objectives comparing</p>	<p>Developer of draft guidelines: CSCC</p> <p>Approved by: Council of Coordination Institution</p> <p>Adopted by: CSCC</p>

the planned and achieved results. If deviation from the planned results reaches or exceeds 15% management should provide its explanation.

- if necessary, SOEs can review and, if needed, update the financial indicators and targets to display SOE's financial and market situation. The changes in medium-term strategy should be in accordance with the objectives set in OLE. Consequently, in case of material changes in the market conditions (mostly influenced by low frequency external events), the Supervisory board is encouraged to initiate a dialogue with the owner explaining the prevailing circumstances of why the OLE should be reviewed and updated.

Additionally, the guidelines should be amended by including:

- A mechanism that guides Supervisory boards and Executive management teams on setting 5-year financial targets that are similar to those of comparable businesses. This is driven by applying credit rating methodology, industry/sector averages and a targeted sample size of comparable peers;
- A set of critical financial aspects – capital structures, return targets and dividends and the corresponding financial ratios, that have to be factored in to converge to comparable businesses and deliver sufficient returns without excessive risk taking. These financial aspects tackle company's balance sheet (optimal capital structure), income statement (rate of return targets), and shareholder's compensation level. This set of financial aspects tackles the most common financial targets set for SOEs as well as assesses a company from a similar perspective as OECD in defining well-defined optimal capital structures.
- Concrete financial metrics to be used for defining appropriate target values for each of the previously mentioned financial aspect (developed for a 5-year period and being subject to yearly review in case a allowable deviation range has been breached).
- A list of preferred financing instruments to be actively considered for each SOE segment



<p>2. Amend Cabinet of Ministers Ruling and CSCC Guidelines stipulating the procedure for evaluation the yearly performance of capital companies in which State has a decisive influence by including that:</p> <ul style="list-style-type: none"> • The evaluation of the medium-term strategic objectives is performed together with the evaluation for State’s participation in the SOE. • The medium-term strategic objectives are evaluated by comparing the planned and achieved results. If deviation from the planned results reaches or exceeds 15% management should provide its explanation. • The evaluation should also include the evaluation of the fulfilment of objectives set in the Owner’s letter of expectations. The SOE should provide an overview of an activities performed to reach each of the set objectives, as well as provide an overview of the achieved results. If the company has not reached the set objectives it is required to provide reasoning for it. • The Supervisory board and shareholder should evaluate the overall performance of the SOE, including the fulfilment of the non-financial and financial objectives, as well as fulfilment of the objectives set in Owner’s letter of expectations. <p>Line ministry should provide its evaluation regarding the fulfilment of non-financial objectives set in Owner’s letter of expectation.</p> <p>Coordination Institution should provide its opinion on general fulfilment of the objectives set in owners letter of expectations, with particular focus on the fulfilment of the financial objectives and non-sectorial public policy objectives set in OLE. This step should be accommodated with a sufficient data provision for Coordination Institution to be able to evaluate the previously mentioned aspects.</p>	<p>Developer of draft regulation: CSCC, Approved & Adopted by: Cabinet of Ministers</p> <p>Developer of draft guidelines: CSCC Approved by: Council of Coordination Institution Adopted by: CSCC</p>
<p>3. Amend Cabinet of Ministers Ruling on Procedures by which State-owned enterprises and public private capital companies in which the State is a shareholder forecast and determine the share of profit to be disbursed in dividends and make payments to the State budget for the use of State capital excluding that the minimum expected share of profit to be paid in dividends and the share of profit to be paid in dividends is 80% of the profit of the capital company for the reporting year.</p> <p>Amend Section 3 of the Rulings by stating that the minimum expected profit share to be paid in dividends should be based and paid out accordingly to the objectives set in owner’s letter of expectations and SOE’s medium-term strategy which is based on the principles specified in the SOE Ownership Policy.</p>	<p>Developer of draft regulation: CSCC, MOF Approved & Adopted by: Cabinet of Ministers</p>
<p>Proposed legislative changes in SOE yearly performance evaluation</p>	<p>Stakeholders involved in the legislative procedure:</p>



<p>1. Amend the Cabinet on Ministers Ruling on procedures for evaluating the performance and financial performance of a capital company in which the state has a decisive influence stipulating that:</p> <ul style="list-style-type: none">• the SOE short-term performance evaluation should be based on the evaluation of the SOE management and operational reports providing an adequate notion on the SOE’s operations. The SOE operational results should be compared with the SOE’s set short-term (yearly) target set in the budget or operational action plan.• For SOE that have established a Supervisory board, the evaluation of the yearly performance evaluation should be the Supervisory board’s responsibility.• For SOEs not having Supervisory boards, the existing SOE performance evaluation process should be strengthened by providing Coordination Institution access to the SOE budgets or operational actions plans allowing to evaluate SOE short-term performance.	<p>Developer of draft regulation: CSCC,</p> <p>Approved & Adopted by: Cabinet of Ministers</p>
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Annex 18. Example of the target setting methodology

Please be informed that the following example provides only theoretical approach and is not based on any particular SOE.

Non-financial objectives set in OLE:	Non-financial objectives set in medium-term strategy (5th-year target)	Non-financial targets set in yearly operational plan / budget:
1. Restore and modernize SOE's infrastructure	1.1. Renewed proportion of infrastructure (buildings and equipment), no less than X% ²¹⁵	1.1.1. Renewed proportion of infrastructure (buildings and equipment) in year 1, no less than X%; 1.1.2. Attracted investments in year 1, not less than X; 1.1.3. Renewed proportion of infrastructure (buildings and equipment) in year 2, no less than X%; 1.1.4. Attracted investments in year 2, not less than X; etc.
	1.2. Introduce new and innovative technologies, not less than X	1.2.1. Introduce new and innovative technologies in year 1, not less than X 1.2.2. Organized industry related seminars on the newest technologies in year 1, not less than X; 1.2.3. Introduce new and innovative technologies in year 1, not less than X 1.2.4. Organized industry related seminars on the newest technologies in year 1, not less than X; etc.
2. Increase society's satisfaction with SOE's provided services	2.1. Customer satisfaction, not less than X%	2.1.1. Customer satisfaction in year 1, no less than X%; 2.1.2. Returning clients in year 1, no less than X;
		2.1.3. Customer satisfaction in year 3, no less than X%; 2.1.4. Returning clients in year 4, no less than X; etc.

²¹⁵ All changes in percentages are either compared with baseline or previous year, based on the SOE's preferences.

Financial objectives set in OLE:	Financial objectives set in medium-term strategy (5th-year target)	Financial targets set in yearly operational plan / budget:
1. Achieve a rate of return target based on the stipulated SOE financial target setting methodology (commercial SOE category)	1.1. Return on equity (ROE) target of 13%	<u>Assuming linear progression towards the OLE (5yr) target. Starting year ROE 8%.</u> 1.1.1. Achieve ROE target of 9% in year 1. 1.1.2. Achieve ROE target of 10% in year 2. 1.1.3. Achieve ROE target of 11% in year 3. 1.1.4. Achieve ROE target of 12% in year 4. 1.1.5. Achieve ROE target of 13% in year 5.
2. Achieve and/or maintain capital structure based on the stipulated SOE financial target setting methodology (commercial SOE category)	2.1. Debt-to-equity (D/E) target of 0.4	<u>Assuming uneven progression towards the OLE (5yr) target. Starting year D/E 0.7 (overleveraged).</u> 2.1.1. Achieve D/E target of 0.7 in year 1. 2.1.2. Achieve D/E target of 0.8 in year 2. 2.1.3. Achieve D/E target of 0.7 in year 3. 2.1.4. Achieve D/E target of 0.6 in year 4. 2.1.5. Achieve D/E target of 0.4 in year 5.



Annex 19. IPO readiness assessment (confidential)

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