Transformation of corporate governance in the face of modern challenges

Galina Sheveleva

Melentiev Energy Systems Institute, Siberian Branch of the Russian Academy of Sciences, Irkutsk, Russia

Abstract. Russian generating companies in the power industry require a certain transformation of corporate governance to reduce the investment risks associated with today's challenges in order to increase investment attractiveness. For this purpose, the paper examines the rotation of ownership in these companies, the updated methodology of the Bank of Russia for assessing corporate governance, including in the context of the ESG agenda, HR strategy and growing digitalization. The results of a general assessment of the corporate governance of generating companies are presented; an additional analysis of the compliance of companies with the criteria for each of the sections of the Russian Corporate Governance Code was carried out; a comparative analysis of the structural characteristics of the boards of directors of Russian generating companies and foreign companies that are similar in terms of concentration of ownership (Germany) and the presence of the state in it (France) was carried out; the article presents the results of the assessment of internal documents. The generalization of the obtained data makes it possible to formulate proposals for further transformations of corporate governance in generating companies in the face of modern challenges, including new corporate governance standards with a certain set of additional compliance criteria, reorganization of boards of directors by updating the structural characteristics of the board, as well as the composition and content of internal documents.

Introduction

The problems of attracting investments in Russian electric power generating companies, which have become aggravated under the conditions of anti-Russian sanctions and the lack of alternatives to the domestic borrowing market, have not been resolved.

The purpose of the study is to search for further transformations of corporate governance in these companies in the interests of investors, taking into account modern challenges.

Mainly, wholesale and territorial generating companies of the electric power industry (hereinafter referred to as generating companies) were studied. The corporate governance assessment was performed for generating companies that published in their annual reports or reports on sustainable development on their official websites or the Interfax website reports on compliance with the principles and recommendations of the Corporate Governance Code (hereinafter referred to as the principles of the Code) [1]. This Code is based on OECD standards [2].

Publicly available information was used: reporting data and general corporate governance practices of these companies; Corporate Governance Code; Unified State Register of Legal Entities; information from the Bank of Russia; materials of information agencies Bigelectricpowernews and RosBusinessConsulting; business newspaper Kommersant; international company Spencer Stuart; National Council on Corporate Governance; French AFEP-MEDEF Code; JPMorgan Chase & Co. ESG reports; LECAP laboratories reports; authoritative ESG ratings (MSCI ESG rating, RAEX-Europe ESG ranking, ACRA); draft model methodology for ESG ratings of the Bank of Russia; Russian Institute of Directors, publications of domestic and foreign authors.

The rotation of ownership in generating companies at the end of 2022 and the accompanying transformation of corporate governance have been determined. The features of the updated methodology of the Bank of Russia for assessing corporate governance have been identified [3]. On its basis, the corporate practice of generating companies was assessed, which showed a relative deterioration, especially in section II of the Code (Board of Directors). A comparative analysis of the boards of directors of these companies and companies similar in terms of concentration of ownership (Germany) and the prevalence of the state in it (France) was carried out. By summarizing all the data obtained, the transformations of corporate governance are indicated. The transformations mainly concern in updating corporate governance standards and criteria for assessing compliance with these standards, as well as structural reorganization of boards of directors, and updating internal documents.
1 Property rotation

One of the current challenges is the departure of foreign owners and the accompanying rotation of the ownership of generating companies.

In 2022, the Italian Enel sold the shares of Enel Russia PJSC to Lukoil PJSC (26.9%) and the investment fund Gazprombank-Frezia (29.5%). The name of Enel Russia PJSC was changed to EL5-Energo PJSC. In 2023, 56.4% of the shares of EL5-Energo PJSC were transferred to Lukoil PJSC, 5.5% of this company was acquired by LLC PPTIT-7 [4]. Finnish Fortum and German concern Uniper were not allowed to withdraw from Russian generating assets. However, Uniper, which owns Unipro, deconsolidated the assets of this company in 2022 and classified its activities as “discontinued” [5]. Finnish Fortum also excluded the Russian company Fortum PJSC from its new strategy [6]. The Russian assets of these two foreign companies were transferred under the external management of the Federal Agency for State Property Management. It is possible that the assets will be transferred to Rosneft. The appointment of their new general directors, who came from Rosneft, is evidence in favor of this possibility [7].

The main shareholder of Quadra PJSC changed in 2022. 82.47% of its shares were bought out by JSC Rusatom Infrastructure Solutions (a division of the state corporation Rosatom) [8]. Taking into account further transactions, this share increased to 95.02% [9]. 92.2% of the shares of TGC-14 PJSC was acquired by Far Eastern Management Company JSC [10]. The main shareholder of this company is the former top manager of Russian Railways K. Lyulchev. The shares of TGC-2 PJSC owned by its offshore companies, as well as Kores Invest LLC and Debt Agency LLC, were transferred to the trust management of SOVLINK LLC (57.8%). According to Rescore, its owner is a nominal holder [11]. En+ Group O. Deripska maximized his participation in EuroSibEnergo JSC (formerly Irkutskenergo JSC). All generating assets of SIBEKO JSC (formerly Novosibirskenergo JSC) were transferred to the Siberian Generating Company (A. Melnichenko). One of the current challenges is the departure of foreign owners and the accompanying rotation of the ownership of generating companies.

With an increase in the state presence, large private owners and business groups among the owners of generating companies, a certain transformation of corporate governance and the associated investment risks are inevitable.

1.1 Risks of ownership rotation

When the state's presence expands, the number of former government employees on boards of directors and CEOs tends to increase. To vote on the most important issues, members of the board of directors receive certain directives “from above”. Their responsibility (including independent directors) to shareholders and the company as a whole is reduced [12]. There are increasing risks of government promotion of social and strategic programs at the expense of shareholder value of companies. Most likely, this becomes possible due to the lack of a clear separation of the functions of the state as a regulator and as a shareholder. In the role of a regulator of corporate relations, the state has achieved some success in recent years, however, as an owner, it exercises only its own rights, ignoring the interests of other shareholders [13].

In the case the company is owned by large private owners, it was noted that they can usurp the powers delegated “de jure” to the boards of directors. In such companies, the majority shareholders, as a rule, are closely connected with the top management, and the boards of directors turn into formal participants in corporate relations, often into mere observers [13-14]. Related party transactions, expropriation of minority shareholders, overpayments for resources or asset purchases, underpriced products or asset sales, extension of loans to affiliates, or excessive compensation to management are not uncommon. Indirect evidence of this is a formal attitude to compliance with the principles of the Code [15] and a relatively low market value [16]. For large private owners or business groups, electricity generation, as a rule, is not a core activity, but performs the function of supplying the main industries under their control, where “points of profit” are concentrated. Investors in generating companies are at risk of missing dividends and low share prices.

The ownership structure of generating companies, in our opinion, should be included in the methodology of the Bank of Russia as a separate corporate governance standard, and not as an “inconspicuous” criterion of the Code in its Section IV [17-18]. Moreover, this is accepted by the international and national ESG agenda, authoritative rating agencies (MSCI ESG Rating, RAEX Europe ESG, and ACRA) along with the allocation of a separate standard “implementation of the principles of the Code” in the assessment of corporate governance [19-21].

2 Assessment of corporate governance

Certain steps to reduce investment risks in the face of modern challenges have been taken by the Bank of Russia. In part, they are defined in the updated (2021) methodology of the Bank of Russia (hereinafter referred to as the updated methodology) for assessing corporate governance.

2.1 Updated methodology of the Bank of Russia

The updated methodology retained 7 sections of the Code of the A part: I Shareholder rights and equality of conditions for shareholders exercising their rights; II. Board of directors of the company; III. Corporate secretary of the company; IV. System of remuneration due to members of the board of directors, the executive bodies, and other key managers of the company; V. Risk management and internal control system; VI. Disclosure of information about the company and its information policy; VII. Material corporate actions. The number (24) of subsections of the part B of the Code has not changed (“1.1.” etc.). 79 principles have been preserved under three-digit numbers (“1.1.1.” etc.). The status of the criteria for assessing compliance with the principles of
the Code has remained (“complied with”, “partially complied with”, and “not complied with”).

The distinctive features of the updated methodology are listed below.
• Increased the number of Code criteria (135 instead of 128).
• The criteria are more clearly articulated.
• Redistributed differently between principles.
• Part of the criteria has been excluded.
• Additional criteria have been introduced (from the Code, which were not included in the previous methodology of the Bank of Russia).
• New ones were formulated (they were not in the Code, nor in the previous methodology).
• Mandatory fixing of these criteria in the internal documents of companies has been introduced.

The criteria of the updated methodology Code were identified, reflecting modern challenges related to the ESG agenda (5.2.2., 6.2.2., and 6.1.1.), new technologies (1.1.5., 2.7.2.), and HR strategy (2.1.1., 2.3.1., 2.3.3., 2.9.1.).

Unfortunately, the updated methodology did not include the criteria identified during the additional analysis of the Code: an Internet forum was organized to collect opinions on candidates for the Board of Directors; a preliminary discussion by the shareholders of these candidates was held; information about the persons who nominated them was disclosed, as well as the nature of the relationship of candidates with affiliated persons of the company.

2.2 Implementing the principles of the Code

The assessment of compliance with the Code criteria by generating companies was carried out mainly on the basis of data from their annual reports “Report on compliance with the principles and recommendations of the Bank of Russia Corporate Governance Code” for 2021 using the updated methodology of the Bank of Russia.

Based on the results of the assessment, clear leaders were identified, which are companies with state participation - Inter RAO PJSC and RusHydro PJSC, as well as with foreign owners - the Italian Enel Russia PJSC and the German Unipro PJSC. Of the 135 criteria of the Code, they met 85.9%, 97.0%, 88.9% and 85.9%, respectively. Among the outsiders - TGC-2 PJSC, Quadra PJSC and T Plus PJSC, owned by domestic private owners, these companies meet 56.3%, 52.3%, 49.0% of the Code’s criteria, respectively. Only in non-compliance with these criteria, outsider companies showed their leadership - 20.7%, 28.1%, and 31.0%.

An additional analysis of partially and non-complied criteria for each section of the Code showed a certain “vulnerability” of the boards of directors of generating companies.

Almost all generating companies included in the research did not meet more of the criteria of Section II (Board of Directors) of the Code. Failure to comply with the criteria specifically for this section (without diminishing the significance of other sections) can provoke significant risks for investors. Indeed, in domestic companies, boards of directors have been delegated the vast majority of all powers to ensure the rights and interests of shareholders, which is due to the lack of proper external control with the relative weakness of the institutional environment. In our opinion, in the situation that has arisen, a certain structural reorganization of the boards of directors of these companies is required.

3 Reorganization of boards of directors

In Russian generating companies, boards of directors “de facto” do not play the key role delegated to them “de jure” in ensuring the rights and interests of investors [22]. The overdue structural changes in the boards of directors of these companies are indicated in their comparative analysis with the boards of directors of France and Germany (at the beginning of 2021). The main material for this analysis was a typical set of structural characteristics of the Spencer Stuart Board Index, which provides data on the boards of directors of foreign companies [23].

3.1 Analysis of structural characteristics

The vector of development of the boards of directors of Russian generating companies is outlined below through a comparative analysis of their structural characteristics with the boards of directors of France and Germany.

3.1.1 Numbers

The average number of boards of directors of Russian generating companies (10.7) is below the level of France (13.7) and Germany (13.8).

3.1.2 Executive directors

The share of executive directors in the identified leading companies in corporate governance (Inter RAO PJSC, RusHydro PJSC, Enel Russia PJSC and Unipro PJSC) is comparable to that of France (8%). In outsider companies (Quadra PJSC and TGC-2 PJSC) it was overestimated (33%) even relative to the recommended values of the Federal Law “On Joint Stock Companies” (25%).

3.1.3 Independent directors

The share of independent directors (25.7%) is lower than recommended by the Code (30%). Its highest value was noted in Enel Russia PJSC (45.5%). Although this value is relatively small in comparison with its values in France (58%) and Germany (60%).

3.1.4 Serving on other boards of directors

Work on other boards of directors per director (1.8) is almost comparable to the French average (1.3).

Taking into account the additional structural characteristics proposed by the author (work in other organizations), which is typical for Russian companies,
this average indicator has increased by 3 times (up to 5.4). The maximum presence of individual directors in other boards (without brackets) and other organizations (in brackets) is noted in RusHydro PJSC 17 (22), Enel Russia PJSC 16 (20) and PJSC Mosenergo 37 (37).

3.1.5 Proportion of women

The proportion of women is small (about 9%) compared to France (42.5%) and Germany (32%). The presence of women on boards of directors is highly valued in foreign companies: the microclimate of work is improving; the number of violations of laws and regulations is decreasing; monitoring of the actions of top management is intensified; and the number of cases of fraud, including transactions with related parties, is decreasing [24-26].

3.1.6 Foreign directors

Foreign directors are few in number. In purely Russian companies, there is a maximum of one (Inter RAO PJSC, TGC-1 PJSC). In companies with foreign owners, there are naturally more of them: Enel Russia PJSC (9), Unipro PJSC (6). Such directors are characterized by high competence and independence in decision-making. The disadvantages are mainly related to language and cultural barriers, lack of knowledge about the Russian specifics of doing business.

3.1.7 Age

The average age of board members (49.9) is lower than in France (58.9) and Germany (58). Unipro PJSC (60), Inter RAO PJSC (54), RusHydro PJSC board members (53) look relatively aged among Russian generating companies. Apparently, these companies value age diversity, which combines the relatively high technological level of young directors with the experience and discretion of older colleagues.

3.1.8 Term of office

The term of office of directors is not more than 7 years. It is slightly higher than the average values of this indicator in France (5.7) and Germany (5.7).

3.1.9 Number of meetings

The average number of meetings per year is 17.3. As a rule, all of them are in absentia, Unipro PJSC is an exception (4 in-person). However, a large number of meetings (especially in absentia) is not sufficient evidence of the effectiveness of corporate governance. The duration of the meetings and the quality of the discussions are valued. Meetings in absentia are most often “formal” [27]. In France, for comparison, boards of directors meet on average 9.1 times a year, in Germany - 6.8.

3.1.10 Self-evaluation and external evaluation

Unipro PJSC, Inter RAO PJSC, Enel Russia PJSC and RusHydro PJSC conducted an annual self-assessment and an external assessment (at least once every three years) of the work of the boards of directors. An independent company (PricewaterhouseCoopers Consulting LLC) was involved in the external evaluation. For comparison: in France, 75% of CAC 40 companies conduct an external evaluation of boards of directors. Current assessments of boards of directors, in our opinion, underestimate the importance of the personal and behavioral qualities of their members, although the regulator (the Bank of Russia) directly suggests paying attention to these criteria [28-29]. Unfortunately, in the recommendations of the Bank of Russia, these qualities are presented in a generalized form and require further development, for example, using foreign experience [30].

3.1.11 Remuneration

The remuneration of members of the boards of directors (for comparability, recalculated at the euro exchange rate as of December 31, 2020) in Russia was characterized by high values and disclosure of mainly the total amount, without division by person and their specific merits. The average amount of remuneration for non-executive directors in 2020, for example, at RusHydro PJSC was 44,173 euros, at Inter RAO PJSC - 37,755 euros. For comparison: in France, with a larger number of councils, each member accounted for 24,449 euros.

Conclusion

In the face of modern challenges, the problems of attracting investment in generating companies are becoming more acute. The reason is partly the investment risks of corporate governance in these companies. Ownership rotation, non-compliance of fundamental principles of corporate governance, relatively low structural characteristics of boards of directors and weak updating of internal documents reduce the level of investor confidence in generating companies. The paper proposes new corporate governance standards with a specific set of additional compliance criteria, which, along with updated structural characteristics of boards of directors and timely updating of internal documents, could improve the corporate governance of these companies in the interests of investors.

The research was carried out under State Assignment Project (No. FWEU-2021-0001) of the Fundamental Research Program of Russian Federation 2021-2030.

References

http://dx.doi.org/10.1787/9789264252035-en (Accessed 15.01.2022)


4. Lukoil sent an offer to buy back the shares of El5-Energo at a price of 0.48 rubles per share. [Online] URL: https://bigpowernews.ru/print/107032.phtml (Accessed: 01.09.2023)


17. Galina I. Sheveleva. ECO, 7, pp. 51-70 (2023)

18. Galina I. Sheveleva, Corporate governance factors in the ESG agenda of Russian electric power companies, in Proceedings of the International Conference on Management of Large-Scale System Development, MLSD, September 26-27, Moscow, Russia (2022)


